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[Field Research]

A Critical Analysis on Capital Market Developments in India: Pre and Post Liberalization Period

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Abstract

Purpose – This paper aims to critically examine capital market developments in India before and after liberalization.

Research design, data, and methodology – The paper examinesthe Indian capital market from its inception to the latest developments related to both primary and secondary markets, and also discusses recent initiatives ofcapital markets to enhance the expected level of services to the investor community. It also sheds light on the regulatory framework for investor protection.

Results – The study further highlights the future roadmap for the radical development of the Indian capital market. The paper identifies the various initial obstacles and intricacies that affect the smooth functioning of the Indian capital markets. Hence, the paper articulates that these concerns should be addressed by the regulatory authorities and at the policy level at the earliest for further strengthening the capital markets in the interests of the economy in general and retail investors in particular.

Conclusion – This is a topic of utmost contemporary importance to worldwide national economies, and calls for novel methods and techniques in dealing effectively with the menace facing capital markets.

Keywords: Capital Markets, Primary Markets, Secondary Markets, India.

JEL Classifications: E44, N25, O16, M39.

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1. Introduction

Capital market is the spine of any country's economy. It is an engine for economic growth, providing an efficient means of resource mobilization and allocation. A well-organized capital market is an indispensable pre-requisite for industrial and commercial development of a country. Predominantly, credit is imperatively required to the business establishments to meet their short and long term commitments. The money market caters to the short-term needs and capital market is ready to extend its support to meet the long term requirements of the business world. Capital market is a central coordinating and directing mechanism for free and balanced flow of financial resources into the economic system operating in a country. The expansion of an excellent capital market in a country is dependent upon the availability of savings, proper organization of its constituent units and the entrepreneurship qualities of its people. Before independence, the capital market of India was ill-developed because of its certain defects. But, in recent years since 80's, the capital market of India, considerably changed and has been changing for the better. Whatever the changes, the Indian public has noticed in the last thirty years were not giving any contentment but has given significant number of shocks in terms of the world's biggest financial scams. After assuming office in June 1991, the new government under the leadership of Dr. P.V. Narasimha Rao with the support of the then Finance Minister Dr. Man Mohan Singh accelerated the process of economic liberalization under the auspices of the International Monetary Fund (IMF).The opening up of the Indian economy as a result of these measures promised an unprecedented growth and prosperity for the private corporate sector as new sectors of the economy were being allowed private participation and various administrative impediments were being removed. Anticipating the good tidings for the private sector, the stock market started booming-the Bombay Stock Exchange Sensitive Index (Sensex) rose from around 1000 in February 1991 to a peak of 4500 in March 1992 (Barua & Varma, 1993). In light of the developments as well as turmoil situations in the capital market, the authors are herewith attempting to critically evaluate the developmental and damage recovery pattern of the Indian capital market in the periods of pre and post liberalization.

2. Literature Review

The Indian capital market is one of the oldest capital markets in the world. It dates back to the 18th century when the securities of the East India Company were traded in Mumbai and Kolkata. However, the orderly growth of the capital market began with the setting up of The Stock Exchange of Bombay in July 1875 and Ahmadabad Stock Exchange in 1984. Eventually, 22 other stock exchanges sprang up in various parts of the country (Bajpai, 2006). The term capital market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. In the widest sense, it consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprises and public authorities. It is concerned with those private savings, individual as well as corporate, that are turned into investments through new capital issues and also new public loans floated by government and semi-government bodies. A capital market may be defined as an organized mechanism for effective and efficient transfer of money capital or financial resources from the investing parties, i.e. individuals or institutional savers to the entrepreneurs (individuals and institutions) engaged in industry or commerce in the business either is in the private or public sectors of an economy (Gupta, Aggarwal & Gupta, 2004). A structured and able-bodied capital market is operating in a liberated market economy just to ensure best feasible synchronization and balance between the flows of savings on the one hand and the flow of investment leading to capital formation on the other; directs the flow of savings into most profitable channels and thereby ensures best possible deployment of financial resources. Consequently, an ideal capital market is one where finance is used as a hand-maid to serve the needs of industry. Finance is accessible at a rational rate of return for any intention which offers a potential yield adequate to make borrowing valuable. The capital market must facilitate the movement of capital to the point of highest return. Therefore, a capital market attempts for the mobilization of national savings for the economic growth and the mobilization and import of foreign capital and investment to enhance the insufficiency in the required financial resources so as maintain the expected rate of economic growth. The Indian capital market is working not only for the procurement of finance but also for securing the foreign capital and know-how to fill up the deficit in the required resources for economic growth at a faster rate and ultimately for effective allocation of the mobilized financial resources to the projects which are providing high yielding or to the projects to promote balanced economic development.

