Rajiv Gandhi Equity Savings Scheme - A newbie investor’s wisdom or folly??

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Abstract
There is not much awareness and penetration amongst the Indian general public when it comes to capital markets. To add fuel to fire, the dependence on Foreign Investors and their dollars is taking a big toll on the market. This has also lead to depleted value of our rupee. The question arises that is our economy to be blamed for the same or is the general population to be blamed because their lesser participation & investment in the capital markets which has lead to the situation what it is today? On the other hand, even the government with the help of Rajiv Gandhi Equity Savings Scheme (RGESS) is trying to make capital markets attractive to small investors and is hoping to rope in their investments. The expectation is that more and more people will be attracted to equity markets and the equity culture will spread to the people. This paper intends to create an awareness about the newly launched scheme RGESS but at the same time also wants to look into the same with a question in mind, which is “whether the first time investor will benefit from this or will it be his biggest mistake”?

Keywords: RGESS, equities, small investors, capital markets.

Introduction
The union budget 2012-13 introduced this equity savings scheme with a view to promote equity investments among people and to promote the scheme, will allow a deduction of 50% of the amount invested subject to a maximum of Rs 25,000. The deduction is claimed through a new section introduced in chapter VI A of the income tax Act, called the 80CCG. The investments can be made in installments throughout the year or in a lump sum and it should be made after 23rd November 2012-the date on which the scheme came into force.

Schemes similar to RGESS were earlier introduced in Belgium and France which had positive results. In France, the implementation of a similar scheme resulted in public participation in retail trade which increased from 7% to 17%. The scheme is introduced in India with the same objective – to promote equity investment among freshers. That means, only first time investors will get the twin benefit of equity investing and tax exemption. One more condition that has been attached to this is that the new investor should not have an income before tax deductions that exceed 10 lakhs in a year.

From the government’s side, the benefit of this scheme is that it would improve the depth and liquidity of our equity markets. More savings would be channelized into the market which will improve common people’s perception about the stock market as something very dangerous. So it’s a win-win scheme. Both the government and the investor have benefits from it.

Concerns:
An investment of Rs 50,000 results in a deduction of Rs 25,000 from the taxable income. This in effect, means that the investor will get a maximum tax saving of Rs 5,000 in a year, assuming that he falls in the tax bracket of 20% under the Income Tax Act. Now, the big question is – equities are inherently risky investments. It’s a field where only expert investors can make money. However, the exemption is for new investors who may not know the basics of investing. Would it be worth for such a new investor to open a demat account and make such a high investment even before knowing what to buy? Even if someone manages to quickly learn all the basics and make an attempt to invest, would it be worth to take a risk of Rs 50,000 for getting a tax benefit of Rs 5000? The answer would depend from person to person, we guess. May be those who have already exhausted 80C limits may prefer this scheme.
Eligible Equity investor

The scheme offers tax soaps only to ‘new’ equity investors. A new equity investor is someone who has not done any trades in the equity or derivative markets on or before 23rd November 2012. The logic is that, 23rd November was the date on which the scheme came into force. So, that date has been fixed as the cutoff date.

The scheme says that no investments / trades should have been entered into by a ‘first holder’ on or before 23rd November 2012, but does not mention the date on which the trading and demat account should be opened. So, that means - Even if you have an old demat account in which you have not bought even a single stock or derivatives before 23rd November 2012, you are still eligible to be counted as a new equity investor and, Even if you are the ‘second holder’ of an existing demat account in which trades have been made, you can still avail the benefit by becoming the ‘first holder’ of a fresh demat account opened in your name.

Other conditions:

There is a lock in period.

The investment should be held for a minimum period of 1 year. You cannot sell / pledge the shares/ mutual funds for 1 year. This 1 year period is also called a ‘fixed lock in period’.

After the completion of 1 year fixed lock in period, the lock-in extends to 2 more years, which is known as the ‘flexible lock-in period’. During the flexible lock in period, the investor can trade in the RGESS eligible securities, subject to certain conditions. The conditions is that, the investor should maintain the value of investments at the amount for which they have claimed income tax benefit or at the value of the portfolio before initiating a sale transaction, whichever is less, for at least 270 days in a year. This process of maintaining the value of the portfolio may be a bit complicated for new investors.

