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CHAPTER-IX: INDIA INVESTMENTS – THE WAY FORWARD

& CONSTRUCTIVE SUGGESTIONS

Capital markets in any country play a pivotal role in the growth of economy and meeting the country's socio-economic goals. They are an important constituent of the financial system given their role in the financial intermediation process and capital formation of the country. The importance of capital markets cannot be under-emphasized for a developing economy like India which needs significant amount of capital for development of strong infrastructure.

The Indian economy's current size is approximately USD 1.2 trillion in 2010-11 with the savings rate of Indian households of 33.4%. In the next decade or so, it is expected that the economy will grow at an average rate of 8%. This translates into incremental savings of USD 5 trillion over the next decade. Comparatively, the US economy’s current size is around USD 13.22 trillion in 2010. Assuming a savings rate of 5%, it may not be a surprise if the amount of savings of Indian households exceeds savings of US households in absolute terms by 2020.

Also, Indian households have traditionally preferred safety of bank deposits and government saving schemes and much less than 10% of the their investments in financial assets is in shares, debentures and mutual funds, which is very low as compared to some of the developed economies.

Given the quantum of savings, the need to mobilize savings into productive channels and the opportunity for financial intermediation, the next decade will be an opportunity of a lifetime for Indian capital markets players.

The Government, the Regulators and the financial institutions have an important role to play in building a strong and robust capital market. The growth trajectory of a country’s capital markets is significantly influenced by the actions of these stakeholders. Concerted efforts of the Government and the Regulators supported by a long-term vision and clarity in action can significantly help in fostering a climate that is conducive to growth and investments.

Before diving deep into the Way forward & roadmap, it may be useful to pause and better understand the functions of an efficient capital market. Such functions comprise

- Mobilize capital from suppliers of capital;
- Create a platform to facilitate exchange of capital through buying and selling of securities and other asset classes;
- Facilitate price discovery in a quick and transparent manner;
- Facilitate settlement of transactions;
- Protect rights of the investors.

Components of the Indian Capital Market

In light of the above backdrop, this section of the report broadly analyses the current Indian Capital Markets, their constituents and the impetus required, especially from a regulatory
perspective to take the capital markets to the next level. This report is divided into the following segments:

- Equity Markets
- Debt Markets
- Commodity Markets
- Currency Markets
- Equity Market

The equity market comprises of the primary market and the secondary market with key constituents being Domestic Institutional Investors such as mutual funds and insurance companies like LIC, Foreign Institutional Investors and retail investors who directly participate in the capital markets.

Domestic Institutional Investors: The size of the Indian Mutual Fund industry (comprising both, equity and debt funds) is estimated at USD 162 billion.

Since the 1990s when the mutual fund space opened up to the private sector, the industry has traversed a long path. Assets under Management have grown at a CAGR in excess of 25% over the last four years, slowing down only over the last two years, as a fall out of the global economic slowdown and financial crisis.

As a Regulator focused on protecting retail investors' interests, SEBI has done a commendable job with the changes it has introduced in the regime in recent past such as abolition of entry load, abolition of additional management fee for schemes launched on “no load” basis, compliance with documentation/KYC norms, transferability of units of mutual funds, etc.

However, the industry continues to be plagued by low margins and stiff competition from other investment products such as those offered by of the life insurance industry and the portfolio managers. To develop the industry in a manner that is fair to all the stakeholders of the industry, amongst others, the following suggestions could be considered:

1. Allowing Asset Management Companies the flexibility to charge management fees. In a "perfect competition" scenario, the price of goods or services is efficiently determined by the market itself. There are more than 35 asset management companies with many other in the pipeline. Over a period of time, the market should be able to price the services provided by asset management companies in an efficient manner such that their interests are also protected.

2. Mutual fund distributors in India are largely unregulated. Further, there are instances of distributors rendering investment advice without requisite qualification, information of mutual fund schemes/investor and consideration of the investor’s needs. Distribution supported by quality investment advice is clearly the need of the hour. Herculean effort is required and the
entire asset management industry should work towards this goal. Regulation of the distributors by a Regulator can be a point worth debating. More importantly, SEBI should strongly reach out to create/support infrastructure to train the distributors to meet the needs of the investors.

3. There are a plethora of similar sounding schemes offered by the asset management companies resulting in a craving for lower number of schemes with similar investment strategy. Unfortunately, that is only one side of the story. The products are not innovative and offer limited asset classes with inadequate opportunities for diversification. SEBI and the mutual fund industry need to work towards amending mutual fund regulations and offering more diversified products such as Real Estate Mutual Funds, which despite enactment couple of years ago have not seen the light of the day! This will help in optimizing the utility of mutual funds as well.

4. As regards investment by pension funds, the current regulations allow only about 10 percent of the pension fund corpus to be invested in the equities market directly or through mutual funds. In contrast, internationally, up to 50 percent of pension funds are permitted to be invested in equities. Also there are certain restrictions on the exposure of insurance companies to the capital markets which reduces the much needed inflow of long term investments into the capital market. Moving the Indian pension funds and insurance companies closer to international levels could give a much needed boost to domestic institutional investor participation.

Foreign Institutional Investors

The number of FIIs/sub-accounts and the amount invested by them in the Indian capital markets is a reflection of the potential of the Indian economy. In the last decade, the investment by FIIs/sub-accounts has multiplied 7 times, it has already topped USD 12,289 million.

From time to time, SEBI has brought in changes which have supported the growth of investments by FIIs/sub-accounts. Some of the key changes include:

1. Qualified Institutional Buyers defined to include FIIs.

2. Allowing FIIs to invest in debt markets including corporate debt, government securities and security receipts issued by Asset Reconstruction Companies.

3. Permitting stock exchanges to allow Direct Market Access ("DMA") to institutional clients. An institutional investor can access broker's system from its office and can book orders directly into the system. In DMA, the brokers' infrastructure is bypassed. However, the trade and settlement obligations will continue to apply to the broker, as will the risk management compliance, which involves payment of margins and exposure limits.
arising from orders and trades in the DMA. The DMA system helps in better and faster execution of orders with avoidance of leakage of sensitive information of trades.

4. The concessional taxation regime for listed securities and for FIIs has also supported the growth of FII investments though more certainty around the taxation consequences and eligibility of treaty benefits is desirable.

5. A key change that could bring a paradigm shift in the asset management industry is allowing domestic fund managers to manage funds raised from offshore investors for investment in India. But for a taxation issue, such funds are being currently managed from more tax efficient jurisdictions such as Singapore. If the taxation regime were to be amended to provide for “safe harbor” rules exempting foreign funds from Indian taxation (in a manner similar to Singapore), then, the asset management industry would grow exponentially.

Retail investors

With a population of more than a billion, a mere 1% of the population participates in capital markets, and of that only a fraction is active.

1. One of the daunting challenges before the Indian capital markets is expanding the investor base and providing them access to high quality financial services. With a population of more than a billion, a mere 1% of the population participates in capital markets, and of that only a fraction is active. Trading volumes in Indian Capital Markets are lower as compared to other markets such as United States, the United Kingdom, Germany, China etc.

2. Similarly, Indian households invest much less in equity markets than do their developed market counterparts, particularly in the United States and the United Kingdom. As a result, retail equity ownership (non-promoter) amounts to only around 10 percent of total equity ownership, and has come down by 3 per cent over the last seven years. While corporates see markets to raise low cost risk capital, investors see liquid secondary markets for exit options. The regulated markets have grown significantly, but the markets need greater depth and liquidity.

3. Another challenge faced by the investors is the costs involved in trading (brokerage, commission, taxes etc.), which are comparatively higher in India than in developed markets. The investor participation is fairly shallow considering the size of the economy.

