



THE BOSTON CONSULTING GROUP



Confederation of Indian Industry

DEEPENING OF CAPITAL MARKETS

Enabling Faster Economic Growth

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CONTENTS

5	FOREWORD
6	EXECUTIVE SUMMARY
9	CAPITAL MARKETS CRITICAL FOR OVERALL ECONOMIC GROWTH: THE MACRO-ECONOMIC POLICY CONUNDRUM
12	URGENT NEED FOR REFORMS IN INDIAN CAPITAL MARKETS
15	CAPITAL MARKETS — CRITICAL FOR OVERALL ECONOMIC GROWTH
19	FINDING THE POT OF GOLD AT THE END OF THE RAINBOW — WHERE IS THE ELUSIVE RETAIL INVESTOR IN EQUITIES
21	DEEPENING THE INDIAN CORPORATE BOND MARKET
23	KEY MONETARY REFORMS FOR THE DEVELOPMENT OF DEBT MARKETS IN INDIA
28	DEBT CAPITAL MARKET — REFORMS REQUIRED IN CORPORATE DEBT MARKET IN INDIA
31	RETAIL INVESTMENT IN CORPORATE BONDS — SUSTAINED, FOCUSED EFFORTS NEEDED
34	BREATHING LIFE INTO THE DEBT MARKETS
37	NATIONAL GOLD PLUS SCHEME — TURNING INDIANS' GOLD OBSESSION TO INDIA'S ADVANTAGE
40	ROLE OF PE IN THE INDIAN MARKET — THE INDIA PE MODEL
43	NURTURING ENTREPRENEURSHIP ECOSYSTEM IN INDIA — TAKING A LEAF OUT OF JOBS ACT

FOREWORD

WE ARE PLEASED TO present this joint publication from the Confederation of Indian Industry and the Boston Consulting Group on 'Deepening of Capital Markets: Enabling Faster Economic Growth'. This Publication explores the links between capital markets and economic growth underscoring the pivotal role they play in economic development and suggests measures to develop vibrant capital markets in the country.

Across the globe, the financial markets have been a long-standing determinant in the overall economic growth of any country. Stable and mature capital markets, both primary and secondary, create efficient capital raising opportunities for companies and also assist in channelizing domestic savings towards capital formation—fueling a nation's economic growth. Though Indian capital markets have evolved dramatically over the past two decades, they have not yet accomplished the expanse witnessed in countries like US, UK, Korea, Malaysia or even Thailand. Uncertain outlook for the global economy and heightened risk of a much longer period of sluggish growth in developed countries have further amplified the need to raise capital from domestic sources to finance our country's GDP growth.

CII and BCG, with the help of members of CII National Committee on Capital Markets, have drawn up recommendations aimed at deepening capital markets by increasing participation from domestic institutions, FIIs and retail investors; creating markets which would help realize India's inclusive growth aspirations and strengthen investors' confidence in the face of the global financial crisis.

We are thankful to the authors for their contributions to the Publication, each of them an expert in their own right. We would also like to place on record our appreciation for Mr. Uday Kotak, Chairman of CII National Committee on Capital Markets for his guidance and leadership to the development of the agenda of the Committee as well as this Publication.

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EXECUTIVE SUMMARY

CAPITAL MARKETS ARE CRITICAL for economic growth. In fact, it has been observed that a developed capital market is a valuable national asset. Developed capital markets provide for some key macro economic benefits, including: a) higher economic growth, b) higher productivity and capital growth, c) higher employment, and d) a better developed financial sector. In addition, developed capital markets also provide some micro economic benefits, including: a) wealth creation for private investors, b) more flexible financing for companies, c) improvement of governance structures, d) higher cross border M&A power, and e) driving entrepreneurial behavior.

The benefits of a developed capital market are immense and these have been well researched. An oft quoted study by the World Bank (“Stock Markets: A Spur to Economic Growth”, Ross Levine) has clearly demonstrated that GDP grows faster in economies with more liquid capital markets. The reasoning is simple—liquid markets make investments less risky and more attractive, allowing savers to acquire and sell assets quickly and cheaply, and by making investments less risky and more profitable, it leads to more investments and hence higher growth of the economy.

However, the development of capital markets poses its own challenges. If not managed properly, rapid growth in capital markets can make the market vulnerable to fraud, volatility, excessive speculation and misuse by select parties. Capital markets ride on the savings of small and often uninformed retail investors, directly or indirectly. For policy makers, the challenge hence is to strike a balance between the pace of growth and conservatism to ensure transparency and robustness in growth.

The Indian capital markets have evolved dramatically over the past two decades. However, India still has a long way to go. The total market cap of all the Indian companies is nearly 65 percent of the GDP today as compared to the US at nearly 90 percent, Thailand

and Korea at about 100 percent and Malaysia and the UK at about 150 percent. Even starker, the total Debt Capital Market (DCM) in India is only 34 percent of GDP as compared to China at 49 percent, Brazil at 68 percent and the US at 177 percent. And corporate debt market is even smaller—accounting for only 20 percent of all debt in the case of India. Corporate debt in India is nearly 8 percent of GDP as compared to 16 percent in China, 19 percent Brazil and 130 percent in the US.

India has a very high household savings rate. In fact, along with China, India has the highest savings rate in the World. If one was to segment the savings, nearly 50 percent of all savings is in physical assets like real estate and gold, with the remaining 50 percent in financial assets, of which equity (both direct and through mutual funds) is a small percentage, just less than 4 percent of total household savings.

The above facts raise a few questions for the Indian market:

1. How can one grow the Equity Capital Markets?

To grow the Equity Capital Markets, one needs to look at both the key stakeholders, the companies as well as the investors. From the companies' point of view, it would help if the process for IPO / FPO was made smoother and less time consuming, as well as if some of the other regulations impacting the offer were simplified, for example preferential allotment, QIP treatment at a level playing field with retail, etc. At the same time, it would be critical to address the investor side challenges in terms of increasing awareness, creation of appropriate products, enabling an efficient distribution and having favourable regulations.

2. What can be done to breathe life into corporate debt markets?

It is clear that India needs to really accelerate the development of the corporate debt markets. However, for this to happen, the market needs traction on multiple dimensions, including: creation of an active arbitrage free yield curve, enabling liquidity in corporate debt paper to ensure ability of banks to manage asset liability mismatch, increasing retail investor awareness, enhanced transparency, improved products and having appropriate regulations—example relaxing investment norms for insurance, pensions and PPF; making the stamp duty regime more investor friendly, having customer friendly TDS norms, and maybe even bonds with tax incentives.

Similarly, to attract foreign investments to Indian corporate debt paper, it would mean addressing the key issues of stability of India rating, exchange rate volatility and having appropriate norms for withholding tax for foreign investors.

Looking at where India is today in the corporate debt market, SEBI, RBI as well as MoF need to work together in tandem to make a real difference.

3. How can the under utilized capital locked up in gold be utilized?

Indians' obsession with gold has made India the largest holder of gold in the world, with an official estimate of India's gold holding at about 18,000 tonnes. At current retail market prices, this calculates to more than a trillion dollars of capital. Clearly, a gross under utilization of a lot of capital. And like most official estimates in India, this is likely to be an under estimate. The question, in this context, is whether there is some innovative way in which the government can leverage this large savings pool.

4. Are there alternate source of capital that can be tapped? How?

Private Equity (PE) has over the last few years grown substantially in India. The value of PE investments in the country grew more than 20 times in less than a decade, to over US\$ 10 billion in 2011 from around US\$ 500 million in 2002. The key question is—"How can India increase the share of wallet of PE in its capital requirement for growth?"

In addition, the question is whether there are other alternative funding sources for risk capital. For example, is there something to learn from the JOBS (Jumpstarting Our Business Startups) Act in the US. The JOBS Act is a good attempt to channel the HNI money to the newly defined Emerging Growth Company (EGC—another name for SME entrepreneur / start ups with right ideas for growth sans access to capital).

The articles on the succeeding pages each highlight one of the above questions and share the authors' points of view on how these could be addressed in India and what could be done to make the capital markets in India more dynamic.

CAPITAL MARKETS CRITICAL FOR OVERALL ECONOMIC GROWTH: THE MACRO-ECONOMIC POLICY CONUNDRUM

CAPITAL MARKETS REFER TO segments of financial system that help enterprises raise long-term capital by way of equity or debt. In turn, they also help savers to invest their money optimally in productive enterprises. Capital markets comprise financial institutions, banks, stock exchanges, mutual funds, insurance companies, financial intermediaries or brokers etc.

A growing economy like India, where more than 15 million youth are added to workforce every year, needs huge investment on a continuous basis for new capacity as well as for expansion, renovation and modernization of existing productive capacity and creation of supporting infrastructure. This investment, technically referred to as 'gross capital formation', is crucial to sustain growth. Economists work out capital output ratio by computing units of capital required to produce a unit of additional incremental output. In the Indian context, the capital output ratio has historically been around 4, i.e. 4 units of capital are required to produce one unit of incremental output. Therefore, to sustain growth of 8 percent per annum, we need new investments or gross capital formation of 32 percent per annum. In other words to sustain growth, we need capital to invest. And to raise capital, we need an efficient capital market. Therefore, capital markets are critical for the country's overall economic growth. There is broad consensus that macro-economic policy framework should be condu-

cive for the development and efficient working of the capital markets.

However, the development of capital markets poses its own challenges. If not overseen properly, capital markets can be vulnerable to frauds, volatility, and excessive speculation. Capital markets mobilize savings of naive investors, directly and indirectly. For policy makers, the conundrum is therefore to strike a balance between pace and order, sophistication and transparency, and regulations and simplicity.

Over the past two decades, Indian regulators have taken the path towards tighter regulations. As a result, in relative terms, our capital markets have been less vulnerable to crises or frauds. Quite justifiably, our regulators and government officials are proud about this. We have a robust regulatory structure in place for the capital markets. However, the flip side is that they are not geared to meet the capital requirement to realize the growth potential of the economy. India has tremendous potential to sustain higher economic growth compared with China because of favorable demographics and the enterprising nature of its people. India can sustain double-digit economic growth for at least a couple of decades more, which can lift millions of people out of poverty as has been the case with China, Singapore, and many other countries.

Let us separately look at equities and debt, the two major parts of the capital markets.

Our debt markets are evolving slowly and quite far from being mature, with multi-tier structure to handle risks and enable large capital flows. Several government committees have been appointed to look into this and develop corporate bond markets. However, very little has happened at the ground level. The absence of an efficient debt market has become a major constraint for new investments, especially in infrastructure, where debt component of a project is significantly higher. Given an underdeveloped corporate bond market and regulatory restrictions on deposits by non-banking sectors, a bulk of intermediation in the debt market is per force through the banking channels. The cost of intermediation in our country is perhaps the highest in the world. Typically, a good individual saver earns 4 percent per annum whereas a good corporate borrower pays 12 percent per annum a fair, market-linked, inflation-proof and risk-free return will go a long way in reducing the diversion of savings to unproductive asset classes such as gold and real estate. In today's world, such spreads can exist only with regulatory protections because free markets elsewhere in the world have driven it down to a few basis points. Our policy makers would justify this as a social obligation to the agriculture and SME sectors. However, relative to their urban counterparts, our farmers have become much poorer since independence and the Indian SME sector is much worse than its global counterpart as far as availability of capital is concerned.

