ILLUSTRATION: BINAY SINHA

Sebi at age 31. Or is it 35?

The three-plus decades of Sebi's existence offer important lessons for public policy and security market reforms

The Securities and Exchange Board of India (Sebi) recently unveiled a new logo on the occasion of its 35th anniversary. However, the Sebi Act came in 1992, which is only 31 years ago. There hangs a tale behind this and some interesting insights into public policy.

Policy thinkers in India had understood the requirement for a securities market regulator in the 1980s. Well before the Act was passed, on April 12 1988, a non-statutory Sebi was constituted, through an administrative resolution of the Government of India. The economist Surendra Dave was the founding chairman, and he chose a team, mostly comprising IDBI officers, to help him create the new organisation.

Sebi is now marking the 35th anniversary of the work begun by this team. This team envisioned the role of a securities regulator in India, and wrote the first draft of what became the Sebi Act.

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In April 1992, Parliament passed the Sebi Act. It is widely understood that the impetus for this was the Harshad Mehta affair. However, most of the difficulties associated with this were rooted in the government securities market. It would have been logical to focus on reforms of the government securities market, in response to the crisis. But two things went against this: The bureaucratic and agency politics of the incumbent Reserve Bank of India, and the fact that Dr Dave's team at the non-statutory Sebi was ready with a package of ideas on what could be done to make the equity market better.

There is a broader lesson here. It is important to nurture teams that are building knowledge and policy documents well in advance because we cannot predict when the opportunity to implement an important reform will arise. Indeed, the journey of Sebi should correctly be seen as emanating from the G S Patel committee of 1984. An economist at IDBI — R H Patil — who worked on this report was tapped to head the National Stock Exchange in the early 1990s, and his leadership team was largely drawn from the Dave team at Sebi. The main rhythm of our development journey lies in building knowledge and communities, and we have to continually nurture these foundations.

Sebi was the first of the full and modern regulators in India. We need to commend the work and the insights of those who built it and who have run it well over the years. And, with the benefit of hindsight, we now know there are many aspects for improvement.

The statutory Sebi of 1992 is the first regulator in India to be legislatively autonomous in the area of human resource and finance. The domain autonomy — to legislate on a subject that requires serious expertise without the approval of government — to regulate the sector was also conferred on Sebi within two years of its statutory creation.

In addition, the government wisely decided in favour of a new legislation (not amendments to an old broken one), a new agency (not repairing the old broken agency), located physically away from Delhi (in this case in Mumbai where the markets are) staffed with entirely new people. All this played a major role in the creation of an agency with a completely new work culture. Starting completely anew is the second lesson when dealing with systems that are entirely outdated and broken.

What about the record of Sebi? The first thing to commend about Sebi is that since the Ketan Parekh scandal of the early 2000s, there have been no serious market scams under its watch. Beyond this, there are many measures of the performance of the securities market. For example, in our case, market capitalisation has risen impressively. The gross domestic product to market capitalisation ratio, which was 0.123 in 1989-90 had risen to 1.115 in 2021-22. Similarly, many other parameters, such as assets under management of mutual funds, total number of dematerialised accounts, dematerialised turnover, number of derivatives contracts, etc, have all grown exponentially. Some of the credit for this goes to Sebi, but these metrics also reflect the overall growth of the economy.

It is interesting to ask: What are the policy levers that can be credited for (say) the TCS market capitalisation of ₹11.6 trillion and the Infosys market capitalisation of ₹5 trillion? There are many elements which fed into these, ranging from the establishment of the IITs decades ago to the telecom reforms of the 1990s. Financial reforms played a role in this, primarily through (a) the reduction of capital controls and (b) the emergence of equity market liquidity and market efficiency.

Financial economic policy, therefore, should focus less on the market capitalisation of the equity market, and more on the extent to which the securities markets are deep and liquid. The key attributes of this are market depth, market resiliency and market efficiency. These are not visible in the public domain in India today.

The best proxy measure for a lot of these required characteristics is the turnover ratio (TR): The trading volume of the latest one year divided by current market capitalisation. To some extent, this is related to market capitalisation as the TR of a company with a market capitalisation of ₹1 trillion will naturally be higher than one with ₹0.1 trillion or ₹0.01 trillion.

What does the evidence show? The base line that we adopt is 2003-04, as this is the time by which the equity derivatives introduction had stabilised. In 2003-04, the trading volume of the spot market was ₹11.86 trillion and the turnover ratio was 1.34. In 2022-23, the corresponding values were ₹25.8 trillion and 0.54.

It is surprising to see that over this 20-year period, the turnover ratio of the Indian equity spot market actually went down when, by rights, it should have gone up owing to the increase in market capitalisation. This is a wake-up call on the need for fresh thinking about Sebi and the exchanges: How the inputs (the foundations of Sebi and exchanges) can be improved so as to create better outputs (regulations governing the working of the equity market) so as to generate better outcomes (liquidity and market efficiency).

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