In order to overcome the above bottlenecks and to deepen the capital markets, participation of retail investors, directly and through intermediaries such as mutual funds and portfolio managers needs to be further promoted. This can be achieved only through investor education initiatives, development of quality independent financial advisors and using the Information Technology to reach out across the length and breadth of the country.
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Other aspects

Indian Depository Receipts ("IDRs"): IDRs are instruments in the form of depository receipts created by a depository in India against the underlying equity shares of the issuing foreign company. IDRs are an important step towards integrating Indian capital markets with foreign markets and enabling Indian investors to hold stake in foreign securities.

For various reasons, IDRs have taken more than couple of years to be operationalized. Also, there are certain unresolved tax issues relating to taxation of income from IDRs. For example, the concessional tax regime for listed securities does not extend to IDRs. Also, there is no clarity on taxability of conversion of IDRs into underlying foreign equity shares.

Further, IDRs could be made more attractive by introducing two way fungibility of IDRs and removing the mandatory lock-in of a year for conversion of IDRs into equity shares of the foreign company.

Securities Lending and Borrowing ("SLB") Scheme

SLB facilitates short-selling, increasing liquidity, improving pricing and arbitrage between derivatives and cash markets. SEBI amended the SLB scheme in January, 2010 with a view to make short-selling more accessible to investors. This move provides the investors including FIIIs to have greater opportunity to access the Indian securities market. However, there are certain issues revolving around this amendment like the use of stock lending by promoters, applicability of insider trading regulations and the takeover code.

1. In case of corporate action in SLB contract period, the lending and borrowing gets suspended. This condition should be relaxed.
2. Insurance companies should also be allowed to lend their securities, which is currently not permitted.
3. Presently, very high margins are required to be maintained under the SLB. SEBI should consider relaxing the same in the due course.

Small and medium size Enterprises ("SME")

SMEs seeking to list on stock exchanges need not have a track record of a minimum of three years in making profits and paying dividend.

Currently SMEs contribute 17% to India GDP and as per survey by ASSOCHAM; it is likely to be 22% by 2010. SMEs play an important role in the economy but their contribution to the main financial market is low. SMEs face a road block in the form of high cost of raising capital. SMEs lack access to formal capital market due to low credibility and low profitability.

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In order to enable Small and Medium Enterprises to raise finance through Capital Markets, SEBI has proposed to encourage promotion of dedicated exchanges and/or dedicated platforms of the exchanges for listing and trading of securities issued by Small and Medium Enterprises ("SME"). Certain relaxations are provided to the issuers whose securities are listed on SME exchange.

To ensure success of a SMEs-designated exchange, SEBI has proposed several incentives not available to other exchanges. The most striking one relates to doing away with Disclosure guidelines for SMEs. This means that SMEs seeking to list on stock exchanges need not have a track record of a minimum of three years in making profits and paying dividend. Doing away with this guideline is indeed a positive move toward the promotion of SMEs exchange as many SMEs might not have operated for the required number of years.

Further, to speed up the listing process and give greater flexibility to the disclosures made in the offer document, SEBI has also proposed that it would not vet the offer document. But the challenge before SEBI is to attract enough investors as many of them, because of fewer disclosures norms, may act cautiously while subscribing to shares of these companies.

Some concession is also proposed to be given to companies to reduce the cost and strain of publishing quarterly results. Thus companies seeking listing on the SMEs exchange will be allowed to publish their results every six months. While this measure will surely give a fillip to companies' interest in listing on the exchange; it would have to be ensured that it doesn't lead to excessive drop in investors' interest owing to an increased risk perception.

The SME exchange could prove to be a landmark development and help in promoting the vibrancy of our capital markets.

Exchange Traded Derivatives

Exchange traded derivatives like options and futures are hedging tools, used especially in a bearish market with lower transaction cost as compared to some of the other instruments. Since they are exchange traded, their pricing and volume transacted are transparent and are highly liquid. However, there is a risk of adverse price movement resulting into losses.

The trading of foreign exchange traded derivatives has emerged as very important financial activity all over the world just like trading of equity-linked contracts or commodity contracts. India's ranking in the global exchange-traded derivatives market continues to rise. According to latest volume rankings for the first half of 2010 by the Futures Industry Association (FIA), National Stock Exchange (NSE). India's ranking has improved by two places and it's now the fifth largest derivatives exchange in the world.
SEBI recently allowed physical settlement in equity derivatives and subsequently the Bombay Stock Exchange (BSE) also decided to replace the decade-old cash settlement procedure in the equity derivatives segment with physical settlement as a mechanism for better price discovery. SEBI’s nod for physical settlement is a regulatory response to the vulnerability of domestic markets and is perhaps aimed at ring fencing the stock markets from excessive shorting, which can often bring stock markets crashing down. Basically, it is a move to check excess volatility in the underlying cash market.

NEW Takeover Code SEBI constituted the Takeover Regulations Advisory Committee (‘TRAC’) in September 2009 to suggest recommendations for amending the existing Takeover Code. Accordingly TRAC submitted its report to SEBI which is currently implemented. The new takeover code which is in motion, has brought in major changes in regulations in India, including raising the open offer size to 100 per cent. Increase in the open offer would make takeovers more costly under the new rules. The cost of acquisition would also surge. But, from a shareholder’s perspective, the new rule is a big positive as it will give all shareholders an option to exit during the open offer.

The other major change includes the threshold to trigger the takeover code to 25 per cent. This is likely to open financing options for corporates. This would make it easier for companies wanting private equity money to raise the cash without attracting open offer provisions, up to 25 per cent.

Public Issue Regulations: SEBI notified the SEBI (Issue of Capital and Disclosure Requirements or ICDR Regulations, 2009) repealing the erstwhile SEBI (Disclosure and Investor Protection or DIP Guidelines, 2000). The ICDR Regulations attempts to streamline the framework for public issues by removing unnecessary stipulations, introducing market-driven procedures and simplifying the clutter of legality.

Minimum Public Shareholding: The Ministry of Finance recently brought the minimum threshold of public shareholding for all listed companies to 25%. The amendment was a move towards providing better liquidity to public shareholders and to reduce the scope of price manipulation.

**Debt Market**

**Corporate and Government Bonds:** In developed economies, bond markets tend to be bigger in size than the equity market. A well-developed capital market consists of both the equity market and the bond market. In India, equity markets are more popular and far developed than the debt markets.
The Indian debt market is composed of government bonds and corporate bonds. However, the government bonds are predominant (constituting 92% of the volume) and they form the liquid component of the bond market. An active corporate bond market is essential for India Inc. The corporate bond market is still at the nascent stage.

Although we have the largest number of listed companies on the capital market, the share of corporate bonds in GDP is merely 3.3%, compared to 10.6% in China 41.7% in Japan, 49.3% in Korea among others. Further, close to 80% of corporate bonds comprises privately placed debt of public financial institutions. The secondary market, therefore, has not developed commensurately.

Though there has been an increase in the volumes, the trading activity is still negligible in the secondary markets. If we look at the ratio of secondary market volume to primary market volume, the ratio is below 1 indicating very low trading activity in the secondary market.

SEBI has made efforts to facilitate trading of corporate bonds on the stock exchange platforms, however, government securities trading have turned out a better performance owing to several structural changes introduced by the Government and RBI.

Over the past few years, some significant reforms have been undertaken to develop the bond market and particularly the corporate bond market. The listing requirements for corporate debt have been simplified. Issuers now need to obtain rating from only one credit rating agency unlike earlier. Further, they are permitted to structure debt instruments, and are allowed to do a public issue of below investment grade bonds. One more welcome change was, the exemption of TDS on corporate debt instruments issued in demat form and on recognized stock exchanges.

