Our Views

Thoughts on Capital Formation

At a seminar recently organized by SEBI and NISM, I participated in an interesting panel discussion on path-breaking ideas for capital formation. Remarkably, it was our regulators asking the panelists about out-of-the-box ideas for capital formation over a horizon of next 5 to 10 years. It was indeed heartening to see a regulator taking the lead on this topic and to see that they are thinking forward and long term about it.

One of the important aspects of capital formation is to increase the supply of variety of assets in the capital markets. This will enable the formation of capital for various class. In my view, from a medium to long term capital formation perspective we should focus on

digitization, corporatization, and rationalization. These three elements will help capital formation in medium to long term.

Digitization, according to me, will play a pivotal role in capital formation. We have already seen the impact of it in our capital markets. In the early 1990s, the average trading volume of at Indian Stock Exchange per day was hardly 10,000 trades per day. Today, this number is more than 25 crores. This has been made possible because of digitization of the trading, delivery, and payments processes. Again, in 2014, SEBI created the roadmap to digitally monetize one of the most difficult and physical asset-class, real estate. Today, the market cap of digitized real estate in the REITs form is more than Rs. 1 lac crore. This is a significant capital formation for a sector which was totally dependent upon unsecured private financing. The unlocking of the underlying value through larger participation and churn of such investments in this hard asset has been made possible only though its digitization under REITs.

Similarly, if we digitize and put several other locked up and unproductive assets in the markets it will add to new classes of assets and will create more value. Gold is one such asset class. Various studies suggest that US$1.4 trillion worth of gold (estimated 25000MT) are lying unproductive in our *tijoris*. Digitalization of this can create a larger market leading to a lot more capital formation. According to AMFI, the number of gold ETF folios has gone up from 3.1 lakhs to 46.7 lakhs between Sep-18 to Nov-22. This shows the investor interest in this asset class. Similarly, there can be other assets classes which could be considered for digitization including agri products, corporate bonds, and municipal bonds, etc. So, in my view, we don't necessarily need artificial assets like cryptocurrency to invest in. The digital conversion of assets lying with us will be large enough to create capital through the multiplier effect of larger participation.

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Corporatization is another initiative that helps an enterprise raise capital. This leads to larger participation in a business and gives a strong fillip to capital formation. The listing of Coal India and later of LIC confirms this hypothesis. Similar corporatization of several other enterprises such as railways, postal services, local corporations, utilities can lead to significant capital appreciation. We have seen that many other countries following this path. Singapore is a prime example. Singapore created two main holding companies – Temasek with and AUM of over US$300bn and GIC with an AUM of app US$ 370bn. The government enterprises are mostly held by these two entities who professionally manage this portfolio of state corporates. More recently, Saudi Arabia corporatized and listed Saudi Aramco which has become the 4th largest market cap company in the world with a market cap of US$2.1trillion. Corporatization not only brings larger capital participation but also better governance, openness, and possibility for distribution of wealth. Startups funded by venture capital have created capital through a better corporate construct. Similarly, private equity/ buy out funds have created a new class of professionally managed companies which have in turn created substantial capital.

Finally, rationalization of the regulatory structure can also help in capital formation. A regulatory framework where there could be specialized single regulators for the specific sector would be a better approach. For example, for financial services there are several regulators – the central Bank, SEBI, IRDA, PFRDA, Competition Commission, NCLT (in some cases) and many others. This should be rationalized in the interest of time and to build value. Expediting regulatory approvals and cutting down time spent on multiple compliances will help preserve and enhance value of assets and situations that can enhance capital value. Another suggestion is to create an economic green corridor on the lines of income tax or customs wherein transactions are pre-approved. A subsequent sample scrutiny of transactions would ensure that a right balance is maintained. Any deviations could be dealt with through strict regulatory actions. This self-regulation-based approach will speed up transaction execution and make the market participants more responsible. We all know that *Laxmi Chanchal hoti hai.* So, speed is very important to retain *Laxmi* on our side.

In conclusion, to give a strong fillip to capital formation over the next decade, we will need to digitize as many new assets classes as possible, corporatize as many enterprises as possible, and finally focus on the efficiency of our regulatory framework.

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