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Review
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INDIAN CAPITAL MARKET REVIEW: ISSUES, DIMENSIONS AND PERFORMANCE ANALYSIS

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Abstract:
The purpose of an efficient capital market is to mobilize funds from those who have it and route each them to those who can utilize it in the best possible way. India's financial market is multi-facet but not balanced. It has state of art equity market but relatively less developed and immature corporate bond market. The Indian capital market in the recent year has undergone a lot of innovation in term regulation and mode of operation. A well developed corporate bond market is also essential for financial system stability, efficiency and overall economic growth. However, If we look at the scenario of capital market in India we find that Indian households have traditionally preferred parking their surpluses in bank deposits, government savings schemes and less than 10% of their investments in financial assets in shares, debentures and mutual funds. The Indian capital market has recently put the worst behind and moved towards strong growth. In this back drop the present paper aims to (i) identify various grey points of Indian capital market; (ii) Evaluated how it performed during post financial crisis period; and (iii) suggests necessary policy reforms for a relatively mature capital market.

Key words: primary market, secondary market, Sensex, Nifty, volatility.

Jel Classification: N25, G15, O16

INTRODUCTION

The Darwinian theory of evolution states, "Survival for the fittest"; acknowledges the fact that mantra for growth has been "adapt and innovate or die". India has been embarking for robust growth and be one of the leading economies of the world. Thus, Nehruvian-Mahanobis Model of economic growth was discarded and LPG Model was adopted in 1991 which paved the way for financial sector reforms in 1992 and 1997. Since then Indian economy has been growing at a pace of about 7–8 per cent.

During the last couple of years Indian financial market recorded a phenomenal growth. Stock market capitalisation reached a trillion USD. Indian banking system has strong asset and capital base and poised to adopt Basel III norms shortly.

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INDIAN CAPITAL MARKET: A REVIEW

India's financial market is multi-facet but not balanced. It has state of art equity market but relatively less developed and immature corporate bond market. Corporate bond market is less than 10 per cent of the total bond market. A study of the World Bank Financial Structure database (May 2009) revealed that private bond capitalization in India was only 2.67% of GDP in 2007, whereas it was 58.81% in South Korea, 38.79% in Japan and 24.46% in China. India has a narrow corporate bond due to low yield and absence of hedging opportunities. However, government bonds are highly marketable and traded freely. The derivatives market is still at infant stage where trading in only selected equity, currency and commodity derivative is allowed. These sophisticated financial instruments are used mainly by professional investors and high net worth clients.

The cascading effect of Sub-Prime Crisis, 2008 was comparatively less on India as it is has less exposure to sub-prime credit and structured credit products. The extent of leverage in India has been subject to prudential limit. In India, retail intermediation is mainly through the banking system. Housing mortgages in India require the borrower to come up with margin money. Stock brokers are subject to limits on margin financing and conservative valuation of the collateral. Indian households are yet not highly geared and the savings habit is strong. Other important characteristics of Indian financial markets are as follows.

- Access of credit and financial services for SMEs, agriculture and rural household are limited with imbalanced geographical outreach and sectoral distribution.
- There are very few financial institutions like India Infrastructure Corporation Ltd. (IIFCL) to fund infrastructure project by issue of local currency bond.
- Repos for corporate bond, interest rate and currency future are a missing link in the process of maturing financial market.
- The absence of wide range of institutional investors like underwriting companies, endowment funds, pension funds, municipals, hedge funds and private equity funds in India creates a natural demand for more sophisticated financial instruments in the Over-the-Counter (OTC) market.
- Indian has large pool of saving into investable funds for long term financing. This calls for innovation by our regulatory agencies and service providers to channelise funds for productive economic activity. The following Figure 1 depicts percentage of cash saving preferred by location which need to be tapped in the right direction.