Data released by SEBI indicates that companies raised Rs 2.12 lakh crore through corporate bonds in 2009-10, up 22.71% from Rs 1.73 lakh crore in 2008-09. India has witnessed a boost in trading in the recent past. Total trading in corporate bonds more than doubled from an average of Rs. 1,550 crore in October 2009 to Rs 3,356 crore in March 2010, as reported by the National Stock Exchange and the Bombay Stock Exchange.

In view of the current macroeconomic environment in India, the Indian government increased the FII investment limit in Government Securities and Corporate Bonds by USD 5 billion. Increased limits would open up new avenues for FII investment in debt and cater to
the growth of debt markets in the country.

In a recent move, SEBI has stipulated that all trades in corporate bonds would now be routed through stock exchange platform. This would help in reducing settlement risk and reduce transaction costs. At the same time the exchanges would document the trades, thus creating transparency as well as assist in price discovery. The transparent dissemination of corporate bond prices and quantities traded will also facilitate better participation by market participants. Based on the feedback received from market participants, SEBI also relaxed the exposure margin requirement for stock derivatives.

The challenges involved in developing the bond market in India include generating demand from domestic investors along with boosting market infrastructure and rationalizing the taxation regime. A liquid secondary market is necessary as investors get easy exit route. However, we do not have an active secondary market too. The exchange market is not active and the market is largely OTC.

The price of bonds is influenced by cost of rating, listing and marketing which makes them costly for investors. Stamp duty rates for primary issue of bonds are very high and differ from state to state.

Other markets have a much more diversified mix, with interest rate futures, foreign exchange futures and corporate bonds accounting for a sizable share of exchange trading. Deeper corporate debt markets also provide the required support to make a balanced capital markets.

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Effective reforms in corporate debt market could help support the growth of overall capital markets. Some of them have been listed below:

1. Required changes that can lead to the expansion of the Corporate Bond market would be means to uniform stamp duty, screen based trading clearing house settlement, increase in secondary market activity and thereby assist in transparent price discovery and avenue for early exits for investors and consequently also lead to more Issuers of long tenor debt.

2. The investment guidelines of provident and pension funds for investing in corporate bonds are stringent and biased towards category of issuers. There should be a gradual relaxation of investment restrictions and forced rule based buying on long-term investors such as insurance companies, pension funds and Banks. This will give the required flexibility in deciding the investments based on its merit. The insurance and pension segments will be crucial not just for increasing social security, but are also likely to emerge as a catalytic factor in development of long term debt markets in India, a crucial feature for the massive financing needs for infrastructure projects.

3. Consolidation of existing series of Government bonds to improve liquidity and facilitate better price discovery.

4. Relaxing FII limits for corporate bond participation when needed. Allow greater participation for FIIs (not just limited by their exposure) as it will help create liquidity.

5. Interest-rate derivatives are needed to hedge rate risks, the largest macro-economic risk. Make interest rate futures available on a broader range of securities (both long- and short-term).

6. Introduce interest rate options to attract a wider investor base.

7. Credit trading is an essential prerequisite for the development of the corporate debt market. Regulatory reforms are required in this space keeping in mind the learning from the International space.
8. The current withholding tax of 20% should be removed to encourage investors to invest in debt securities.

Islamic Bonds and other Shariah compliant investment products: Another debt instrument that has gained popularity in the worlds markets since 2007 is the Islamic Bonds. Islamic Bonds are asset backed interest free bonds. Islamic finance does not involve payment of interest and is based on sharing of both profit and loss. In India, the concept of Islamic bonds and other Shariah compliant products is yet to take-off but it certainly has immense potential.

The RBI should take the lead to encourage efforts to enhance the legal and regulatory framework required for Islamic finance to ensure uniformity with international practices. Also, steps to be taken for creation of awareness within the financial system and investor community and engage Shariah advisors to provide consensus, guidance to uphold Islamic financial products and structures.

Commodity Market: Commodities are emerging as an important asset class that can help market savvy investors diversify risks. The commodity markets have been growing at a phenomenal pace, as evident from the number of commodity exchanges set-up and proposed to be set-up (pending approval from the Regulator). In addition to augmenting capital markets, commodity markets have an important role to play in development of a country’s agricultural sector and related eco-systems.

Commodity markets have traditionally been quite volatile and hence, it is important to allow institutional investors to invest in commodity markets as they bring significant trading experience. Internationally, there are different ways in which mutual funds invest in commodity markets. Domestically, gold is the only commodity where retail investors can participate. Further, presently, other investors such as FIIs, banks, etc. are not permitted to invest in the commodities markets. These investors should be allowed to take exposure in commodity markets. If there are any concerns around excessive speculation, then, the same could be addressed by limiting exposures to certain amounts/ percentages, etc. or through other methods.

A key element for development of commodity markets is the presence of a strong regulator. Currently, the Forward Markets Commission ('FMC') acts as the regulator. As compared to SEBI, FMC has limited autonomy in making regulations or policy changes. The Bill to grant additional authority to the FMC has been pending enactment for several years now. It is imperative to pass the law as it will lead to the strengthening of the FMC and the commodity markets.

Currency Market: The currency derivatives segment on the NSE and MCX has witnessed consistent growth both in traded value and open interest since its inception. India already has an active over-the-counter (OTC) market in currency derivatives. The exchange-traded currency
futures market is an extension of this already available OTC market, but with added benefits of greater accessibility to potential participants; high price transparency; high liquidity; standardized contracts; counterparty risk management through clearing corporation and no requirement of underlying exposure in the currency. As the market participants are realizing these benefits of exchange-traded market in currency, they are choosing this market over OTC.

Stock exchanges in India will also be launching Options in Currency Derivatives soon. The RBI and SEBI have given in principle clearance to launch options in Currency Derivatives. Similarly, the Currency market should provide for diversified products such as futures and options on cross currencies and currency ETFs.

Summarized below are some recommendations which could move Indian capital markets closer to efficiency and scale greater heights

1. Investor education and regulation of mutual fund distributors
2. Allowing AMCs the flexibility to charge fees
3. Innovative products across different asset classes including operationalisation of REMFs
4. Amending tax regime to encourage domestic AMCs to manage foreign funds from India
5. Allowing higher investment by domestic institutional investors such as insurance companies, pension funds and provident funds to make investments in capital markets
6. Make tax regime friendly for issuers/investors of IDR$s
7. Make implementation of proposal of SME stock exchange effective.
8. Reduction in the current withholding tax of 20% on income from debt securities to encourage investment in debt market
9. Developing a legal and regulatory framework for Islamic finance and structure new capital market products that are Shariah compliant
10. Allowing institutional investors to participate in commodity markets
11. Strengthening the autonomy of the FMC.

The year 2009-10 was marked by the stabilizing operations of regulatory bodies in various segments of the financial market, with the support of a resilient regulatory framework. All measures and initiatives undertaken were dedicated to strengthen the financial market, while increasing reach and accessibility by introducing new range of product offerings, enhancing transparency and liquidity in the financial system.

The contours of the financial markets are expanding with the advent of new technology, innovations in products and fast changing customer expectations. The Indian financial services sector comprises a good blend of domestic and foreign participants. Opening up of the financial
markets has resulted in competition and greater efficiency; however, foreign participation could also bring in the baggage of increased risk and exposure as recent events have shown. Stability is therefore a critical need for financial markets for which safeguarding mechanisms need to be established, to prevent systemic risks and absorb shocks.

The equity market in India is extremely vibrant, but equity based funding solely, cannot lead the economy to growth. The debt market remains under-developed, with a huge potential for increased activity. A strong bond market is required to drive long term financing of infrastructure, housing and private sector development.

