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POLICY BRIEF

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Introduction

The Centre for Policy Research (CPR), Delhi in collaboration with the BSE Ltd., Mumbai have started a monthly Macro Economic Seminar Series. The objective of these Seminars is to generate fresh analytical insights into the Indian macroeconomic issues for potential use by policy makers. The unique format of these seminars is to bring together macroeconomists who have different perspectives on the state of the macro economy, depending upon their location in think tanks, financial institutions and corporate organisations.

The Second seminar of the series was held at CPR, Delhi on 30th November. The topic of the seminar was 'Channelling household savings to productive uses through the capital markets'. A panel discussion between Ajit Ranade, K P Krishnan and Praveen Chakravarty was moderated by Partha Mukhopadhyay.

Household (HH) savings has continued to account for the bulk of gross domestic savings over the years. Recent trend shows that share of HH savings into physical assets is rising as compared to that in financial assets. Interestingly, in the decade 2004 to 2014, India has imported $176bn of gold (including re-export) which is higher than $130bn of FII inflows. This has raised questions on why Capital market has not been able to attract HH savings to spur economic growth. Moreover, in spite of increase in number of listed companies and market capitalisation, capital raised through IPO is less than 1 percent of GDP in India and even falling. So, it is necessary to look into how savings can be intermediated through capital market into capital formation.

Summary of the Panel Discussion

The panel agreed that even though the share of HH savings in Financial assets has almost doubled from 26% in 1950 to 50% in 2010 while that in Physical savings had come down from 70% in 1950 to 50% in 2010, the trend has reversed in recent years. The share in physical assets has increased again to 68 percent in 2014. For every dollar added to GDP, 21 cents were invested in banks, 15 cents in Gold and only 2 cent in Equity. This was observed even when the BSE Sensex generated higher returns compared to gold.

It was highlighted that, globally, investment in land or housing is not considered unproductive but in India, land and gold are termed as unproductive investment because there is no further secondary liquidity.

The panel did not agree that the oft-quoted reasons like cultural factors or lack of awareness can fully explain the Indian households' aversion to equity market with less than 2 percent investment. It is found that confidence of Indian households in financial market is very low and scandals in the market create distrust. This is also corroborated by the household survey results published in SEBI annual report. In addition, bouts of high inflation that results in lower returns from even safer investment avenues like fixed income assets makes people wary of all financial assets.

The primary role of the market is to act as an intermediary to channelize household savings for productive uses or capital raising. This is achieved through IPOs of companies. Secondary role of the market is price discovery through trading of shares. The tertiary role is to provide tools to enhance liquidity and efficiency of trading through innovative financial products like derivatives for hedging purposes. However, in India, surprisingly the tertiary market is 15 times larger than the secondary market while capital raised for productive purposes through IPOs and other offerings is mere 1/30th of amount traded in shares and derivatives - lowest among large economies. Moreover, in most of the merger and acquisition (M&As) deals money just flows from one set of promoters to another with very little money available for fresh capital formation or expansion plans.

In India, the tertiary derivative market is second largest in the world after Korea, ten times larger than that in US. From 2008- 2014, non-institutional investors accounted for 83- 88 percent in derivative market. Large retail presence in the derivative market actually points to rise in speculation in Indian market. The panel debated on the levels of speculation that is healthy in terms of supporting the price discovery process. They panel sought to identify the reasons behind this rise in derivative trading. The main factors that would drive this was the tax levels in the spot and derivatives markets and the size of contracts.

The two aspects of tax discussed were the removal of LTCG and the introduction of STT tax on transactions. In 2004, LTCG (Long Term Capital Gains) tax was abolished for shares held for longer than one year while STT (Security Transaction Tax) was introduced to encourage long term investment and discourage speculations. However, differential tax structure for derivatives where buyer is required to pay a tax only on the settlement price if the option is exercised led to an attractive investment proposition for STT. Small lot size also added to the problem.