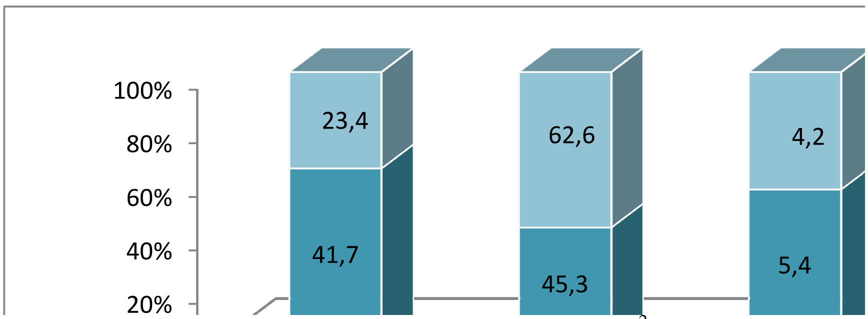


Figure 1. Percentage of Cash Saving Preferred by Location[2]

[2] Source: National Council for Applied Economics- Centre for Marco Consumer Research (NCAER-CMCR)

INDIAN CAPITAL MARKET: EMPIRICAL EVIDENCES

Indian Capital Market is multi-facet. Thus, empirical studies of current status could be studies under following subheads.

Performance of Primary Market

Primary market facilitates government as well corporate in raising capital to meet their requirements of capital expenditure and/or discharge of other obligation such as exit opportunity for venture capitalist/ Private Equity firm. The most common primary mechanism for raising capital is an Initial Public Offer (IPO), under which shares are offered to common public as a precursor to the trading in secondary market of an exchange. When securities are exclusively offered to the existing shareholders of company, as opposed to the general public it is called Rights Issue. Another mechanism whereby a listed company can issue equity shares, fully and partly convertible debentures which can be converted into equity shares later on, to a Qualified Institutional Buyer (QIB) is termed as Qualified Institutional Placement. Apart from raising capital in domestic market, companies can also issue securities in international market through ADR/GDR/ECB route and raise capital.

Table 1. Resource Mobilisation through primary market[3]

	Mode	2007–08	2008–09	2009–10	2010–11	2011–12
1	**Debt**	0	1500	2500	2,245	4,791
2	**Equity**	54,511	2,082	46,737	46,678	11,647
	Of which IPOs	42,595	2,082	24,696	33,068	4,981
	Number IPOs	85	21	39	40	29
	Mean IPO Size	501	99	633	827	402
3	**Private placement**	1,18,485	1,73,281	2,12,635	1,47,400	1,56,634
4	**Total**	2,16,176	1,79,066	2,87,240	2,15,009	1,73,072

The Indian capital primary market showed a skewed growth. The heat of the financail crisis 2008 was also felt by the primary market when companies put public offer on hold and preferred private as important source of funds mobilisation which accounted for about 95% of the total funds. The negative impact of current recession and much awaited reforms could also be observed for the financail year 2011-12. It could be observed that primary debt market in India is not yet mature which range between 1 to 2%. Private placement has been the most popular source of raising funds from the primary market by the companies in India which account for about average 76%. The sharp decline in Mean IPO Size reflect to 402 indicate that companies have abstained raising funds from the market due to recession in the economy. (Table 1).

Performance of Secondary market

Sensex and Nifty are the barometer of India's feel-good factor was at 21,000 mark prior to Global Financial Crisis followed Great recession worldwide. However, in

[3] Source: SEBI

recent years both the index witnessed a volatile trends due to global and domestic factors which is evedenced by fact that three years high on Sensex was 21,108.64 and Nifty 6,338.80 (November 5, 2010) tumbled to a three year low of 8,047.17 and 2,539.45 respectively (March 6, 2009) . Benchmark indices Nifty and Sensex registered a negative growth due to rising crude oil prices, persistently high inflation, successive policy rate hikes by the Reserve Bank, domestic political developments and the worsening Greek sovereign debt crisis. The worst performing sectors were Metal, Consumer Goods & Power. Banking sector suffered the consequences of adverse interest rate scenario, Basel II recapitalization norms and rating downgrades.

