4

CAPITAL AND MONEY MARKETS

The process of capital market reforms was carried forward during 1996-97 with an array of reforms encompassing primary and secondary markets for equity and debt, and foreign institutional investment. Primary market reforms aimed at providing greater flexibility to the issuers and strengthening the criteria for accessing the securities market. Reforms in the secondary market focused on improving market transparency, integrity and infrastructure. The first depository was launched in October 1996. This will help ease the bottlenecks associated with a higher volume of paper work and boost the process of dematerialisation of scrips. A modified take over code and a stock lending scheme have been approved by SEBI. Despite the maintenance of the pace of capital market reforms, market developments presented a different picture. The primary market was characterised by a reduced number of issues and lower amounts raised, while the secondary market witnessed low trading volumes and declining prices during much of the year, amidst persistence of generally subdued market sentiment. Most mutual fund schemes attracted lukewarm response from the investors. However, the securities markets attracted foreign institutional investment at almost double the level of the previous year.

2. The Government securities market saw a strengthening of the primary dealer system. The excess demand for investment funds moderated, and the liquidity conditions eased in early 1996-97. The yield to maturity on auctioned 91-day treasury bills fell steadily to 6.92 per cent in November 1996 from the high of 12.97 per cent at the beginning of the year. The fall in the yield on 364-day treasury bills was relatively less pronounced, but it also fell to 10.33 per cent by end-December, 1996 from 13.12 per cent in end-March, 1996. The coupon rate on 10 year GOI bonds fell only marginally to 13.85 per cent in 1996-97 from 14 per cent in 1995-96. This significant softening in the cut-off yields along with the decline in the call rates indicated an easing of demand-supply gaps in the money and credit market conditions.

Primary Market Reforms

3. The eligibility criteria for issuers were strengthened in 1996-97. At the same time, SEBI took several measures to provide issuers with more flexibility in the issue process. As part of this effort, stringent and detailed disclosure norms were prescribed, greater transparency in the draft prospectus required, and separate criteria for finance companies prescribed.

4. Criteria for accessing the securities markets were strengthened. Issuers proposing to make the first offer to the public of equity, or any security convertible at a later date into equity, are now required to have a track record of dividend payment in three of the immediately preceding five years. Issuers not meeting this requirement can get their securities listed, provided their project is appraised by a financial institution or scheduled commercial bank, and the appraising institution contributes at least 10 per cent of the project cost. This requirement was also imposed in the case of issues by listed companies where the post-issue equity capital exceeds five times the equity capital prior to the issue.

5. In view of the circumstances in which public sector banks operated in the past, they have been permitted to comply with less stringent criteria. The entry criteria required for other issuers would not apply to public sector banks. Further, public sector banks have been allowed to price issues at a premium provided they have a two year profitability record, as against the three year requirement for other issuers.

6. SEBI announced several measures aimed at providing greater flexibility to the issuers. Offer documents would no longer be vetted by the SEBI.

Merchant bankers and issuers would remain responsible for ensuring compliance with the norms on disclosure and investment protection prescribed by the SEBI. A number of steps were taken to encourage the development of a debt market. Debt issues not accompanied by an equity component, can be sold entirely by the book-building process, subject to Section 19 (2) (b) of the Securities Contracts (Regulation) Rules. The requirement of 90 per cent minimum subscription in case of offers for sale has been done away with for exclusive debt issues, subject to certain disclosures and exemptions under the Companies Act. Issuers have been allowed to list debt securities on stock exchanges, even if their equity is not listed. Book-building has been allowed for equity issues of less than Rs.100 crore, subject to compliance with the SC(R) Rules. For all companies in whose issue the promoters' contribution exceeds Rs.100 crore, promoters have been allowed to bring in their contribution in a phased manner, irrespective of their track record. Corporate advertisements between the date of issue of acknowledgement card and the date of closure of the issue, have been allowed, subject to specific conditions which include the disclosure of risk factors. To ensure that public issues were widely subscribed to and held new norms of shareholding were prescribed. (Box 4.1).

Primary Market Developments

7. The downtrend in primary markets seen in 1995-96 continued in 1996-97. Capital raised through new issues during April-December 1996 was down to Rs.10,369.21 crore from Rs.14,151.1 crore during April-December 1995. Over the same months, the number of issues fell correspondingly from 1,132 in 1995 to 793 in 1996, but the average size of the issue rose marginally from Rs. 12.50 crore to Rs.13.07 crore. The mix of public and rights issues also changed, with the proportion of the former rising to 83 per cent of the total. Public issues fell by only 11 per cent from Rs.9,694.48 to Rs.8,619.37 crore. The average size of public issues rose from Rs.10.50 crore to Rs.12.66 crore. Rights issues, on the other hand, fell to Rs.1,749.84 crore, less than 40 per cent of the amount raised in April-December 1995 (Table 4.1). Their average size also declined to Rs.15.62 crore from Rs. 21.32 crore. One hypothesis consistent with these facts, is that it was easier to raise funds for new goods and services, than for the existing menu of products produced by older companies.

8. The declining trend in issues and funds raised through the primary market is expected to continue through the rest of 1996-97, since the number of the offer documents received by the SEBI in the first half of 1996-97 is significantly lower than offer

BOX 4.1

Primary Market Reforms: 1996-97

- Norms for companies to access the capital market further tightened to improve the quality of paper.
- First time issuers required to have a dividend payment record in three of the immediately preceding five years.
- For issuers who do not meet this requirement, access to markets allowed, provided their projects were appraised by a scheduled commercial bank or a public financial institution with minimum 10 per cent participation in the equity capital of the issuer or, provided their securities are listed on the OTCEI.
- No entry restrictions for public sector banks to access market, and they have been allowed to price issues at a premium, with only a two year profitability record.
- A norm of 5 shareholders for every Rs.1 lakh of fresh issue of capital and 10 shareholders for every Rs.1 lakh of offer for sale prescribed as an initial and continuing listing requirement.
- Prohibition was imposed on payment of any direct or indirect discounts or commissions to persons receiving firm allotment.
- SEBI gave up vetting of public issue offer documents. SEBI's comments on offer document, if any, will be communicated within 21 days of filing, as is the case with rights issues.
- Debt issues not accompanied by an equity component permitted to be sold entirely by the book building process subject to Section 19(2) (b) of the Securities Contracts (Regulation) Rules.
- If minimum shareholding requirements are met, the requirement of 90 per cent minimum subscription in case of, "offers for sale" no longer necessary.
- The 90 per cent requirement also done away with in case of exclusive debt issue subject to certain disclosures and exemptions under the Companies Act.
- Housing Finance Companies considered to be registered for issue purposes provided they were eligible for refinance from the National Housing Bank.
- Corporate advertisements, between the date of issue of acknowledgement card and the date of closure of the issue have been allowed, subject to specific conditions which include the disclosure of risk factors.
- Promoters with contribution exceeding Rs. 100 crore have been allowed to bring in their contribution in a phased manner, irrespective of their track record.
- Issuers have been allowed to list debt securities on stock exchanges without their equity being listed.

TABLE 4.1

Issues Launched

(Rs.Crore)

Types of Issues	1994-95		1995-96		1995 (Apr.-Dec.)		1996 (Apr.-Dec.)	
	No	Amount	No	Amount	No	Amount	No	Amount
Rights	324	6576.62	299	6564.12	209	4456.62	112	1749.84
Public	1342	21044.45	1426	14240.52	923	9694.48	681	8619.37
Total	1666	27621.07	1725	20804.64	1132	14151.10	793	10369.21

documents received in the first half of 1995-96. The general downtrend in the secondary market and the stricter eligibility criteria introduced by SEBI are among the reasons behind this downtrend in the primary market issuance.

