Chapter III

INDIAN FINANCIAL SYSTEM – AN OVERVIEW

Introduction

The Indian financial system can be broadly classified into the formal (organized) financial system and the informal (unorganized) financial system. The formal financial system comes under the purview of the Ministry of Finance (MOF) Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI) and other regulatory bodies. The informal financial system consists of:

(i) Individual money lenders such as neighbors, relatives, land lords, traders, store owners and so on.

(ii) Groups of persons operating as funds or ‘associations’. These groups function under a system of their own rules.

(iii) Partnership firms consisting of local brokers, pawn brokers and non banking financial intermediaries such as finance, investment, chit fund companies.

In India the spread of banking in rural areas has helped in enlarging the scope of the formal financial system.
Components of formal financial system

Formal financial system consist of four segments, these are financial institutions, financial markets, financial instruments and financial services. Financial institutions are intermediaries that mobilize the savings and facilitate the allocation of funds in an efficient manner. Financial institutions are classified as banking and non banking financial institutions. Banking institutions are creator of credit while non banking financial institutions are purveyors of credit. In India non banking financial institutions namely the Development Financial Institutions (DFIs) and Non Banking Financial Companies (NBFCs) as well as Housing Finance Companies (HFCs) are the major institutional purveyors of credit.

Financial institutions are further classified as Term Finance Institutions such as Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Financial Corporation of India (IFCI), Small Industries Development Bank of India (SIDBI) and Industrial Investment Bank of India (IIBI). Specialized finance institutions like the Export Import Bank of India (EXIM), Tourism Finance Corporation of India (TFCI), ICICI Venture, Infrastructure Development Finance Company (IDFC) and sectoral financial institutions such as National Bank for Agricultural and Rural Development (NABARD) and National Housing Bank (NHB). Investment institutions in the business of mutual funds (UTI, Public Sector and Private Sector Mutual Funds) and insurance activity (LIC, GIC and
its subsidiaries) are also classified as financial institutions. There are state level financial institutions such as State Financial Corporation and State Industrial Development Corporation (SIDCs) which are owned and managed by the State Governments.

Financial markets are a mechanism enabling participants to deal in financial claims. Money market and capital market are the organized financial markets in India. Money market is for short term securities while capital market is for long term securities. Primary market deals in new issues, the secondary market is meant for trading in outstanding or existing securities.

Financial instrument is a claim against a person or an institution for the payment at a future date a sum of money or a periodic payment in the form of interest or dividend. Financial instruments may be primary or secondary securities. Primary securities are issued by the ultimate borrowers of funds to the ultimate savers e.g. Bank Deposits, Mutual Fund Units, Insurance Policies, etc. Financial instruments help the financial markets and the financial intermediaries to perform the important role of channelising funds from leaders to borrowers.

Financial services include merchant banking, leasing, hire purchase, credit rating etc. Financial services rendered by the financial intermediaries’ bridge the gap between lack of knowledge on the part of the investors and increasing sophistication of financial market and instruments.
The four components are interdependent and they interact continuously with each other. Their interaction leads to the development of a smoothly functioning financial system.

**Savings and Investment**

Saving is abstaining from present consumption for a future use. Savings are sometimes autonomous coming from households as a matter of habit but the bulk of the savings come for specific objectives like interest on income, future needs, contingencies, precautionary purposes, growth in future wealth, leading to rise in the standard of living etc.

Investment is the exchange of the money or cash for a future claim on money or the purchase of a security or a promise to pay at a later date along with a regular income as in the case of a share, bond, debenture etc. Investment is also a service like consultancy, construction, hotel or hospital and services in future as in the case of consumer durables.

Securities purchases are investment for the economy and some investments are offset by corresponding disinvestments. Gross investments are total investments made from all sources by an economy or a single economic unit and net investment are those which are gross investment minus disinvestments for an economic unit. Gross Assets and Investments minus Depreciation for the economy or a company or corporate sector or government sector is net investment, which is termed as capital formation.
Changes or fluctuations in economic activity may occur when investment spending is greater or smaller than the savings at a given level of income. The resources going into the productive process, i.e. capital formation, may have direct relationship with economic growth. All economic activities – agricultural, industrial or services – depend on the availability of financial resources. The amount of financial resources and the volume of capital formation depend upon the intensity and efficiency with which savings are encouraged, gathered and directed towards investment.

**Investment purpose**

The investment purpose of public may be set out in terms of their savings for:

(i) Transactions purpose (for daily needs or regular payments)

(ii) Precautionary purposes (for contingencies or special needs)

(iii) Speculative or asset purposes (for capital gains and building of assets).

**Investment for Consumption and Business**

The income is divided into two components namely Consumption and Investment. The amounts not consumed are saved and invested. Investments are also useful for present and future consumption in the case of consumer durables, cars, gold and silver etc. Investments generally promote larger
consumption in future as they lead to more income and larger capital appreciation in the years to come.

**Investment and speculation**

Purchases of assets like shares and securities can be for either investment or speculation or for both. Investment is long term in nature while speculation is short term. All investments are risky to some extent but speculation is most risky as it involves short term trading, buying and selling which may lead to profits sometimes and losses at other times.

**Financial Investment and Physical Investment**

The savings at household sector which account for the bulk of savings are measured by the total financial savings and savings in physical assets. The savings in financial form include savings in currency, bank deposits, non bank deposits, life insurance funds, provident and pension funds, claims on government, shares and debentures, units of UTI, mutual funds and trade debts. The currency and deposits are voluntary savings and motivated by transactions and precautionary motives and are governed by income and other incentives. The savings in life insurance, provident fund and pension fund are contractual savings governed by precautionary and contingency motives. The claims on government are compulsory deposits, tax credits and investment in government bonds, etc. The savings in the form of units, shares and debentures etc are
voluntary savings and are used for investment in the business sector directly or indirectly.