The bigger policy conundrum pertains to equities markets. Our policy makers need to understand and appreciate that:

1. Equities are risky but very crucial to sustain high economic growth.
2. There can be no equities markets without financing and speculation.

Equity investing is perceived as risky and akin to gambling. One should not forget that the risk capital or equity capital forms the base on which enterprises can leverage and raise debt capital. Without equities, no project can even be conceived. Therefore, a healthy equity market forms the foundation for an efficient capital market. It will also benefit individual inves-

tors over the long term as the equities market can generate 15–18 percent per annum tax-free returns compared with 7–8 percent returns per annum in fixed income assets.

We have the most benign fiscal policy structure for the equities capital market. Return on Equity by way of dividend and capital gains is either tax-free or attracts lower tax rate compared with interest income. The same has not been effective nor will schemes such as Rajeev Gandhi Equity Investment will yield much results. This is evident from the fact that only 4 percent of household savings is directed to equities and retail penetration and participation continues to be weak. We are overly dependent on investment from Foreign Institutional Investors (FIIs) of US\$ 20–25 billion per annum even though our domestic savings are more than US\$ 400 billion.

Equity investors are not lured by sops but expectations of above-normal profit which obviously will entail higher risk as well. We can have a conducive environment for equities only when our policy makers appreciate that neither super profit nor super loss (even to a small investor) by itself is a bad word. My favorite analogy is of a Church priest who becomes a football referee and does not want players to be violent, wants them to avoid injuries and follow queue discipline. No doubt, the game of football has to have rules of fair play. There are fouls and penalties for pushing, tripping, and rough tackling but normal injuries and aggression are an essential part of the game. In equities, although excessive speculation or manipulation has to be punishable but volatility, speculation and losses to investors, small or big, are part of the game.

It appears that our policy makers perceive all financing, intra-day, and speculative activities as undesirable or evil elements and want to encourage only genuine investors. The interesting paradox is that, investors can be attracted only in a market with financiers and speculators. Typically, equity shareholders are owners who do not directly manage the company's affairs. For them, liquidity or an easy option to exit is important. World over, in the equities markets, liquidity is provided not by genuine investors but by traders, speculators, and arbitrageurs who essentially need financiers. The rapid

growth of the derivative market also corroborates the same characteristic of the equity capital markets. The genuine investment transactions among investors are so rare and even a blue chip trades only a few times in a month. For instance, millions of shares are traded in a stock like Infosys; but the buyers and sellers are not those who have simultaneously got excited and unexcited about valuation and long-term potential of the IT sector and on Infosys as a company.

Although manipulation is not healthy, lack of liquidity will prevent growth and participation. Our regulators frown on speculation and on financing. SEBI's margin funding guidelines are too onerous to secure any meaningful response. RBI has put several restrictions on bank' finance to the capital markets and it discourages capital market financing by NBFCs.

As we look at the next five years, to get our infrastructure ready to sustain growth, the magnitude of capital required is staggering. Our policy makers need to have clarity on the macro-economic objective, which to my mind can be: we need to encourage directing savings into equities, particularly from retail investors. We should reduce our dependence on FII hot money, which causes greater volatility in the market. We need more competition, more products and easy regulations in the debt markets and in banks. The fiscal, monetary, and all other policy framework should recognise this and be conducive.

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The views expressed in the article are author's personal views

URGENT NEED FOR REFORMS IN INDIAN CAPITAL MARKETS

ONE OF THE FUNDAMENTAL drivers of growth in an economy is the availability of capital to industry. Capital needs to be available at a reasonable cost. Capital also needs to be available through a process that is reasonably efficient—both in terms of time as well as effort required to be spent by a company and its management. The traditional sources of capital have included financing by banks and financial institutions, fund infusions (by promoters as well as other investors such as private equity and venture capital investors) and last but not the least, capital markets. A strong and stable capital market is an essential requirement for any economy, not least a growing economy such as India's.

The Indian capital markets have unfortunately, over the past couple of decades, been the victim of a few major scams. For example, the “Big Bull” scam in 1992 as well as the Ketan Parekh scam of 2001 both caused an immense loss in investor confidence, and exposed certain lacunae and inadequacies in the then prevalent regulatory mechanisms of the Indian capital markets. However, in both cases, there were swift regulatory responses. In 1992, there was a major overhaul of securities regulations in India, resulting in the enactment of the Securities and Exchange Board of India Act, 1992, which formed the Securities and Exchange Board of India (SEBI). Again, after the Ketan Parekh scam, SEBI responded swiftly

with several measures, including imposing several risk management reforms such as introducing additional deposit margins, placing restrictions on short selling, introducing mark to market margins and intra-day limits, circuit breakers, etc. SEBI's primary focus has been the protection of the retail investor, while at the same time endeavoring to introduce reforms and plug policy vacuums.

However, since the global recession struck in 2008–09, barring a few periods of frantic activity, the Indian capital markets have suffered from longer periods of lethargy. Initial Public Offerings (IPOs) of a significant size have been few and far between, and listed companies have also faced constraints in accessing the capital markets. The time has therefore come, for SEBI to implement reforms in securities regulations, both substantive and procedural, designed to (i) make it easier for companies to access the capital markets, and (ii) boost investor confidence. A few suggested reforms in key areas are set out below:

IPO Process

The IPO process in India is currently a fairly time consuming and cumbersome process. An IPO would typically take a minimum of four to six months to complete, at best. The timeline and disclosures involved in an IPO by an Indian company typically result in

higher time and transaction costs being imposed on the issuer company. This is a result primarily of two factors:

1. Extensive disclosures being required to be made in the offer document, and
2. SEBI not clearing draft offer documents in a timebound manner

The disclosure requirements for offer documents presently contain a significant amount of quantitative disclosures, which are time consuming to prepare, and which would presumably not have a material bearing on an investor's investment decision. Examples of these include (i) details of all litigations against the issuer company, its subsidiaries and group companies, irrespective of materiality, and (ii) details of all approvals required for the business of the company, irrespective of materiality. Indian investors have become increasingly more sophisticated, and it would be better if they are provided with disclosures that are qualitatively material in the context of their investment decision, as opposed to voluminous offer documents that make it difficult to find and analyze the material issues.

It should also be made mandatory for SEBI to respond with comments on draft offer documents in a time bound manner. In the present market conditions, windows of opportunity open and close within very short timespans. A clear timeframe for a response from SEBI on offer documents would go a long way towards enabling issuers and merchant bankers to plan offering schedules for transactions with a greater degree of certainty.

Preferential Allotments

The floor price for preferential allotments (to persons other than qualified institutional buyers) is currently the higher of the average of the weekly high and low of the closing prices of the shares for (i) 26 weeks, or (ii) 2 weeks, in both cases, preceding the date falling 30 days prior to the shareholder meeting where the preferential allotment is approved. However, the floor price for Qualified Institutional Placements (QIPs) is the average of the weekly high and low of the closing prices of the shares for the 2 weeks

prior to the date that the board of directors decides to open the proposed issue. In order to encourage equity investments in companies (by private equity and other investors), it is suggested that the pricing guidelines for QIPs be replicated for preferential allotments, provided that such allotments are not made to promoters or persons related to or associated with the promoters of the company. This would make equity investments in listed companies more attractive to investors.

Minimum Public Shareholding Norms

Currently, there is a uniform requirement for listed companies (other than a few limited excepted class of companies) to have a minimum public shareholding of 25 percent. Companies that do not presently meet this requirement are required to ensure compliance by June, 2013. Further, the 25 percent limit can only be achieved through one or more of the prescribed methods. Until recently, these methods were limited to primary and / or secondary public offers through prospectuses, institutional placement programs and offers for sale through the stock exchanges. However, recently, two new routes were added, namely rights issues or bonus issues to the public shareholders, with the promoters / promoter group forgoing their respective entitlements.

While the recent additions of rights and bonus issues are welcome, it should be noted that all the prescribed modes of compliance (with the exception of bonus issues) are heavily dependent on market conditions and investor appetite, in order to be successful. In light of the uncertainty in the global and domestic markets, SEBI may consider permitting additional modes of compliance, such as preferential allotments and private sales by promoters, whether through the stock markets or otherwise. Appropriate conditions can be introduced to ensure that such allotments / sales are not undertaken to persons who are related to the promoters or who have any arrangements with the promoters with respect to passing back the economic or voting benefit of the shares back to the promoters.

CONCLUSION: The above suggestions are unfortunately only indicative of the reforms that are required in Indian securities regulations. There are a number of other areas that require a relook from SEBI, including (i) regulations relating to delisting (with a special emphasis on the price discovery mechanism), (ii) insider trading, (iii) corporate governance requirements, and (iv) continuous listing requirements. SEBI should also be careful not to take any measures that may be seen as making it more difficult companies from accessing the capital markets—SEBI's recent proposal on introducing a mandatory safety net mechanism for IPOs is an example of such a measure.

As discussed earlier, the driving force behind many of the changes that SEBI has made to Indian securities regulations over the past two decades has been the tightrope of protecting

retail investors, while at the same time making efforts to develop and deepen the capital markets. Whilst the simultaneously proactive and cautious approach hitherto followed by SEBI has certainly resulted in enhanced investor comfort and disclosure requirements, SEBI has great challenges ahead of it in the ever evolving Indian securities market, especially in light of local and global market conditions. The regulators will need to ensure a well reasoned and rational approach to meeting these challenges, including taking into account the views of all major stakeholders, including market intermediaries, legal experts and most importantly, investors.

MS. ZIA MODY

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The views expressed in the article are author's personal views

CAPITAL MARKETS — CRITICAL FOR OVERALL ECONOMIC GROWTH

ACROSS THE GLOBE, THE financial markets have been a long-standing determinant in the overall economic growth of any country. Well developed capital markets, both primary and secondary, contribute not only to efficient capital raising opportunities for companies from both onshore and offshore sources, but also assist with efficient mobilization of savings and effective allocation of financial resources towards increasing the investment rate, across various sectors of the economy.

Over the years, these inter-linkages have been extensively analyzed through various studies, statistics and other theoretical literature. For instance, in 1873, in a publication titled *Lombard Street*, Walter Bagehot argued that it was England's efficient capital markets in the 19th century that made the industrial revolution possible. A World Bank working paper published in 1996 also brought this co-relation to the forefront and on the basis of various empirical data, concluded that stock market growth indicators, for example, size, liquidity, volatility, and integration with overseas capital markets are correlated with economic growth.¹ Another important contribution of the capital markets is its key role in assisting with the globalization of an economy, by increasing access to foreign capital, which has proven to be very essential and productive for developing economies such as India, especially in its post liberalization growth period.

Key Factors for the Growth of Capital Markets

It is important to note that the stock markets, in isolation, are unlikely to stimulate economic growth and effective resource allocation using the capital markets is possible only where the overall economic indicators of a country are efficient. Therefore, the development of stock markets is not dependent on the government and the securities market regulator alone. Rather, the overall economic health of the country is the strongest determining factor for its capital markets to develop and flourish. In India, a combination of legal hurdles, lack of institutional reforms, policy paralysis and uncertainty on tax treatment, allegations of corruption across sectors have acted as an investment deterrent in the recent past. The Vodafone judgment of the supreme court as well as the introduction of data protection measures in the Information Technology Act, 2000 have helped in restoring investor confidence. However, major reforms are needed in other areas such as labour and employment laws, privacy laws, direct tax laws (especially post the Finance Act, 2012 and the Shome Committee Report), infrastructure law, land acquisitions laws and anti-graft laws in order to improve investment sentiment and enable effective contribution by the capital markets to the growth of Indian economy.