Secondary Market Reforms

9. SEBI took several initiatives to further develop secondary markets. The Depositories Act, 1996 was enacted in July, 1996. SEBI (Depositories and Participants) Regulations, 1996 were notified. They are the foundation of an institutional framework for minimising the problems associated with physical handling of securities. They provide a legal framework to record ownership details in a book-entry form. Other secondary market reforms were aimed at improving the transparency and integrity of markets and market infrastructure, and introducing uniform

BOX 4.2

Secondary Market Reforms: 1996-97

- Custodians of securities existing for a considerable period and engaged in providing services to a number of institutional investors can reach the required minimum net worth of Rs.50 crore in a phased manner over a period of 5 years.
- Custodians required by SEBI to appoint a Compliance Officer who will interact with the SEBI regarding compliance and reporting issues.
- SEBI will have monthly meetings with the Association of Custodial Agencies of India (ACAI) before incorporating any changes that have an impact on settlement of transactions of institutional investors.
- Stock exchanges asked to modify the listing agreement to provide for payment of interest by companies to investors from the 30th day after the closure of a public issue.
- Uniform good-bad delivery norms and procedure for time bound resolution of bad deliveries through Bad Delivery Cells prescribed. Bad Delivery Cell procedure have helped to standardise norms.
- All exchanges to institute the buy-in or auction procedure being followed by the National Stock Exchange.
- In view of the falling percentage of deliveries, exchanges asked to collect 100 per cent daily margins on the notional loss of a broker for every scrip, to restrict gross traded value to 33.33 times the brokers base minimum capital and to impose quarterly margins on the basis of concentration ratios.
- Study group constituted to make recommendations for imparting greater transparency and fairness in bulk or negotiated deals.
- Stock exchanges asked to set up a clearing house or clearing corporation.
- Stock exchanges disallowed from renewing contracts in cash group of shares from one settlement to another.
- A core group for inter-exchange market surveillance set up for coordinating action in case of abnormal volatility.
- The Stock Exchange, Mumbai and other exchanges with screen based trading systems allowed to expand their trading terminals to locations where no stock exchange exists, and to others subject to an understanding with the local stock exchange. The setting up of trade guarantee scheme or clearing corporation, mechanisms for handling investor grievances arising from other centres and adequate monitoring mechanisms will be a prerequisite.
- Several restrictions, including limits on the size of issues proposed to be listed on OTCEI removed, and listing criteria for OTCEI, relaxed. Besides, OTCEI permitted to move to a five day accounting period settlement.
- Both, short and long sales will have to be disclosed to the exchange at the end of each day. They would be regulated through the imposition of margins.
- A stock lending scheme has been introduced. Stock lending has been approved in which short sellers could borrow securities through an intermediary before making such sales. The approved intermediary should have a minimum net worth of Rs.50 crore.

and streamlined market practices. A synoptic view of these reforms is presented in Box 4.2.

Depository

10. Reduction of settlement risks and shortening of settlement cycles are the basic requirements for upgrading the existing trading system into a modern one. Severe infrastructure bottlenecks have often come in the way of upgrading the Indian clearing and settlement system. These bottlenecks have become more pronounced with a growing number of investors and consequent increase in trading volumes. The inability of clearing and settlement infrastructure to keep up with the flow of paper has made it more difficult for the exchanges to shorten settlement cycles and move to rolling settlement. The Depositories Act, 1996 allows for dematerialisation (and rematerialisation) of securities in depositories and the transfer of securities through electronic book entry. This will help in reducing settlement risks and removing some of the infrastructure bottlenecks. The dematerialised securities will be fungible, meaning thereby that they will not have any distinctive numbers or specific identification. As the network of depositories expands and the proportion of securities dematerialised increases, the benefits would percolate to the vast majority of market participants. This is expected to lead to better investor service and investor protection.

11. The Depositories Act vests SEBI with the powers of registration of depositories and participants, and to approve or amend the bye-laws of a depository. After the notification of the SEBI (Depositories and Participants) Regulations, 1996, the National Securities Depository Limited (NSDL) has been set up. The NSDL, sponsored by the IDBI, the UTI and the NSE commenced operation in October, 1996. 13 companies have joined NSDL. Scrips of 5 companies are trading in dematerialised form and the option for dematerialisation is available for scrips in 11 companies. The Depositories Related Laws (Amendment) Ordinance, 1997 was promulgated to remove some lacunae in the Depositories Act. This will enable units of mutual funds and UTI, securities of statutory corporations and public sector bonds, to be dealt through depositories.

12. The depository regulations provide for selection of various categories of market participants as depository participants. The eligible categories include: public financial institutions, scheduled commercial banks, SFCs, RBI approved foreign banks in India, certified custodians of securities, clearing corporations of stock exchanges, registered stock brokers, and NBFCs. The depository regulations stipulate that agreements should be entered into between the depository and every participant, between participant and every client as well as among depository, issuer company and the registrar.

Stock Exchanges

13. An effective monitoring and surveillance mechanism is an important element contributing to the efficiency and integrity of stock exchanges. The automation process initiated at the BSE, NSE, OTCEI and other exchanges has made it possible to put such a monitoring mechanism in place. The reach of the capital market is also increasing significantly through the same process of automation. SEBI allowed expansion of the trading terminals of screen based trading systems of stock exchanges to cities having no stock exchange. Expansion to cities with stock exchanges has also been permitted, subject to an understanding with the local exchange allowing the installation of outside terminals within its jurisdiction. The participating exchange would keep its membership open to the brokers of the other local exchanges. It will ensure an adequate arrangement for resolving investor grievances and for timely settlement of arbitration cases arising out of trades executed on the extended terminals. The expansion of Bombay On Line Trading (BOLT) system of the stock exchange, Mumbai to the trading systems of other exchanges will be subject to general conditions. These include ensuring adequate monitoring and surveillance mechanism, stipulation of usual margins, capital adequacy, intra-day trading limits fixed for the broker stock exchange and the introduction of trade guarantees. The expansion of trading networks will lead to healthy competition between various stock exchanges and increase their efficiency.

14. SEBI has directed all stock exchanges to set up clearing houses or clearing corporations and to provide trade guarantees. This would reduce counterparty risks and enable investors trading through the exchanges to take advantage of settlement of transactions through a depository. Uniform norms and procedures for timely resolution of bad deliveries have been prescribed and are soon expected to become operational with the setting up of Bad Delivery Cells in the exchanges. The National Securities Clearing Corporation Limited (NSCCL) is entrusted with the task of guaranteeing settlement of trades in the capital market segment of the NSE. It has made considerable progress in enhancing clearing facilities in other regions by establishing regional clearing facilities. The setting up of Delhi Regional Clearing House and other regional clearing facilities of the NSCCL will enable the regional relocation of the settlement facilities. This will increase the efficiency of the system and lead to timely settlement of transactions on the NSE.

15. Stock Exchanges have been disallowed from renewing contracts in cash group of shares from one settlement to another. They have to institute a buy-in or auction procedure on the lines of that being followed by the National Stock Exchange. A time limit of four months has also been prescribed for the disposal of arbitration cases by the exchanges. In view of the falling delivery percentages, exchanges have been asked to collect daily margins on the notional loss of a broker for every scrip. Quarterly margins have been imposed on the basis of concentration ratios.