The role of capital markets is vital for enhancing growth in wealth distribution and increasing availability of funds for infrastructure development. One of the underlying challenges that the banking and financial services sector is dealing with is the issue of increasing the out-reach & enhancing financial inclusion.

The huge scale of the drive towards inclusive growth is intimidating, as various stakeholders like banks, insurance companies and asset management companies struggle to move a step closer to the untapped areas and newer target consumers.

The challenge lies in devising a cost-effective delivery model to reach out to the low income group of society, penetrating the remote areas. A debate on new banking licenses, banks developing and formulating strategies for inclusive banking and an increasing thrust on infrastructure financing, have been some of the initiatives which have been taken to give an added impetus to financial inclusion.

The road ahead for deepening the financial markets needs to be paved by the formulation of a strong linkage between the development of the economy and the capacity of the financial system.

The global financial environment is moving towards an integrated financial system, and will serve in good stead to standardize compliance norms and procedures. A greater measure of transparency is also required to be built into regulatory procedures, to bring in a new dimension to financial markets, and take it to the next level.

Global financial market conditions in Q1 of 2011-12

Global financial markets were generally in a corrective mode since end-April 2011. Stagnant real estate markets, high unemployment and weak sovereign balance sheets in Advanced Economies (AEs) continue to pose major concerns for the financial markets. In the IMF June 2011 Market Update of the Global Financial Stability Report, a rise in the financial risks was reported due to

(i) downside risks to the multi-speed recovery baseline;
(ii) concern about debt sustainability in Europe’s periphery; and
(iii) “Search for yield” pushing investors into riskier assets. The flattening of yield curves in
both AEs as well as Asian Emerging Market Economies (EMEs), particularly since end-
March 2011 suggest moderation in economic growth, albeit differentially, during 2011-
12.

- **Widening credit spreads, rating downgrades reflect micro and macro prudential risks**

On an average, credit spreads widened during Q1 of 2011-12 as balance sheet risks came to
fore. Sovereign Credit Default Swap (CDS) spreads rose sharply in the Euro Area following the
accentuation of the Greek debt crisis and the indications that the crisis may spread from
periphery to some core Euro zone countries (See Chart).

Rating downgrades or downward revision of outlook in case of the US, Japan, Spain and Italy
impacted financial market confidence that were reflected in widening spreads. Amplification of
refinancing risks in Greece and Portugal and the sharp four notch downward revision by
Moody’s of Portugal’s credit rating to junk status with a negative outlook in early July
reconfirmed the Euro zone fragilities.

![Chart 1: Indicators of Global financial market developments](chart.png)

Recapitalization of the banking system in the fragile Euro zone countries is the most important
element of an enduring Euro zone solution. The stress tests conducted by the European
Banking Authority (EBA) have not succeeded in restoring confidence amongst investors and
creditors. The EU needs to deal with capital shortfalls for banks that fail stress tests, but market
access is limited for weaker sovereigns like Greece, Portugal and Ireland. On the other hand,
with hardly any fiscal space and the potential moral hazard risk from bailouts, the solution is not easy. Euro zone risks may lead to global financial market volatility.

- **Financial risks increased while interest rates softened**

While interest rates are firming up in the Indian economy, global financial markets witnessed rising financial risks and softening interest rates in Q1 of 2011-12. Libors for 1-month to 1-year tenors edged down marginally even from the low prevailing rates. G-secs yields across maturity spectrum eased by 30-50 bps in 5-10 year segment for the US, the UK and Germany. Falling interest rates co-existed with

1. policy rate hikes by some AE central banks, most notably by the ECB in April and again in July,
2. rising sovereign and credit spreads and
3. inflation in the AEs with escalating energy and food prices that have spilled over to rising producer price and headline inflation. It remains to be seen whether the movements in interest rates reflect temporary overreaction or are on the basis of expectations of future global growth.

- **Indian financial markets remain orderly and range bound**

Even as domestic and global factors resulted in two-way movements in the Indian financial markets, asset price movements remained broadly range-bound and orderly. This was despite the challenges posed by persistent inflation, tight liquidity conditions and uncertainty in the international markets on account of Greek sovereign debt crisis and slowdown in AEs.

The call rate declined in the beginning of Q1 of 2011-12 on the backdrop of surplus liquidity, but firmed up thereafter, in step with policy rate hikes since May 2011. The interest rates on commercial paper (CP) and Certificates of Deposit (CDs) moved in tandem with the overnight money market rates. The yield curve for Government securities (G-sec) shifted upwards during the first two months of the quarter in line with the policy rate hike, but moderately shifted downwards in June 2011.
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& CONSTRUCTIVE SUGGESTIONS

<table>
<thead>
<tr>
<th>Items</th>
<th>Stock Price Variations (Per Cent)</th>
<th>P/E- Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia (Jakarta Composite)</td>
<td>93.7</td>
<td>32.5</td>
</tr>
<tr>
<td>Brazil (Bovespa)</td>
<td>71.9</td>
<td>-2.5</td>
</tr>
<tr>
<td>Thailand (SET Composite)</td>
<td>82.6</td>
<td>32.9</td>
</tr>
<tr>
<td>India (BSE Sensex)</td>
<td>80.5</td>
<td>10.9</td>
</tr>
<tr>
<td>South Korea (KOSPI)</td>
<td>40.3</td>
<td>24.4</td>
</tr>
<tr>
<td>China (Shanghai Composite)</td>
<td>31</td>
<td>-5.8</td>
</tr>
<tr>
<td>Taiwan (Taiwan Index)</td>
<td>52</td>
<td>9.6</td>
</tr>
<tr>
<td>Russia (RTS)</td>
<td>128</td>
<td>30</td>
</tr>
<tr>
<td>Malaysia (KLCI)</td>
<td>51.3</td>
<td>17</td>
</tr>
<tr>
<td>Singapore (Straits Times)</td>
<td>69.9</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Table 1: Stock price movements and PE ratios in EMEs (Year-on-Year variations)

@: Year-on-year variation. *: Variation Over End-March 2011 Source: Bloomberg.

Chart 2: Movement in money market rates and turnover

Researcher: CVSL Kameswari
CHAPTER-IX: INDIA INVESTMENTS – THE WAY FORWARD

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Stock prices fell during Q1 of 2011-12, albeit at a lesser pace than that of other BRIC nations, influenced by domestic and global concerns. There was, however, some rally towards the end of the quarter due to FI inflows. The P-E ratio of Indian equities was higher than those of other BRIC nations (See Table). On a quarter-on-quarter basis, prices in the housing market firming up during Q4 in majority of cities tracked by the Reserve Bank after showing signs of moderation during Q3 of 2010-11.

- **Money market rates firm up on tight liquidity and rate hikes but do not exhibit signs of stress**

Short-term rates moved up further, but there were no signs of stress in money markets. The interest rate movement tracked the 75 bps repo rate hike during the quarter and the tight liquidity conditions. Monetary transmission strengthened further during Q1 of 2011-12.

The call rate, which had declined in April 2011 on the back of easing of liquidity conditions, firming up thereafter, in response to the increase in the repo rate in May and June 2011 (See Chart and Table). The rates in the collateralized segments (i.e., CBLO and market repo) moved in tandem with the call rate, but generally remained below it.

Transaction volumes in the CBLO and market repo segments were higher during the Q1 of 2011-12 than in the preceding quarter (See Table). During the quarter, banks and primary dealers were the major groups of borrowers in the collateralized segments whereas mutual funds (MFs) contributed nearly three-fourth of the total lending in CBLO, and more than half in market repo segment. The collateralized segment of the overnight money market remained dominant, accounting for more than 80 per cent of the total volume during Q1 of 2011-12.