Table 2. Performance of secondary market in India[4]

			NSE Nifty		
	2007–08	2008–09	2009–10	2010–11	2011– 12$
Return (percent)	23.9	-36.2	73.8	17.9	NA
Market Cap (Rs crore)	1240071	771483	6009173	6702616	5547723
Gross Turnover	NA	NA	4129214	3577410	1784844
Daily Vitality	2	2.6	1.9	1	NA
P/E ratio	20.6	14.3	22.2	21.1	17.5
			BSE SENSEX		
Return (percent)	15.9	19.7	-37.9	17	NA
Market Cap (Rs crore)	831033	1071940	6165619	6839084	5672255
Gross Turnover			1378809	1105027	442770
Daily Volatility	1.8	1.9	2.8	1	NA
P/E ratio	20.3	20.1	13.7	21.2	17.1

Stock price returns are affected by stock return volatility, and the extent of impact depends crucially on the permanence of shocks to the variance in returns. An analysis of the returns from the broad based S&P CNX Nifty index against the backdrop of the financial crisis and monetary policy action demarcates the time varying volatility persistence in the returns data. The variability in returns, controlling for all other past factors, shows a sharp decline from the crisis period and appears to be moderating (Table 3). The subdued current market volatility is no guidance for future. Financial market volatility can return if macro conditions worsen. Indian financial markets would continue to be influenced by the global as well as domestic factors.

Table 3. Volatility of Weekly Returns on Indian Equity Markets (Standard Deviation)[5]

Index	2008-09	2009-10	2010-11
Nifty	5.5	3.8	2.2
Nifty junior	6.6	4.5	2.5
Sensex	5.8	3.6	2.2
BSE 500	5.7	3.9	2.2

[4] Source: BSE and NSE.$ As on last trading day of November 2011
[5] Source: BSE and NSE

Net Flow of funds via Foreign Institution Investments (FIIs) into the Indian Capital market witnessed a revival thereby supporting equity market growth momentum. However, FIIs has been showing greater interest in equity market investment in India (Table 4). The inflow of foreign funds into emerging markets will keep on increasing and India will be a major beneficiary and to facilitate such fund inflows Indian capital markets have to undergo a major transformation.

Table 4. Transactions of FIIs[6]

	2008–09 March	2009–10 March	2010–11 (December)
Number of FIIs (Actual)	1,635	1,713	1,718
Number of sub-accounts (Actual)	5,015	5,378	5,503
1. Equity Market Activity(Rescore)			
Gross Buy	5,54,585	7,05,523	6,03,406
Gross sell	6,02,292	5,95,302	4,90,785
Net	-47,706	1,10,221	1,12,622
2. Debt Market Activity (Rescore)			
Gross Buy	59,993	1,40,914	1,54,081
Gross sell	58,098	1,08,477	1,29,241
Net	1,895	32,438	24,839
3. Total Activity (Rescore)			
Gross Buy	6,14,579	8,46,437	7,57,487
Gross sell	6,60,389	7,03,779	6,20,026
Net	-45,811	1,42,658	1,37,461

Comparative Study of Indian Capital Index VS. Selected Global Indicators

Table 5 and Table 6 depict the performance of capital market of emerging markets in Asia in the recent years. The data on the said table indicates that year 2010 has been strong year for Indian capital markets due to global recovery and prompt corrective action taken by our regulators in terms of monetary policy. Strong domestic economic fundamentals and policy measures motivated the FIIs to pump in investments. The year 2009 was the year of recovery from the crisis. Indian Capital Market registered a net gain of 18 per cent. Jakarta Composite in Indonesia gained the most among indices with about 45 per cent rise; US Dow Jones and UK's FTSE have each risen by around 11 per cent and 9 per cent respectively. NASDAQ composite index was up 16.91 per cent while S& P rose by 13 per cent. However, Japan's Nikkei and China's Shanghai Composite dipped 3 per cent and 14 per cent respectively (Economics Survey 2010–11).

[6] Source: SEBI

Table 5. Cumulative Change in Movement of global indices[7]

	Cumulative changes over end-2003 level (%)						
Index	2004	2005	2006	2007	2008	2009	2010
BSE SENSEX India	13.1	61	136.1	247.4	65.2	199.1	251.2
Hang Seng Sensex Hongkong	13.2	18.3	58.8	121.2	1.1	74.2	83.2
Jakarta composite index Indonesia	44.5	68.1	161	296.8	35.5	264.1	435.3
Nikkei225, Japan	7.6	50.9	61.3	43.4	-22.9	-5.3	-4.2
Kospi Index South Korea	10.5	69.7	76.8	133.9	25.6	104.4	153
Kuala Lumpur Comp. Index Malaysia	14.2	13.4	38	82	-3.3	58.7	-35.3
TSEC weighted Index, Taiwan	4.2	11.2	32.8	44.4	-25.2	32.3	35.3
SSE Composite Index, China	-15.4	-22.4	78.7	251.5	43.7	116.9	87.6

In terms of growth rate of both the Sensex and Nifty in terms Price Earning (P/E) Ratio has been most promising when compared to other emerging market economies of Asia. The P/E Ratio has been consistently rising over the past few years which have made the Indian Capital Market an attractive destination for FIIs (Table 6).