The gross savings of the household sector is around 19 percent of the GDP. This constitutes more than one third is in physical assets and three fourth in financial assets. The savings in physical form include agricultural implements, tools, tractors, consumer durables, gold, silver etc among the rural households and such items as real estate, buildings etc among all households. The savings in physical form are less productive while savings in financial form are more productive in various degrees depending on the efficiency of their rise.

The household sector in India has emerged as the single most important contributor to Gross Domestic Savings. A sustained annual growth rate of 10 percent can be achieved with the right policies aimed at increasing the domestic savings on the one hand and attracting a larger flow of capital from abroad, on the other.

Investment avenues

There is large number of investment avenues for savers in India. Some of them are marketable and liquid while others are more risky and less safe. Risk and return are the major characteristics which an investor has to face and handle. The investor has to choose proper avenues from among them
depending on his objectives, preferences, needs and abilities to take the minimum risk and maximize the returns.

**Return**

Return being prime mover to induce investment and probably is one to sustain it. Market participants are always tempted to scout for better investment alternatives for higher return or yield. But the measurement of investment return has an uphill task with investment literature because presence of idiosyncratic variables with regard to periodicity of return measurement and performance – return horizon. If the two coincides (which never do) the measurement criteria become very simple and straightforward.

**Risk**

Commensurate to investment objectives risks distracts investment flows with added agility. Conservatism is embedded in investors psychological texture while making investment decisions. Portfolio investment is primarily designed to mitigate risk through diversification.

**Risk and Return Relationship**

Risk and returns are positively related variables. These go along in the investment process: A higher return is always accompanied with a larger risk so that lower risk yields lesser return. Under such circumstances investors face dilemma as to preference for one and distraction for other. Therefore one is
destined to face the drama orchestrated by the risk return duo. Preference for one over the other determines the contour of investment philosophy followed by investors and fund managers. A conservative investor pre-empts risk reduction over return magnifications and thus search for such investments alternatives commensurate with given level of risk tolerance. Aggressive investors on the other hand pay more weight to return magnification and readily been the risk accompanied thus scout for investment alternatives commensurate on this risk return tolerance and preference.

The investor has to choose proper avenues from among them depending on his objectives, preferences, needs and abilities to take the minimum risk and maximize the returns.

The financial investment avenues are classified under the following heads:

1. Corporate Shares, Debentures, Deposits, etc.
2. Bank Deposits and Schemes
3. UTI and Mutual Fund Schemes.
4. Post Office Deposits/Certificates, etc
5. Government and Semi-Government Bonds/Securities
6. PSU Shares and Bonds.
Recent Trends in Indian Securities Market

Transfer of resources from those with surplus resources to others who have a productive need for them is perhaps the most efficiently achieved through the securities markets. Securities market provide channels for allocation of savings to investment and thereby decouple these two activities. As a result, the savers and investors are not constrained by their individual abilities, but by the economy’s abilities to invest and save respectively, which investably enhances savings and investments in the economy. Securities markets channel the savings to the most productive investments which increases the rate of return on investments. Thus the securities market fosters economic growth by augmenting the quantities of real savings and capital formation from any given level of national income and also by raising the productivity of investments by improving allocation of investible funds.

The securities market has two interdependent and inseparable segments, the new issues (primary) and the stock (secondary) markets. The primary market provides the channel for scale of new securities while the secondary market deals in securities previously issued. The prime signals, which subsume all information about the issuer and his business including associated risk, generated in the secondary market, help the primary market in allocation of funds.
The issuers of new securities in the primary market to raise funds for investment and/ or to discharge some obligation. They do so either through public issue or private placement. It is a public issue if any body and everybody can subscribe for the securities. If the issue is made to select people, it is called private placement. If the securities are issued exclusively to the existing shareholders it is called ‘rights issue’. If a public issue of the offer is made to public at large.

There are two major types of issuers who issue securities. The corporate entities issue mainly debt and equity instruments (shares, debentures, etc) while the governments (central and state governments) issue debt securities (dated securities and treasury bills).

The securities market has essentially three categories of participants, namely the issuers of securities, the investors in securities and the intermediaries. The issuers and the investors are the consumers of services rendered by the intermediaries while the investors are consumers of securities issued by the issuers. Those who receive funds in exchange of securities and those who receive securities in exchange for funds often need the reassurance that it is safe to do so. This reassurance is provided by law and custom often enforced by the regulator. The regulator ensures a high standard of service from the intermediaries and supply of quality securities and non manipulated demand for them. In the Indian context the regulators have an additional
responsibility of developing the market and also the responsibility of protecting the interest of investors in securities.

There are three main sets of entities depend upon securities market. The corporate and governments raise resources from the securities markets to meet their needs of investment and the house holds invest their savings in the securities. During 2003-04, corporate sector and governments together raised a total of Rs.267660 crores from the securities market while the household sector invested Rs.2254 crore of their financial savings through securities market. The central government and the state governments nowadays finance about two third and one third of their fiscal deficits respectively through borrowings from the securities market. Corporate sector finances about one third of its external finance requirements through the securities market. The household invest about six per cent of their financial savings in securities.

The societies for capital market research and development carries out periodical surveys of households to estimate the number of investors. The first survey was carried out in 1990 which placed the total number of share owners at 90-100 lakh. Their second survey estimated the number of share owners at around 140-150 lakh by mid 1993. Their latest survey estimates the number of share owners at around 2 crore by 1997 end. Approximately half of the share owners at the end of 2000 had, for the first time entered the market.
According to the first SEBI-NCAER survey of Indian investors 1999, an estimated 12.8 million or 7.6% of all Indian households representing 19 million individuals had directly invested in equity shares and debentures at the end of financial year 1998-1999. More than 156 million or 92% of all Indian households were non-investor households who did not have any investments in equity/debentures. The lack of awareness about securities market and absence of dependable infrastructure and distribution network coupled with aversion to risk prevents the non-investor households from investing in the securities market. An estimated 15 million (nearly 9%) of all households representing at least 23 million unit holders had invested in units of mutual funds.