<table>
<thead>
<tr>
<th>Call Rate*</th>
<th>Market Repo Rate (Non-RBI) %</th>
<th>CBL Rate %</th>
<th>Commercial Paper WADIR %</th>
<th>Certificate of Deposit WAEIR %</th>
<th>G-Sec 10-year yield @ %</th>
<th>Corporate Bonds Yield AAA 5-Yr bond %</th>
<th>Exchange Rate@ (7/US$)</th>
<th>CNX Nifty #</th>
<th>BSE Sensex #</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar-10</td>
<td>3.51</td>
<td>3.32</td>
<td>3.15</td>
<td>6.29</td>
<td>6.07</td>
<td>7.94</td>
<td>8.61</td>
<td>45.5</td>
<td>5178</td>
</tr>
<tr>
<td>Mar-11</td>
<td>7.15</td>
<td>6.56</td>
<td>6.46</td>
<td>10.4</td>
<td>9.96</td>
<td>8</td>
<td>9.23</td>
<td>44.99</td>
<td>5538</td>
</tr>
<tr>
<td>Apr-11</td>
<td>6.58</td>
<td>5.55</td>
<td>5.63</td>
<td>8.62</td>
<td>8.66</td>
<td>8.05</td>
<td>9.25</td>
<td>44.37</td>
<td>5839</td>
</tr>
<tr>
<td>May-11</td>
<td>7.15</td>
<td>7.05</td>
<td>6.94</td>
<td>9.49</td>
<td>9.3</td>
<td>8.31</td>
<td>9.48</td>
<td>44.9</td>
<td>5492</td>
</tr>
<tr>
<td>Jun-11</td>
<td>7.38</td>
<td>7.3</td>
<td>7.06</td>
<td>10.15^</td>
<td>9.61</td>
<td>8.28</td>
<td>9.63</td>
<td>44.85</td>
<td>5473</td>
</tr>
</tbody>
</table>

*Table 2: Domestic financial markets at a glance

*: Average of daily weighted call money borrowing rates. #: Average of daily closing indices.
@: Average of daily FIMMDA closing rates. @@: Average of daily RBI reference rate. ^: As at mid-June 2011.
WADIR: Weighted Average Discount Rate. WAEIR: Weighted Average Effective Interest Rate.

Researcher: CVSL Kameswari
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<table>
<thead>
<tr>
<th>Money Market</th>
<th>Bond Market</th>
<th>Forex Market</th>
<th>Stock Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>LAF</td>
<td>Call Money</td>
<td>Market Repo</td>
<td>CBLO</td>
</tr>
<tr>
<td>Mar-10</td>
<td>37,640</td>
<td>8,812</td>
<td>19,150</td>
</tr>
<tr>
<td>Mar-11</td>
<td>-80,963</td>
<td>11,278</td>
<td>15,134</td>
</tr>
<tr>
<td>Apr-11</td>
<td>-18,809</td>
<td>13,383</td>
<td>14,448</td>
</tr>
<tr>
<td>May-11</td>
<td>-54,643</td>
<td>10,973</td>
<td>15,897</td>
</tr>
<tr>
<td>Jun-11</td>
<td>-74,125</td>
<td>11,562</td>
<td>16,650</td>
</tr>
</tbody>
</table>

Table 3: Domestic financial markets at a glance
Amount in Rs Crores; *: Outstanding position. @: Average daily outright trading volume in Central Government dated securities. #: Volumes in BSE and NSE. ^: As at mid-June 2011. **: Up to June 24, 2011.
Note: In col. 2, (-) ve sign indicates injection of liquidity while (+) ve sign indicates absorption of liquidity.

With from strong growth in retail deposit mobilization, banks offered a relatively lower rate of interest on CDs during 2011-12 so far (up to June 17) compared with the previous quarter. The CD issuance declined in Q1 of 2011-12. In contrast, the CP issuance increased. The ‘leasing and finance’ and ‘manufacturing companies’ were the major issuers of CPs (See Chart).

Primary yields on Treasury Bills (TBs) firmed up during Q1 of 2011-12 in line with the spike in short-term interest rates (See Table). The rise in yields reflected a sharp increase in Government short-term borrowing, through issuances of TBs over and above the amount as per the indicative calendar announced in March 2011 as also through issuances of Cash Management Bills (CMBs) to meet the unanticipated sharp cash flow mismatches, particularly, in the wake of large tax refunds.

▸ Yield curve flattens with sharper rise at the short end

Reflecting the larger than anticipated issuances of TBs and CMBs by the Government, and the higher than expected hike in the Reserve Bank’s policy rate in May 2011, the G-sec yield curve shifted up, particularly at the short end, flattening the yield curve. The rise in yields across the maturity spectrum also reflected the increase in the global commodity prices, including crude oil, and persistent high inflation. The yield curve, however, moved downward thereafter in the wake of growth concerns and moderation in crude oil prices (See Chart).
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Chart 3: Major issuers of commercial paper

<table>
<thead>
<tr>
<th>Year/ Month</th>
<th>Notified Amount (Rs. crore)</th>
<th>Average Implicit Yield at Minimum Cut-off Price (Per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>91-day</td>
</tr>
<tr>
<td>2009-10</td>
<td>3,80,000</td>
<td>3.57</td>
</tr>
<tr>
<td>2010-11</td>
<td>3,03,000</td>
<td>6.18</td>
</tr>
<tr>
<td>Apr-11</td>
<td>30,000</td>
<td>7.32</td>
</tr>
<tr>
<td>May-11</td>
<td>44,000</td>
<td>8.05</td>
</tr>
<tr>
<td>Jun-11</td>
<td>53,000</td>
<td>8.21</td>
</tr>
<tr>
<td>Jul-11*</td>
<td>20,000</td>
<td>8.16</td>
</tr>
</tbody>
</table>

*: Up to July 15, 2011.

Table 4: Major issuers of commercial paper

Researcher: CVSL Kameswari
In the context of inflationary pressures and tight liquidity conditions, the primary market yields moved up. The weighted average yield in primary auctions firmed up during Q1 of 2011-12 (See Table). The investor sentiment, however, was largely sustained. The bid-cover ratio stood in the range of 1.39-3.20 during Q1 of 2011-12 as against 1.39-3.87 during the corresponding quarter of the previous year. In view of the flattening yield curve, more long dated securities were issued and accordingly, the weighted average maturity of the dated securities issued during Q1 of 2011-12 increased.

During 2011-12 so far (up to July 15, 2011), 13 States raised Rs.31,773 crore on a gross basis as compared with Rs.28,210 crore raised during the corresponding period of 2010-11.

The spreads of 5-year corporate bonds over comparable G-secs decreased during May 2011, reflecting the impact of unanticipated increase in Government short term borrowing. The spreads increased in June mainly reflecting the hardening of corporate bond yields (See Chart).

**Monetary transmission strengthens with rates hardening in the credit market**

Monetary policy transmission to credit market strengthened further during Q1 of 2011-12 as banks increased their deposit and lending rates in response to the increase in the policy rate by the Reserve Bank (See Table). During Q1 of 2011-12, deposit rates of banks were increased in the range of 10-300 basis points (bps) across all maturities. Twenty-three major banks accounting for around 65 per cent of the total bank deposits raised their deposit rates in the range of 25-175 bps. The rise in deposit rates was relatively sharper for maturities up to 1 year for all categories of banks. As savings account deposits constitute around a quarter of total deposits, the 50 bps hike in the savings deposit rate also increased the cost of funds for the...
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banks. During the quarter, all scheduled commercial banks increased their Base Rates in the range of 25-225 bps, of which 47 major banks with a credit share of around 98 per cent raised their Base Rates by 50-125 bps.