16. The Dave Committee on Over the Counter Exchange of India (OTCEI) has recommended relaxation of the maximum size of the issues that may be listed on OTCEI, relaxation in listing criteria and a shift from a rolling (T+3) settlement to five day account period settlement being followed by other exchanges. These and most of the other recommendations of the committee for making OTCEI more effective and viable have been accepted by SEBI and are in the process of implementation.

17. The expansion of the NSE trading network, and the trading networks of the Mumbai and other stock exchanges, the expansion of the clearing facilities of the NSCCL to centres outside Mumbai, the setting up of clearing corporations or clearing houses by the other exchanges, and the expansion of the network of depository participants is expected to generate healthy competition between the stock exchanges, stock brokers and other market participants. This is expected to provide transparent and efficient services to investors, as well as bring investors in diverse parts of the country within a nation-wide trading and settlement framework.

Takeover Code

18. The SEBI (Substantial Acquisition of Shares and Take-overs) Regulations, 1994 aim at making the take-over process transparent, and also protect the interests of minority shareholders. The first competitive bid and the first hostile bid in terms of the regulations were launched in 1995-96. While the launching of these bids marked the maturing of the process of take-overs, these bids highlighted the need to strengthen the regulations. SEBI approved the modified takeover code based on the recommendations of the Bhagwati Committee chaired by former Chief Justice P.N. Bhagwati.

19. Under the revised code, a mandatory public offer of 20 per cent purchase will be triggered off when the threshold limit of 10 per cent equity holding is crossed. This will, however, not apply to consolidation by those in control, who can purchase

BOX 4.3

Substantial Acquisition of Shares and Takeovers

- Definitions of 'acquirer' and 'persons acting in concert' have been amplified to cover direct as well as indirect acquisitions. The definition of "control" would be modified to safeguard shareholders' interest.
- Mandatory public offer is triggered off when the threshold limit of 10 per cent is crossed and there is change in control.
- For the purpose of consolidation of holdings, acquirers holding not less than 10 per cent but not more than 51 per cent are allowed 'creeping acquisition' upto 2 per cent in any period of 12 months. Any purchase for a holding more than 51 per cent will have to be in a transparent manner, through a public tender offer.
- An acquirer, including persons presently in control of the company, should make a public offer to acquire a minimum of 20 per cent in case the conditions for mandatory public offer mentioned earlier are valid.
- SEBI would not be involved in the pricing of offer. Pricing will be based on the parameters such as the negotiated price, average of the high and low price for 26 weeks period before the date of the public announcement, highest price paid by the acquirer for any acquisition during the 26 weeks period before the date of the public announcement, and the price for preferential offers, if any. Use of discretion by SEBI will be reduced to the bare minimum.
- The concept of 'Chain Principle' has been introduced requiring a public offer to be made to shareholders of each company when several companies are acquired through acquisition of one company.
- Disclosure requirement has been strengthened, requiring disclosure of additional details on financial arrangements for implementing the offer, future plans of the acquirer for the target company etc. Disclosure of misleading information will be deemed a violation attracting penal action. Non-exercise of due diligence will also attract penalties.
- Conditional offer has been allowed subject to either a minimum mandatory acceptance of 20 per cent with differential pricing; or, with a deposit of 50 per cent of the value of the offer in cash in the escrow, in cases where the bidder does not want to be saddled with the 20 per cent acquisition.
- The obligations of the board of the target company have also been spelt out. During the offer period, the board is precluded from inducting any person belonging to the acquirer or transfer shares in his name until all the formalities relating to the offer are complete.

2 per cent of shares per annum as long as their total holding is below 51 per cent. The pricing of public offers would have to satisfy certain conditions. To discourage frivolous attempts, acquirers will have to deposit a certain value of cash and assets in an escrow account. The escrow deposit would be higher for conditional public offers, unless the acquirer agrees to acquire a minimum 20 per cent even when the full condition is not met. This mandatory acquisition could be at a lower price to be specified in the conditional offer (Box 4.3).

Surveillance and Enforcement

20. Strong and effective enforcement against violations by intermediaries is vital for ensuring the integrity of markets. Pursuant to this objective, SEBI introduced a number of enforcement measures during 1996-97. The stock exchanges were asked to implement uniform norms for imposition of circuit breakers and trading suspensions in cases where price manipulation is suspected. Special and penal margins have also been introduced. All the exchanges have set up surveillance departments, and have begun to co-ordinate with SEBI. Daily settlement and pre-issue monitoring reports have been prescribed by SEBI, for submission by the exchanges. A trading database has been created within SEBI for trades on the National and Mumbai stock exchanges and is being expanded to include other stock exchanges. Where price manipulation has been detected, auction proceeds have been frozen and, in several cases, impounded so that they do not accrue to manipulators.

21. SEBI now inspects each exchange and mutual fund at least once every year. It is in the process of increasing the coverage of inspection of other intermediaries such as stock brokers and merchant bankers. Intermediaries are also inspected in the process of investigation. On the basis of these inspections, action has been taken against a wide variety of violations, and penalties ranging from monetary fines to suspension of their registration for different periods have been imposed. SEBI has also launched prosecutions against issuers for various violations.

Secondary Market Developments

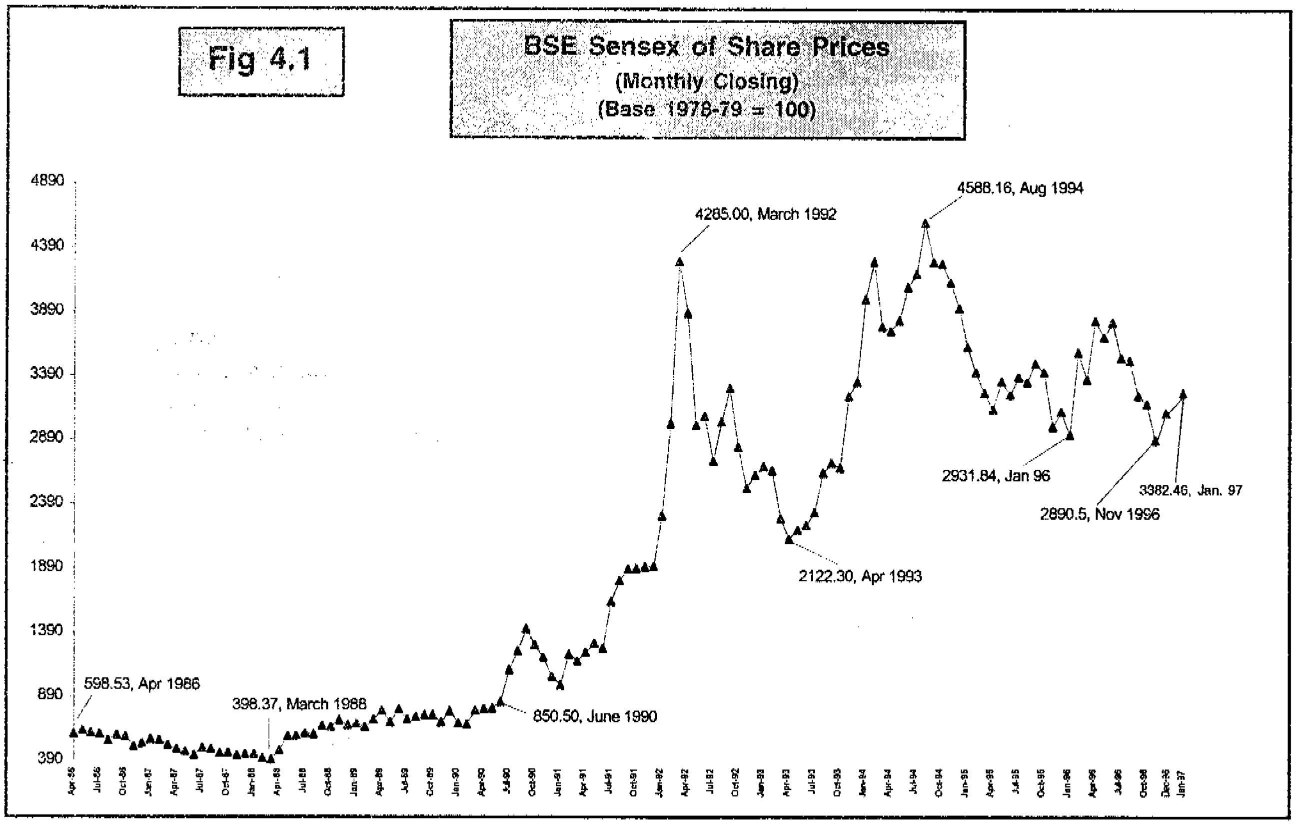
22. The bear phase in the secondary markets which had started during 1994-95 continued to persist during much of 1996-97 (Figure 4.1, Table 4.2). Prices in the secondary market reached a peak in mid-September, 1994 when the sensitive index (Sensex) of the stock exchange, Mumbai closed at 4630.54. There was a clear down-trend in the Sensex from October 1994 to April 1995, with a month-end closing price index of 3133.28. Since then, the sensex has been characterised by several ups and downs. The gradually rising trend in May to October 1995 was reversed by a decline in sensex till January