According to the second SEBI-NCAER Survey conducted in late 2000, 13.1 million or 7.4% of all Indian households representing 21 million individuals directly invested in equity shares and/or debentures during the financial year 2000-2001. There were 19 million unit holders who had invested in units of MF’s in 2000-01. Of the 48 million urban households an estimated 8.8 million households (18%) representing 13 million urban investors owned equity shares and/or debentures. Of the 121 million rural households only about 4 million households or 3% representing nearly 6 million rural investors owned these instruments.

An indirect but very authentic source of information about distribution of investors is the data base of beneficial accounts with the depositories. At the
end of March 2004 there were 5.2 million and 0.6 million beneficial accounts with the National Securities Depository Limited (NSDL) and Central Depository Services (India) limited (CDSL) respectively.

Average annual capital mobilization by non government public companies from the primary market is about Rs.70 crore in 1960s and about Rs.90 crore in the 1970s, increased manifold during the 1980s, with the amount raised in 1990-91 being Rs.4312 crore.

The Indian Household investor’s Survey 2004 conducted by SCMRD has found that there has been great improvement in the general public perception about capital market regulation in India. The availability of good public issues (particularly PSU disinvestments) with the improved perception about regulatory effectiveness attracted the attention of investors to public issues.

Indian market is getting integrated with the global market through in a limited way through euro issues. Since 1992 when they were permitted access, Indian companies have raised over Rs.40,000 crores through ADR/GDR and ECBs.

The market is getting institutionalized as investors prefer mutual funds as their investment vehicle, thanks to the evolution of a regulatory framework for MFs, tax concessions offered by government and preference of investors for passive investing. Though the MF industry was opened up to private sector
only in the 1990s, the private sector MFs accounts for three fourth of the assets under management.

The primary issues of the central government securities have increased manifold during the decade of 1990s from Rs.8989 crore in 1990-91 to Rs.147636 crore in 2003-04. The yield on government securities has been declining over the years due to soft interest rates, comfortable liquidity and RBI undertaking substantial private placement. There is a conscious effort to elongate the maturity profile of the government securities issuing longer dated securities. The average maturity of securities issued in 2003-2004 increased to 14.94 years with the highest tenor being 30 years.

Stock Market Growth

The number of stock exchanges in India increased from 11 in 1990 to 23 now. All the exchanges are fully computerized and offer 100% on line trading. 9359 companies were available for trading on stock exchanges at the end of March 2004. The trading platform of the stock exchanges was accessible to 9368 stock brokers 829 derivative brokers and 12815 sub brokers from over 400 cities on the same time. The market capitalization grew ten fold between 1990-91 and 1999-2000. It declined thereafter following major market misconduct. It however picked up in 2003-2004 to Rs.13, 77, 612 crores which indicates the size of the market increased sharply to 60% by March 2000. Traditionally manufacturing companies and financial services sector accounted
for a major share in market capitalization. However in the recent past, the importance of these traditional sectors has declined and new sectors like information technology, pharmaceuticals and fast moving consumer goods have picked up.

The trading volumes on exchanges have been witnessing phenomenal growth during 1990s. The average daily turnover grew from about Rs.150 crore in 1990 to Rs.12000 crore in 2000. The turnover ratio which reflects the volume of trading in relation to the size of the market has been increasing by leaps and bounds after the advent of screen based trading system by the NSE. The turnover ratio for the year 2000-01 increased to 448 but fell substantially to 118 during 2003-04. The average trade size in the equity segments of the changes was about Rs.27000 during 2003-04. NSE is the market leader with over 89% of the total turnover in 2003-04.

**Derivative Trading**

Derivatives trading commenced in India in June 2000. The exchange traded derivatives witnessed a volume of Rs.21, 42, 920 crores with about 6 crore contracts during 2003-04. While NSE accounted for about 99.4% of the total turnover, BSE accounted for the balance. Mumbai contributed for about 48% of the total turnover indicating the all India participation in the derivatives market. Both in terms of number of contracts traded and national turnover in stock futures, NSE tops the list of world’s derivative exchanges. It is observed
that futures are more popular than options; contracts on securities are more popular than those on indices, call options are more popular than put options, and near month contracts are more popular than not so near month contracts.

In order to get rid of ills of paper-based securities and promote dematerialisation of securities, though the investors have a right to hold securities in any form, the regulator introduced some kind of compulsion through trading and settlement. At the end of March 2004 there are two fully operational depositories with about 4000 depository participants offering depository services from over 2000 locations. The growth of dematerialisation is considered as a success story in the Indian securities market as there are about six million beneficial accounts with these depositories.

The aggregate turnover in central and state government dated securities, including treasury bills, through SGL transactions increased 50 times between 1994-05 and 2003-04. During 2003-04 it reached a level of Rs.26,39,244 crore, higher than the trading volumes in cash or derivatives segments of all exchanges in the country, reflecting deepening of the market.

**Reforms in securities market**

Given the importance of securities market in the economy and the need of the economy to grow at the projected rate of six percent to eight percent per annum the authorities have been promoting the securities market as an engine of growth to provide an alternative but efficient means of resources
mobilization. Authorities have effected fundamental institutional changes in the market design in the last decade resulting in drastic reduction in transaction costs and significant improvements in efficiency, transparency and safety. They have ushered in as much as ten special legislative interventions during the last decade to support the reforms in the securities market, which is the most reformed sector in the Indian economy today. It acquired the first ever autonomous regulator in India. It gave birth to the first ever demutualised stock exchange in the world. It used satellite based communication technology for securities for the first time. It started real time live position monitoring of brokers. It is the first to introduce the straight through processing in securities transactions and has implemented T+2 rolling settlement. In many areas such as biometric based identification of market participants, disclosure and accounting standards, corporate governance rating etc have been introduced.