Summary of the scheme:
- It’s only for new investors in equity markets
- Annual income should be less than 10 lakhs
- Maximum exemption is Rs 5000
- Fixed lock-in period of 1 year and flexible lock in period of 2 years.

How to invest:

To be eligible for investment under this scheme, you must open a demat account and designate the demat account for RGESS by submitting the duly signed ‘Form A’, which is available with brokerage houses. An investor can invest in any of the eligible mutual funds or shares in lump sum or in installments during the year in which the deduction is to be claimed. Though any amount can be invested through the demat account, tax benefit will be available only on an investment of up to Rs 50,000. The investments under the scheme would automatically be subject to lock in during the first year. From second year onwards, you can sell the units of securities if you maintain the minimum amount for which you have claimed income tax benefit. Failing to do so will lead to reversal of the tax benefit availed.

The tax benefit under RGESS is available only for one year. If an investor has claimed a deduction once, he will not be allowed any deduction under the scheme in subsequent years. One can invest in non-RGESS stocks and mutual funds through the same demat account and those investments would not be subject to conditions such as the lock-in of the scheme. If a person invests on the last trading day of the financial year, you get a three-day grace period so that the securities get credited in the demat account and you can avail tax benefit under the scheme.

Eligible securities under RGESS

A. Equity shares, which are part of BSE 100 and CNX 100 indices, on the day of purchase
B. Equity shares of public sector enterprises which are categorized as Maharatna, Navratna or Miniratna.
C. Units of exchange-traded funds (ETFs) or Mutual Fund (MF) schemes with RGESS-eligible Securities as underlying
D. Follow on public offer of point A and B above
E. New fund offers (NFOs) of point C above
F. Initial public offer of a public sector company in which the government holds at least 51 per cent stake and whose annual turnover is not less than Rs 4,000 crores in the preceding three years

Analysis of the market sentiments:

İ. The burning question in mind is why ignore the old investors?
While this scheme has given an incentive to the new retail investor to get him to invest in stocks, one of the important questions being raised is: why are the old boys being ignored?
But first let’s see what the intent behind this scheme is.
The RGESS has been announced with the intention to get more people to invest in the stock market. The idea is to introduce them to an investment opportunity which gives the best returns and to make the stock market more robust by giving more control to retail investors. This scheme comes with a dual benefit – i.e. will help increase retail participation in the stock market as well as entails a tax benefit for the investors.
The RGESS scheme as of now is aimed only at new investors. Though not yet clearly defined, it is for those who do not have a demat account as yet and whose annual income is less than Rs. 10 Lakh per year. Obviously there are many views as to whether the existing guys should be included or not. But first, let’s see what the positives of including new investors are?
There are about 3.5 crore equity investors in India currently, but over 10 crore people earn more than Rs 2 lakhs a year (requisite of scheme – annual income is less than Rs. 10 Lakh). The Finance Ministry is looking to rope in a large section of the population (1.5 crore as new investors is the number being discussed) to invest in stocks.
A lot of the investors shy away from stock markets because they think of the stock market as a complex machine which takes all your money and gives back nothing in return. This could not be farther from the truth! This misconception has to be corrected, and soon. And this correction should start with the new investors, so that the stock market creates more happy investors than disappointed ones.
It is important that these investors know that the right way of investing in stocks is by keeping in mind the fundamentals of stock investing. It is only then that the stock market can give better returns in the long run than any other form of investing. These returns will in turn give them the confidence to invest in the stock market again and again. And gradually the fear of the stock market will be done away with.
But these new investors need to be first lured into the stock market. Which is exactly what the RGESS is doing – providing a little push by way of a tax exemption to the new retail investor to invest in stocks. The scheme has provided the required incentive, it is upto the investors to make maximum gain of this opportunity.

There are two types of investors that the RGESS does not have under its purview:
1. Retail investors who are presently active investors in the stock exchange
2. Retail investors who have invested, but left the stock exchange disenchanted
Both these groups are certainly entitled to be aggrieved about their exclusion from the RGESS. While their exclusion does not help anybody, there certainly are a few benefits if they are included:
It will bring more investment into the capital market:
The idea behind the RGESS is to bring in more investors to the stock market. Hence, it makes sense to make it available to all those who invest in the stock market, whether they are first time investors or not. The tax benefit entailed would definitely be a bait for them to invest more, in effect, getting more money into the stock market.
It will bring back disgruntled investors:
Many investors bear a grudge against the stock market, as they may have invested in the stock market while it was in the uptrend, only to see it crash as investments bit the dust. They now accuse it of being
volatile and tend to stay away from it. So it is important that these investors are provided with an incentive, just like the RGESS scheme, that will bring them back to the capital markets. These investors will flock back to the markets, bringing in fresh investment and increased retail participation, thus fulfilling the objective of this scheme.