TABLE 4.2

Stock market indicators

Indicator	Index[1] Sensex	Index[1] Natex	Price/Earn. Ratio Sensex	Price/Earn. Ratio Natex	Average Daily Turnover (BSE) Rs. Crore	Market Capitalisation[2] Rs. Crore
1995						
April	3359.27	1631.55	27.84	31.84	127	494908
May	3206.09	1539.44	29.78	32.65	112	495414
June	3336.46	1570.48	18.03	21.11	194	506780
July	3334.86	1550.57	19.32	21.54	242	505592
August	3402.81	1568.33	18.41	20.21	244	547424
September	3396.37	1555.07	18.67	20.15	239	576977
October	3528.10	1603.84	17.83	18.61	267	563721
November	3172.02	1442.54	15.44	16.17	183	472942
December	3060.05	1406.95	15.99	16.95	239	486192
1996						
April	3599.66	1649.60	19.57	20.14	371	636868
May	3732.20	1701.17	19.25	19.85	436	563739
June	3906.72	1771.88	19.56	20.29	602	576973
July	3668.21	1676.60	16.86	17.69	646	545150
August	3449.17	1575.49	14.34	15.80	380	540340
September	3390.11	1522.17	13.19	14.17	347	518266
October	3154.38	1407.96	12.50	12.11	422	495440
November	3052.83	1360.42	11.34	11.03	347	452989
December	2918.68	1290.21	12.20	11.78	386	477425

[1] Average for the month. Sensex (Base 1978-79=100) Natex (Base 1983-84=100) [2] Estimated for all India.



1996. This was followed by a rising trend till mid-June 1996, and a falling trend till the beginning of December 1996. There has been a substantial recovery since then, and the Sensex closed at 3502 on February 11, 1997. This recent trend in equity prices may be partly attributed to the overall monetary conditions, especially as reflected in the real rates of interest that are available to potential equity investors in the corporate bond markets, and in fixed deposits offered by banks and NBFCs.

Long term perspective

23. It is seen that in the period from August 1994 to December 1996, price-earnings (P/E) ratios have fallen more steeply than prices. For example, in December 1996, the monthly closing level of the sensex was 3085,20 and the monthly average sensex P/E ratio was 12.20, while the monthly average sensex P/E ratio for November 1993 (sensex closing level 3233.14) was 34.44, and the monthly average sensex P/E ratio for October 1993 (sensex closing level 3294.42) was 38.76. The monthly sensex P/E ratio in November 1996 was at its lowest level since April 1989.

24. Since April 1986 equity prices have seen two extended periods of declining prices and two periods of rising prices. From April 1986 to March 1988, the sensex fell from 598.53 to 398.37, a decline of 200 points or almost 33.44 per cent. Prices also fell between March 1992 (when the monthly closing level of the sensex was 4285.00) and April 1993 (when the monthly closing level was 2122.30), by 50.47 per cent. Periods in which prices generally rose extended from March 1988 to March 1992, and from May 1993 to August 1994. The monthly closing level of the sensex rose from 398.37 for March 1988 to 4285.00 for March 1992, an increase of over 9.5 times in the a year time span. This period in which prices were generally rising may be divided into two sub-periods from March 1988 to June 1990, and from June 1990 to March 1992. The monthly closing level of the sensex for June 1990 was 850.50 indicating that the sensex had risen by 2.13 times over its March 1988 level. In the sub-period between June 1990 and March 1992, the monthly closing level of the sensex increased by just over four times its June 1990 level. In the second period of extended increases in equity prices between April 1993 and August 1994, the monthly closing level of the sensex increased by 1.16 times.

Market Capitalisation and Turnover

25. While equity prices have been declining in 1996-97, the total turnover on the Mumbai and National Stock Exchanges has been increasing. The combined turnover of the Mumbai and National Stock Exchanges in 1995-96 was Rs.1,17,341 crore. The combined turnover of the Mumbai and National Stock Exchanges till December 1996 was Rs.2,83,699 crore, over double the level of 1995-96, and over five times the combined turnover of Rs.50,093 crore of the Mumbai and National Stock Exchanges in

1995-96 till December 1995. The large expansion in turnover may be attributed primarily to the expansion of the trading network of the National Stock Exchange. Turnover is further expected to expand with the expansion of the trading networks of the Mumbai and other stock exchanges. Total market capitalisation as of December 1996 stood at Rs.4,77,425 crore. This was a marginal decline in the total market capitalisation as of December 1995, of Rs.4,86,192 crore.

Foreign Institutional Investors (FIIs)

Reforms

26. The SEBI (Foreign Institutional Investors) Regulations, 1995 were amended to permit the FIIs to invest up to 10 per cent in the equity of any company, to invest in unlisted companies, and to invest in debt securities without any requirement for investment in equity. It was further decided to permit FIIs to invest in dated Government securities within the frame work of guidelines on FII investment in debt instruments for 100 per cent debt funds. For purpose of BOP management investment by FIIs through the 100 per cent debt route will come within the overall level of External Commercial Borrowing. The list of eligible FIIs was expanded to include endowment funds, university funds, foundations and charitable trusts/societies with good track record. Proprietary funds will also be permitted to make investments through FII route subject to the condition that they are regulated by their home regulators or are registered with their tax authorities.

Developments

27. FIIs' net Investment in 1996-97 until end-December 1996 at US $ 2,032.8 million was higher than in the corresponding period of 1995-96 by almost 100 per cent. In 1996-97, monthly net investment at US $ 433.6 million in April 1996 was at its highest level since the FIIs began investing. During the first quarter 1996-97, net FII investments rose by more than 340 per cent. (Table 4.3). In the second quarter it was at approximately the same level as in the second quarter of 1995-96. In the third quarter of 1996-97, net FII investment was 69 per cent higher than in the corresponding quarter of 1995-96.