The Indian capital market has classified into organized and unorganized categories. In the organized sector of capital market demand for long-term capital comes from corporate enterprises, public sector enterprises, government and semi-government institutions. The sources of supply of funds comprise individual investors, corporate and institutional investors, investment intermediaries, financial institutions, commercial banks and governments. In India, even the organized sector of the capital market was ill developed till recently because of the following reasons: a) Agriculture was the main occupation which did not lend itself to the floatation of securities; b) The foreign business houses hampered the growth of securities market; c) Managing agency system also accounted for ill-development of capital market as managing agents performed both activities of promotion and marketing of securities; d) The investment habit of individuals; e) Restrictions imposed on the investment pattern of various financial institutions. The unorganized sector of the capital market consists of indigenous bankers and private money-lenders. The main demand in the unorganized capital market comes from the agriculturists, private individuals for consumption rather than production and even small traders. The supply of money-capital comes, usually from own resources of money lenders and falls short of the requirements made on them (Gupta & Aggarwal, 2004). Levine, Ross & Zervos (1996) argue that well developed stock markets may be able to offer financial services of different kind that may provide a different kind of impetus to the economic development. In India, Aggarwall's (1996), study clearly supports the Levine, Ross & Zervos's argument and proves that the two main parameters of capital market development namely, size and liquidity, are found statistically significant to explain the economic activity.

2.1. Indian Capital Market: Pre-Liberalization Period

Indian capital market was dormant till the mid 1980s (Fama, 1991). The long-term financing needs of the corporate sector were met by the Developmental Financial Institutions (DFI's) viz. IDBI, IFCI, ICICI as well as by other investment institutions like LIC, UTI, and GIC etc. Working capital needs were met by the commercial banks through an elaborate network of bank branches spread over the country. Capital market activities were limited mainly due to the easy availability of loans from banks and financial institutions and administered structure of interest rates. However, three important legislations viz. Capital Issues (Control) Act, 1947; Securities Contracts (Regulation) Act, 1956; and Companies Act, 1956 were enacted to provide suitable legal framework for the development of capital market in India. The pricing of the primary issues was decided by the Office of the Controller of Capital Issues. A few stock exchanges, dominant by Bombay Stock Exchange (BSE) provided the trading platforms for the secondary market transactions under an open outcry system.

As of 1992, the Bombay Stock Exchange (BSE) was a monopoly (Shah and Thomas, 1997). It was an association of brokers, and imposed entry barriers; leading to elevated costs of intermediation. Membership was limited to individuals; limited liability firms could not become brokerage firms. Trading took place by 'Open Outcry'on the trading floor, which was inaccessible to users. It was routine for brokers to charge the investor a price that was different from that actually transacted at. Retail investors and particularly users of the market outside Bombay, accessed market liquidity through a chain of intermediaries called "sub-brokers". Each sub-broker in the chain introduced a mark-up in the price, in the absence of unbundling of professional fees from the trade price. It was common for investors in small towns to face four intermediaries before their order reached the BSE floor, and to face mark-ups in excess of 10% as compared with the actual trade price. The market used 'future-style settlement' with fortnightly settlement. A peculiar market practice called 'badla' allowed brokers to carry positions across settlement periods. In other words, even open positions at the end of the fortnight did not always have to be settled. The efficiencies of the exchange clearing house only applied for the largest100 stocks. For other stocks, clearing and settlement were done bilaterally, which introduced further inefficiencies and costs.