The Indian securities market is either the first or the best in the world. These have yielded considerable benefits to the market as evidenced by the growth in the number of market participants, growth in the volumes of securities transactions, increasing globalisation of Indian market, reducing in transaction costs and the level of compliance with international standards.

In order to improve market efficiency, enhance transparency, prevent unfair trade practices and bring the Indian market up to international standards a package of reforms consisting of measures to liberalize, regulate and develop
the securities market is being implemented since early 1990s. The issuers complying with the eligibility criteria were allowed freedom to issue the securities at market determined rates. The market shifted formally and completely from merit based regulation to disclosure based regulation. Domestic issuers/investors were allowed choice to raise resources/invest within/across the borders. Overseas issuers and investors were granted access to Indian market. The secondary market overcame the geographical barriers by moving to screen based trading. The trading system is now accessed through 10000 trading terminals spread across more than 400 cities/towns in the Indian subcontinent and also through the internet and hand held mobile devices from all over the world. All kinds of securities debt and equity, government and corporate – are traded side by side. Traders enjoyed counterparty guarantee. The trading cycle shortened to a day and trades are settled within 2 working days while all deferral products were banned. Physical security certificates almost disappeared. A variety of derivatives were permitted corporate governance practices improved significantly (Table Market Design)

**Securities**

The issue of capital to public by Indian companies is governed by the Disclosure and Investor Protection (DIP) Guidelines of SEBI. The guidelines provide norms relating to eligibility for companies issuing securities, pricing of
issues, listing and disclosure requirements, lock in period for promoters contribution, contents of offer documents, pre and post issue obligation.

**Capital Market Indicators**

**Eligibility**

An unlisted company can make public issue of equity shares or any other security convertible into equity shares, on fixed price basis or on book building basis provided –

(i) It has net tangible assets of at least Rs.3 crore in each of the preceding 3 years.

(ii) It has a pre-issue net worth of not less than Rs.1 crore in each of the preceding 3 years.

(iii) It has a track record of distributable profits for at least 3 out of the preceding 5 years and

(iv) The aggregate size of the issues made during the same financial year and the proposed issue does not exceed 5 times its pre issue networth.

An unlisted company cannot make allotment of the prospective allottees is less than 1000. A listed company can access market in a financial year to raise resources up to 5 times of its pre-issue net worth. If the company listed or
unlisted does not meet the above criteria the issue can be made only if it
satisfies two conditions: a) the issue is made through book building with
minimum offer of 50% of the issue size to Qualified Institutional Buyers or the
project has participation of at least 15% from FIs and 10% is allotted to QIBs
and (b) the minimum post issue face value of capital of the company is Rs.10
crore or there is market making for at least 2 years from the date of listing.
These provisions do not apply to a banking company, an infrastructure
company and right issue by a listed company.

**Pricing of Securities**

An eligible company is free to make public/rights issue of securities of
any denomination and at any price. It can issue the equity shares in the firm
allotment category at a different price than the price at which net offer to public
is made provided the former price is higher than the latter. It has option to
determine the price and justify the same in prospectus or may allow investors
to determine the price through book building. An eligible company is free to
make public or rights issue of equity shares in any denomination. However in
case of Initial Public Offer (IPO) by an unlisted company, the face value can be
less than R.10 (but not less than Re.1) if the issue price is Rs.500, the face
value shall be Rs.10.

The admission to a depository for dematerialisation of securities is a
prerequisites for making a public or rights issue or an offer for sale. The
investors have the option of subscribing to securities in either physical or dematerialized form. All new IPOs are compulsory traded in dematerialized form. Every public listed company making IPO of any security for Rs.10 crore or more is required to do so only in dematerialized form. A company cannot make a public issue unless it has made an application for listing of those securities with stock exchanges).

**Government Securities**

The issue is governed by the terms and conditions specified in the general notification of the government and also the terms and conditions specified in the specific notification issued in respect of issue of each security. Government issues securities with fixed coupon rates, floating rate bonds, zero coupon bonds and securities with embedded derivatives. The securities are issued through auction either on price basis or yield basis.

**Trading Platform**

The stock exchanges, recognized under the Securities Contract Regulation Act, are the exclusive centres for trading securities. Though the area of operation/jurisdiction of an exchange was being specified at the time of its recognition, they have been allowed to set up trading terminals anywhere in the country. OTCEI, NSE and ICSE were permitted since their inception to have nation wide trading. With the extensive use of information the trading
platforms of few exchanges are also accessible from any locations through the internet and mobile devices.

**Exchange Management**

Mumbai, Ahamedabad, Madhya Pradesh Stock exchanges are organized in the form of ‘Association of Persons while the balance 20 are organized as companies either limited by guarantee or by shares. Except NSE all exchanges are not for profit organisations. Most of the stock exchanges in the country are organized as ‘Mutuals’ which was considered beneficial in terms of tax benefits and matters of compliance. The trading members who provide brokering services also own, control and manage the exchanges. In the demutualised exchange, the ownership and management and the trading membership are segregated and vested generally with different set of persons. The exchanges (except NSE and OTCEI who are already demutualised) have been mandated by the securities laws (Amendment) Act 2004 to demutualised and corporatise themselves by an appointed date.

**Membership**

The trading platform of an exchange is accessible only to brokers. They execute trade on exchanges either on their own account or on behalf of their clients. Demutualised exchanges allow free entry and exit of brokers. No stock broker or sub broker is allowed to buy, sell or deal in securities unless he or she holds a certificate of registration granted by SEBI. The standards for
admission of members stress on factors such as corporate structure, capital adequacy, track record, education, experience etc and reflect a conscious endeavour to ensure quality broking services. Out of 9368 brokers registered with SEBI (March 2004) 3787 were corporate entities. There were 12815 sub brokers also registered with SEBI.