There is a lot of literature around the various factors that must be strengthened, in or-

der to influence the growth of the capital markets and thereby the growth of the economy. An interesting paper, published in 2004, has identified some key factors to set such economies on the right path of capital resource allocation.² A brief understanding of these factors, along with their role and importance *vis-à-vis* the Indian economy is set out below:

INVESTOR RIGHTS

A strong investor protection regime goes a long way in limiting the abuse by corporates. The investor protection regime in India has its basis in the establishment of SEBI, as is evident from the preamble to the SEBI act, 1992, which states that SEBI was established with the primary goal of investor protection. The erstwhile Disclosure and Investor Protection Guidelines and the current SEBI ICDR Regulations mandate disclosure and fulfilment of other parameters by issuer companies with the ultimate aim of protecting the rights of the investors. Disgorgement of ill—gotten gains in the 2006 IPO scam by SEBI is an important milestone in this area. The recent Sahara order is also of significance where supreme court has directed Sahara to refund INR 24,000 crores, raised by two of its group companies without compliance with the public issue process. In fact, an approach paper issued by FSLRC also seeks to take the investor protection regime further by proposing constitution of a separate redressal mechanism for consumer complaints. Apart from the above, investor awareness programs are also frequently undertaken by the regulator, exchanges and other institutions, to build stronger foundations for investor protection and education in the Indian markets.

Recently, SEBI has also sought to offer additional protection to retail investors by proposing a mandatory safety net mechanism for specified securities in public issues. The SEBI (Framework for Rejection of Draft Offer Documents) Order, 2012 entitles SEBI to weed out undesirable or ineligible public offers. Whilst the intent behind these two reforms is laudable, a safety net mechanism takes away the equity risk of an investor and the guidelines on rejection of offer documents effectively introduces a merit-based

regulation of capital markets, which was done away with the abolition of the Controller of Capital Issues decades ago.

CORPORATE OWNERSHIP STRUCTURE

It is fairly common in India for large corporate groups, with a wide network of businesses and inter-linked structures to remain controlled by a small group of persons. To ensure transparency from a corporate governance perspective, especially in such companies, India law has put in place a number of checks and balances. For instance, the Companies Act requires every director of a company to make disclosure of the nature of his concern or interest in a contract or arrangement (present or proposed) entered by or on behalf of the company.³ A significant step in this regard was also taken by introduction of independent directors in India. Based on the recommendations of Kumar Mangalam Birla committee, Clause 49 was incorporated in the Listing Agreement in 2000–01 which enshrined the basics of independence of directors. It noted that independence of the board is critical in ensuring that the management fulfils its oversight and role objectively and holds itself accountable to the shareholders. Various committees like Naresh Chandra Committee Report, 2003, Narayan Murthy Committee Report, 2003, Dr. Irani Committee Report, 2005 revised and strengthened the definition of independence, structure and composition of the board, appointment and remuneration of independent directors and their inclusion in audit committees.

Despite such initiatives, there continue to be instances where the appointment of independent or non-executive directors remains a matter of mere legal compliance and there are instances where independent directors remain personally known to the promoters, without regard to a specified selection process or other qualifications for their appointment. These are matters of concern that need to be addressed systemically

CORPORATE TRANSPARENCY

Corporate transparency enables informed decision-making by investors and can be achieved by mandating adequate disclosures from companies. Ranging from disclosures in offer documents for accessing public funds, up until disclosures on an ongoing basis

about material events, financial performance, insider trading and takeover code filings etc., sea changes has been brought about in the disclosure regime in India and it is now comparable to the best, globally. Besides information dissemination, corporate transparency has also been achieved and made effective by electronic portals like MCA21 as well as websites of stock exchanges, which have not only simplified filing but also made access to data simpler and more efficient.

CAPITAL ACCOUNT OPENNESS

Openness to the global economy, particularly capital account openness, is another important factor. Capital openness promotes capital inflow, increases competition and in turn efficiency, and also provides financial backing to local entrepreneurs.

The Foreign Exchange Regulation Act, 1973 was the primary statute that governed foreign investments but its provisions were restrictive and did not encourage investment, both inward and outward. The announcement of liberalization policy in 1991 ushered in foreign direct investment and equity portfolio inflows. Subsequently, it allowed debt instruments and equity outflows also, although cross-border credit flows have been relatively limited. Since the 1990s, the broad approach towards permitting foreign direct investment has been taken through a dual route, for example automatic and discretionary, with the ambit of the automatic route being progressively enlarged to almost all the sectors, coupled with higher sectoral caps stipulated for such investments. The concept of capital account liberalization, first mooted in the 1997 Tarapore Committee Report, has also been the driving force of many reforms. Consequently, net capital inflows shot up from 2.2 percent of GDP in 1990–91 to around 9 percent in 2007–08. The foreign investment, including both the direct investment and portfolio investment, increased from US\$ 103 million in 1990–91 to US\$ 61,851 million in 2010–11.

Mapping the Development of Indian Capital Markets

Although capital markets in India evolved around the close of 18th century, the 1990s

were perhaps the most significant. This decade was characterized by a spate of reforms being introduced in the country, in terms of a new industrial policy, freedom to issuers to issue securities at market determined rates, setting up of new stock exchanges, introduction of screen based trading, improved settlement mechanisms. In the 21st century, the Indian securities market continued to witness introduction of new financial products like IDRs, FCCBs, FCEBs along with significant improvements in corporate governance. One can gauge the impact of reforms in the securities market on the economy from the GDP growth of 9.8 percent achieved in the last quarter of 2006–07. The co-relation between stock market and economic growth is also apparent when the stock market plunged post the 2008 peak leaving the growth of the economy at 6.7 percent in 2008–09 (April–March).

Way Forward

In its 2008 report, the High Level Committee on Financial Sector Reforms headed by Raghuram G. Rajan aptly noted that “*Given the right environment, financial sector reforms can add between a percentage point and two to the economic growth rate*”⁴. Empirical data also supports this hypothesis, as stock market development, over the years has mirrored in the increase in GDP growth rate from 1.40 percent in 1991–92 to 9.0 percent in 2007–08, and major reforms are required to keep up this growth rate. In the past few months, the government has taken a positive step ahead with the introduction of 51 percent foreign direct investment in multi-brand retail as well as relaxation of norms for foreign direct investment in the aviation, insurance and pension sectors. These measures are not only likely to encourage investments in India, but will also act as a significant confidence booster to market sentiment. Setting up of the FSLRC is also aimed at creating a more stable and resilient financial sector, and FSLRC has in fact, suggested various reforms to revise and ensure consistency across financial sector laws in its approach paper released in October 2012. However, the Indian markets continue to require a second generation of reforms in certain financial segments such as corporate bond mar-

ket, currency derivatives, etc., and in making the IDR space more attractive for foreign companies to assist with economic growth, going forward.

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The views expressed in the article are author's personal views

NOTE:

1. Levine, Ross and Zervos, Sara (1996) "Stock Markets, Banks, and Economic Growth", World Bank Policy Research Working Paper, No. 1960
2. Durnev, Art, et al, (2004) "Capital Markets and Capital Allocation: Implications for Economies in Transition", Economics of Transition, Vol. 12(4), 593–634.
3. Sections 299, 309(1) and Schedule VI of the Companies Act, 1956.
4. High Level Committee on Financial Sector Reforms with Raghuram G. Rajan as its Chairman was set up on August 17, 2007 and the committee submitted its report on September 12, 2008.

FINDING THE POT OF GOLD AT THE END OF THE RAINBOW — WHERE IS THE ELUSIVE RETAIL INVESTOR IN EQUITIES

INDIA IS ONE OF the largest domestic savings markets in the world. However, of this overall savings, equity / capital market participation is extremely low. A SEBI—sponsored household survey provides some startling insights into household saving preferences. The study estimated that only 11 percent of Indian households (24.5 million of 227 million) invest in equity, debt, mutual funds, derivatives and other instruments in the capital market. The remaining 89 percent are also likely to be net savers, but rely on non-risky avenues such as banks, insurance or post office savings instruments. While this 11 percent is very different for urban and rural India, it still translates into only 20 percent for urban households and 6 percent for rural households. And the unfortunate part is that this percentage has not changed much over the past few years. As a result, in spite of a large amount of aggregate savings, there is an acute shortage of domestic risk capital.

This is compounded by the disparity across geographies. The equity AuM is extremely concentrated, with the top ten cities accounting for approximately 74 percent of the total equity AuM and the top 30 cities accounting for about 90 percent of total equity AuM. This would be similar for direct equity as well. While locations beyond the top ten cities are gaining share continuously, the movement is slow and steady. The share of AuM beyond the top ten cities has increased from about 10 percent in 2003 to about 26 percent in 2011. The disparity become stark

when one compares the spread of equity with other financial assets, example insurance and bank FDs. While the top 10 cities account for nearly 75 percent of the equity investments, they account for only 35 percent of the bank's term deposits (savings plus fixed deposit).

There are a variety of reasons holding back retail participation in equity. And it is going to require action on several counts to change this. The key areas that need to be addressed are as listed below:

1. Enhancing customer awareness

The lack of awareness or the amount of ignorance about capital markets in India is incredible. Among the households (89 percent) that did not invest in the capital markets (SEBI survey mentioned above), nearly 41 percent felt that they had inadequate information about financial markets and lacked investment skills. This perception was prevalent across various income groups and education categories. In addition, a stunning 16.5 percent of the most educated and 16 percent of the upper middle and upper income groups thought that investments in the capital markets were not safe. It is this ignorance that needs to be addressed.

It is critical that customers are educated about the concept of risk return trade-offs. Unfortunately, many Indian customers are still living in the “License Raj”, with the IPO / NFO premium

market. The belief is that once one gets allocations in the IPO / NFO, attractive returns are guaranteed. And when that does not happen, it results in huge disappointment. This takes us back to the 80s and 90s, when, every time a new car model was launched, people booked whether then wanted a car or not, just so that they could sell their booking with the “on” premium. It is high time that the Indian customers come out of this “World of scarcity—access is critical for value generation mindset”. Additionally, the other key element is timing. Most investors typically get the cycle completely wrong. They get in when the market has gone up and exit when the market starts going south.

The India market is going to need serious awareness programs to address the large amount of ignorance that exists today.

2. Creating a value proposition for the customers through products and performance

The second element that needs to be looked at is that of a clear value proposition for investors. And this has to address two simple levers — (i) performance / returns; and (ii) meeting a specific customer need.

While the base product is equity, there are multiple product variants—growth versus value equity, ETFs versus actively managed equity funds, SIPs versus one time investment, Portfolio Managed Services (PMS) and structured products. And in each of these cases, the important element of the proposition has to be performance / returns commensurate with the risk that the customer is taking. This obviously pre-supposes a certain base customer awareness.

3. Ensuring an active distribution network—organizing the unorganized

The Indian market today has three key distribution channels for equity mutual funds and direct equity—distributors, banks and Independent Financial Advisors (IFAs). The not so recent ban on entry load and hence the corresponding reduction in the commissions for the channels has resulted in a major overhaul of the distribution. Large distributors with scale and negotiation ability have negotiated

better terms and are in a position to survive, while the smaller ones are hurting.

