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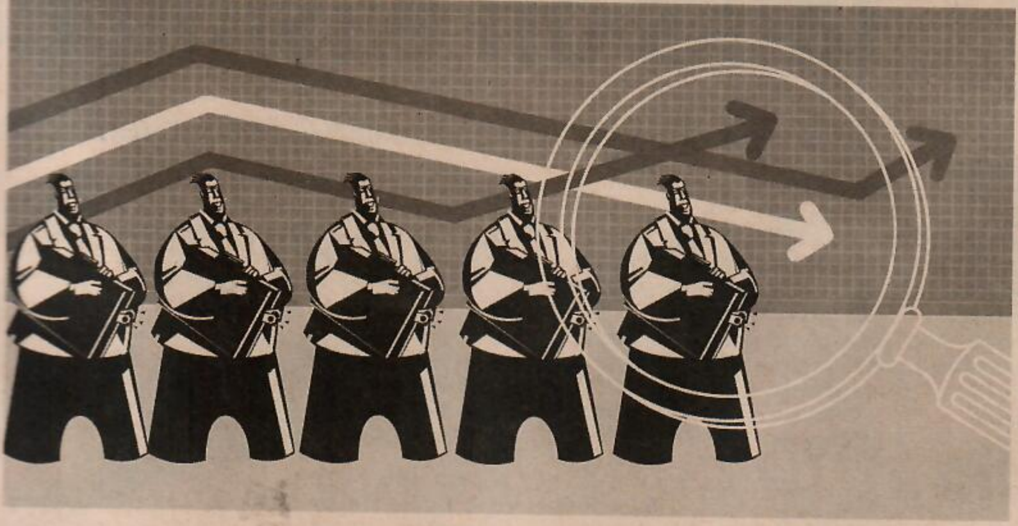


Strategic thinking in financial markets policy

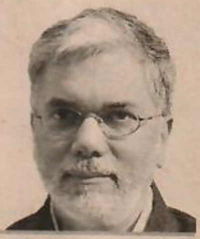
The machinery of the equity market can be used to obtain benefits for all the other parts of financial markets trading

The Securities and Exchange Board of India (Sebi) has released a discussion paper on the working of the equity derivatives markets, which represents a collection of views of the critics. The equity market in its modern avatar came into place in 2000-01 and largely works well. The concerns that have been collected together in the discussion paper have been debated and turned down many times. Financial markets policy must aim to obtain high liquidity to foster capital raising, and to address India's declining market share in the global trading for Indian underlyings. The ideas of the discussion paper will harm these objectives.

A pool of seasoned participants

Fairness to consumers is important as an end in itself. In addition, it is not possible to have a liquid financial markets system without the trust of financial market participants. If there is a lack of fair play, individuals will defect from the markets, which will hamper market liquidity.

The participation of individual investors in the equity spot and derivatives markets has long been a touchy point. We in India want individual investors to obtain profit but avoid losses. We want individuals in the IPO market, but we are unhappy when the price on the secondary market goes down after the company is listed. This is an incorrect conceptual framework. Equity investment is the best asset class, but it comes with associated risks.



SNAKES & LADDERS

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Consumer protection problems in Indian finance fall into two categories: Those at the edges of the law (ponzi schemes, dabba trading, NSEL) and those within it (insurance products). In the latter case, a key ingredient of the problem is the long delay: The years or decades between the decision to buy and the discovery of the outcome. In financial market trading, there is no such delay. When bad decisions are made, losses show up within a day or three. Everyone involved in financial markets makes mistakes, gets rapid feedback, and corrects herself. This helps reduce the consumer protection problem.

Research on investor behaviour in India has shown that there is a learning process: When people come into financial markets trading for the first time, they make mistakes on questions like diversification, but they get better in time. Over time, there has been steady growth in the community of persons who have finished this learning.

Policy decisions about the equity market in the late 1990s and early 2000s were difficult, as a pool of seasoned financial market participants was then lacking. Policymakers at Sebi, the National Stock Exchange, and the Ministry of Finance made the call that we should start on this journey, knowing that there would be this learning process. The process of maturation has been underway since 2000. There is a small trickle of new participants every year, but the bulk of the people in the market are seasoned participants. Every new participant talks with a few seasoned ones. The fixed cost of getting knowledge about derivatives trading into the Indian financial markets ecosystem has been paid.

Concepts and evidence in consumer protection

Many elements of the Sebi paper have weaknesses in information and logic. It expresses the point of view of the critics of the Indian financial markets, but does not demonstrate that there is a problem and the case for intervention. The state of the art in Indian policy thinking on consumer protection is found in the work of the Financial Sector Legislative Reforms Commission (FSLRC). The FSLRC fully thought out the economic principles and legal foundations for consumer protection. When questions about individuals and the financial markets are raised, the path to systematic use of evidence and logical conclusions lies in using this framework.

Policy thinking requires thorough research and evidence. The experience of individual investors from 2000 onwards is visible in the records of brokerage firms and at NSDL/CDSL. A significant body of financial markets research is now available, and much more needs to be done, which poses questions and obtain sound answers using these datasets. The right path to sound thinking on these questions lies in combining the intellectual framework of the FSLRC with this empirical evidence. The Sebi discussion paper lacks both.

The purpose of financial markets policy

The objective of financial markets policy is to achieve liquid and efficient financial markets. Market liquidity reduces the costs of trading suffered by all market participants, including individuals. Market efficiency yields sound pricing for all buyers and all sellers, so that everyone gets a fair price when buying or selling.

High liquidity must percolate to the 500th and 1000th and 4000th company, so that the widest possible list of firms are beneficiaries from the reduced cost of capital of listed equity. This will spur greater primary market issuance, as smaller firms harness the unlisted-to-listed premium. The Indian financial markets ecosystem should yield lower costs of transacting when compared to Singapore or London, so that India can have a higher market share on the global landscape. These objectives will not be served by the thought process of the Sebi discussion paper.

The Ministry of Finance, Sebi, and the NSE pulled off one of the biggest achievements of India's economic reforms in the 1990s and early 2000s, with the transformation of the equity market. The equity market is the construction site where the Indian financial markets system is built. The machinery of the equity market can be used to obtain benefits for all the other parts of financial markets trading. A single consistent framework of financial firms, exchanges, and regulations is now feasible for equities, corporate bonds, government bonds, commodities, and currencies.

The rest of Indian finance has worked poorly. Banking has lurched across crises, insurance has struggled with fair play, the bulk of pensions is at the Employees Provident Fund Organisation, which has not changed, the BCD (bond-currency-derivatives) Nexus has stagnated. Most parts of Indian finance have floundered, while organised financial markets trading has made progress, led by the equity market. The Sebi discussion paper shows a certain loss of institutional memory about this journey. It is important to go back to the foundations, about why we have financial markets, the objectives of financial markets reform, and the long-run strategy for policy.

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