The panel agreed that LTCG and STT are two distinct and separate debates. STT should be abolished as a theoretical proposition. However it will be difficult to do so as it is included in several of India's FTAs (free trade agreements). Moreover, some members of the European Union have recently introduced financial transaction tax and China is proposing to do so. It was however recommended that the tax levels should be rationalized and made comparable over the different assets and re-introduction of LTCG.

Second problem in Indian market is the dominance of foreign investors. Share of FIIs in the market is 20 times larger than domestic participants – half of all available shares are owned by the FIIs. The decisions of the domestic investors are lead by the FII decisions. It is found that volume and direction of FII flows have significant impact on Indian market. The household savings have shifted away from formal financial markets to informal markets such as chit funds. It might be because of the large distribution network and reach of such funds in tier II and tier III cities where penetration of mutual funds is low. Investment in land and gold is seen as a hedge against inflation as households do not have option to plan long term savings. There is a need for good quality empirical research on household financial saving patterns in India to understand these issues in greater detail.

The stimulus to channelling household savings back to formal financial markets needs to be given through some targeted actions by policy makers.

Conclusion

- There is a need for good quality empirical work done for a long period on the household investment patterns in India to understand various issues like i) the drivers of investment decisions, ii) awareness of various financial assets available, iii) impact of inflation on investment decision, iv) long term saving options in absence of social security nets etc.
- Confidence of households in equity market was never high and it has not improved in recent times. Consumer protection records of Indian Financial Regulatory System leaves a lot to be desired (e.g., miss-selling of investment products, including derivatives). In the short term, consumer protection and regulation needs to be strengthened. In the long run, enactment of Indian Financial Code (IFC) with focus on consumer protection and inflation control will help.
- The tax structure in derivative as compared to cash market trading needs to be rationalized. The lot size should be increased to discourage retail speculators. Institutional investors need to be attracted into derivative market.
- Domestic flows into equity market should be increased as these are more long term in nature. This will reduce the FII flow induced volatility in the market. Regulatory policies regarding provident funds, pension plans and insurance funds investing in equity market should be relaxed.
- Tight control on mutual fund product innovations exists. There is a need to regulate distribution and not product innovations.
- Address the issue to LTCG by extending the capital gains exemption limit to 3 years instead of current 1 year to begin with and take it to 5 years. This will eliminate tax evasion using stock exchanges.
- Increase the lot size in derivatives to reduce mis-selling to small investors. Current lot size of Rs 5 lakhs in equities and Rs 65,000 in currency need to be taken to at least 50 lakh rupees to ensure institutions participate in the derivatives market and small investors without any training do not participate in such markets. This way, they will have to go to underlying spot market and will learn to invest. Current easy and very high leverage using derivatives is luring small investors to lose their money and become disappointed with entire capital markets.

- Promote delivery based derivatives instead of current cash settled derivatives to bring derivatives market closer to real markets.
- Provide tax incentives for people to invest in IPO Rights issues and Offer for sale of equities of small companies below Rs.1,000 cr market capitalisation. They can invest up to Rs.1 lakh per annum for holding to minimum 3 years to promote entrepreneurial activities and long term funding to small companies. If 50% of the current tax payers which works out to 2 crore tax payers-each invest Rs.1 lakhs each for getting benefits of tax exemption, it will bring Rs.2 lakh crore or close to USD 30 billion directly to be given to small companies. This will serve the purpose of promoting entrepreneurial culture and allow participation by small investors in equities of the companies. A safety net has to be provided to these investors to ensure they don't lose their capital in most cases. It will help create huge number of jobs which will bring additional direct and indirect taxes to government.
- Allow retail investors to subscribe to government bonds in an easy to subscribe to and easy to hold in depository mode framework to improve market penetration. People need risk free instruments. Currently they are using PSU banks as proxy to government. Whenever government backed bonds come up in retail, there is a huge appetite. This will enhance the trust of people in financial markets and bring more people to invest in Indian markets. This will also reduce the dependence of government of India on banks as vehicles for fund raising directly, through special purpose vehicles and public sector units.