Going forward, banks and distributors will evolve to meet customer requirements. But, it is more an evolution than a revolution. However, in the case of IFAs, there is serious need for major overhaul. This is where the need of the hour is to organize the unorganized sector and therein lies the challenge for the Indian market. Get this right, and we have a robust independent advisor network, get this wrong, and the channel disappears. Also, the other interesting opportunity for India is leveraging affinity networks. Globally, different affinity networks have succeeded in different markets. There are multiple possibilities, ranging from the more tried and tested post office and retailers, to the Teclos, to the communities like IFFCO, Amul, ITC Chaupals. The list is long. The question for India is, “Which of the affinity networks will work in an economically viable manner?”

4. Continuing with favourable regulations

The tax regime has always been favourable for equity investments—both direct and mutual funds. This is going to have to continue, because India really needs the risk capital.

In summary, while the market has evolved significantly over the past decade, it is as always a case of the glass half full versus the glass half empty. India has a long journey to continue.

It will need multiple entities, SEBI, Ministry of finance, AMCs, Industry bodies, etc. to work together on multiple fronts, else the pot of gold will remain elusive.

The words of Robert Frost capture this sentiment the best

“The woods are lovely, dark and deep. But I have promises to keep, And miles to go before I sleep, And miles to go before I sleep.”

ALPESH SHAH

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The views expressed in the article are author's personal views

DEEPENING THE INDIAN CORPORATE BOND MARKET

INDIAN HOUSEHOLDS SAVED 22 percent of GDP in FY11. About half of the savings went to physical assets like gold and real estate. Financial savings comprised of 13 percent in currency, 47 percent in bank deposits, 24 percent in insurance, 9 percent in pension and provident funds and 7 percent in small savings. Majority of financial savings is unlikely to earn real return as inflation levels are higher. This composition reflects that Indians are great savers but poor investors. Increased allocation to physical savings is also proving the point that financial savings probably have not given adequate real return to Indian households. Inadequate real return on financial savings is mostly hitting the retail investors. HNIs are able to generate far higher real return due to combination of factors like scale and size of investment, leverage, superior knowledge and range of investment product. Indian society is experiencing widening inequality as HNIs are able to compound their already higher wealth at a faster pace than the retail investor on their meagre wealth.

Corporate bonds can provide adequate real return to investors. Corporate fixed deposit was part and parcel of an average retail investor's life in not so distant past. Corporate fixed deposit market lost its appeal and diminished in size as investor's looked at coupon rather than safety, distributor's bothered for incentive rather

than client interest and regulations were bypassed through innovative structures like plantation scheme. Focus on return on principal rather than return of principal led to the decline of the corporate fixed deposit market.

Corporate bond market could have easily filled the void left by corporate fixed deposits. However in spite of several steps taken by regulators to develop the corporate bond market, it remains a glass half full or half empty story. Introduction of trading and settlement system like NDS for gilts, hedging product like interest rate futures and increased FII participation has deepened corporate bond market. A lot of thinking has been done to further develop corporate bond market but it has not been converted into actions for various reasons.

Following steps can be taken to deepen the corporate bond market which is necessary to migrate physical saving to financial saving and provide long-term financing for infrastructure development:

- Include corporate bonds as an acceptable security in Collateralised Borrowing and Lending Obligation (CBLO) with reasonable margin
- Allow pension and PF trusts to invest in higher credit corporate bonds from the limited freedom of investing in dual highest credit rated bonds

- Allow pension and PF trusts to sell the shorter maturity corporate bonds in the market to create liquidity at the short-end and appetite for investment at long-end
- Incentivize insurance companies to sell the shorter maturity corporate bonds in the market to create liquidity
- Hair cut for corporate bond in repo market should be duration weighted rather than flat rate
- Introduce netting in corporate bond settlement (DVP III) like in gilt market encouraging efficient utilization of capital
- Expand interest rate futures across the maturity spectrum to generate liquidity along with cash settlement of interest rate futures
- Introduce speedy and sure enforcement of security. Investor's confidence on measures like Section 138 in case of cheque bouncing has evaporated with the time consuming process of law. A high yield market can not develop in India unless there is surety of enforcement of security. A lot of doubts are prevailing about fundamental matters like options, selling of pledged securities etc. These fears are pushing investor towards highest rated bonds depriving lower rated issuers from market access
- Encourage larger size of issuance by capping stamp duty on issuance and allowing re-issuance of security
- Lay out clear process for attracting FII flows in infrastructure debt starting with simpler definition of infrastructure and asset backed model of financing
- Bring OIS (swap for hedging) market on the exchange to facilitate better participation as well as reduce the settlement risk
- Reduce the cost of retail distribution of bonds. It can be done through combining the IPO process with placement through the exchange or online platform. Allow appropriate advertisement for secondary placement of bonds to gain traction from retail investors
- Popularize structured product through generic exchange traded products. Retail investor's participation in Indian equity markets has declined over last two decades as their experience has been unpleasant. Entry in a bullish market and exit in a bearish market along with wrong stock selection has caused this unpleasant experience. Structured product could act as a good bridge for money moving from fixed income to equity by providing safety of debt and partial return of equity. An exchange based distribution will bring much needed transparency in the structured product and enhance retail participation

Clearly the above measures are not all encompassing to develop a vibrant corporate bond market. May be some of them will work and some of them will not. May be some better suggestions will come on the way as we implement these measures. May be there will be consensus on some of the measures and outright rejection of few. What is important is to continue the process of deepening of Indian corporate bond market through actions rather than waiting for the perfect solution.

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The views expressed in the article are author's personal views

KEY MONETARY REFORMS FOR THE DEVELOPMENT OF DEBT MARKETS IN INDIA

INDIAN CORPORATES HAVE CONVENTIONALLY depended on the strong domestic bank financing sector as the primary source of debt funding. However, there exist certain constraints on bank financing for example single and group exposure limits, sectoral restrictions. The existence of a vibrant debt capital market is imperative from a macro-economic perspective to provide mechanisms for greater sources of funding and liquidity and for minimization of risk in any economy. The development of the domestic bond market would result in lesser systemic strain for both banks (for example, depositors) and corporates (for their sources of funding). Strong debt capital markets facilitate financial intermediation, put providers and consumers of capital together and make the credit evaluation and discovery process more transparent.

The high and growing savings amounts of customers in India (who would want higher yielding instruments than bank deposits) together with the approximately 9,000 listed companies is a powerful combination for the development of the debt capital markets in India. More recently, we have seen an increase in the number of public offers of bonds (for example offers to more than 49 persons). Although starting from a low base, the number has increased to 12 issues in 2011 from 1 issue in 2008 and 3 issues in 2010. Private placements of corporate bonds have also increased from

744 issues in 2007–08 to 1,278 issues in 2009–10 and 1,404 in 2010–11.

As a proportion of global GDP, the world bond market increased to 130 percent at the end of 2010 from 80 percent a decade earlier. According to a survey conducted by IOSCO in November 2011, on corporate bond markets for emerging markets, the size of the bond markets are projected to rise significantly in the next few years on the back of increased economic growth, greater local and foreign investments to fund large scale infrastructure projects, and the narrowing of gaps in income between emerging markets and developing markets. China (23 percent), Korea (57 percent), India (21 percent), Malaysia (40 percent) and Thailand (20 percent) dominate the corporate bond market arena and account for more than 80 percent of the total corporate bond markets among the emerging markets.

There are various challenges, high rates on withholding tax for foreign investors on interest income from bonds and high rates of stamp duty applicable on bonds. Any change to the investment-grade rating of India or extreme volatility in the US Dollar to Indian Rupee exchange may well deter the growth of India's corporate bond market.

While, the foundations have been laid for the corporate debt market in India to develop over the next decade, there are certain other

measures that may also be considered. The purpose of this article is to analyze certain key monetary reforms in the taxation system and stamp duties payable on bonds which may ease the way forward for a vibrant debt market.

Making the Stamp Duty Regime More Investor Friendly

The stamp duty on bonds is a central subject and is governed by the Indian Stamp Act, 1899. While the same has been amended to make it uniform across all states, there is an urgent need to address the issue of differential stamp duties levied by various state governments on bonds secured by immovable property.

Currently, stamp duty on bonds (unsecured or secured with collateral other than immovable property) as amended in 2008 is 0.05 percent per year of the face value of the bond subject to a maximum of 0.25 percent or INR 25,00,000, whichever is lower. Further, there is no stamp duty on transfer of bonds issued in dematerialized form.

However, where there is a registered mortgage deed (which is duly stamped in respect of the full amount of bonds to be issued), in most states there is no further stamp duty on the actual bonds issued for example the bonds are exempt from stamp duty. Whilst the stamp duty on bonds has been capped, the stamp duty payable on the mortgage deed (to be determined by the stamp statutes applicable in each state) is different. Further, stamp duty payable in some states is capped whereas in other states it is *ad valorem*.

Therefore, the stamp duty on bonds should be reduced to a nominal rate. The rate may be made INR 200 (similar to a loan agreement if executed in New Delhi) or lesser so that there is a level playing field with the transaction costs applicable to the bank loans market. Further, there should be no differentiation in rates between secured or unsecured (whether secured by immovable property or other assets) and there should be a uniform nominal amount in all states. This may be achieved by having a nominal amount of stamp duty payable on a mortgage deed for bonds in all

states which will require to be so determined by each state government in consultation with the central government.

Separately, the Indian Stamp Act is silent on the stamp duty for re-issuance of the same security. Hence currently it is treated as a fresh issuance for the purposes of the stamp duty and stampable at the above mentioned rates again. Therefore, amendments should be made to the Indian Stamp Act to clarify that re-issuance of bonds should be stampable at no or nominal stamp duty.

Further, transfer of bonds, while in dematerialized form is exempt, in physical form is still stampable with differing rates as per applicable state laws even if secured by a mortgage deed. Transfer in physical form should therefore also be made exempt from stamp duty which will result in more participation from retail investors who traditionally prefer to hold bonds in physical form.

Removing Tax Deduction at Source (TDS) and Reducing Withholding Tax (WHT) on Interest for all Bonds Issuances

One of the key recommendations in the “The Report of the High Level Expert Committee on Corporate Bonds and Securitization”—commissioned by the Union Government and chaired by R. H. Patil in 2005 was that the TDS rules for corporate bonds should be similar to the ones applicable to government securities. Currently, government securities do not attract TDS on interest income.

After amendments to the Income Tax Act, 1961 (IT Act), no tax is required to be deducted on interest income payable to an Indian resident on securities (including corporate bonds) issued in dematerialized form and if listed on a recognized stock exchange in India and at 10 percent if the bonds are issued in physical form. Further, TDS is not applicable as regards interest on corporate bonds (all types) payable to certain insurance companies who hold full beneficial interest in such bonds.

However, the aforementioned exemptions for domestic investors are not available for for-

eign investors. WHT on interest on bonds as per the IT Act is generally 20 percent for foreign investors except, where such rate for certain specific types of bonds is not specifically reduced by the IT Act itself or a more beneficial rate is provided under a Double Taxation Avoidance Agreement (DTAA) with a specific country (for example the WHT on interest for Singapore, Cyprus, and Luxembourg is 10 percent whereas for Mauritius it is 20 percent).