<table>
<thead>
<tr>
<th>Item</th>
<th>2009-10</th>
<th>2010-11</th>
<th>2011-12*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Central Government</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross amount raised (Rs crore)</td>
<td>4.51,000</td>
<td>4.37,000</td>
<td>1.59,000</td>
</tr>
<tr>
<td>Devolvement on Primary Dealers (Rs crore)</td>
<td>7.219</td>
<td>5.773</td>
<td>1.506</td>
</tr>
<tr>
<td>Bid-cover ratio (range)</td>
<td>1.44-4.32</td>
<td>1.39-3.88</td>
<td>1.39-3.20</td>
</tr>
<tr>
<td>Weighted average maturity (years)</td>
<td>11.16</td>
<td>11.62</td>
<td>12.35</td>
</tr>
<tr>
<td>Weighted average yield (per cent)</td>
<td>7.23</td>
<td>7.92</td>
<td>8.38</td>
</tr>
</tbody>
</table>

| **State Governments**                          |         |         |          |
| Gross amount raised (Rs crore)                 | 1.31,122| 1.04,039| 31,773   |
| Cut-off yield range (per cent)                  | 7.04-8.58| 8.05-8.58| 8.36-8.69|
| Weighted average yield (per cent)              | 8.11    | 8.39    | 8.57     |

*: Up to July 15, 2011.

Table 5: Issuances of central and state government dated securities

<table>
<thead>
<tr>
<th></th>
<th>Sep-10</th>
<th>Dec-10</th>
<th>Mar-11</th>
<th>Jun-11</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Domestic Deposit Rate (1-3 years tenor)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Public Sector Banks</td>
<td>6.75-7.75</td>
<td>7.00-8.50</td>
<td>8.00-9.75</td>
<td>8.25-9.75</td>
</tr>
<tr>
<td>(ii) Private Sector Banks</td>
<td>6.50-8.25</td>
<td>7.25-9.00</td>
<td>7.75-10.10</td>
<td>8.00-10.50</td>
</tr>
<tr>
<td>(iii) Foreign Banks</td>
<td>3.00-8.00</td>
<td>3.50-8.50</td>
<td>3.50-9.10</td>
<td>3.50-10.00</td>
</tr>
<tr>
<td><strong>Base Rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Public Sector Banks</td>
<td>7.50-8.25</td>
<td>7.60-9.00</td>
<td>8.25-9.50</td>
<td>9.25-10.00</td>
</tr>
<tr>
<td>(ii) Private Sector Banks</td>
<td>7.00-8.75</td>
<td>7.00-9.00</td>
<td>8.25-10.00</td>
<td>8.50-10.50</td>
</tr>
<tr>
<td>(iii) Foreign Banks</td>
<td>5.50-9.00</td>
<td>5.50-9.00</td>
<td>6.25-9.50</td>
<td>6.25-9.50</td>
</tr>
<tr>
<td><strong>Median Lending Rate</strong>*</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Public Sector Banks</td>
<td>7.75-13.50</td>
<td>8.75-13.50</td>
<td>8.88-14.00</td>
<td>-</td>
</tr>
<tr>
<td>(ii) Private Sector Banks</td>
<td>8.00-15.00</td>
<td>8.25-14.50</td>
<td>9.00-14.50</td>
<td>-</td>
</tr>
<tr>
<td>(iii) Foreign Banks</td>
<td>7.25-13.00</td>
<td>8.00-14.50</td>
<td>7.70-14.05</td>
<td>-</td>
</tr>
</tbody>
</table>

Table 6: Deposit and lending rates of banks

*: Median range of interest rates at which at least 60 per cent of business has been contracted. -. Not available.

Note: Bank group-wise variations in deposit interest rates worked out from the table would differ from those reported in the text as the latter are based on bank-wise and tenor-wise variations in deposit interest rates.

Researcher: CVSL Kameswari
Equity markets remained sluggish and less volatile

Volatility in equity markets declined substantially in the post-crisis period. This declining trend continued into Q1 of 2011-12. Although, in relative terms, the performance of the Indian equity markets was better than that of other BRIC nations during Q1, the two key indices, Sensex and Nifty, declined by about 3 per cent (See Table).

Rising crude oil prices, persistently high inflation, successive policy rate hikes by the Reserve Bank, domestic political developments and the worsening Greek sovereign debt crisis affected market sentiment negatively. Net investment by FIIs in equity and debt segments was USD 1.0 billion during Q1 of 2011-12, of which flows to equity market amounted to USD 0.8 billion (See Chart). Equity markets, however, rallied towards end-June with a revival in FIH investments.

Stock price returns are affected by stock return volatility, and the extent of impact depends crucially on the permanence of shocks to the variance in returns. An analysis of the returns from the broad based S&P CNX Nifty index against the backdrop of the financial crisis and monetary policy action demarcates the time varying volatility persistence in the returns data (See Charts). The variability in returns, controlling for all other past factors, shows a sharp decline from the crisis period and appears to be moderating.

Turnover in the equity derivatives segment constituting almost 90 per cent of the overall investments, witnessed some moderation during Q1 of 2011-12. Volatility in Nifty index options as measured by the India Volatility Index (VIX) was lower in Q1 of 2011-12 than Q4 of 2010-11.

The resource mobilization in the primary segment of the domestic capital market through public issues was lower during Q1 of 2011-12 than the corresponding quarter of the previous year (See Table). Poor performance of the IPOs after their listing affected investor and promoter sentiments.

Chart 5: Movement in stock prices and turnover

Researcher: CVSL Kameswari
Resource mobilization by mutual funds during April-June 2011 was higher than that during the corresponding period of the previous year, although there were net outflows during May-June 2011, particularly in debt mutual funds. The increase in dividend distribution tax for non-retail investors in liquid/debt mutual funds effective from June 1, 2011 and the cap of 10 per cent of net worth placed on banks' investment in liquid/debt funds which will be made effective over a six-month period beginning July 5, 2011, could have affected flows into debt mutual funds.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Prospectus and Rights Issues*</td>
<td>37,620</td>
<td>7,737</td>
<td>7,000</td>
</tr>
<tr>
<td>1. Private Sector (a+b)</td>
<td>24,831</td>
<td>7,737</td>
<td>2,422</td>
</tr>
<tr>
<td>(i) Financial</td>
<td>4,335</td>
<td>2,550</td>
<td>901</td>
</tr>
<tr>
<td>(ii) Non-financial</td>
<td>20,496</td>
<td>5,187</td>
<td>1,521</td>
</tr>
<tr>
<td>2. Public Sector</td>
<td>12,790</td>
<td>0</td>
<td>4,578</td>
</tr>
<tr>
<td>Euro Issues</td>
<td>9,441</td>
<td>4,844</td>
<td>1,237</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mutual Fund</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobilisation(net)@</td>
<td>-49,406</td>
<td>3,547</td>
<td>73,039</td>
</tr>
<tr>
<td>1. Private Sector</td>
<td>-19,215</td>
<td>14,109</td>
<td>64,425</td>
</tr>
<tr>
<td>2. Public Sector#</td>
<td>-30,191</td>
<td>-10,562</td>
<td>8,614</td>
</tr>
</tbody>
</table>

Table 7: Resource mobilization from capital market

*: Excluding offer for sale. @: Net of redemptions. #: Including UTI Mutual fund.
Source: Mutual Fund data are sourced from SEBI and exclude funds Mobilized under Fund of Funds Schemes.