Listing

A company seeking listing satisfies the exchange that at least 10% of the securities subject to a minimum of 20 lakh securities, were offered to the public for subscription, the size of the net offer to the public (ie. the offer price multiplied by the number of securities offered to the public, excluding reservations, firm allotment and promoters’ contribution_ was not less than Rs.100 crore and the issue is made only through book building method with allocation of 60% of the issue size to the qualified institutional buyers. Otherwise it is required to offer at least 25% of the securities to the public. The company is also required to maintain the minimum level of non-promoter holding on a continuous basis. The basic norms for listing of securities on the stock exchanges are uniform for all the exchanges. The listing agreements prescribes a number of requirements to be continuously complied with by the issuers for continued listing and such compliance is monitored by the exchanges. It also stipulates the disclosures to be made by the companies and the corporate governance practices to be followed by them. SEBI has been
issuing guidelines/circulars prescribing certain norms to be included in the listing agreement and to be complied with by the companies. According to Delisting guidelines, a listed company can voluntarily delist its securities from a stock exchange after providing an exit opportunity to holders of securities at a price determined through reverse book building.

The new clause 49 of the listing agreement relating to the corporate governance has been finally notified with immediate effect. This clause though notified and amended earlier was put under suspension on account of certain difficulties faced.

**Capital Market Indicators**

**Turnover**

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<td>BSE + NSE</td>
<td>Rs. 172583 Crores</td>
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<tr>
<td>Market capitalisation BSE</td>
<td>Rs. 1698428 Crores</td>
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<tr>
<td>Market capitalisation NSE</td>
<td>Rs 1585585 Crores</td>
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<tr>
<td>Foreign Institutional Investors equity flow</td>
<td>Rs 7502 Crores</td>
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**Trading mechanism**

The exchanges provide an online fully automated screen based trading system (SBTS) where a member can punch into the computer quantities of securities and the prices at which he likes to transact and the transactions is executed as soon as it finds a matching order from a counter party. SBTS
electronically matches orders on a strict price/time priority and hence cuts down on time cost and risk of error as well as on fraud thereby resulting in improved operational efficiency. It allows a large number of participants, irrespective of their geographical locations to trade with one another simultaneously improving the depth and liquidity of the market. It provides full anonymity by accepting orders, big or small from members without revealing their identity thus providing equal access to everybody. Trading platform is also accessible to an investor through the internet and mobile services such as WAP.

**Trading Rules**

SEBI has framed regulations to prohibit insider trading as well as unfair trade practices. The acquisitions and takeovers are permitted in a well defined and orderly manner. The companies are permitted to buy back their securities to improve liquidity and enhance the shareholders wealth.

**Demat Trading**

There are two fully developed depositories which maintain and transfer ownership records in electronic form for the entire range of securities. A large variety of instruments including all securities and money market instruments are held in depositories. Investor is sovereign under the depository legislation which gives him the right to hold the securities in physical form or demat form. The depositories operate under the depositories Act, 1996 and SEBI
(Depositories and Participants Regulation) 1996. Stamp duty on transfer of demat securities have been abolished. Securities held in depositories are freely transferable. The admission to depository for dematerialisation of securities has been made a prerequisite for making a public or rights issue or an offer for sale. It has been made compulsory for public listed company making initial public offer of any security for Rs.10 crore.

**Charges**

The investors directly on indirectly pay different kinds of charges for securities transactions. These are ultimately paid to the exchange depositories, SEBI, state governments and central government. The Securities Transaction Tax (STT) is payable by the brokers. The maximum brokerage a trading member can levy in respect of securities transactions is 2.5% of the contract price exclusive of statutory levies like SEBI fee, service tax and stamp duty. Stamp duties are payable as per the rates prescribed by the relevant state. A depository is required to pay a registration fee of Rs.25 lakhs and an annual fee of Rs.10 lakhs to SEBI while a Depository Participant (DP) is required to pay a registration fee of Rs.1 lakh and an annual fee of Rs.1000.

**Trading Settlement**

The trades accumulate over a trading cycle of one day and at the end of the day, these are clubbed together and positions are netted and payment of
cash and delivery of securities settle the balance after 2 working days. All trades executed on day “T” are settled on T+2 day.

**Regulatory framework**

The four main legislations governing the securities markets are (1) SEBI Act 1992 which established SEBI to protect investors and develop and regulate securities market, (2) The companies Act 1956 which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of Securities and disclosures contracts (Regulation) Act 1956 which provides for regulation of transactions in securities through control over stock exchanges and (4) The Depositories Act 1996 which provides for electronic maintenance and transfer of ownership of demat securities.

**Regulators**

The responsibility for regulating the securities market is shared by Department of Economic Affairs (DEA), Ministry of Company Affairs (MoCA), SEBI and Reserve Bank of India (RBI). The activities of these agencies are co-ordinated by High level committee on Capital and Financial markets. The orders of SEBI under the securities laws are appellable before Securities Appellate Tribunals (SAT). The orders of the SAT are appellable only before the Supreme Court on points of law.
The powers of the Department of Economic Affairs under the SCRA are concurrently exercised by SEBI. The SEBI Act and Depositories Act are mostly administered by SEBI. The rules under the securities laws are framed by government while the regulations are framed by SEBI. The powers under the companies Act relating to issue and transfer of securities and non payment of dividend are administered by SEBI in case of listed public companies and public companies proposing to get their securities listed.

The securities market uses the services of a large variety of intermediaries to bring the suppliers of funds and suppliers of securities. All the intermediaries in the securities market are now registered and regulated by SEBI. A code of conduct has been prescribed for each intermediary as well as for their employees in the regulations; capital adequacy and other norms have been specified, a system of monitoring and inspecting their operations has been instituted to enforce compliance; and disciplinary actions are being taken against them for violating any regulation. All the intermediaries in the market are mandated to have a compliance officer who reports independently to SEBI about any non-compliance observed by him.