The Ministry of Finance has introduced section 194LC in the IT Act through the Finance Act, 2012. This new section has reduced the WHT on interest on long term infrastructure bonds in foreign currency and External Commercial Borrowings (ECBs) which are raised under a loan agreement, from 20 percent to 5 percent. By a circular in September 2012, the Central Board of Direct Taxes (CBDT) has done away with the requirement of obtaining prior central government approval for availing the reduced rate of WHT of 5 percent. The lower rate applies to monies borrowed or bonds issued between July 1, 2012 to June 30, 2015.

While the above measures are steps in the right direction for easing the cost on long term infrastructure bonds for foreign investors, such steps should include all bonds or a wider range of bonds. The scope of section 194LC of the IT Act should be expanded to include bond issuances by all corporates which are permitted under the ECB regulations to raise ECBs. Other than the ECB regulations, corporates have been permitted to raise debt by issuance of Non-Convertible Debentures (NCDs) / commercial papers and bonds to Foreign Institutional Investors (FIIs) under Schedule 5 of the Foreign Exchange Management (Transfer or Issue of Security by a person resident outside India) Regulations, 2000. Section 194LC of the IT Act does not provide the reduced rate of WHT for bonds issued to FIIs and should be extended to cover them.

Benefits of reduced WHT on interest should be made uniformly applicable to all debt instruments and should not be limited to only specific sectors and for limited time periods for a cost efficient Indian debt market. For the development of the debt market, it is consequently suggested that exemption from TDS

be extended to unlisted bonds and bonds held in physical form. WHT on interest for all bonds held by any non-resident investor should be consistently reduced. Further, there should be no differentiation in taxation on interest for bonds based on the currency of issue.

Introducing Bonds with Tax Incentives

Historically, bonds having tax benefits have been introduced by the central government for domestic investors and entities permitted have included a select group of public sector entities or Non-Banking Financial Companies (NBFCs) in the infrastructure finance sector.

In 2010, a new section 80CCF was introduced under the IT Act that provided income tax deduction of INR 20,000 in addition to INR 1,00,000 available under other provisions for claiming tax deductions for investments made in the long term infrastructure bonds. Eligible borrowers for this category of bonds were restricted to Industrial Finance Corporation of India, Life Insurance Corporation of India, Infrastructure Development Finance Company and NBFCs who are classified as an infrastructure finance company by the RBI. Only resident individuals and Hindu Undivided Family (HUFs) are permitted to invest in these bonds. Any investment in such bonds up to INR 20,000 is eligible for tax deduction from the taxable income. Section 80CCF bonds have been discontinued in the current fiscal year.

80CCF bonds should be reintroduced in the next financial year but it should be reintroduced with modifications such as (i) increased numbers of eligible issuers including issuers in the non-infrastructure sectors, (ii) broader base of domestic investors, and (iii) permitting foreign investors (who may not be able to get tax benefits but should be allowed to invest).

To take another example, tax free bonds had been introduced in 2011 having exemption from tax on interest on the bonds under Section 10(15)(iv)(h) of the IT Act. In 2011 only four issuers had been permitted to issue such bonds—National Highways Authority of India, Indian Railway Finance Corporation Limited, Housing and Urban Development Corpora-

tion Limited, and Power Finance Corporation. In 2012, the central government has issued a notification permitting tax free bonds for seven additional issuers—India Infrastructure Finance Company Limited, Housing and Urban Development Corporation Limited, National Housing Bank, Rural Electrical Corporation, Jawaharlal Nehru Port Trust, Dredging Corporation of India Limited, and Ennore Port Limited. The investor base has also been increased by permitting qualified institutional buyers, corporates, high net worth individuals, and retail individual investors.

The central government has taken the right step by increasing the investor base for such tax free bonds and in order to make it a more effective step, many more types of issuers should be permitted to issue such bonds as the eligible issuers are still very limited.

Section 80CCF bonds and tax free bonds have been very effective in the market and have generated a lot of investor interest due to their lucrative benefits. Introduction of such category of bonds will definitely boost the corporate bond market in India.

Leveling the Field — Removing the Process of Buying Debt Limits

A key factor to the development of any capital market is the participation of foreign investors. In India, the way in which this happens is investments by FIIs and Qualified Financial Investors (QFIs). While investments in the equity markets have been facilitated to a great extent, FIIs having more or less been placed at an equal footing with domestic investors, the same is not the case for the debt market as FIIs do not have the same standing as domestic investors.

A key monetary area where FIIs are in a disadvantageous position compared to domestic investors and QFIs is the expensive process of actually buying debt limits for subscribing to NCDs. In order to invest in NCDs in India, an FII first needs to procure the debt investment limits. While part of the investment limit is allocated by Securities and Exchange Board of India (SEBI) by way of an open bidding process, the remainder is allocated on a first come first served basis, subject to the condi-

tions and procedure stipulated in the circulars issued by it from time to time in this regard. The maximum allocation limit for an FII by bidding process as well as by first come first served basis is changed frequently by the SEBI.

This process not only limits the ability of FIIs to invest in the NCDs as FIIs are first required to procure debt limits before purchasing NCDs in the market but of course affects their net return as the debt limits purchased is a cost to the FII. Such an arrangement places an undue burden on the FII since FIIs are required to account for the time and cost required to procure debt limits which is not the case with domestic investors. This also affects price discovery.

This is further aggravated by the fact that while FIIs originally enjoyed a period of fifteen working days for replacement of the NCDs that have either been disposed off or matured for example FIIs could reinvest the proceeds received on the expiry or sale of the initial NCDs into new NCDs provided such investments were made within the period of fifteen working days, this re-investment facility has been discontinued by SEBI since January 2012 for all new allocations of debt limits, as a result of which re-investment period shall not be allowed for all new allocations of debt limit to FIIs or sub-accounts. As regards debt limits that had been acquired prior to January 2012, the facility of re-investment will continue for the FIIs until any one of the following thresholds is breached: (i) total sales made from the existing debt portfolio (current debt investment and the un-utilized limit currently with the entity, if any) is twice the size of its debt portfolio as on the date of the circular, or (ii) expiry of two years from the date of the circular for example January 2, 2014 and up to 50 percent of their debt holdings at the end of the previous calendar year during each calendar year post that.

Thus, fresh debt limits paid for and acquired by FIIs in the bidding sessions post January 3, 2012 will lapse on either sale or at maturity and will be allocated in subsequent bidding processes. The FII now needs to purchase debt limits (in case the debt limits were procured post January 3, 2012) every time he wishes to buy NCDs which given auction frequencies also affects

their return since such amounts will remain un-invested for a period following sale or redemption of NCDs. Further, the move could discourage investments by FIIs in short term debt instruments as any FII would seek to invest only in long term debt instruments.

Thus the requirement of FIIs to procure debt limits every time they wish to buy NCDs should be done away with and any overseas investor dominance may be managed through reporting and by putting specific limits if the concern is that FII investment in a particular issuer or in the domestic debt market is becoming excessive.

CONCLUSION: Several measures have been taken to improve and develop the Indian bond markets. Nevertheless in our view the suggested fiscal and monetary reforms will go a long way in incentivizing the investors and will encourage wider participation not only by domestic investors but by foreign investors as well.

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The views expressed in the article are author's personal views

DEBT CAPITAL MARKET — REFORMS REQUIRED IN CORPORATE DEBT MARKET IN INDIA

INDIA NEEDS TO DEVELOP a viable corporate debt market to meet the projected investment of US\$ 1 trillion required to enhance the country's economic growth rate in the 12th five-year plan (2012–17), majority of which is expected to come from the private sector. A corporate debt market enables private industry to raise funds through debt instruments and channelize these into specific sectors, including infrastructure. Infrastructure financing in India depends on the growth of the corporate bond market. As the Raghuram Rajan report on financial sector reforms stated that a well developed corporate debt market provides a stable source of funds and thus reduces volatility in the equity market. Since the gestation periods of infrastructure projects are generally long, financing these through bank loans is not feasible. This is because banks accept deposits for 5–10 years and thus can not give 30-year loans for these projects, as this would create asset liability mismatch. But a bank would be perfectly comfortable buying a 30-year bond if a liquid market exists.

Despite strong economic growth and significant financial system reforms, India's corporate debt market remains underdeveloped. A major area of concern is that regulatory vision of the fixed income market is tinting with learning from the equity markets. Unfortunately, this hurts rather than helps the cause of developing the markets. Pushing corporate

debt market too fast into a compulsorily cleared and settled mechanism is likely to stunt the market rather than help its cause—because the nature of the players and the size of the deals make transactions infrequent, large and for big boys alone. The few dozen players in the market typically know each other and the size of many deals ensure that they are afraid of putting it in an anonymous order matching system as doing so would move the price. Finally, the lack of a yield curve makes it impossible to price corporate debt accurately as there is no benchmark on which to price such securities.

There are certain outstanding issues pertaining to the affairs of the fixed income market in India. Since every committee set up for the development of India's infrastructure has recognized the need for a well developed corporate debt market for the wholesome development of the country's infrastructure, the development of the debt market would be a key to higher growth for the Indian economy.

There is a need for an active co-operation among all the concerned regulators for example, RBI, SEBI, and the Ministry for Finance. The following are certain broad issues to be considered by the ministry and the concerned regulators to provide competitors with a level playing field in, and for creating a more active, transparent, and orderly growth of the corporate debt market in India.

Ministry of Finance

The following are certain issues which require the Ministry of Finance's attention in order to bring in policy reforms with respect to corporate bond markets in India:

First, the dissonance between the ECB borrowing limits (no overall cap) for companies and FII limits on corporate bonds make no sense from a policy perspective. The currency risk is borne by the investor in case of FII investment—by allowing a generous ECB borrowing and limiting the FII exposure to corporate debt we are importing currency risk by regulatory fiat. In any case, they do not substitute completely but complement each other.

Second, the current monopoly of the Clearing Corporation of India Limited (CCIL) in government securities trading and settlement has undercut the emergence of an arbitrage free yield curve. If what is known as a yield curve can not be formed out of risk free government securities, it would be impossible to form a curve of corporate debt market yields as corporate debt is priced at a premium to the riskless securities. For example, if risk-free one year government security yields an 8 percent per annum interest, an investment grade one year corporate debt may be priced to yield 11 percent and a more risky corporate debt at 14 percent. Similarly, a five year government security would be used to value five year corporate debt paper. In the absence of this reference rate at various maturities, the market for corporate debt is confused and remains underdeveloped.

Third, in a market where only institutions trade, and in a market where dematerialization and Permanent Account Number (PAN) exist, there is no need for imposing TDS on interest payments. Government securities and certain entities are exempt from TDS, making this an administrative nuisance and back office pain for dealing in corporate debt.

Fourth, there is a logical fit between the long tail of liabilities of pension funds and insurance companies and the possibilities of long duration corporate bonds. But today the investment guidelines create artificial allocation restricting the long-term buyers from

buying long dated corporate bonds, thus choking the supply of such instruments. Without demand from long term purchasers who are best suited to hold such securities, the market would not properly develop. Several of these would require policy and statutory modifications.

Securities and Exchange Board of India

The following are certain issues to be considered by SEBI in order to promote competition and innovation in, and for facilitating the development of the corporate bond markets in India:

First, SEBI currently mandate that a minimum net worth of INR 100 crores is required for a new stock exchange to enter the market. This acts as an entry barrier and is not good for healthy competition in the market—in a modern market, it is the clearance and settlement agency which bears the risk and capital requirement and thus requires to be capitalized.