Researcher: CVSL Kameswari
Housing prices and transaction volumes rise in Q4 of 2010-11

Property prices increased during 2010-11, despite firming up of mortgage rates. The Reserve Bank’s Quarterly House Price Index (HPI) based on data in respect of seven cities collected from the Department of Registration and Stamps (DRS) of the respective State Governments show that house prices in five of the seven major cities were higher on a quarter-over-quarter basis in Q4 of 2010-11, but were flat in Ahmedabad and had continued to fall in Chennai (See Chart). The data on volume of transactions show that after stalling in Q3, transactions increased during Q4 of 2010-11. On a year-on-year basis, there has been an increase in housing prices in Q4 in six cities (i.e., barring Chennai). Housing transactions, however, fell in five of the seven cities (i.e., barring Delhi and Mumbai).

Market volatility could resurface if macro conditions deteriorate

The subdued current market volatility is no guidance for future. Financial market volatility can return if macro conditions worsen.

Indian financial markets would continue to be influenced by the global as well as domestic factors. Money market rates would continue to be conditioned by monetary policy actions. If prolonged inflation feeds into inflationary expectations, it would affect all segments of the markets, particularly the G-sec markets. A widening of the fiscal deficit leading to a higher than budgeted market borrowings could also exert upward pressure on G-sec yields. A slowdown in economic growth could affect corporate performance which, in turn, would weigh on equity markets.

Chart 7: Trends in housing indices

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Researcher: CVSL Kameswari
Indian Equities – The way forward

We realize, as all others, that equity markets are forward looking and price movements are a reflection of what we expect in future rather than what has happened. With this in perspective, we have attempted to gaze in the future and tried to see what the key variables impacting the economy and equity markets would look like, one year from now.

We look at variables in key categories namely, global macro, domestic macro, corporate earnings, valuations, flows and policy environment. We elaborate individual variables later, but highlight that most variables would be showing marked improvement if we fast forward one year.

However, the final conclusion is not different from our earlier note; near term challenges notwithstanding, the current uncertainty possibly provides a good opportunity for long term Indian investors.

Here is our analysis:

Global Macro: With the slew of recent poor economic data, many in the market have started to worry about the renewed fears of recession (double dip) in DM (developed markets). This coupled with sovereign debt crisis has instilled fears in investors' mind. While slow global growth is likely, the evidence is far from being conclusive to assume a new recession is inevitable.

In fact, we expect repeated efforts by the DM policymakers to stimulate their economy and markets. Also, EM (emerging markets) economies are in far better shape and therefore would be less impacted in case of western slowdown.

In this context most emerging markets have already corrected over 20 per cent in last 2-3 quarters. Further, we highlight that growth rate in most of the emerging markets are likely to remain robust in 2012 and the fears of excessive interest rate tightening in key EMs have reduced. Indeed, in a major sign of interest rate cycle in EM is now turning on the easing path, one of most conservative large EM central bank in Brazil has positively surprised last week by cutting their official interest rates.

Consensus has already reduced their global forecasts and still global growth in CY12 is likely to be better than CY11. Indian economy: The key variables which have kept Indian macro environment under pressure for the last 3-4 quarters i.e., inflation and policy tightening are near peak. We expect incrementally positive news on the both fronts. By 2QFY13, inflation should be as low as 5 per cent and similarly the RBI in all likelihood would have already started easing the interest rates.

On the growth front, while the consensus has acknowledged the downside risk to growth in FY12, they expect better growth in FY13 over FY12. Moreover, capex cycle, which has been a
big drag on fundamentals, would bottom in next six months and by 2QFY13, we expect recovery in capex cycle along with the RBI easing.

In terms of expectations, analyst expectations which are currently on the conservative side due to ongoing negative news flow may also turn optimistic as and when signs of macro improvement are more visible over the course of the year.

Earnings and valuations: Indian earnings growth expectations have been significantly revised down in consonance with bad news flow and sentiments. Even after that Indian markets are trading at a 10 per cent discount to long term 1 year forward PE. Not only this discount is expected to revert to mean levels in the coming year but also the expectations of earnings growth for FY13 are higher than that of FY12.

Consensus earnings growth expectations for FY13 are 14 per cent compared to 13 per cent in FY12. We believe that earnings downgrade cycle for Indian market is in the latter stage. Though FY13 EPS growth is already higher than FY12, it may rise further as the earnings downgrade cycle changes its course.

Flows and policy environment: Post the US rating downgrade, India has seen 3 bln USD outflows in August 11 taking the ytd FII flows into equities to almost flat level. Other than global headwinds, domestic macro concerns have led to low risk appetite and in turn dismal portfolio inflows in Indian equities.

As explained, most of these headwinds would subside if we fast forward one year. Other than inflation and rates, another key reason for the investors' despondency is the Govt policy inactivity and related uncertainties. Government policy disappointment resulted in lack of confidence among corporates who postponed their expansion plans and that has disappointed investors.

However, in recent weeks we have seen definite steps towards improving the policy environment. Few recent announcements: cabinet reshuffle, a much overdue fuel price hikes, revamped GST taskforce, softer stance on pesky environmental clearance issue and clearance of land acquisition bill, roadmap to cut down state electricity board's losses, etc. In our base case, we expect further pickup in momentum in policy action over the next one year.

Few likely actions: introduction of GST and DTC, new banking licenses, FDI in retail and insurance, reforms on infrastructure financing, etc. This shall help assuage investors' concerns.

Conclusion: We acknowledge that Indian markets have remained under pressure for the last few quarters due to significant macro headwinds both on the domestic and international front. While the market has been pricing a lot of those concerns, we think these headwinds are peaking now. Investors should put in perspective that current concerns may be short lived and the environment may not be as gloomy or rather be pretty decent over a year. Therefore, in
such times of adversity, long term investors should objectively assess the medium term picture and how equities look from risk reward perspective.

We reiterate that notwithstanding the events/risks in the next few months, if one invest in equities now, in the ensuing period one can expect relatively better returns over the following 12-18 months.

In the following page we provide an exhaustive snapshot of key variables to highlight how different and superior they would be looking after a year.

Snapshot of key variables now versus what they could be in a couple of scenarios in a year.
## CHAPTER-IX: INDIA INVESTMENTS – THE WAY FORWARD & CONSTRUCTIVE SUGGESTIONS

