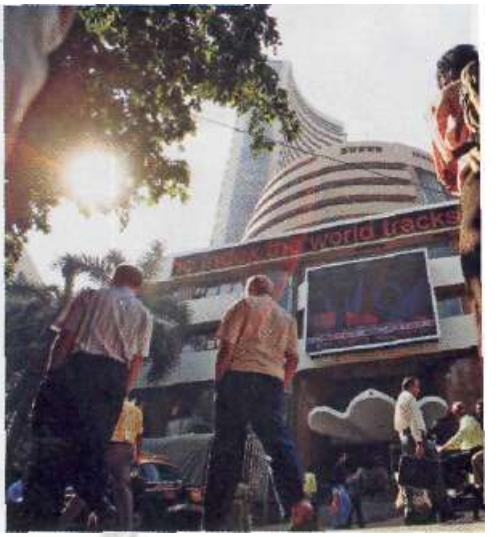
What's Roiling India's Stock Market? Bonds

Mumbai needs a more robust debt market to prevent violent swings in equities trading



By Manjeet **Kripalani**

India's markets have long enjoyed a reputation for being well run. But after shares in Mumbai fell 10% in the first 57 seconds on Jan. 22 and regulators halted trading, investors startedgrousing that India's bourses still have a long way to go before they're on par with the world's leaders. "India has made major strides with market reform, but in finance...it's antediluvian," says Percy S.Mistry, chairman of London consultancy Oxford International Group.

The bond market—or lack thereof—is the core of the problem. Although India has long had the regulatory framework for companies to offer debt, the disclosure requirements are so stringent that fewbother. Last year, Indian companies issued bonds equivalent to just 1% of the country's gross domestic product, compared with 112% of GDP in the U.S. and 10% in China, according to Britain's University of Reading. Lacking other financial options, Indians funnel almost all their money into stocks. "If there were more debt available," says Alan Rosling, a director of Indian conglomerate Tata Sons, "some institutional investors would buy and hold rather than join the hot money rushing in and out of equities."

That means Indian companies often sell shares rather than bonds, and some $50 billion in initial public offerings are in the pipeline for the next two years.

The stock exchange gains from India's strict bond rules

But this creates another problem: IPOs in India are painfully slow. Regulators want all of the country's 20 million individual investors—many living in remote areas without computers—to have a shot at getting shares. So companies must also accept paper applications for allocations. Anyone who wants to buy must put down 10% of the value of the stock requested. Consequently, when a popular offering is in the works, investors' money is locked up for three weeks while the shares are parceled out—which saps liquidity from the market.

India paid the price for this in January. Reliance Power was in the midst of a $3 billion IPO to fund 13 new generating plants, and investors jumped at the chance to buy into the blue chip. The listing was oversubscribed 73 times, meaning Reliance was sitting on more than $21 billion in deposits just as the market headed south. The problems were aggravated because of the preference Indians have for trading in futures; last year 121 million futures contracts were traded, compared with just 6 million in the U.S.

SHAKY MARGINS

Futures are attractive in a rising market because investors put down only about 10% to 25% of the price of a share—called a margin—but can capture the entire value of any increase. Losses pile up fast, though, in a declining market. In most countries, when the underlying share price falls, margins do, too. So investors need less cash to hold the stock future. But when shares in India dive, margins can increase. As prices tumbled in January, margins soared while billions were tied up by Reliance. The company asked regulators to release the funds early, but by Feb. 1, when the cash was finally available, plenty of damage already had been done.

India's regulators are starting to listen to the griping. On Jan. 30, the Securities & Exchange Board said it may consider changing the margin structure and will shrink to five days the time taken to process IPOs and simplify disclosure requirements for bond issues. The key, says Naina Lai Kidwai, CEO of HSBC India, is to make it easier to sell bonds at home. If not, "we will end up exporting our debt market instead of developing a vibrant Indian one." IBWI

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