Table 6. P/E Ratio in select emerging Markets

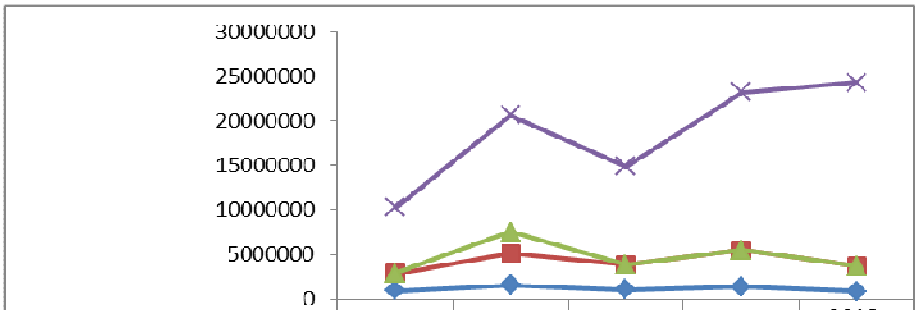
Country	Index	2008–09	2009–10	2010–11
Korea	Kospi	25.7	11.1	14.8
Thailand	SET	15.7	12.3	15.0
Indonesia	Jakarta Composite	20.1	16.6	20.9
Malaysia	Kuala Lumpur Comp.	15.0	18.9	17.4
Taiwan	TSEC Weighted	65.7	19.1	15.7
India	BSE Sensex	13.7	21.3	23.6
India	S&P CNX Nifty	14.3	22.3	24.5

Performance of Derivatives Market in India

Derivatives markets broadly can be classified into two categories (i) Exchange trade Derivatives and (ii) OTC Derivatives (Over The Counter). Traditionally equity derivatives have a long history in India in the OTC market. Options of various kinds (called Teji and Mandi and Fatak) in un-organized markets were traded as early as 1900 in Mumbai. The SCRA however banned all kind of options in 1956. In the exchange-traded market, the biggest success story has been derivatives on equity products. Index futures were introduced in June 2000, followed by index options in June 2001, and options and futures on individual securities in July 2001 and November 2001, respectively. While there has been growth in financial products such as derivatives, futures and options, corporate bond markets are still in nascent stage. Turnover in the equity derivatives segment constituting almost 90 per cent of the

[7] Source: BSE, NSE, Bloomberg and Economic Survey 2010–11

overall investments. NSE dominates BSE in equity derivates trade of both OTC and exchange trade derivatives. (Figure 2)



	2006-07	2007-08	2008-09	2009-10	2010-2011$
Equity Derivatives (NSE)	7356242	13090478	11010482	17663665	20599192
Equity Derivatives (BSE)	59007	2423008	12268	234	35
Cash (NSE)	1945285	3551038	2752023	4138024	2787862
Cash (BSE)	956185	1578670	1100074	1378809	893839

Figure 2. Performance of Equity derivatives in India[8]

Over the years the foreign exchange market in India has shown significant growth in terms of volumes, product range, liquidity, and participation level. The average daily turnover in the foreign exchange market in March 2007 was a whopping 33 billion USD. Due to lack of exchange traded currency instruments, these transactions were done in over-the-counter (OTC) market like currency forwards, swaps, and options. The exchange trading makes the transaction more transparent. The price discovery is more efficient in case of exchange trading because of presence of large number of market players. It also offers trading opportunity for relatively smaller players because of small contract size compared to OTC market. Moreover, in exchange traded products the counter-party risk is eliminated by the clearing corporation. Using electronic trading superior risk management systems can be used for exchange trading thereby minimizing the overall risk in the portfolio. In August 2008, RBI and SEBI allowed selected exchanges to offer currency trading.