<table>
<thead>
<tr>
<th>Aug-11</th>
<th>Aug-12</th>
<th>Base Case</th>
<th>Best case</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Domestic Macro</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>1QFY12 - 0.9% (yoy)</td>
<td>2QFY13 - 6% (yoy) - Inflation should no more be a major concern</td>
<td>2QFY13 - 5% (yoy)</td>
</tr>
<tr>
<td>Interest rate</td>
<td>RBI has hiked policy rates by 150 bps since Jan-11 (last leg of massive tightening)</td>
<td>Interest rate easing began [100 bps cut]</td>
<td>May see sharper rate cuts of 150 – 200 bps by FY13 end</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Extremely tight since June-2010</td>
<td>Improved liquidity scenario due to higher deposit growth, lower inflation and relatively less borrowing from the government</td>
<td></td>
</tr>
<tr>
<td>GDP Growth (%yoy)</td>
<td>FY12 growth (Est.) - 7.5%</td>
<td>FY13E - 7.8% (Better than FY12E and robust)</td>
<td>FY13E - 8.5%</td>
</tr>
<tr>
<td>Govt - Policy actions (reforms)</td>
<td>Few actions/reforms from govt side</td>
<td>Recent events point towards renewed action on policy front – Positive steps likely over next year - GST, DTC, banking license, FDI reforms, infrastructure development &amp; financing, etc</td>
<td></td>
</tr>
<tr>
<td>Indian Rupee/US$</td>
<td>Almost flat on yoy basis</td>
<td>Appreciate 4% to 44 on stronger portfolio flows, surge in FDI, and better than expected CAD</td>
<td>INR may appreciate by 9% to 42 level</td>
</tr>
<tr>
<td>Real Capex growth (%yoy)</td>
<td>FY12E - 7% (yoy) - Subdued</td>
<td>FY13E - 8.3% (yoy) - Capex to pick up from FY13</td>
<td>FY13E - 10.6% (yoy)</td>
</tr>
<tr>
<td>Fiscal deficit (central)</td>
<td>FY12E - 5.2%</td>
<td>FY13E - 4.6% - Fiscal tightening to improve deficit status</td>
<td>FY13E - 4.4%</td>
</tr>
<tr>
<td>Credit growth</td>
<td>FY12E - 17%</td>
<td>FY13 - 19%</td>
<td>FY13E - 22%</td>
</tr>
<tr>
<td>Corporate capital raising</td>
<td>Tight - resources raised remains subdued</td>
<td>More robust with easing macro headwinds</td>
<td></td>
</tr>
<tr>
<td>Investment sentiment</td>
<td>Uncertain/negative</td>
<td>Incrementally positive as macro environment improves</td>
<td></td>
</tr>
<tr>
<td>Global and EM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global growth</td>
<td>CY11E - 4%</td>
<td>CY12E - 4.2% (Better than CY11)</td>
<td>CY12E - 4.4%</td>
</tr>
<tr>
<td>US growth</td>
<td>CY11E - 3.7%</td>
<td>CY12E - 2.2%</td>
<td>CY12E - 2.4%</td>
</tr>
<tr>
<td>EM growth</td>
<td>CY11E - 6.6%</td>
<td>CY12E - 6.2% (Growth rate 3x that of DM)</td>
<td>CY12E - 6.7%</td>
</tr>
<tr>
<td>EM as % of global GDP</td>
<td>35%</td>
<td>Estimates - 37% (3x DM growth rate)</td>
<td></td>
</tr>
<tr>
<td>Global banking system</td>
<td>Global banks - Concerns whether well capitalized or not</td>
<td>More clarity needed on the state of Global banks</td>
<td></td>
</tr>
<tr>
<td>Markets and valuation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FII flows outlook</td>
<td>Flat since CY11ytd - Extremely subdued</td>
<td>May attract inflows as the macro concerns subside</td>
<td></td>
</tr>
<tr>
<td>Implied PE</td>
<td>1 yr Fwd PE - 13.2</td>
<td>Fwd PE – 11.7 (At current level with EPS growth of 15% CAGR in FY11-13 and FY13 expected EPS of 1400)</td>
<td></td>
</tr>
<tr>
<td>PE discount/premium</td>
<td>10% discount to long term average</td>
<td>May revert to mean levels of 16.5, if that happens implied Sensex is 23100 (PE -16.5, FY13EPS – 1400)</td>
<td></td>
</tr>
<tr>
<td>Earnings growth</td>
<td>FY12 Est EPS growth - 13% (Sensex EPS of 1200)</td>
<td>FY13E - 14% (EPS - 1370) - Higher than FY12</td>
<td>FY13E - 17% (EPS - 1400)</td>
</tr>
<tr>
<td>ROE</td>
<td>FY12E - 16%</td>
<td>FY13E - 16.5% (Having fallen for last 2-3 yrs ROE expected to improve marginally from FY13)</td>
<td></td>
</tr>
<tr>
<td>Market cap to GDP%</td>
<td>66% (declined from 95% in CY10)</td>
<td>At current estimates this may fall to 58% by 2QFY12 against an average of 100% in the medium term</td>
<td></td>
</tr>
<tr>
<td>Brent crude oil ($/bbl)</td>
<td>FY12ytd avg – 115 $/bbl</td>
<td>5 yr avg of 86 $/bbl</td>
<td>10 yr avg of 60 $/bbl</td>
</tr>
<tr>
<td>Global earnings growth (MSCI ACWI)</td>
<td>CY2011E - 14.3</td>
<td>CY2012E - 14.7 (EPS growth estimates for CY12 is higher than that of CY11)</td>
<td></td>
</tr>
</tbody>
</table>

Source: RKF estimates, Bloomberg, CMIE, Nomura estimates, Cit research, RBS-MI

Table 8: Snapshot of key variables now versus what they could be in a couple of scenarios in a year

Researcher: CVSL Kameswari
Where will the market be?

Following table gives a scenario analysis of where the Sensex could be trading on a 1 year forward basis (PE ratio) under various earnings growth and PE multiples scenario. The implied level of Sensex under various scenarios of PE multiples are as follows:

<table>
<thead>
<tr>
<th>EPS Growth*</th>
<th>Sensitivity Analysis</th>
<th>PE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12%</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>14%</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>16%</td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>18%</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>20%</td>
<td>20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>12</th>
<th>14</th>
<th>16</th>
<th>18</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>12%</td>
<td>15,977</td>
<td>18,640</td>
<td>21,303</td>
<td>23,966</td>
<td>26,628</td>
</tr>
<tr>
<td>14%</td>
<td>16,553</td>
<td>19,312</td>
<td>22,070</td>
<td>24,829</td>
<td>27,588</td>
</tr>
<tr>
<td>16%</td>
<td>17,139</td>
<td>19,995</td>
<td>22,652</td>
<td>25,708</td>
<td>28,564</td>
</tr>
<tr>
<td>18%</td>
<td>17,735</td>
<td>20,691</td>
<td>23,464</td>
<td>26,602</td>
<td>29,558</td>
</tr>
<tr>
<td>20%</td>
<td>18,341</td>
<td>21,398</td>
<td>24,555</td>
<td>27,511</td>
<td>30,568</td>
</tr>
</tbody>
</table>

*Table 9: Implied Sensex levels at different earnings growth assumptions and PE multiples.

Implied Sensex for April 2012 = FY11 EPS * CAGR EPS for two years up to and FY13 *PE multiple.

*Base for earnings growth is actual Sensex FY11 EPS of 1061
**Earnings growth CAGR for two years FY12 and FY13.
***1 yr fwd PE ratio, To cite, 5 yr average of 1 yr Fwd PE is 16.5x

The Way Forward

**Increasing Participation from domestic and foreign investors**

Rising incomes coupled with increase in savings and investment rates in the domestic economy have led to a higher investment demand in the economy. There is a need to channelize these investment flows into capital markets to yield returns.

**New Products**

Emphasis needs to be laid on product innovation within a sound regulatory and supervisory framework. Focus on development of the derivatives market can help investors hedge against financial risk.

**Deepening of the bond market**

Higher participation needs to be encouraged, by whetting the appetite of the investors as well as by enhancing liquidity in the market. Investments by banks in the corporate bonds need to be encouraged. The limit of FII investments also needs to be increased, as they bring in huge volumes to the corporate bond market there by increasing liquidity.

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Researcher: CVSL Kameswari
Global integration of markets

Unification of markets and integration of financial markets across product segments, use of technology and investors has led to a step forward in global integration. Deregulation, technological developments aiding cross-border mobility of funds and competitive pricing of products are some of the other factors which will strengthen the process of market integration.

Inclusive Growth

Concerted efforts need to be made to drive the agenda of inclusive growth, encouraging more investors to access capital markets. Regulators and other industry stakeholders are driving this single-point agenda to tap the potential in smaller towns and cities.

Regulatory Reform

Regulatory reform is required across all dimensions of capital markets, to remove structural bottlenecks. Alignment of regulations with that of international best practices will go a long way in creating a robust governance framework.

Apart from the above points, in our view, globalization has led to intense competition in the capital markets, reducing the fees charged by the stock exchanges. To ensure nominal transaction costs for the investor, competition needs to be encouraged, with entry barriers being reduced. Competition in capital markets will drive efficiency and innovation.