28. Of the 427 FIIs registered, on average 130 have been active in any given month in 1996-97. Almost 60-65 per cent of purchases and sales have been accounted for by only 25 FIIs. FIIs have been active in over 600 scrips and they transact business through more than 140 brokers. 60-70 per cent purchases and sales by the FIIs are through the Mumbai stock exchange, and between 25-40 per cent through the NSE. In 1996-97 until November, gross FII transactions accounted for only a small fraction (2-3 per cent) of the gross turnover on the NSE and BSE, but for a larger share of deliveries at the end of the settlement periods.

TABLE 4.3

Net Investment by FIIs : 1992-93 to 1996-97

Period	Amount (US $ Million)	Per cent variation[1]
1992-93		
Jan.-March	4.3	-
Total	**4.3**	
1993-94		
Apr.-June	47.7	-
Jul.-Sept.	176.2	-
Oct.-Dec.	599.1	-
Jan.-March	811.1	-
Total	**1634.1**	
1994-95		
Apr.-June	706.9	1382.0
Jul.-Sept.	441.0	150.3
Oct.-Dec.	205.8	-65.6
Jan.-March	174.6	-78.5
Total	**1528.3**	**-6.5**
1995-96		
Apr.-June	244.4	-65.4
Jul.-Sept.	510.0	15.6
Oct.-Dec.	262.4	27.5
Jan.-March	1018.9	483.6
Total	**2035.6**	**33.2**
1996-97		
Apr.-June	1078.7	341.4
Jul.-Sept.	511.5	0.3
Oct.-Dec.	442.6	68.7
Total	**2032.8**	**99.5**

1 Variation over the level in the corresponding period of the previous year.

Global Depository Receipts

29. Foreign investment in Indian securities also takes place through the issue of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs). In 1996-97, till December, Indian issuers made Euro-Issues of US $ 1304 million. This was higher than the amount raised through Euro-Issues in the whole of 1995-96, but much lower than overseas issuance in 1993-94 and 1994-95. In 1995-96 and in 1996-97 upto December, the FII's portfolio investment was larger than the foreign investment through GDRs and FCCBs, reversing the relative position observed in 1992-93 and 1993-94.

Venture Capital Funds

30. The SEBI Act requires SEBI to regulate venture capital activity. This area is of particular importance to our markets and needs to be nurtured. Hence,

the regulations (November 1996) provide for a lot of flexibility. The regulations allow investments only from "institutional investors" and "high net worth" individuals who are in a position to assess and evaluate the investment risk in such funds. Regulations allow venture capital funds to make equity investments, invest in unlisted companies, finance turnaround companies and permit them to provide loans and other forms of assistance. There is no restriction on the period within which the funds raised should be utilised. The same could be listed on a stock exchange after a period of 3 years from the date of initial setting up subject to listing agreements and appropriate regulations. Venture capital funds may be set up as companies or trusts. The entry of institutional investors and high net worth individuals through venture capital activities is expected to provide an important source of institutional funds to fledgling firms.

Gilt-edged Market

Reforms

31. Reforms in the Government securities market aimed to deepen and broaden the market and increase its liquidity. There was further progress towards a fully "marked to market" valuation of government securities. The ratio of investments classified in current category by banks was raised from 40 per cent to 50 per cent for the year ending 1996-97. The new private sector banks were advised to "mark to market" 100 per cent of their investments. The Delivery vs Payment (DVP) system was extended to auction treasury bills with effect from February 14, 1996 and to other public debt offices by May 1996. In April 1996 encouragement was provided to schemes of mutual funds dedicated to Government securities and to create a wider investor base for such securities. The RBI announced, liquidity support to mutual funds dedicated exclusively to investment in Government securities. This would be either by way of outright purchases or reverse repos, and be limited to 20 per cent of outstanding investment in Government securities. RBI issued guidelines to banks in June 1996 for retailing of Government securities with non-bank clients. These include (a) no repurchase of securities sold to the client before the expiry of 30 days, (b) retailing should be on the basis of on-going market rates/yield curve emerging out of secondary market transactions, (c) sale should be effected by banks only if they hold the securities in their portfolio either in the form of physical scrips or in the Subsidiary General Ledger (SGL) Account maintained with RBI, and (d) on sale, deduction of the corresponding amount by the bank from its investment account and also from its SLR assets. Besides, banks should put in place adequate internal control checks and mechanisms, and these transactions should be subjected to concurrent audit. Non-bank clients such as provident funds, trusts, non-banking financial companies and high net worth individuals will provide a big push to the development of the retail trading in the debt instruments.

Primary Dealers

32. The Discount and Finance House of India Ltd. (DFHI) and the Securities Trading Corporation of India (STCI) started operating as primary dealers from March 1996. Four more primary dealers, namely, SBI Gilts limited, PNB Gilts limited, ICICI Securities and Gilt Securities Trading Corporation have commenced operation on June 1, 1996. They would act as market makers for Government securities.

33. To enable them to undertake their operations in an effective manner, RBI announced certain incentives for them. RBI decided to pay commission on primary purchases (including the underwriting commitment) of Central Government securities by primary dealers, effective July 10, 1996. The rate of commission for 91-day treasury bills was fixed at 25 paise per Rs. 100 face value, 50 paise for 364-day treasury bills, and Re. 1 for dated securities. The commission on 91-day treasury bills has been reduced to 12.50 paise with effect from August 23, 1996.

34. All PDs provide two way quotes for Government Securities and bid in the auction of 91-day and 364-day treasury bills, as also in the floatation of new loans. Against their commitment to bid for Rs.4110 crore of Government dated securities during 1996-97, all PDs together have already bid for Rs.5125.65 crore till end November, 1996. They had a success ratio of 77.30 per cent, against the required success ratio of 33.33 per cent. In the case of treasury bills, against a committed amount of Rs. 2570 crore for the year as a whole, they bid for Rs.17395 crore till end-November, 1996. The success ratio of 48.73 per cent was, however, higher than the required 40 per cent. The rate of interest charged by RBI on reverse repos in 91-day treasury bills is 11.5 per cent per annum and on Government dated securities is 13 per cent annum.

Central Government Borrowing

35. The borrowing programme of the Central Government has been achieved much more comfortably during 1996-97 than in 1995-96 because of relatively easier liquidity conditions since April 1996. The net market borrowings under "market loans" has been budgeted at Rs.3,700 crore, and the other medium and long term borrowings at Rs.21,798 crore for the year 1996-97. The budgeted

gross borrowing, including repayments of Rs.9,796 crore, would amount to Rs.35,294 crore. As of December 24, 1996, Government of India had completed a gross borrowing programme of Rs.33,252 crore representing 94 per cent of the total budgeted programme of Rs.35,294 crore for 1996-97. The coverage was only about 70 per cent for the comparable period in 1995-96. The gross issues through dated securities amounted to Rs.26,911 crore and through 364-day treasury bills amounted to Rs.6,341 crore (Table 4.4).

TABLE 4.4

Net Market Borrowings of Central Government[1]

(Rs. Crore)

Instruments	1995-96	1995-96 April-December	1996-97 April-December
a) Conventional Market borrowing	3700	3700	3025
b) Other medium and long term borrowing	29379	19879	15965
c) 364 day treasury bills	-6288	-6399	4783
Total	26790	17180	23773

[1] Actuals as per RBI records.