In India, NSE was the first stock exchange, permitted by the SEBI, to set up its separate currency derivatives segment. Standardized currency futures trading started on 28th August, 2008 in NSE. Similarly, the BSE and MCX started trading the currency futures from 1st and 7th October, 2008 respectively (Pandey 2011). The Indian currency futures market has experienced an impressive growth since its introduction which is evidence by the upward trend of the volumes in terms of number of contracts, trading value and average daily trading value for currency futures in both NSE and MCX. However, trading of currency future at MCX is growing at a faster rate than that of NSE. Further USE which began operations in the currency derivatives segment on 20 September 2010, witnessed a turnover of Rs. 5,37,836 crores as on November 2010. (Table 7).

[8] Data Source: BSE and NSE. ($ As on November 2010)

Table 7. Currency Futures[9]

	NSE		MCX- SX		USE	
Year	2009–10	2010–11$	2009–10	2010–11$	2009–10	2010–11$
No. of Contracts	37,86,06,983	50,02,21,743	40,81,66,278	6193,53,844	0	11,87,44,133
Trading Value (`crore)	17,82,608	23,04,219	19,44,654	28,89,445	0	5,37,836
Average daily trading Value (`crore)	7,428	14,045	8,103	17,636	0	7,504

Performance of Mutual Funds Industry

Mutual Funds play an important role in financial services by offering diversification, liquidity and professional management at an affordable price. The Indian Mutual Fund industry consists of 44 players. In addition to advance tax commitments adverse interest rate scenario, slowing growth in India and concerns of global recession were other important reasons that led to the downfall. The increase in dividend distribution tax for non-retail investors in liquid/debt mutual funds effective from June 1, 2011 and the cap of 10 per cent of net worth placed on banks' investment in liquid/debt funds could have affected flows into debt mutual funds. However, Mutual Funds stayed positive on the markets, which evinced by the fact that they have emerged net buyers in both debt and equity. Asset managers responded to the current challenging interest rate scenario by launching a number of close ended debt funds. However what was significant was the average lower realization per fund (Table 8).

Table 8. Trends in resource Mobilisation (net) by Mutual Funds[10]

Rs. In Crore

		2006–07	2007–08	2008–09	2009–10	2010–11	2011–12
1	UTI	7,326	10,677	-3,659	15,653	-19,216	91,980
2	Public	7,621	9,820	9,380	12,499	16,636	5,323
3	Private	79,038	1,33,304	-34,018	54,928	-13,555	3,035
	Total (1+2+3)	93,985	1,53,802	-28,296	83,080	-49,407	1,00,338

ISSUES AND SUGGESTIONS FOR DEVELOPMENT OF CAPITAL MARKET IN INDIA

India has successfully implemented the first phase of reforms in 1990s which slowed down. India needs to follow through with deeper and more wide ranging reforms which will bring the regulatory environment and the framework of the economy to a level which can cope with the challenges of growth.

[9] Source: NSE, MCX, and US ($ As on November 2010)
[10] Source: SEBI

The primary objective of effeicient capital market is mobilize fundsl from those who have it and channelise them to those who can utilize the it in the best possible way. Capital markets in order to be efficient and fair to the investor must (i) be transparent, (ii) have robust systems and processes, (iii) be well regulated and (iv) be able to tap into the savings of investors both nationally and internationally to facilitate exchange of capital. However, if we look at the scenario of capital markets in India we find that Indian households have traditionally preferred safety of bank deposits and Govt. Savings Schemes and much less than 10% of their investments in financial assets is in shares, debentures and mutual funds. While Indian capital markets are vibrant and are an attractive destination for global capital inflows

The delivered cost of credit to most enterprises is much above comparable international standards; an important issue that need to addressed on priority. Innovation in product design, promtion of functional and opeation al efficiency can help in addressing this issue in a better way.

There is an urgent need of redefining regulatory architecture. gaps. Presently there are over half a dozen of reualtory agnecies viz. SEBI, IRDA, PFRDA, EPFO, RBI, FMC besides several ministies leading to jurisdiction overlaps, narrow sectoral attitudes and regulatory gaps, regualtory arbitrage. The most recent have been conflict between IRDA and SEBI over Unit Linked Inusrance Plans (ULIP). This overlapppling regualtory body is the major cause of ineffective regulations, inablility and delay in exploring new markets and products design etc. India needs to streamline financial market regulatory srchtecture and move to single window approval process.