**Globalisation and Capital Market Reforms in India**

Globalisation aided by rapid absorption of technology has integrated financial markets as never before. Equity culture has therefore to address global issues as well. As it was impossible to leave and operate efficiently in
the past without being literate i.e., knowing how to read and write, so it is very hard to live and operate efficiently today without financially literate. Given the complexity of current financial instruments and financial decision required in everyday life from comparing credit card offerings to choosing methods of payments in deciding how much to save, when to invest and how to get the best loan, individuals need to know how to read and write financially. Therefore financial literacy has to play an important role for the balanced growth of Indian stock market in coming days.

Foreign institutional investors in Indian stock market are to assume both positive as well as negative effects. On the positive side they help to gain a higher degree of liquidity by increasing the price earnings ratios. On the negative side they are highly unreliable and cause severe market fluctuations. They are basically depend on short term games and withdraw funds as soon as they see slightest trouble which can shake the entire domestic economy and also lead to currency crisis. South Asian Financial crisis, Mexico crisis are best examples. However China’s economy is less risky and the percentage of domestic savings in capital market represents more proportion when compared to India. In order to maintain a stable growth of stock market excessive dependence of foreign institutional investors is to be reduced. The flow of investments of FIIs is extremely volatile compared to other forms of capital force. Investors often pull back portfolio investment if they loose confidence in host economy.
### Table 3.1

Year wise trend inflows of FIIs into Indian Capital Market

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (Rs in Crores)</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>2608.13</td>
<td>-</td>
</tr>
<tr>
<td>1994</td>
<td>6892.66</td>
<td>+4284.53</td>
</tr>
<tr>
<td>1995</td>
<td>4005.03</td>
<td>-2887.63</td>
</tr>
<tr>
<td>1996</td>
<td>9569.37</td>
<td>+5564.34</td>
</tr>
<tr>
<td>1997</td>
<td>6439.53</td>
<td>-3129.84</td>
</tr>
<tr>
<td>1998</td>
<td>-930.96</td>
<td>-7370.49</td>
</tr>
<tr>
<td>1999</td>
<td>6422.77</td>
<td>+7353.73</td>
</tr>
<tr>
<td>2000</td>
<td>6202.51</td>
<td>-220.26</td>
</tr>
<tr>
<td>2001</td>
<td>13144.45</td>
<td>+6941.94</td>
</tr>
<tr>
<td>2002</td>
<td>3734.92</td>
<td>-9409.53</td>
</tr>
<tr>
<td>2003</td>
<td>31325.35</td>
<td>+27590.08</td>
</tr>
<tr>
<td>2004</td>
<td>39200.27</td>
<td>+7874.12</td>
</tr>
<tr>
<td>2005</td>
<td>45963.37</td>
<td>+6763.10</td>
</tr>
<tr>
<td>2006</td>
<td>36541.01</td>
<td>-9422.36</td>
</tr>
<tr>
<td>2007</td>
<td>58000.00</td>
<td>+21458.99</td>
</tr>
</tbody>
</table>

*Source:* compiled form [www.bseindia.com](http://www.bseindia.com) & [www.nseindia.com](http://www.nseindia.com)

The above table depicts that the net investments by FIIs were increasing steadily from 2002 onwards except in 2006. The changes over the years are fluctuating very violently. However, there is tremendous increase in the inflows during the post liberalization period as it has been increased more than 22 times when compared to the inflows in 1993.

The Indian stock market is among the most volatile market in the world due to heavy investments by FIIs. One of the main reasons for volatility is due to lack of participation by the domestic savers.
Table 3.2

Volatility of the Asian Stock Market during 2007

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage of volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>India (BSE)</td>
<td>47.1</td>
</tr>
<tr>
<td>China (SSE)</td>
<td>96.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>52.0</td>
</tr>
<tr>
<td>Hongkong</td>
<td>39.3</td>
</tr>
<tr>
<td>South Korea</td>
<td>32.3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>31.9</td>
</tr>
</tbody>
</table>

*Source: NCEAR, 2007.*

From the above table it can be noticed that Chinese and Indonesian market how performed the Indian stock market in respect of volatility. The growth of share holding by FIIs is needed to be curbed. In order to achieve this mission the proportion of domestic savings need to be increased by appropriate equity culture through financial education to domestic savers.

Improvement of participation in financial market by domestic savers is a sign of equity culture. Unfortunately, Indian investors are investing very negligible portion of their saving in capital market. A developing country like India should have strong financial base for facilitating capital formation without much dependence on foreign institutional invertors. In the present day context the relevance of equity culture is more important for our country due to the following factors
1. Changing Demographics

The economic survey released by Union Ministry of Finance indicates that by 2015, 50 percent of the Indian population will be over 50 years. The country’s head counts will be 141 crores by 2026. The most significant part of this story is that the number of elderly people in India expected to go up significantly during this period. As a result the share of aged (those above 65 years) in total population raise to 8 per cent (11.6 crores) by 2026 from 4.7 percent (5.2 crores) in 2006.

Table 3.3

Estimates of patterns of population (in crores)

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2006</th>
<th>2011</th>
<th>2016</th>
<th>2021</th>
<th>2026</th>
<th>Increase between 2006-26</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 15 years</td>
<td>36.3</td>
<td>36.0</td>
<td>35.1</td>
<td>34.3</td>
<td>33.7</td>
<td>32.8</td>
<td>-8.91%</td>
</tr>
<tr>
<td>15-64 years</td>
<td>62.2</td>
<td>70.2</td>
<td>78.0</td>
<td>85.4</td>
<td>91.6</td>
<td>96.7</td>
<td>37.75%</td>
</tr>
<tr>
<td>Above 65 years</td>
<td>2</td>
<td>5.2</td>
<td>6.6</td>
<td>7.8</td>
<td>9.4</td>
<td>11.6</td>
<td>123.00%</td>
</tr>
<tr>
<td>Total</td>
<td>102.7</td>
<td>111.4</td>
<td>119.4</td>
<td>127.5</td>
<td>134.7</td>
<td>141.1</td>
<td>26.67%</td>
</tr>
</tbody>
</table>

Source: Economic Survey, 2005-06

The above table leads to a conclusion that the proportion of aged population is increasing over the period. Due to increase in longevity a large part of population should seek some other sources of income for a period of at least 10-20 years after their retirement. This emphasise the need for financial security in the later half of one’s life with financial plan. These demographic
trends point to a rising on dependency ratio (non working population to working population).