Dated Securities

36. Dated securities, consisting of market loans and other medium and long term borrowings, aggregating Rs.38,634.24 crore were issued during 1995-96. In view of the high level of net issue of ad hoc treasury bills, exceeding the limits agreed to for the intra-year, the RBI had to enter the market more frequently during 1995-96. There were larger primary subscriptions by the RBI. In addition, RBI added to its stocks by issuing in its favour Central Government dated securities for a value aggregating to Rs.5,500 crore on a private placement basis. The recourse to private placement has been made for the first time since 1987. The devolvement on the RBI in total primary issues, including conversions, rose from a low of 0.74 per cent in 1994-95, to 32.8 per cent in 1995-96. The devolvement on primary dealers stood at 0.2 per cent. During 1996-97, (upto December 24, 1996), total issues of dated securities amounted to Rs.26,911.05 crore. The devolvement on the Reserve Bank declined to 13.7 per cent in 1996-97 while that on primary dealers marginally went up to 1.3 per cent.

Treasury Bills

37. Following various measures undertaken by RBI (Chapter 3), a marked softening in the structure of interest rate was seen during the first half of 1996-97. The implicit yield at cut-off price declined sharply for both 91-day and 364-day treasury bills, between April and December 1996.

91-Day Treasury Bills

38. The Bank followed a policy of consistently placing Rs.500 crore in weekly auctions of 91-day treasury bills. The RBI subscribed in many auctions during 1996-97 for amounts ranging from Rs.25.92 crore to Rs.388.80 crore. Reserve Bank's holding amounted to as much as Rs. 1,663.85 crore on December 28, 1996 against the total outstanding of Rs.6,500 crore. At the end of 1995-96, it had stood at Rs.3,211.47 crore. There has, however, been an increased response from non-competitive bidders, particularly state governments. During 1995-96, a sum of Rs.11,956.13 crore, comprising 49.82 per cent of the total issue amount was raised from non-competitive bidders. During 1996-97 (upto December 28, 1996), about Rs.5,288.98 crore (27.84 per cent of total issue) was raised from non-competitive bidders. The implicit yield at cut-off prices ranged between 11.40 per cent and 12.97 per cent in 1995-96. During 1996-97 (upto December 28, 1996), the implicit yield ranged between 6.92 per cent and 12.97 per cent.

39. During the first auction in early April 1996, the cut-off yield stood at a high of 12.97 per cent. Since then, the cut-off yields have been treading downward. It had declined to 12.41 per cent by early May. The declining trend continued till July and cut-off yields reached a low of 8.46 per cent in August. The downtrend was interrupted thereafter, as cut-off yields rose to 10.17 per cent by early October 1996. The yields declined significantly to reach a low of 6.92 per cent in early November. By end-December it firmed up again to 8.16 per cent (Table 4.5).

364-Day Treasury Bills

40. A gross amount of Rs.6,340.68 crore has been raised during 1996-97 (upto December 20, 1996) against a meagre Rs.1,875 crore raised during the corresponding period of 1995-96 through 364-day treasury bills. The stock of 364-day treasury bills at Rs.6,657.84 crore as on December 20, 1996 showed an increase by Rs.4,783.10 crore over end-March 1996, as against a decline by Rs.4,632.96 crore during the corresponding period in 1995-96.

41. The number of bids received for 364-day treasury bills varied in the range of 12 to 143 in 1996-97 (up to December 20, 1996) as against 3 to 66 during 1995-96. The implicit yield at cut-off prices ranged between 10.10 per cent and 13.12 per cent in 1996-97 as compared with 12.08 per cent and 13.16 per cent in 1995-96.

TABLE 4.5

Implicit yield of 91-Day T-Bills at cut off price

(Per cent per annum)

Month	1995-96	1996-97
April	11.99	12.97
	11.99	12.84
	12.03	12.63
	11.90	12.46
	11.40	
May	11.95	12.41
	12.07	12.37
	12.07	12.37
	12.07	12.37
June	12.33	12.41
	12.33	12.41
	12.37	12.41
	12.58	12.41
July	12.71	12.41
	12.97	11.86
	12.97	9.88
	12.75	9.21
		9.46
August	12.67	9.04
	12.67	8.46
	12.63	9.46
	12.58	9.96
		9.96
September	12.54	9.96
	12.54	10.00
	12.54	10.13
	12.67	10.17
	12.67	
October	12.67	10.17
	12.75	10.09
	12.80	10.05
	12.88	8.83
November	12.97	6.92
	12.97	7.21
	12.97	7.21
	12.97	8.16
		8.16
December	12.97	8.04
	12.97	8.16
	12.97	8.16
	12.97	8.16
January	12.97	8.16
	12.97	8.16
	12.97	8.12
	12.97	8.00
	12.97	7.50
February	12.97	
	12.97	
	12.97	
	12.97	
March	12.97	
	12.97	
	12.97	
	12.97	
	12.97	

42. The rising trend in the cut-off yield on 364 day treasury bills which had continued throughout 1995-96, had plateaued by January 1996. The rate remained stable till April 1996. The downtrend in the cut-off yields of 364-day treasury bills has been less sharp but more sustained than in 91-day treasury bills. Cut-off yields fell from 13.12 per cent in April to 12.61 per cent in July. They plateaued out at this rate for a couple of months, and then resumed their downtrend in October. They had reached 10.33 per cent by end-December, 1996 (Table 4.6).

TABLE 4.6

Implicit yield of 364-Day T-Bills at cut-off price

(Per cent per annum)

Month	1995-96	1996-97
April	12.08	13.12
	12.21	12.99
		12.99
May	12.50	12.94
	12.52	12.94
June	12.52	12.94
	12.60	12.97
July	12.71	12.87
	13.16	12.61
August	13.16	12.61
	12.87	12.61
		12.61
September	12.87	12.61
	12.87	12.61
	12.91	
October	12.93	12.61
	12.94	12.10
November	12.99	10.10
	12.99	10.40
December	12.99	10.33
	12.99	10.33
January	13.07	10.33
	13.12	10.10
February	13.12	
	13.12	
March	13.12	
	13.12	

Long Term Debt Market

43. LIC, GIC and the provident funds are important potential sources of funds for the long-term debt market. Some of the controls imposed on these institutions have been gradually eased. As a result, the proportion of investment going into corporate investment has increased. Further replacement of controls by prudential regulations will be an important factor in the development of the debt market.

Listing of Debt Instruments

44. The earlier restriction that debt instruments of a corporate could be listed only after its equity had been listed on any exchange was removed. The removal of this restriction will particularly ease the listing of debt instruments for infrastructure projects.

Life Insurance Corporation

45. Investment guidelines regarding the utilisation of funds of LIC were last revised in 1995 (Table 4.7). According to these guidelines, fixed proportions of the funds have to be invested in various instruments. These include Central and State Government securities and loans for socially oriented sectors like house building (75 per cent) and only 25 per cent can be put in corporate sector investments.

46. During 1995-96, LIC invested Rs.6485 crore in Central Government securities, Rs.1139 crore in State Government securities and Government guaranteed marketable securities and another Rs.1841 crore on disbursing socially oriented sector loans. Though only Rs. 3406 crore was invested in corporate investments, this represents a trebling of corporate investment since 1993-94. It also represents a growth of 29.6 per cent over Rs.2629 crore in 1994-95. The pattern of LIC investment has consequently been changing.

47. During 1996-97 upto November, LIC invested Rs.7182 crore in Central Government Securities. The share of these securities has therefore, declined from 75.3 per cent in April-November, 1995 to 71.1 per cent in April-November, 1996. The share of public sector, cooperative sector and housing, called the "social sector", has declined from 5.12 per cent to 4.03 per cent over the same time period. Investment in the corporate sector increased by 13.3 per cent to Rs.1537 crore (from Rs. 1356 crore). This took its share from 14.94 per cent in April-November, 1995 to 15.22 per cent in April-November, 1996.