The final leg of the trade was physical settlement, where the share certificates were electronically documented which is quite implausible to ease of operation. This was intrinsically vulnerable to theft, counterfeiting, inaccurate signature verification, administrative inefficiencies, and a variety of other malpractices. Involuntary and deliberate delays in settlement could take place both at the BSE and at the firm. Many firms used the power of delaying settlement as a tool to support manipulation of their own stock. The problems were somewhat simpler for investors in Bombay, who could physically visit the BSE broker, the BSE clearinghouse, or the company's Registrar, and accelerates transfer. For investors outside Bombay, who lacked this recourse and were crippled by the exorbitantly expensive telephone system, delays of six months between purchasing a stock and the transfer of legal title were common. If stock splits, rights issues, or dividend pay-outs took place during this period, it was common for the purchaser not to obtain the benefits. Floor-based trading, the inefficiencies in clearing and settlement entry barriers into brokerage, and the low standards of technology and organizational complexity that accompanied the ban upon corporate membership of the BSE led to an environment where order execution was unreliable and costly. These factors led to an extremely poor functioning of the capital markets till 1992.

2.2. Indian Capital Market: Post-Liberalization Period

The Indian capital markets have witnessed major transformation and structural change during the past one and half decades, since the early 1990's (Rathor, 2003). The Financial Sector Reforms in general and the Capital Market Reforms in particular were initiated in India in a big way since 1991-1992. These reforms have been aimed at improving market efficiency, enhancing transparency, checking unfair trade practices and bringing the Indian capital market up to International Standards. The Capital Issues (Control) Act, 1947 was repealed in May 1992 and the office of the Controller of Capital Issues was abolished in the same year. The National Stock Exchange (NSE) was incorporated in 1992 and was given recognition as a Stock Exchange in April1993, which has been playing a lead role as a change agent in transforming the Indian Capital Market to its present form (NSE, 2006). The Securities and Exchange Board of India (SEBI) was set up in 1988 and acquired the statutory status in 1992. Since 1992, SEBI has emerged as an autonomous and independent statutory body with definite mandate such as: a) to protect the interests of investors in securities, b) to promote the development of securities market and c) to regulate the securities market. In order to achieve these objectives, SEBI has been exercising power under: a) Securities and Exchange Board of India Act, 1992, b) Securities Contracts (Regulation) Act, 1956, c) Depositories Act, 1996 and delegated powers under the d) Companies Act, 1956. Indian Capital Market has made commendable progress since the inception of SEBI and has been transformed into one of the dynamic capital markets of the world (Damodharan, 2005). And a series of reforms introduced to improve investor protection, automation of stock trading, integration of national markets, and efficiency of market operations. India has experienced a tremendous change in the secondary market for equity. Its equity market will most likely be comparable with the World's most advanced secondary markets within a year or two.

The key milestones achieved during the past one and half decades are given below: A) Primary Market Developments: The 1990s witnessed the emergence of the capital market as a major source of finance for trade and industry in India. A growing number of companies have been accessing the capital market rather than depending on loans from financial institutions (NSE, 2008). Tremendous developments have taken place in the primary market where the Corporates issue fresh securities through public issues as well as private placements. The cumulative mobilized amount for the financial year 2010-11 (April-February) stood at Rs. 64,169.4 crore through 77 issues as against Rs. 42, 578.8 crore through 60 issues during the corresponding period in 2009-10(SEBI, 2011). Since the early 1990's there has been a paradigm shift from merit based regulated regime to disclosure based regime. Comprehensive guidelines on disclosures and investor protection were issued and were amended by SEBI from time to time. The companies accessing the capital market through public issues have to comply with adequate disclosure norms on initial as well as continuous basis. India's disclosure norms are considered as one of the best in the world and are often cited as a benchmark for the global standards. In a deregulated regime, the market determines the price of the public issues, i.e. either by the issuer through fixed price or by the investors through book-building process. A fair system of proportionate allotment of shares has been put in place. The Foreign Institutional Investors (FII's) have been allowed to invest in primary issues within the sectoral limits set by the Government. B) Secondary Market Developments: The securities issued in the primary market are traded in the secondary market.