More over the society evolved in to the industrial age, people who worked in factories needed to leave their villages and housed in search of work to be production units were located. This migration started eating into the joint family support system as nuclear family’s units. In the mean time our economy has been rapidly evolving into a service economy with further fragmentation of families. These factors further calls for financial awareness in order to ensure financial security.

The Indian economy growth has seen the national income increase at a nominal rate of 14 percent plus over the last three years touching Rs 28,46,762 crores in 2005-06. Given a population growth rate of 1.1 percent the per capita income is also grown by the 14.3 percent raising from Rs 25716 (2005-06) to Rs 29382 (2006-07). This clearly indicates the raise if huge middle class in india. In fact the Indian middle class house holds expected to account for 40 percent of the total population in the next 20 years. The demographic changes underlined the need for a better financial education for a middle calls people.

**Changing Economic Environment and Pattern of Household Savings and Investment**

Pursuant to the process of globalisation the economic and financial landscape of India is undergoing a significant transformation. In the process the economy has more diversified with the new sources of growth. In tune with these changes, we have seen the modernization of financial sector that has also increasingly more diversified to meet new requirements of the economy.
Equity culture assumes importance in changed financial status of the families, financial literacy can play a major role by equipping consumers with the knowledge required to choose from a myriad of financial products and providers.

In India both savings and investment rates are growing but the cause of concern is where they are investing their savings. Investments in households have increasingly moved either to risk free, government backed, fixed return, low yielding investment or non-financial assets. As per RBI report, only 6 percent of household savings was invested in equity, mutual funds and debentures in 2006-07.

It is the household sector which occupies a position of dominance over other institutional sectors like private corporate sectors and public sectors in terms of generating savings. This sector is defined to comprise individuals, non-government, non-corporate enterprise. The rate of Gross Domestic Savings has proportion of Gross Domestic Product at current market price has increased more than thrice form an average of around 10 percent in 50’s to 34.3% in 2006-07.

According to Economic Survey 2007-08 the Per Capita Consumption in the current fiscal would be 57.56 percent of the income, a drop from the average 61 percent and 64 percent witnessed during 10th and 11th five year plans. With a Per Capita Income of Rs 29786 and consumption of Rs 17145, Indians on an average left with a surplus of Rs 12641 an amount nearly double what they retained during the 9th plan period.
Table 3.4

Financial and physical savings of household sector during the post liberalization period (as a percentage of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross financial savings (A)</th>
<th>Financial liability (B)</th>
<th>Net financial savings (A–B)</th>
<th>Physical savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993-94</td>
<td>12.8</td>
<td>1.7</td>
<td>11.1</td>
<td>7.4</td>
</tr>
<tr>
<td>94-95</td>
<td>14.4</td>
<td>2.4</td>
<td>12.0</td>
<td>7.8</td>
</tr>
<tr>
<td>95-96</td>
<td>10.5</td>
<td>1.6</td>
<td>8.9</td>
<td>9.3</td>
</tr>
<tr>
<td>96-97</td>
<td>11.6</td>
<td>1.2</td>
<td>10.4</td>
<td>6.7</td>
</tr>
<tr>
<td>97-98</td>
<td>11.3</td>
<td>1.6</td>
<td>9.7</td>
<td>8.0</td>
</tr>
<tr>
<td>98-99</td>
<td>11.9</td>
<td>1.5</td>
<td>10.4</td>
<td>8.4</td>
</tr>
<tr>
<td>99-2000</td>
<td>12.4</td>
<td>1.8</td>
<td>10.6</td>
<td>10.7</td>
</tr>
<tr>
<td>2000-01</td>
<td>11.7</td>
<td>1.5</td>
<td>10.2</td>
<td>11.0</td>
</tr>
<tr>
<td>2001-02</td>
<td>13.1</td>
<td>2.3</td>
<td>10.8</td>
<td>11.2</td>
</tr>
<tr>
<td>2002-03</td>
<td>12.8</td>
<td>2.5</td>
<td>10.3</td>
<td>12.7</td>
</tr>
<tr>
<td>2003-04</td>
<td>14.0</td>
<td>2.6</td>
<td>11.4</td>
<td>12.0</td>
</tr>
<tr>
<td>2005-06</td>
<td>14.1</td>
<td>3.8</td>
<td>10.7</td>
<td>11.7</td>
</tr>
</tbody>
</table>


From the above table 3.4 it is evident that the net financial savings were measured over a period at slow phase where as physical savings as consistently out phase in the financial savings. It can be deduced that domestic savings are not opting for financial savings which is more productive and rewarding. At the commencement of liberalization process the proportion of net financial savings are almost 150 percent of physical savings where as at present the financial savings are only 88 percent of physical savings of household sector. On this back ground let us make an analysis of savings pattern of Indian house
hold during the post liberalization period to access their performance in various financial assets.