TABLE 4.7
Current Portfolio Restrictions: LIC
(per cent)

	Investments in:	
(a)	Central Government marketable securities being not less than	20
(b)	Loans to National Housing Bank including (a) above being not less than	25
(c)	State Govt. Securities including government guaranteed marketable securities, inclusive of (b) above being not less than	50
(d)	Socially oriented sectors including public sector, co-operative sector house building by policy holders, own your home schemes, inclusive of (c) above not less than[1]	75

[1] The remaining 25 per cent may be used for investment in the private corporate sector, loans to policy holders for construction and acquisition of immovable property under the guidance of investment committee.

General Insurance Corporation

48. Under Section 27(B) of the Insurance Act, 1938, GIC and its subsidiaries are allowed to invest upto 55 per cent of their funds in the market sector and the remaining 45 per cent has to be invested in socially oriented sector (Table 4.8). During 1995-96, GIC invested Rs.421 crore (19.93 per cent) in Central Government securities, Rs.248 crore (11.72 per cent) in State Government securities and other approved securities and bonds/debentures of PSU's, and disbursed Rs.171 crore (8.1 per cent) in socially oriented sector loans. It invested Rs.827 crore (39.20 per cent) in the corporate sector securities and Rs. 444 crore as parked funds (21.1 per cent).

49. During 1996-97 upto September 1996, GIC invested Rs.357 crore (24.04 per cent) in Central Government securities, Rs.286 crore (19.29 per cent) in State Government securities and other approved securities and bonds/debentures of PSUs, and disbursed Rs.35 crore (2.37 per cent) in socially oriented sector loans. Against this, Rs.639 crore (43.01 per cent) were devoted to corporate sector investments and Rs.167 crore (11.4 per cent) as parked funds. The proportion of investment going to the corporate sector has consequently increased from 39.2 per cent in 1995-96 to 43.01 per cent in the first half of 1996-97.

TABLE 4.8
Current Portfolio Restrictions: GIC[1]
(per cent)

	Investments in:	
(a)	Central Government securities, being not less than	20
(b)	State Government Securities and other government guaranteed securities, including (a) above, being not less than	30
(c)	Housing (loans to HUDCO and to state governments for housing and fire fighting equipment), not less than	15
(d)	Market sector (subject to prudential and any other guidelines, and provisions of the Insurance Act), not more than	55

[1] Effective from April 1, 1995

Employees Provident Fund (EPF)

50. The funds are invested as per provisions of EPF scheme, 1952 and the guidelines issued by the Government from time to time. The current guidelines stipulate 25 per cent investment in Central Government securities, 20 per cent in special deposit scheme, 40 per cent in bonds/securities of public sector financial institutions and public sector companies and Certificates of Deposits of the public sector banks, and the remaining 15 per cent for State Government or Central/State Government guaranteed securities (Table 4.9). A comparison of the guidelines issued by the Government show a clear trend towards liberalisation of investment in favour of higher yielding avenues. In 1993, a separate category for bonds and securities of public sector financial institutions was created, in which the organisation was required to invest 15 per cent of its funds. This proportion was raised to 30 per cent in 1994 and further to 40 per cent in October 1996. The average yield on this category of financial instruments is about 17 per cent against 12 per cent yield earned on special deposit schemes. In 1995, yet another category of Central Government securities was created for investment by the EPFO. These securities are now yielding 13.85 per cent rate of interest.

TABLE 4.9

Portfolio Restrictions: EPF

(per cent)

			Apr.1995 to Sept.1996	Since Oct 1996
		Investments in:		
(a)		Central Government securities.	25	25
(b)	(i)	Govt. Securities created and issued by State govts. and or		
(b)	(ii)	Any other negotiable securities guaranteed by Central or State Government.	15	15
(c)		Special deposit scheme	30	20
(d)	(i)	Bonds and securities of public sector FIs, Public sector companies.		
(d)	(ii)	Certificates of Deposits issued by public sector banks.	30	40

Money Market Developments

Mutual Funds

51. The SEBI (Mutual Funds) Regulations, 1993 were revised on the basis of the recommendations of the Mutual Funds 2000 Report prepared by SEBI. The revision has been carried out with the objective of improving investor protection, facilitating competition, imparting a greater degree of flexibility and promoting innovation. The existing asset management companies will be required to increase their net worth from Rs.5 crore to Rs.10 crore within 1 year from the date of notification of the regulations. The Asset Management Companies (AMCs) can also have cross trusteeship and cross directorship, provided, there is no conflict of interest. They are also allowed to do other fund based businesses such as providing investment management services to offshore funds, other mutual funds, venture capital funds and insurance companies. The revised regulations for mutual funds, however, retain the present fee structure of the AMCs of 1.25 per cent of weekly average NAV upto Rs.100 crore, and 1 per cent of NAV for net assets in excess of Rs.100 crore.

52. The consent of investors will now have to be obtained for bringing about any change in the "fundamental attributes" of a scheme on the basis of which the unit holders had made initial investments. The revised regulations also provide for portfolio disclosure, standardisation of accounting policies, valuation norms for NAV and pricing. The payment of early bird incentive for various schemes has been allowed provided they are viewed as interest payments for early investment with full disclosures.

53. The various mutual fund schemes would be allowed to mention an indicative return for schemes for fixed income securities. This will be subject to a variety of disclosures, including :

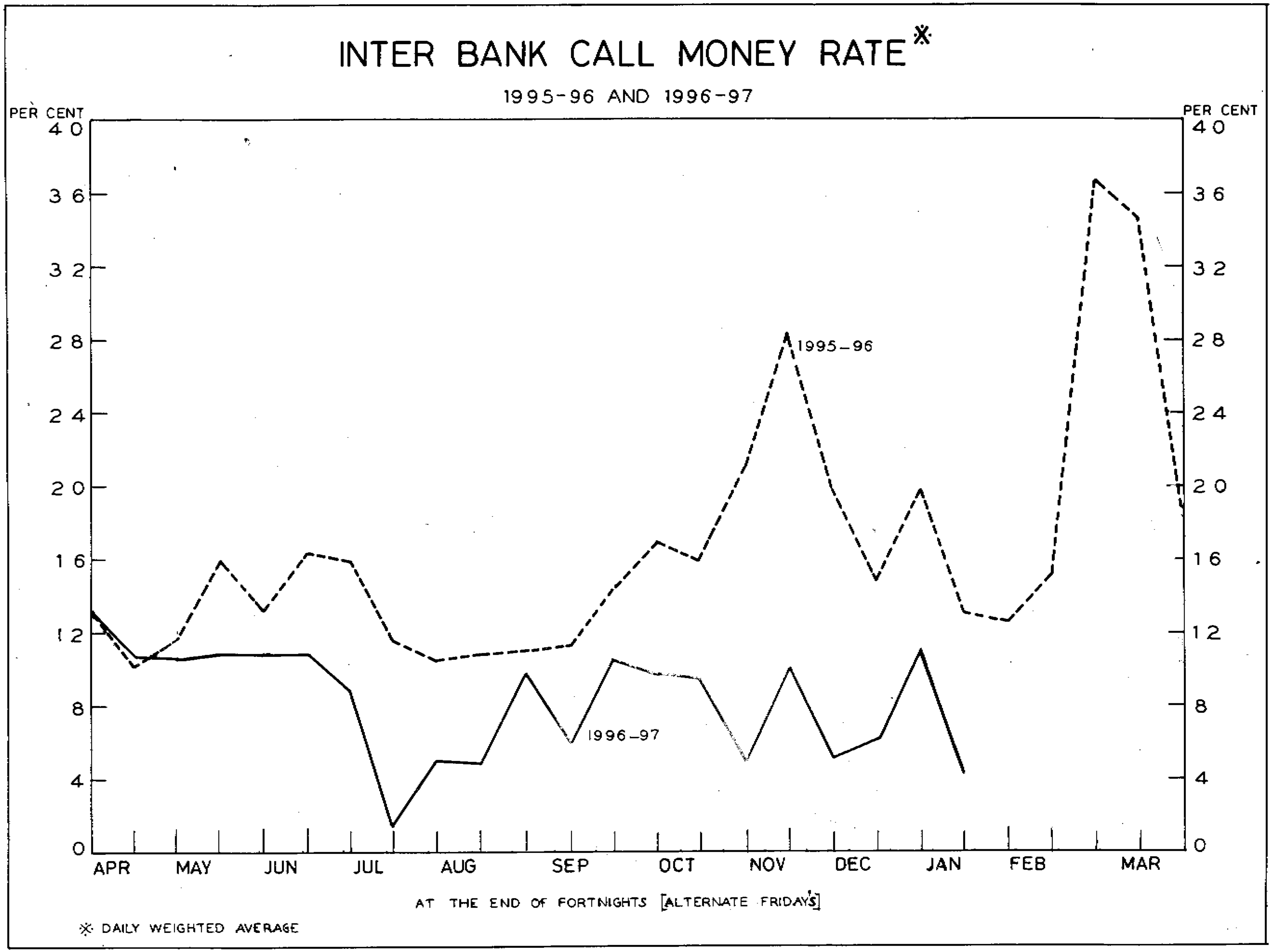
(a) That the returns be based on the current yields of instruments which may change from time to time, depending upon the interest rates prevailing in the market, RBI policy and other relevant factors.