Second, SEBI should permit Alternative Trading Systems (ATs) for corporate bonds. Corporate bond market requires a different system of bringing buyers and sellers together rather than forcing an equity like order matching and guaranteed settlement systems and further restricting trading to a single exchange may be counter-productive.

Third, current market conditions require that there should be consistency and standardization in coupon frequency and day count conventions.

Fourth, a clear demarcation between retail and wholesale Qualified Institutional Placements (QIPs) participants in corporate bond markets should be maintained while regulating them as QIP framework would greatly increase liquidity.

Fifth, the repurchase (sale and buy back) or repo market is essential in creating quick liquidity for investors and changing the dead weight view of corporate bonds (that they are can not be lent while holding them, making them unproductive during their life). In January 2007 Ministry of Finance has clari-

fied certain issues relating to regulatory jurisdiction of RBI and SEBI wherein it was clarified that SEBI has the power to regulate on-exchange repos. SEBI should use its powers to develop the market—which would reduce the dead weight value of corporate debt.

Sixth, SEBI reduced the mark to market requirement period from six month instruments to three months for mutual fund holdings. But investor demand for listed three months securities is cratering and it would be useful if SEBI clarifies that any instrument with upto six months maturity (listed or unlisted) would be carried at cost.

Reserve Bank of India

RBI's role as a regulator of banks is crucial for an efficient development of bond markets in India. Following are the issues to be considered by RBI in order to deepen the primary and secondary markets in the corporate bond market in India:

First, the limit of 5 percent on fixed income intermediary to act as broker should be done away with. Since a lot of active brokers do not exist in the debt market, the restriction leads to lack of transparency as a broker has to route its trade through another broker who provides no service to the client or to the market.

Second, the Negotiated Dealing System (NDS) traders in government securities do not pay 15 percent of the trade value of brokerage revenues as stamp duty. This creates a two tiered system and directs orders to a favoured institution, which is anti-competitive and against the interests of the players and the instruments. Just as public sector undertakings pay the same income tax and indirect tax as the private sector, the government should not pick a public sector organization as a winner.

Third, worldwide clearing corporations are competitive organizations and while CCIL should continue to perform its role in clearing NDS trades, it would be in the interest of

the country and its commitment to G-20 group of nations to settle more and more trades through a clearing corporation. This would not be possible if the country's only clearing corporation refuses to clear other exchanges' trades.

Fourth, RBI should allow banks to pay brokerage in the Interest Rate Swap (IRS) market. Not permitting it stunts the incentives to grow the market.

Fifth, volumes only in short end of spectrum—the corporate bond market is important for matching long-term asset and liability requirements of companies and investors but dated securities daily volume is often less than INR 200 crore. About 80 percent of corporate bond volume is short-term Certificates of deposit. There ought to be a policy encouragement towards developing the more stable long-term debt market which is also necessary for developing long gestation period infrastructure projects.

Sixth, risk weightage for corporate bonds – currently banks are required to provide a 100 percent risk weightage for corporate bonds irrespective of credit rating while cash and government securities carry no weight which is not a desirable policy outcome. There should be a graded approach to risk as equity, junk rated debt and AAA rated debt can not be treated the same. Doing so categorizes unequals as equals and therefore jeopardizes the market.

The above issues are vital from the standpoint of a healthy and orderly development of the debt market in India, which in turn would create the funding structure to finance India's infrastructure needs and would lead to grass-root development of the country.

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The views expressed in the article are author's personal views

RETAIL INVESTMENT IN CORPORATE BONDS — SUSTAINED, FOCUSED EFFORTS NEEDED

UNARGUABLY, THE DEVELOPMENT OF the corporate bond market is key to the creation of a mechanism to finance corporates and infrastructure projects and, thereby, lower the dependence on banks. Over the past few years, this has been an area of focus for policy makers. Various committees have recommended a slew of measures to that effect, such as the need for financial regulators to liberalize investment norms, launch of new products to enhance market liquidity, greater transparency in the secondary market and adoption of electronic trading mechanisms. Most efforts to create a strong primary and secondary market have been targeted at attracting institutional investors.

CRISIL believes that in addition to the focus on the institutional segment, there should also be a concerted effort to attract retail investments into the debt markets. The Indian investor has historically shown a preference to guaranteed return products such as bank deposits. As per the RBI Annual Report 2011–12, household savings in financial assets (retail investments) were close to INR 7 trillion, most of which were in debt oriented assets. Bank deposits were the most popular savings instrument with a 53 per cent share of the investor's wallet. CRISIL estimates the outstanding investments by the retail segment in debt products (including bank deposits) as of March 31, 2011 to be above INR 56 trillion (as shown in Table 1) of which bank deposits and small savings account for more than two-third of the investments. A combination of

measures like increase in investor awareness, development of new products, greater transparency and tax benefits can be used to route more retail investments into the corporate debt market.

Potential for Retail Investment in Debt

Investments in corporate bond markets can be either direct or indirect. Indirect channels include investments through mutual funds, insurance products and retirement products such as Employees Provident Fund Organization (EPFO) and National Pension System (NPS). The details of debt investments held by retail investors at the end of FY 2010–11 are provided in Table 1.

As per RBI annual reports, household savings in debt oriented assets, have grown by 10 percent per annum over the past five years most of which have flown into bank deposits. Even if a small proportion of these deposits are channelized towards corporate bonds, this market can witness a sea change in depth.

Table 1 reveals that bank deposits is the most preferred investment avenue with over 57 percent share, followed by insurance with a 21 percent claim in the total. Interestingly, one represents a direct channel and the other an indirect channel. Small savings, representing a direct channel, is in third place with a 11 percent share.

TABLE 1 | Retail investment in debt products (as on March 31, 2011, INR trillion)

Investment options	March 31, 2011 ¹	Percent
Direct channels	38.39	68.15%
Bank deposits	32.2	57.16%
Small savings	6.19	10.99%
Indirect channels	17.94	31.85%
Mutual funds	1.25	2.22%
Employees Provident Fund Organization (EPFO)	4.66	8.27%
National Pension System (NPS)	0.12 ²	0.21%
Insurance	11.91	21.14%
Total	56.33	100%

¹Source: RBI, Ministry of Finance, AMFI, EPFO, IRDA, and CRISIL estimates.

²As of 13th January 2012.

Presently, outstanding corporate bonds contribute 20 percent of the Indian debt market (excluding fixed deposits and small savings) which is around INR 51 trillion (as shown in Table 2). Money market instruments (commercial papers and certificates of deposits) represent about 10 percent of the total market size.

Given the retail investor's appetite for guaranteed return products, corporate bonds and money market instruments such as CPs and CDs represent competitive alternatives along with bank deposits. Retail investments through these avenues would also bode well to broaden the markets. Products from Indirect channels such as mutual funds are simple and efficient vehicles for participation in these markets as well. They offer products across investor needs such as liquidity, capital appreciation, flexibility (to enter and exit), target maturity etc. which help investors plan their finances better.

However, there are certain challenges that need to be studied and overcome. Some of these challenges include illiquid debt markets, high tax rates, and low investor awareness.

Key Measures to Enable Retail Investments in Debt

1. **Investor awareness:** This is one of the most difficult areas to handle. Communicating the benefits and risks associated with investments in debt, either through direct or indirect channels, requires a sustained effort on the part of policy makers and market participants. Interestingly, debt products are easier to explain than equity as in most cases the return (coupon) from debt can be stated upfront. This may however not apply to debt products offered through indirect channels such as mutual funds that are marked to market.
2. **Taxation:** It is a key driver for Indian investors for taking investment decisions. Compared to equity products, debt products are currently less tax efficient. Within debt products, mutual funds and insurance plans are relatively more tax efficient than direct investments. Tax sops have, in the past, helped channelize savings to financial assets such as insurance, retirement products, equity linked savings schemes and infrastructure bonds. A tax sop also has a positive

TABLE 2 | Size of Indian debt market and yields offered

Security type	March 2012 (INR trillion) ¹	Percentage of total	Yields as on October 31, 2012 ²
Government Securities (G-Secs)	25.08	49.14%	8.38%
State Development Loans (SDLs)	7.57	14.83%	8.84%
Treasury Bills (T-Bills)	2.77	5.43%	8.11%
Corporate Bonds	10.52	20.61%	9%–9.67%
Commercial Papers (CPs)	0.91	1.78%	9.25%
Certificates of Deposits (CDs)	4.20	8.22%	8.60%
Total	51.05	100%	

¹Source: RBI, SEBI.

²Source: CRISIL Research; The yields indicated for T-Bills, CPs (A1+ Rated) and CDs (A1+ Rated) instruments are for 1 year maturity; ⁴The yields indicated for G-Secs, SDLs and Corporate Bonds (AAA Rated) instruments are for 10 year maturity.

psychological impact as investors perceive this as recognition of the product by the government. Schemes such as Rajiv Gandhi Equity Savings Scheme (RGESS) can also be replicated for corporate debt products.

3. **Transparency:** This is critical for all products. Relevant, effective, timely and reliable disclosures made pre and post issue can help gain the retail investors' trust in corporate bonds as an investment avenue. Further, simple communication to investors on issues such as suitability of the product, impact of risks, return expectations etc. would help investors relate to the product better.
4. **Development of new products:** It is equally important to develop new products that are likely to meet varied investor needs such as known investment horizon and assured return. Structured products that incorporate these features can be an attractive option to draw investors. Deeper penetration of indirect products such as mutual funds, pension, and Portfolio Management Services (PMS) and insurance is also likely to help deepen the corporate bond market.

5. Usage of Exchange Traded Funds (ETFs):

Fixed income ETFs can be popularized as they have also emerged as a preferred vehicle for investment globally with 48 percent annualized growth as compared to 19 percent of overall ETFs in the last five years. Fixed income ETFs contribute close to 20 percent to the overall global ETF market of US\$ 1.35 trillion (Blackrock Advisors' Global Handbook). ETFs have inherent advantages like low cost, tax efficient, higher transparency, high liquidity, and low ticket size.

With the rising income levels of India's middle class, there has been a strong growth in savings, most of which has been parked in bank fixed deposits. Considering the retail appetite for debt products, corporate bonds can provide an attractive option provided there is a sustained and focused effort to address the issues on hand.

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The views expressed in the article are author's personal views.

BREATHING LIFE INTO THE DEBT MARKETS

INVESTMENT FOR ECONOMICALLY PRODUCTIVE purposes can be divided into three types: equity, short-term to medium-term debt and long-term debt. The requirement of these types of investments and their proportions will vary from industry to industry, will vary depending on the stage at which a company is at and will also vary depending on the purpose of the investment. If adequate funding in each of the three types is not available, then the economy is either constrained due to unavailability of a suitable form of finance or will take on additional risk by availing of a form of finance not suited to its requirement.

Focused and sustained efforts on the part of policy makers set forth in the 1990's has today led to a well developed equity market. With equity now at the disposal of companies, and the presence of several instruments to manage their short-to-medium term funding requirements, companies today are increasingly focusing on ways to fund their long-term funding requirements.

Currently in India, bank loans accounts for nearly 80 percent of the total long-term funding, while the balance 20 percent is in the form corporate bonds. But there are limitations on banks extending long-term loans and especially to infrastructure projects which have long gestation period, with short-term deposits, as it leads to a severe asset-liability mismatch exposing banks to risk. This issue is far less acute

in developed economies and other developing economies where long-term funding raised through corporate bonds is about 80 percent and 50 percent respectively. The lack of development of sources for long-term debt other than banks is likely to prove to be a constraining factor in the growth of the Indian economy.