There is an urgent need to channel most efficiently increasing amounts of domestic savings and global investment into the infrastructure sector and other productive sectors. Intitiatives required to be taken is (i) liberalizing buyback regulations to allow vendors of major equipments to hold equity in initial stages and buying back such equity when projects get operational; (ii) Allowing Private Equity Funds as bidding partners in infrastructure projects (iii) allowing pension funds to invest a greater part of their corpus in equities either directly or through mutual funds to infrastrucutre projects; and (iv) encouraged private initiatives.

In order to develop the bond market the government of India has also proposed following measures which need to be adopted on priority basis.

1. Launching of exchange traded currency and interest rate futures and developing a transparent credit derivatives market with appropriate safeguards;
2. Enhance the tradability of domestic convertible bonds by putting in place a mechanism that will enable investors to separate the embedded equity option from the convertible bond and trade it separately; and
3. Encourage the development of market based system for classifying financial instrument based on their complexity and implicit risks.
4. Simplify the process of primary issue in case of the corporate bonds.
5. Rationalisation of stamp duty and the abolition of tax deduction at source on the lines of government securities.

CONCLUSION

India needs innovative financial instrument in its domestic capital market. Financial Innovation must aim value addition in existing technologies, risk management practices, credit system, process, and products. Financial innovation must aim at reducing cost of capital; mitigate risk exposure, liquidity management, and broader capital excess.

There is positive correlation between finance and economic growth. Thus, economic development is relatively impossible without quality innovation in financial market. Innovative practices help in exploring viable opportunities propositions. There are many unexplored areas in both domestic and corporate financial market.

Emerging economies like India rely heavily on traditional sources of funding from banks and capital market. Indian capital market has been banking upon relatively few types of securities and largely on financial institutions. India's debt and money markets are yet to develop in terms of products, efficiency, and costs. Corporate bodies have limited avenues from this segment. Even banks find it difficult to expand their loans and advances portfolio in the absences of immature debt and capital market. They have to rely heavily on deposits, which creates lot of problem in liquidity management.

India has a huge market of infrastrucutre finance. The creation of a deep and robust debt capital mechanism is the key to financing infrastructure companies by allowing them to raise long term debt. A well developed corporate bond market is also essential for financial system stability, efficiency and overall economic growth. However, this market is practically nonexistent in India. Most of the debt issues are quasi-governmental, or from public sector oil companies or Govt. sponsored institutions.

A lot of work has been done on technological innovation but innovation for holistic growth has not been taken seriously by financial economist/service providers in India. We often go for adopting products that are gaining popularity in foreign countries. We must recognise that what suit foreign market may not suit domestic market.

There has been growing tendency of innovating financial products to avoid regulation rather filling the gaps of untapped market. A balanced regulated financial market will help to fill these gaps. Crisis arising from financial sector has a huge devastating effect. East Asian crisis and Sub-Prime Crisis has proved that risk can be induced into any system if part of financial sector is not well developed or poorly developed. In Indian the effect of the subprime crisis have been mainly indirect which was in the form of higher volatility of capital market and depreciation of domestic currency (rupees) against dollar. The exit of global investors, particularly the hedge funds from the local market have created liquidity crisis in the economy. Lack of well functioning local currency bond market became the cause of over reliance on banking system which led to funding of long term project with short term bank loan. Thus, liquidity risk was induced into the system due to Assets-Liabilities maturities mismatch.

Emerging economies like India have an advantage of learning from the mistakes of others. Policy makers must ensure broad and deep financial market. A pragmatic approach is required by both regulator and service provider. Regulation must not create hurdle for financial engineering and innovation and service providers must not create a situation of moral hazard by insensitive approach. Innovate for inclusive growth rather growth of balance sheet figure.

As India is poised to develop as a super economic power it must address various challenges associated with the development of capital on priority viz. (i) Development of domestic currency corporate bond market with long maturity (ii) Check on macro-economic variable such as inflation, volatile interest rate etc. (ii) strong legal framework along with monetary policy with fiscal discipline, (iii) development of competitive bank financing and corporate bond financing market; (iv) Issue of GDP Index bond will address the issue of yield defying the country's growth rate (v) free flow of timely information at zero cost, (vi) transparency; and (vii) strike balance between stability and innovation.

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