Exchanges in India offer screen based electronic trading. The trading system is connected using the VSAT technology from around 345 cities. There are 9335 trading members registered with SEBI at the end of March, 2009. Recently, a separate trading platform namely BSE Indonext, has been set up jointly by BSE and the Federation of Indian Stock Exchanges to facilitating transactions of shares exclusively relating to the small and medium enterprises.

Along with the crucial primary and secondary market developments, some noteworthy core developments viz. SEBI registered market intermediaries mutual funds derivatives; screen based trading system designing unique clearing, processing, and settlement system risk management system margin trading facility etc., has introduced in this period which has confidently enhanced and eased the efficacy and efficiency of the regulatory mechanism which in turn leads to foster investor buoyancy and certainty. Most significantly, Foreign Institutional Investments (FIIs) were allowed to invest in India in 1992 under the portfolio investment scheme. They are also allowed to participate in the public issues of debt and equities within the sectoral limits set for equities and the overall limit fixed for the debt instruments by the Government. As a second largest market in the World, India has been a centre of attraction for the FIIs from the last two decades. Introduction of Depositories Act, 1996 was another landmark development in the history of India's capital market. There are two depositories namely; Central Depository Services Limited (CDSL) and National Securities Depository Limited (NSDL) was set-up. Both CDSL and NSDL have been successful in the dematerialization of securities to the extent of 99 percent of the total market capitalization. This has tremendously improved the speed, accuracy and security of the settlement system. About 99.9 percent of trades in BSE and 100 percent of trades in NSE are currently settled through delivery, which is possible only due to dematerialization of scrip by the two depositories.

