Headline: Greater Institutional participation in Capital Markets is needed to Finance India's growth- an article by MD & CEO, NSE

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Greater Institutional Participation in Capital Markets is Needed to Finance India's Growth

By Invite

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India's long-term sustainable economic growth is closely tied to infrastructure development. As per the Global Infrastructure Outlook forecasts noted in the Economic Survey of 2017-18, around $4.5 trillion worth of infrastructure investment is required by India till 2040 and the expected shortfall is $526 billion.

To meet this requirement, India needs a well-developed capital market as this risk may be either too long-term or too risky for commercial banks. Traditionally banks have been providers of long-term finance in India. However, stricter capital adequacy requirements and asset liability mismatches will likely constrain their infrastructure lending in future. The capital markets on the other hand can provide a variety of financial instruments for capital raising and risk management.

Globally, long-term financing is the forte of institutional investors such as pension funds, insurance companies, mutual funds, and most recently, sovereign wealth funds.

As per estimates by Willis Towers Watson, the global pool of funds stood at $131 trillion in 2017. Pension funds and mutual funds have assets under management (AUM) of $45 trillion each, followed by insurance funds at $33 trillion.

The pension funds and insurance funds are among the largest sources of funds for capital formation. As of end 2017, 46% of global pension fund assets of the seven largest markets are deployed in equity shares, followed by 27% in bonds, 25% in other assets and 2% in cash.

In India, some categories of institutional investors have played a pivotal role in the process of market development. Investments by domestic asset managers and foreign portfolio investors (FPIs) in equities and debt have aided capital raising for Indian corporates.

Domestic institutions such as mutual funds through their innovative product suite and services such as systematic investment plans (SIP) instituted a disciplined investment approach amongst the Indian household savers, thereby channelling household savings into financial assets. In the last five years, the cumulative equity AUM of FPIs and domestic institutional investors (mutual funds) has grown 3.6 times.

However, in India, a large proportion of financial savings go to institutional investors like insurance companies and pension funds. Considering the long-term nature of their liabilities, these institutions have the ability to provide long-term capital to meet corporate India's financing needs. Further, investors with a long investment horizon can also have a stabilising influence on asset prices. During volatile times, they are not constrained as some investment managers to liquidate positions.

As mentioned earlier, internationally, pension funds and insurance funds are the largest sources of funds along with mutual funds for capital formation. They participate in a significant way in the capital market and in a wider variety of asset classes.

In India these investors channel the majority of their investments to government securities, some in AAA-rated bonds and a fraction in equities (recently EPFO started investing in the equity market through ETFs).

This structure does not serve the needs of a growing economy like India. Moreover, this construct has placed all the relatively higher risk financing on the banking sector. These large pools of pension and insurance monies need to start looking at extending beyond the AAA-rated instruments.

CHALLENGE & OPPORTUNITY

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While there needs to be vigilance on not investing in poor quality papers, increasing the investment mandate to papers rated 'AA' and 'A' to begin with would certainly aid funding needs. Therefore, prospective regulatory policy reforms should target the pension and the insurance sectors. Some measures could be increased allocation to equities, moving down the credit curve, participation in securities lending and borrowing programmes and participation in corporate bond repo.

Institutional investors play a special role in developing vibrant markets globally and India is no exception. Apart from being a critical driver of economic growth, institutional investment brings transparency and improves corporate governance. With the credit enhancement scheme in place and the bankruptcy code being implemented, further aided by the Budget proposing a greater shift to market linked borrowings, these large investment pools need to play a more active role in financing India's capital requirements.

The derivatives market in India has evolved over a period and is available for equities, currencies and interest rates. Majority of derivative contracts in India trade on exchanges with excellent technology, robust risk management and settlement guarantee of clearing corporations backed by a strong regulatory framework.

Despite this, the exchange-traded derivatives still lack sufficient participation from institutional investors. Banks, insurance, pension and provident funds have no stake in the equity derivatives business and have very limited participation even in the interest rate derivatives markets.

While liquidity in equity derivatives market comes from non-institutional players and some institutional participation from FPIs and mutual funds, participation of institutional investors is critical for building liquidity in interest rate and currency derivatives markets and in further improving liquidity in the equity derivatives market.

Institutional investors, by nature, have exposure to equity, currency and interest rate risks are in a better position to transact in derivatives market. Derivatives, such as interest rate futures and options can be useful to fine-tune the sensitivity of the balance sheet to interest rates. With the ability to manage the market risks using derivatives, institutions can offer products at much better prices to the end investors.

FPIs, too, have huge potential to contribute in the exchange traded derivatives market. While they actively participate in equity derivatives, their participation is constrained in currency and interest rate derivatives.

According to NSDL data, the AUM in equity and debt of FPIs in India is about ₹31,750 billion ($470 billion) as of May 2018, which requires hedging against currency and interest rate risks. Attracting FPIs from the non-deliverable forwards (NDF) market can give a boost to the exchange-traded derivatives market in India.

Addressing India's funding gap will be challenging as government continues with fiscal consolidation and when appetite from banks to provide funding is constrained. The experience from developed economies has shown that institutional investors have the potential to bridge the financing gap.

Going ahead, the role of capital markets in India and particularly institutional investors will play a key role in meeting India's financing requirements.

Institutional monies in India are regulated by IRDA, PFRDA, SEBI and RBI. There is a critical need for all regulators to align and synchronize the investment framework of their respective institutional investors as soon as possible. While fixed income instruments would attract domestic institutions, regulators should also consider the increasing allocation of equity in portfolios of domestic institutions.

The approach therefore needs to be co-ordinated to developing the base of institutional investors in India's capital markets and to significantly enhance their participation in markets.

(The author is MD of the National Stock Exchange)