A quantum leap

India's capital markets need regulatory streamlining, institutional development, and investor education

India can benefit by deepening its financial markets, especially the corporate and securitised bond market, to meet its massive infrastructure funding needs and unlock growth potential. In Part I of this series, we had focussed on market micro-structure issues, which are amenable to short to medium term measures. In this article, we will focus on three longer-term, but equally important enablers of financial deepening – the promotion of an end-to-end system that transforms saving into investment through the securities markets, the nurturing of an institutional investor base, and the promotion of financial literacy in retail markets to enable better and broader use of mutual funds by the growing middle class.

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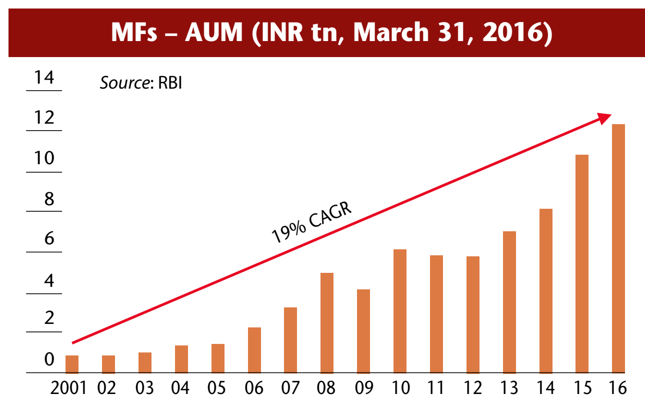
End-to-end system

The financial intermediation process brings together myriad savers and spenders. Investors and issuers try to maximise benefit by choosing the most advantageous security mix subject to the current and expected regulatory backdrop.

In India, as in many other countries, each type of institution and security has its own specific set of regulations, often administered by separate regulatory bodies. For example, the Reserve Bank of India (RBI) oversees banks and the FX market, while the Securities & Exchange Board of India (SEBI) focusses on equities. There are also separate bodies regulating pensions and insurance. However, this approach does not provide a seamless and consistent experience to the end users, namely investors and issuers, whose activities often span multiple industries, markets, and securities. Therefore, there is the opportunity to streamline and optimise the regulatory framework by taking a holistic view of the economy-wide financial intermediation process.



Some countries have had success with a special commission made up of key regulators who are charged with harmonisation of the regulatory framework. Others have appointed a lead minister or agency to look after the securities market. Regardless of the organisational structure, the goal must be to simplify and harmonise the regulations. Prudent regulation is paramount, but complexity and uncertainty are the enemies of a nascent market's development.

Growth needed

Securities market deepening and institutional advancement go hand in hand. The second major initiative would be to encourage the development of the pension (assets: Rs7.1 trillion in 2016), life insurance (investments: Rs25.0 trillion as of 31 March 2016), and asset management industries (equity and debt AUM: Rs17.0 trillion as of December 2016).

Typically, the pension industry has a long gestation period. India's large unorganised sector, ~90 per cent of employment, is an additional hindrance for achieving quick results. The voluntary contributory national pension system (NPS) open to all citizens is a great start. Making the provision of NPS compulsory for the corporate sector could speed up the development process. Contributory pension schemes could be supplemented by a reserve fund with budgetary resources to provide means-tested minimum old age income. This would be in line with but fiscally less demanding than the Universal Basic Income (UBI) discussed at length in the Economic Survey.

Over the years, the Life Insurance Corporation (LIC) has played a critical role in increasing insurance penetration in the country and still controls ~70 per cent of the market. But in the long-run, encouraging the private sector life insurance industry may result in greater product innovation and better capital allocation. The promotion of appropriately targeted property and casualty and health insurance business sectors, which have shorter maturity liabilities, would round out the liability profile.

India's asset management industry offers tremendous potential. Despite rapid growth,

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India's mutual fund assets under management (AUM) to GDP ratio at 11 per cent is well below ~90 per cent for the US, and ~45-50 per cent for the UK and Brazil. In addition, the top 15 Indian cities by GDP contribute more than 70 per cent of the AUM compared with about 15 per cent for the next 15 cities. To address this awareness gap, campaign to educate savers about the relative merits and risk-return potential of different instruments will channel savings towards the capital markets, benefiting the growing middle class and issuers alike.

Promote financial literacy

The NCFE, (National Centre of Financial Education) and CBSE (Central Board for Secondary Education), have launched the financial education training programme (FETP) to coach school teachers so that they can impart basic financial skills to students. This is a great initiative but carries implementation risk. There may be a case for introducing personal finance as core subject matter which is tested.

SEBI, with the 'Resource Person' programme, empanels and trains qualified individuals to provide financial education throughout the country. Financed by the SEBI, in all, about 1,300 certified teachers train groups of at least 50 people, leaving enormous room for growth. In addition, there is a case for making these sessions broadly available at institutions such as colleges, registered companies, and government offices.

India's high mobile penetration offers a 'leapfrogging' opportunity to enhance financial inclusion and literacy. The number of mobile phone users crossed the billion mark in 2016 and smart phone ownership is expected to reach 700-900 million by 2025.

Africa's success in mobile payments, for example, M-PESA's mobile payments platform, offers an example of the tremendous possibilities for financial deepening.

Financial leap

The financial markets are stuck in a low-level equilibrium trap, in which supply is held back by inadequate demand channels and a complex regulatory landscape. Capital markets deepening will require a simultaneous multi-dimensional effort on demand, supply, and regulatory channels.

The nascent instruments and institutions already exist. A nurturing regulatory framework can provide the necessary fillip to these incipient markets while, at the same time, keeping vigil to avoid a build-up of systemic risks.

Deep and rapid capital markets reform could be a key enabler for India's next growth spurt. ◆

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