2.3. Regulatory Framework for Investor Protection

The present functions and powers of regulatory agencies for the securities market seem to be fragmented. SEBI is the primary body responsible for regulation of the securities market, deriving its powers of registration and enforcement primarily from the SEBI Act. There was an existing regulatory framework for the securities market, provided by the Securities Contract Regulation (SCR) Act and the Companies Act, administered by the Ministry of Finance and the Department of Company Affairs (DCA) of the Ministry of Law, respectively. SEBI has been delegated most of the functions and powers under the SCR Act, and shares the rest with the Ministry of Finance. It has also been delegated certain powers under the Companies Act. RBI also has regulatory involvement in the capital market regarding foreign exchange control liquidity support to market participants and debt management through primary dealers. It is RBI and not SEBI that regulated primary dealers in the Government securities market. However, securities transactions that involve a foreign exchange transaction need the permission of RBI. Investors are the major stakeholders in the securities market. It is mandatory for SEBI to protect the interests of the investor community. As a matter of fact, protection of investors' interest is pursued by the securities market regulators throughout the world. Although the objective is more or less the same for most of the regulators, the means to achieve it varies from one jurisdiction to another. In India, one of the major achievements has been to shift from merit-based regime to disclosure-based regime. SEBI issued Disclosure and Investor Protection (DIP)Guidelines in the year 2000 and amended the same from time to time keeping in view the investors' interest. The disclosure norms in India are considered as one of the best in the world. Listed companies have to comply with the disclosure norms on an initial as well as on a continuous basis. The major objectives of the disclosure norms have been to ensure transparency and provide adequate protection to the investors. There is a system of proportional allotment of public issues in India. In case of fixed price public issues, 50 percent shares are being allotted to the retail investors. In case of book-building issues, the share of allotment for the retail investors has been raised from 25 percent to 35 percent. SEBI has given in-principle approval for the introduction of IPO grading at the option of the issuer. IPO grading would be done by rating agencies registered with SEBI. The grading is intended to be an independent and unbiased opinion of the concerned agency. It has been recognized the world over that investors' protection can be strengthened by adhering to high corporate governance standards. The governance standards of the stock exchanges are also being improved through the process called Corporatization and Demutualization (C&D) of stock exchanges. SEBI prescribed several governance standards to be achieved by the companies by 31st December, 2005 under the revised Clause 49 of the Listing Agreement with the stock exchanges. SEBI also introduces a comprehensive investor grievances redressal mechanism at its head office as well as at the regional offices. The Office of Investor Assistance and Education (OIAE) is the single widow interface through which SEBI interacts with investors. Investor education plays a crucial role for the securities market awareness, particularly for the retail investors. A major initiative in this regard during the recent past has been launching of a comprehensive Securities Market Awareness Campaign (SMAC) on 17th January, 2003. The campaign includes workshops, audio-visual clippings, and distribution of educative materials in English, Hindi and also in regional languages. There is a dedicated investor website which archives the booklets/pamphlets/FAQs etc. Even though Union Government and different regulatory authorities has been taking incessant steps to curb the irregularities, some of the mind-boggling financial scams took place in the last two decades with the culprit names of both Mr. Harshad Mehta and Mr. Kethan Parekh. These scams severely hampers the zeal of Indian retail investor and even today after a decade of these outrageous incidents, Indians are just simply addressing these stock markets as shock markets.

2.4. Indian Capital Market: Recent Initiatives and Future Road Map

The Indian Stock Market has taken remarkable initiatives particularly in recent years which have given lot of impetus and confidence to administration of markets as well as investors. SEBI has made Permanent Account Number (PAN) compulsory for trading in Stock Market from 1st January, 2007 and recently PAN has been made the sole identity for financial transactions; It has now been decided to extend the facility of electric transfer of funds viz. ECS to public issue refunds also SEBI in consultation with NSE and BSE is in the process of bringing a common electronic platform maintained/run by stock exchanges; For efficient monitoring of the stock market activities on a real time basis Integrated Market Surveillance System (IMSS) has been put in place; Corporatization and Demutualization of stock exchanges is a priority item in the SEBI agenda. For improved investor protection and also to enhance the confidence in the minds of particularly retail investors, SEBI may go in for fresh investor survey at the earliest to understand the investment behavior of the households during the more recent period Hon'ble Union Finance Minister has proposed to set up an investor protection fund under the aegis of SEBI which would be funded by fines and penalties recovered by SEBI; SEBI would continue to nurture the Mutual Fund Industry and thereby attract more and more households participation in the capital market; Gold Exchange Traded Fund (GETF) has been introduced in India and in addition, SEBI is also working for the introduction of the Real Estate Mutual Fund, which his likely to mitigate the housing requirement of many households; SEBI has been authorized to set-up a National Institute of Securities Markets (NISM) for teaching and training intermediaries in the securities market and promoting research.

3. Conclusion

Thus the Indian Capital Market is in great transition. There have been revolutionary changes over a period of time. In fact, almost all the operational and systematic risk management parameters, settlement system, disclosures, accounting standards; the Indian capital market is at par with the global standards. The goal of SEBI is to make the Indian Capital Market truly world class, competitive, transparent and efficient. A perception is steadily growing about the Indian capital market, as a dynamic market, among the international community. Because of the relentless efforts of the Union Government with the support of regulatory authorities, the Indian as well as global investors' community has revolutionized their outlook on Indian capital market which are incessantly appreciate the wealth of all kinds of investors. Let us dream to make our Indian Capital market as a yardstick for rest of the world's stock markets.

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