The size of the Indian debt market, and in particular corporate debt market, is very small in comparison to both developed markets, as well as major emerging market economies. The ratio of debt capital market as a percentage of GDP in India is 34 percent whereas the same figure in a developed economy like US is 177 percent and in developing economies like Brazil and China is 68 percent and 49 percent respectively; highlighting the staggering difference in the depth of the debt capital markets between India and other economies. The difference is wider when we consider only corporate debt as a ratio of GDP, which is around 4 percent in India versus 130 percent in U.S., 19 percent in Brazil and 16 percent in China. This shows the dominance of Government securities in the Indian debt capital market.

Increasing Demand for Long-term Debt Capital

The demand for long-term debt financing has become all the more acute due to transformation of the economic and industrial landscape. Sectors that are most sensitive to financing

structures, due to heavy capital expenditure requirements, drawn out implementation / gestation timeline and long payback period, were in the past, predominantly owned by the public sector. With the economic reforms, public sector dominance has waned in recent years. Indian public sector investment as a percentage of total investment is today at about 25 percent compared to well over 50 percent in the 1980s. With accelerating increase in the degree of involvement of the private sector in infrastructure and heavy industries, the need for long-term funds, equity or debt, is only set to further grow.

While avenues exist for meeting equity requirements, the possibility of increase in availability of long-term debt funds seems bleak without policy changes and the emergence of an active secondary market for debt instruments.

An equally important perspective on the broad topic is that of the investors. Investors' preference vary depending on the appetite for risk, expectation of levels of return, income versus capital growth, marketability / liquidity, available expertise, expenses involved in investing and realizing investments. There would thus be investors with varying investment needs who are ready to invest and extend all three forms of funding for example, equity, short-term to medium-term debt and long-term debt.

Internationally, insurance companies and pension / provident funds are the main investors in long-term debt. With long-term liabilities, these companies actively seek secure long-term investments. But these institutions also carry an important fiduciary responsibility to their policy holders and pension / provident members, and they rightly prioritize safety and security of the investments over returns. But regulatory constraints and management preference in India have tilted the balance excessively towards safety and security and this has resulted in G-Secs heavily dominating the Indian bond market.

In 2011, the total outstanding government securities were close to INR 29 trillion, with a secondary market turnover of around INR 53 trillion. On the contrary, the outstanding corporate bonds were close to only INR 9 trillion. The turnover in corporate debt in 2011 was roughly INR 6 trillion and this was less than one-fifth

of the equity market turnover. Within the debt market, majority of the activity takes place in high rated bonds with more than 90 percent of the issues being rated AA or above.

Another important class of long term bond investors is the small retail investors. India with a domestic savings rate of around 34 percent with bank deposits accounting for most of this savings, bonds can be an attractive alternative investment option offering better return than bank deposits. Bond holders also have senior claiming rights on the company's assets, which gives them another layer of protection on their investments. Bonds offer a good balance between risk and return compared to bank deposits which offer lower returns, and equity, which is risky by its very nature.

Recent Reforms

Indeed, not all of this has been lost on our policy formulators, the government has unveiled certain initiatives and policy changes to widen the debt markets.

In order to attract foreign investors, the FII limit for investment in corporate bonds has been raised to US\$ 20 billion. In addition to this, a separate limit of US\$ 25 billion has been provided for investment by FIIs in corporate bonds issued by infrastructure companies. Additional US\$ 1 billion has been provided to the Qualified Financial Institutions (QFI).

To promote retail investment in infrastructure bonds, the government has enhanced the tax exemption to INR 20,000 for investors.

Credit Default Swaps (CDS) have been introduced on corporate bonds which will not only enable market participants to hedge credit risk but also allow banks and financial institutions to manage their balance sheet better.

Repo in corporate bonds has been permitted under a comprehensive regulatory framework.

The exposure norms for PDs have been relaxed to enable them to play a larger role in the corporate bond market.

To ease the administrative burden and reduce the compliance cost on issuers, SEBI has intro-

duced shelf prospectus valid for a period of 180 days for frequent issue of debt securities through private placement. Until now, the facility of shelf prospectus was only available for public issue of debt securities.

All these reforms have had a positive impact in enhancing the investor confidence in the corporate debt market, but steps need to be taken in further improving the transparency, liquidity, market infrastructure, and regulatory overview.

The Path Ahead

To provide further impetus to the debt markets, the industry awaits some key initiatives.

Measures taken by SEBI to simplify the listing requirements for debt securities and exemption of TDS for corporate debt instruments by the government of India have been aimed at reducing the cost and length of the issuance process and encouraging public issue of debt securities. However, significant work still needs to be done in rationalizing stamp duty structure across the country.

Steps should be taken to encourage institutional investor participation by easing restrictions on holding investment grade securities, revamping the cash credit system and statutory liquidity requirements of banks.

Steps to develop the securitization market by resolving key outstanding issues and by loosening restrictions on investments by insurance

and pension companies, will open up the market from both supply and demand perspectives.

Empowering bond holders under the “Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002” (SARFAESI) thus providing them a stronger means of realizing their claim on a company’s assets will further reduce risk.

Withholding tax on interest payment has been reduced from 20 percent to 5 percent, but in order to unconditionally support FII inflows into the debt bond markets, the government needs to reduce this tax as it is a major deterrent for FIIs from countries that do not have the DTAA in place with India.

Along with these, educating retail investors, promoting mutual funds and insurance companies to invest in bond markets would enhance the depth and liquidity of the markets.

A determined effort by policy formulators is required to breathe new life into the debt markets. This third pillar of funding avenue is as important as equity finance and short-term to medium-term debt to ensure a sustained and maintainable economic growth.

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The views expressed in the article are author’s personal views

NATIONAL GOLD PLUS SCHEME — TURNING INDIANS' GOLD OBSESSION TO INDIA'S ADVANTAGE

INDIAN'S OBSESSION WITH GOLD has made us the largest holder of gold in the world. Official estimate of our gold holding is about 18,000 tonnes. (This has remained constant for last three years notwithstanding annual imports in excess of 700–800 tonnes every year). Actual holding is likely to be multiple times of that with so many temple vaults and private lockers probably not accounted for.

In FY12, our entire current account deficit of US\$ 57 billion (net of software exports and remittances) would have turned positive if we had not imported gold worth US\$ 62 billion. This story has continued for last many decades where the entire current account deficit is contributed by the imports of gold, silver, and precious stones. In some sense, India is exporting its capital to gold, silver, and precious stones producing nations. Road shows which are being made to attract foreign capital in India will not be required if through some magic Indians stop importing gold, silver, and precious stones.

India pays a very high price for this gold obsession. Indians are investing a large portion of their saving in physical assets like real estate and gold reducing the financial resources for investment. A poor country like India pays a very high price for import of gold, silver, and precious stones in the form of weaker rupee, lower credit rating, higher depen-

dence upon foreign flows, lower investment, lower GDP growth and a substantial part of population living in poverty due to lower employment generation.

As an investor, I want the freedom to invest. I do not want any restriction on where I can invest. Investment is the prerogative of an individual. Gold has given pretty good return in last decade plus. It is an ideal hedge against country risk and unlimited printing of money by central bankers or unlimited borrowing by government. Gold is freely available across India and probably has a better distribution network than even the banking system. Number of jewellery stores outnumbers bank branches or insurance agents or mutual fund agents by a big margin. Attractiveness of gold also lies in the fact that it can be bought in cash. Most of the jewellery stores have 24x7 cameras which will be recording people who are buying gold by paying cash. May be IT authorities can question people based on that evidence. Gold is perceived to be liquid even though its liquidity is not tested. Jewellers are the only one who can provide liquidity to an occasional seller. (Albeit at a high bid offer spread). Banks are allowed to sell gold but not buy it back. Banks and gold finance companies provide short-term finance against the security of gold. These along with past returns has increased the attraction of gold for consumers and investors.

Regulators are trying to shift the allocation of domestic saving from gold to financial products. Measures like Gold Control Act, Gold Deposit Scheme, Gold ETFs, trading of gold derivatives on exchanges, tax incentives for financial products like insurance and mutual funds, levying of duty on gold imports have not slowed down Indian's appetite of gold.

A scheme with the following features can slow down gold imports and ensure that domestic saving is financially available for investment.

GOI should set up Gold Corporation of India (GCI) to market National Gold plus Scheme (NGPS). It should be sold through direct as well as alternate channels. It should be sold on line as well as off line. It should be sold across banks, post office, and GOI offices. It should be sold through jewellers, financial distributors and through brokers on exchange with appropriate incentives. A sustained advertising and marketing campaign should be provided to popularize NGPS. Special tax incentives on income tax (A small deduction for Investment in NGPS on the lines of mutual fund and insurance investment), wealth tax (exemption from wealth tax if gold is held in NGPS) and gift tax (exemption from gift tax if gold is gifted through NGPS) should be given to create a pull for NGPS similar to current financial products like mutual funds and insurance. A special provision of estate duty can be levied on transfer of physical gold to the next generation with exemption for NGPS.

NGPS should offer return equivalent to that of holding gold in physical form. It should provide redemption in physical gold if required by investors through tie up with banks and jewellers. It should give any time liquidity to investors. NGPS should match physical gold in terms of pre-tax return and outperform heavily in terms of post-tax return, liquidity, safety, convenience, safe keeping, and quality assurance.

Once NGPS is established it should be made compulsory for charitable trusts, temples and for high value gold buying in retail market.

GCI will have to pay gold linked return to investors. It will be futile to buy physical gold to hedge that risk. GCI can buy at the money, American call options on gold in global markets. Global markets provide options up to five years. Cost of call option varies from about 8 percent for one year to 22 percent for five year maturity. Buying gold options in the offshore market gives the benefit of historically low interest rates (lower US\$ interest rates compared to rupee rate reduces option cost significantly). Dollar denominated options also removes the need and cost of hedging rupee risk. Cost of option can be reduced significantly by providing preferential access to option writer in Indian financial markets. We need to learn from China and Russia how to leverage domestic market access on a quid pro quo basis. Delta hedging can be used to reduce cost of options even further.

GCI can invest residual money in gilts or PSU bonds to provide much needed alternative funding source to government. Lower GOI borrowing will release banking sector liquidity for private sector investments which will support growth. Added benefit of this surplus will be lower interest rates and accelerated GDP growth.

Safety of NGPS can be guaranteed by the government support and demat holding. Liquidity of NGPS can be made available from the gilt and options portfolio. Quality assurance is in-built in NGPS as it will provide return linked to benchmark 24 carat gold. Convenience of NGPS can be assured through nationwide distribution and strong marketing campaign.

Let's assume GCI pays 22 percent premium to buy American call option on gold at US\$ 1,770 strike price for five years. GCI can invest 78 percent of INR money received from Indian investors in gilts to get approximately 114.60 percent at 8 percent compounding. It will remain fully hedged on the gold return to be delivered to investors no matter where the gold prices move or rupee moves courtesy call options bought.

The benefits of lower gold import will be reflected by way of stronger rupee, lower interest rates, higher liquidity, higher invest-

ments, higher employment generation, higher growth, higher tax collection, lower trade and fiscal deficit, higher credit rating and lower poverty levels.

Obviously NGPS can not become success over night. But if executed well it can change the growth orbit of India and have immense beneficial impact on the future of India like the Green Revolution or Operation Flood.