Table 3.5
Saving pattern of households in India during the post liberalization period
(Rs in crores)

<table>
<thead>
<tr>
<th>Year</th>
<th>Currency</th>
<th>Bank deposit</th>
<th>Non-banking deposit</th>
<th>Life insurance</th>
<th>Provident and pension fund</th>
<th>Claims on Govt.</th>
<th>Shares and debentures</th>
<th>Units of UTI</th>
<th>Trade debt (Net)</th>
<th>Changes in financial assets (2-10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-93</td>
<td>6562</td>
<td>29518</td>
<td>6035</td>
<td>7114</td>
<td>14814</td>
<td>3885</td>
<td>8212</td>
<td>5612</td>
<td>(1398)</td>
<td>80354</td>
</tr>
<tr>
<td>93-94</td>
<td>13367</td>
<td>36236</td>
<td>11654</td>
<td>9548</td>
<td>18323</td>
<td>6908</td>
<td>10067</td>
<td>4705</td>
<td>(1190)</td>
<td>109618</td>
</tr>
<tr>
<td>94-95</td>
<td>15916</td>
<td>55835</td>
<td>11547</td>
<td>11370</td>
<td>21414</td>
<td>13186</td>
<td>13473</td>
<td>3908</td>
<td>(1148)</td>
<td>145501</td>
</tr>
<tr>
<td>95-96</td>
<td>16525</td>
<td>39941</td>
<td>13198</td>
<td>13894</td>
<td>22343</td>
<td>9588</td>
<td>8839</td>
<td>262</td>
<td>(252)</td>
<td>124337</td>
</tr>
<tr>
<td>96-97</td>
<td>13643</td>
<td>50902</td>
<td>25980</td>
<td>16121</td>
<td>30390</td>
<td>11783</td>
<td>6631</td>
<td>3776</td>
<td>(708)</td>
<td>158519</td>
</tr>
<tr>
<td>97-98</td>
<td>12780</td>
<td>74099</td>
<td>6733</td>
<td>19410</td>
<td>32267</td>
<td>22162</td>
<td>4464</td>
<td>595</td>
<td>(770)</td>
<td>171740</td>
</tr>
<tr>
<td>98-99</td>
<td>21822</td>
<td>79433</td>
<td>7670</td>
<td>23428</td>
<td>46408</td>
<td>28220</td>
<td>5105</td>
<td>1887</td>
<td>(6870)</td>
<td>207103</td>
</tr>
<tr>
<td>99-2000</td>
<td>20845</td>
<td>82892</td>
<td>3844</td>
<td>28644</td>
<td>53907</td>
<td>28985</td>
<td>16308</td>
<td>1811</td>
<td>(1023)</td>
<td>236013</td>
</tr>
<tr>
<td>2000-01</td>
<td>15632</td>
<td>94703</td>
<td>6911</td>
<td>33861</td>
<td>47882</td>
<td>39007</td>
<td>11148</td>
<td>934</td>
<td>(183)</td>
<td>248393</td>
</tr>
<tr>
<td>2001-02</td>
<td>28156</td>
<td>112936</td>
<td>7912</td>
<td>41237</td>
<td>46609</td>
<td>51938</td>
<td>9834</td>
<td>1857</td>
<td>(183)</td>
<td>296582</td>
</tr>
<tr>
<td>2002-03</td>
<td>28632</td>
<td>123462</td>
<td>8788</td>
<td>52009</td>
<td>48441</td>
<td>56087</td>
<td>7122</td>
<td>1618</td>
<td>(341)</td>
<td>322583</td>
</tr>
<tr>
<td>2003-04</td>
<td>42675</td>
<td>141967</td>
<td>3803</td>
<td>52240</td>
<td>48952</td>
<td>87372</td>
<td>9078</td>
<td>8586</td>
<td>(114)</td>
<td>377387</td>
</tr>
<tr>
<td>2004-05</td>
<td>36977</td>
<td>158259</td>
<td>3370</td>
<td>67986</td>
<td>56552</td>
<td>106420</td>
<td>8113</td>
<td>3146</td>
<td>(213)</td>
<td>434318</td>
</tr>
<tr>
<td>2005-06</td>
<td>51954</td>
<td>274693</td>
<td>6130</td>
<td>83540</td>
<td>62704</td>
<td>87168</td>
<td>29712</td>
<td>444</td>
<td>(222)</td>
<td>595235</td>
</tr>
<tr>
<td>2006-07</td>
<td>65427</td>
<td>422039</td>
<td>881</td>
<td>113900</td>
<td>69571</td>
<td>39197</td>
<td>48228</td>
<td>310</td>
<td>(183)</td>
<td>758750</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>56</td>
<td>0</td>
<td>15</td>
<td>9</td>
<td>5</td>
<td>6</td>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
</tbody>
</table>

It may be noted from the table 3.5 that the savings pattern of household are varying in nature and during the post liberalization period they are more interested in fixed return, financial assets rather than shares and securities. The percentage of bank deposits was increased from 37 percent in 1992-93 to 56 percent in 2006-07. A further look at the table shows that the preference of households in respect of shares and debentures reduced from 10 percent in 1992-93 to 6 percent in 2006-07.

It may be inferred that in spite of the introduction of a number of innovative financial instruments in the capital market investors are still going after less productive instrument avenues. This low preference towards financial instruments is due to lack of awareness among investors.

It is noted that the financial savings of the households are showing a decline over the recent years were as the physical savings are showing an increase in trend. Even in financial assets Indians are having an inherent reluctance towards financial investments in capital market.

**Table 3.6**

<table>
<thead>
<tr>
<th>Types of financial investment of households</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank/ Post office – liquid assets</td>
<td>65</td>
</tr>
<tr>
<td>Real Estate and Gold</td>
<td>23</td>
</tr>
<tr>
<td>Financial instruments</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
</tbody>
</table>

*Source: NCAER survey.*
The Table 3.6 indicates that Indians have been savings in fixed return products and almost neglected the capital markets. The skewed asset allocation has underlying the demand for a better equity culture for the Indian households.

The present study is having a different dimension and focuses, mainly on equity culture of investor in Kerala. This kind of study hasn’t been attempted so far by the researchers and therefore the research gap in this respect has properly identified and analysed and results were properly deduced. Hence the next chapter is devoted for the analysis and interpretation of primary data collected.

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