(b) In case a portfolio of securities is disclosed, it should also be mentioned that such a portfolio is a purely illustrative example, and the scheme does not assure that it would maintain this portfolio.

(c) The returns mentioned are only indicative and not assured. The actual returns will be based on the actual NAV which may go up or down depending on the market conditions.

54. In all 31 mutual funds (excluding the Unit Trust of India) were registered with SEBI as of December 1996, under the SEBI (Mutual Funds) Regulations, 1993. Of these, 10 belong to the public sector and 21 are in the private sector. 16 private sector mutual funds and 1 public sector mutual fund have foreign participation in their asset management companies.

Figure 4.2


INTER BANK CALL MONEY RATE ※
1995-96 AND 1996-97
PER CENT
40
36
32
28
24
20
16
12
8
4
0
1995-96
1996-97
APR
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
JAN
FEB
MAR
AT THE END OF FORTNIGHTS [ALTERNATE FRIDAYS]
※ DAILY WEIGHTED AVERAGE

55. The performance of mutual funds has not been encouraging during 1995-96, a trend which has continued in 1996-97. Investor confidence in mutual funds, which ideally should be the most preferred investment vehicle for the lay investor, has been low. The lukewarm response to their schemes seen in 1995-96, continued in 1996-97. This could be attributed partly to a lack of confidence and partly to market conditions which have affected the perception of investors. In 1996-97, upto December, mutual funds had mobilised only Rs.2,167 crore. With this trend in resources mobilised, it is unlikely that mutual funds would match Rs.6,508 crore mobilised in 1995-96.

Call Money Market

56. Reflecting the improvement in the liquidity position of the banking system, owing to reduction in CRR and strong growth in bank deposits, there has been a softening in interest rates during 1996-97. The inter-bank call money rates ruled in the range of 10.00-11.25 per cent in the first quarter of 1996-97. By July 1996, the rates declined sharply to as low as 0.10 -3.00 per cent. After staying at such historically low levels for about a fortnight, call rates moved upwards and ruled generally in the range of 5.00 - 10.00 per cent upto October 18, 1996. Subsequent to the announcement of the monetary policy for the second half of 1996-97, there was a further easing in the call rates which ruled in the range of 1.00 - 3.00 per cent in the end-October/ early-November 1996. Call rates firmed up some what and declined thereafter towards the end of December 1996 (Fig. 4.2).

Other Short Term Markets

57. Interest rates on Certificates of Deposits (CDs) and on Commercial Paper (CP) also exhibited a declining trend since the beginning of 1996-97. Rates on 3-month CDs fell from 17-19 per cent in April 1996 to 13 per cent in August 1996. Rates on CPs fell from 18-20 per cent in April to 13-14.24 per cent in September 1996. Typical interest rates on CDs declined further to the level of 11-12 per cent in the month of November 1996. Similarly, typical effective rates of discount offered on CP issues declined steadily to a range of 11.76 per cent to 12.50 per cent per annum in the first fortnight of December 1996.

Repo Operations

58. Repos have been resumed on a modest scale in November 1996. They were intensified and made a regular feature in January and February 1997, with a monthly advance calendar of continuous repos of 3 to 4 days duration. The aggregate amounts of repo operations (liquidity siphoned off) in January and February (upto February 7) was Rs. 19,997.19 crore, at cut-off repo rates ranging from 4.90 to 5.25 per cent. These operations were aimed at mopping up excess liquidity, reducing volatility in call money markets and consequent pressure on foreign exchange markets. The net sale of Government Securities by the RBI in the secondary market amounted to Rs. 6901.996 crore between April and February 6, 1997.

Outlook

59. The financial sector has a vital role in promoting efficiency and growth. It intermediates the flow of funds from those who want to save a part of their income to those who want to invest in productive assets. The efficiency of intermediation depends on the width, depth and diversity of the financial system. Till about two decades ago, a large part of household savings was either invested directly in physical assets, or put in bank deposits and Government small saving schemes. It is only since the late eighties that the equity market has started to play a role in this intermediation process. Other markets, such as the medium to long term debt markets and short-term money markets, remain relatively segmented and underdeveloped. In recent decades, the Government and its subsidiary institutions and agencies, have had an overwhelming and all encompassing role. This has played a part in slowing the evolution and development of these markets. The extensive system of controls, rules, regulations and procedures, directly or indirectly affects the development of these markets. We need to clear this web in the interest of both savers and those who invest in productive assets. Tax deductions and exemptions cannot be a substitute for reforms of policy and procedures. They can, however, create further distortions.

60. The two most serious problems in the financial system are the lack of flexibility in intermediary behaviour and the segmentation of various markets and sets of financial intermediaries. Well developed markets are interconnected; demand-supply imbalances in one market overflow into related markets thereby dampening shocks and disturbances. This inter-connection also ensures that interest rates and returns in any market, reflect the broad demand-supply conditions in the overall market for savings. A rise in the demand for funds for investment, above the existing flow of funds from savings, leads to a rise in the interest rate or rate of return in all markets. The time lag may differ from market to market depending on economic factors. Conversely, a decline in demand for funds for investment below saving, leads to a fall in interest rates across the board. This does not happen in segmented markets. Adjustment in interest rates is

also delayed by the slow speed of response of intermediaries and their lack of flexibility. Because of the historical role of the government and its subsidiary organisations in controlling and directing all financial activity, the autonomy and flexibility if intermediaries was greatly circumscribed. Consequently, adjustment to demand-supply imbalance in each segment was also very slow. Over the last five years a series of reforms. The widening and acceleration of reforms will increase the flexibility and responsiveness of the intermediaries and promote integration.