In the true sense, NGPS can be “*sone pe suhaga*” for India.

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The views expressed in the article are author's personal views

ROLE OF PE IN THE INDIAN MARKET — THE INDIA PE MODEL

THE ROOTS OF PRIVATE equity (PE) in India took hold during the liberalization of the Indian economy in the early 1990s, which triggered unprecedented growth for the next twenty years. GDP rose almost 250 percent when adjusted for inflation and entrepreneurial activities expanded, as underscored by the 300 percent increase in the number of registered private companies.

This period not only transformed the Indian economy, but also established it as one of the world's most important emerging economies.

The post-liberalization period, especially the past decade, also saw the dramatic growth of India's public and private equity markets. As a result, the country enjoyed a rapid acceleration of Foreign Direct Investment (FDI), becoming one of the world's top ten FDI recipients in 2009. PE was instrumental in this acceleration, as evidenced by the fact that it accounted for more than one-third of all FDI flows into India in 2010.

Global interest in the Indian PE market was stimulated by the success of early pioneers. One of the most successful deals at this early stage was Warburg Pincus's backing of Bharti Tele-Ventures starting in 1999. The Bharti transaction has been rightly described by *The Economist* as "stuff that PE dreams are made of," as Warburg Pincus generated a near-600 percent cash return on its investment in just six years.

PE has played a central role in India's growth story over the last two decades by being a catalyst for the development of new businesses. Following early successes, the Indian PE market has grown robustly. For example, the value of PE investments in the country grew more than twenty times in less than a decade, to over US\$ 10 billion in 2011 from around US\$ 500 million in 2002. India thus has the highest PE penetration rate among BRIC countries.

India Is Structurally Attractive and a Key Destination for Investors

India has a huge population of 1.2 billion people, with a demographic shift that favors the workforce (i.e., ages 20–59). While most developed countries and even China will face the risk of an aging workforce, the share of Indians in their prime working years will increase.

As highlighted in both a new book by BCG partners, *The \$10 Trillion Prize: Captivating the Newly Affluent in China and India* and our report *The Tiger Roars* (BCG report, February 2012), the rise in household income, urbanization, the decline of the traditional joint-family structure and the coming of age of "Gen I" (i.e., Indians who were either born post 1991 or were under the age of 14 at the time) will additionally drive growth in the Indian consumer market.

We project that Indian consumer spending will more than triple between 2010 and 2020, to US\$ 3.6 trillion from US\$ 990 billion. This translates to an average annualized growth rate of nearly 14 percent, much higher than our projected rates of 5.5 percent globally and 9 percent for aggregate emerging economies. In the process, India will account for 6 percent of global consumer spending in 2020, double its current 3 percent share.

Indian Companies Poised to Benefit

India has a solid base of local companies that can take advantage of this potential. Companies like Tata Group and Bharti Airtel have, over the years, become effective global challengers that achieve success in their domestic market and expand operations across the world. Tata, for instance, owns established Western brands such as Jaguar and Land Rover. Bharti Airtel, which is among the largest telecom operators worldwide, has aggressively expanded its business in Africa and now has a presence in approximately 20 countries.

Indian companies have rewarded investors by creating more shareholder wealth than their developed—and emerging—markets peers since 2001. This bodes well for the growth of private equity in India.

Doing business in India presents private equity firms with a unique set of challenges.

Minority Stakes

In a majority of deals in India, PE firms own less than 25 percent of investee companies. This makes it more difficult for PE firms to effect operational and other improvements. As a result, they usually must adjust their approach in order to create value.

In addition, PE firms have to deal with strong original owners—both individuals and families—who have successfully developed their businesses thus far. Unlike in mature markets, where PE firms mainly deal with the management of a portfolio company, in India PE firms face a concentration of power and decision-making control in the hands of those who run the business. Given owners' deep involvement

in the operations of their companies, PE firms' ability to forge solid, trusting relationships is critical to the success of their collaboration. As an executive at one of the PE firms we interviewed put it, "We bet more on the entrepreneur than on the company itself."

Longer Holding Periods

As returns have declined (which we describe in the next chapter), PE firms have had to become more patient in exiting deals: Holding periods for the top 10 exits over the last 10 years have risen since bottoming in 2009, and reached a 10-year high in 2011. This has two key positive side effects. First, it creates an opportunity for PE firms to structurally change their relationship with portfolio companies. And second, it can help to sustain growth by driving operational improvements that require longer time periods.

An Emphasis on Growth

The nature of deals in India is very different from that in the US and other developed markets. While a majority of transactions in the US and Europe are buy-outs, India is a high-growth market where most PE deals involve companies in the early or expansion stages. Early and expansion deals predominated from 2002 to 2011, for example, accounting for 76 percent of total PE deals in 2011. Clearly, PE firms in India face challenges that come along with investing in growth companies, and must be prepared to provide sustainable support well into the future.

Growth is a complex business, and creating sustainable value requires companies to continuously adapt their business models to their environment and retune their organizations. Pushing for short-term growth without adapting their organization and business model can destroy value and put companies at risk.

PE-owned companies in the US and Europe have mainly focused on turnaround, post merger integration and resource optimization (example, capex, working capital). In the aftermath of the global downturn, by contrast, Indian companies require a different set of tools that address growth (example, entry into new markets, business-model innovation, etc.).

While portfolio companies must emphasize the challenges of growth to maintain competitiveness, they will have to strive for bottom-line improvements as well. Operational value in India can be created through a broad set of tools that focus on:

- Strategy / Governance (i.e., strategic planning, talent management, recruitment, professionalization of support functions)
- Top-line improvements (i.e., pricing, sales force effectiveness, marketing)
- Sustainable expansion (i.e., business-model development, geographical expansion, M&A)

PE firms will also have to dig deeper to access more deals and generate their own. As a PE managing director said, “We need to go outside the metropolitan areas to find deals.” PE firms will also have to create their own opportunities such as potential carve-outs or consolidations.

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NURTURING ENTREPRENEURSHIP ECOSYSTEM IN INDIA — TAKING A LEAF OUT OF JOBS ACT

The intention of American policy making is clear. Economic growth can only be sustained if it can distribute wealth equitably among all economic strata of the society. Facing signals of growth revival, and in order to achieve appropriate distribution of wealth among all income classes—enactment of JOBS (Jump-starting Our Business Start-ups) Act seems to be well calibrated attempt to induce investors to take risk in making US growth broad-based and employment-oriented. Vocal—media in the west, especially that of America have clearly indicated that wealth continued to accumulate with fewer and fewer hands. Despite all the safeguards, history had witnessed several exceptions to prevalent economic establishments and covenants.

No doubt that Sarbanes–Oxley Act came into being to make public enterprises more transparent enabling investors to take correct investment decisions and to make sure that corporations are accountable to its investors post the Enron fiasco. It's a well known fact that several firms (mainly belonging to financial services sector) especially during—the recent sub-prime crisis invented—new market accepted and regulatory compliant tools such as CDOs to make their accounting process and hence their investment decisions opaque in terms of pricing to the policy makers, market regulators and the investors / public. As it snowballed to attain a greater mass than it can sustain, it pained one and all in the in-

creasingly interconnected economic world. Recovery tells us that any level of economic growth will—remain sustainable when—the benefits of growth shall be distributed to more and more economic participants through appropriate policy measures.

As is the economic conundrum of 'Economic Growth versus Price Levels' so is the investment conundrum of 'Investor Protection versus Entrepreneurialism'. This time around, the US Government and the Congress seems to have opted for the later while letting the task of 'investor protection' to future capacity building measures to enable investors and entrepreneurs to better leverage the developments in information and communication technology while leaving the rest to the existing regulatory regime. Time will stand in testimony as to how the regulation promotes reasonable transparency and at the same time with measures which are light on potentially successful 'capital ideas'. An in-depth analysis of what the current JOBS Act relaxes and what it had kept status quo clearly indicates that the act tries to lighten that part of regulations which could promote entrepreneurialism while making an attempt to keep the process of future American economic growth more inclusive and hence sustainable.

Rightly identifying not only that the average number of IPOs per annum reduced from 442 to 117 during the decade of 2000 com-

pared with the decade of the 1990s but also that the average amount raised per IPO grew higher by 275 percent during the last decade compared with the 1990s, the current effort of the US Administration in terms of JOBS Act will go a long way to provide for healthy growth in the American IPO markets besides providing investors an entirely new asset class through the proposed 'Crowdfunding' mechanism. It is expected to nurture the entrepreneurship and put today's small and medium entrepreneurs with strong growth aspirations on the ramp to become tomorrow's main market fund raisers. Besides 'Crowdfunding', the act also allows the newly defined Emerging Growth Company (EGC—an acronym for SME entrepreneur / start ups with right ideas for growth sans access to capital) to raise funds from accredited investors which in our parlance indicates financial institutions and the high networth individuals who are expected to follow due diligence process in their investment decisions to the extent of US\$ 50 million per annum for the next five years from the date of their registration for a main market float until either their public float turns US\$ 700 million or the number of investing public increases to 2000 by which it becomes mandatory for them to register with SEC as the main market listed entity. Additionally, proposed measures under the act allows them to use all relevant means of solicitation to reach out to the accredited investors besides providing them the choice of filing mandatory financial information with the SEC in a confidential manner along with past 2 year's balance sheets to be made public.

A bird's eye view of the JOBS Act makes it clearly visible that it addresses the core issue for many of the start-ups until they hit the main market to sell their securities i.e. reduce the cost of funding and increase their access to common investors which have so far been limited to a handful of registered institutional players. A slew of measures including reduced reporting, auditing requirements, and exemptions from regulatory filing obligations and other regulatory requirements have been introduced to achieve cost savings for this new class of aspiring entrepreneurs giving them a five year grooming period until they hit the main market. 'Crowdfunding' is expected to provide com-

mon investors with an opportunity to realize the growth potential by offering risk capital besides providing the EGCs with much broader window to access the private placement market with less rigorous reporting and solicitation restrictions that are otherwise in force. These measures if implemented would help the EGCs 'test waters' before plunging into the main market. It takes the next step of providing merchant bankers and underwriters to share their research notes with possible investors keeping aside the fear of conflict of interests to be better managed by the emerging changes in the respective regulatory laws, rules, and procedures and that of the due diligence in what is called as increasingly technology' enabled era of Greenspan.

India's tryst with promoting entrepreneurialism also faced with similar constraints resulting in the birth of a new market place called SME exchange with rules of the game evolving to make it 'The Platform' for fund raising by the start ups before they hit the main market and for investors an opportunity to grow their wealth aligned to the fundamentals of those firms. At this stage of evolution of the SME platforms in India, JOBS Act and its proposed measures provides for core issues to focus in funding such as relaxing regulations to provide for well calibrated yet strong reporting requirements keeping investor interests intact. With transparency playing a critical role in making these measures help the EGCs raise risk capital at the lowest possible cost, it would be highly enlightening to see—how SEC evolves the nuts and bolts of the regulation in alignment with the spirit of the JOBS Act to promote capital access to entrepreneurs and broad-base economic growth, while leaving the task of picking the winning 'Capital Ideas' to the 'Wisdom of the Crowds'. It will be interesting to see the unfolding regulatory developments and stakeholder response post-JOBS Act to take a leaf or two for nurturing SMEs to make India's economic fundamentals more broad-based, inclusive and sustainable.

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The views expressed in the article are author's personal views

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12/12



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