Given that the ultimate objective of the RGESS is to get more retail investors to invest in the stock market it is imperative that all the avenues of achieving this goal are looked into. Including existing investors in the purview of this scheme is definitely a good idea, as it’ll help get more investment and may bring back unhappy investors as well. Obviously with higher retail participation there is an expectation that stocks will trade at their right values driven by earnings rather than by the whims and fancies of the market sentiments. Hence including the existing as well as new investors would be a great push to achieve the ultimate objective of RGESS.

**Brokers unsure about success of RGESS**

Broker sources have expressed apprehension over the success of the scheme. According to Amar Ranu, AVP - research and advisory, Motilal Oswal Wealth Management Ltd, retail investors are hesitant to enter the equity markets even at the current valuation. "It is seen that the current equity markets rally is backed by foreign institutional investors (FIIs). There is a lack of participation of retail investors. Also, There is no incentive for family-led investors, who operate through demat accounts of their family members. So, there is high dependence on new investors for the scheme to succeed," said Ranu. He maintained that barring both the capable and seasoned retail investors from the scheme would limit the prospects of the success of the scheme. "This is going to be a complex scheme to implement. It is unclear about the participation of the normal retail investor. If that restricts them from participating, then there will be no point in having such a scheme. Let us wait for the government notification on the same and let SEBI issue a circular with details on the scheme," said Shah.

**Is Rajiv Gandhi Equity Savings Scheme is good only in parts?**

The broad contours of proposed Rajiv Gandhi Equity Savings Scheme (RGESS) have just been announced by the Central Government. The finance ministry, while announcing the details of the scheme hopes that the scheme will improve the depth of the domestic capital markets, as it aims to promote an equity culture in India. While time alone will tell whether these objectives will be achieved, the scheme as it appears is like a curate’s egg, only good in parts, and requires clarity on several fronts for the smooth operation of the scheme.

**Analysis of the Benefits & the Issues faced by the Investors in this scheme**

**What is the benefit?**

- under section 80CCG for Tax benefits
- Maximum amount individual can invest is Rs.50,000
- 50% of the invested amount can be deducted from the gross income
- This benefit is available only for one year. And not available for the subsequent years, because this person is no longer a new investor in the equity market.

**Under the hood:**

- Investors in RGESS can invest in both primary and secondary market stocks
- Stocks should be from CNX 100 or BSE 100, PSU’s classified as Maharatna, Navratna or Miniratna Or ETF linked to eligible securities.
- There are also list of mutual funds eligible for RGESS.
- Investor need to give a declaration in form A for designating a demat account for RGESS. This form will be sent to depository participant to check for your eligibility. You are eligible only if you haven’t traded in equity or derivative segments before November 23, 2012, which makes you a new investor as per the RGESS scheme.
- Holding period of RGESS investment is three years.
- During the first year, (fixed lock-in period), one cannot pledge or sell the shares.
In the next two years, (flexible lock-in period), you can sell and buy other eligible securities or ETFs, maintaining the value of investment originally made for a cumulative period of 270 days during the two years.

**Issues with the design and delivery of this scheme:**

- **Wrong Target**: Individual with income less than 10 Lakhs will be under 30% tax bracket. So, they will be either 10% tax bracket or 20% bracket. Usually people with surplus funds take risk with stock market and they are informed investors and can live with volatility. But they are not eligible.

- **Less Tax benefit**: If some one in 10% bracket invest Rs.50,000, benefit is Rs.2575/- or some one in 20% bracket, the benefit is 5,150.

- **Small investment does not make sense**: Anything less than Rs.50,000, your tax savings are so negligible, you have no incentive to invest for 3 years lock in.

- **No money beyond 80C savings**: Since 80C scheme is giving one to one deduction, and RGESS is giving only two to one deduction, tax payers first will try to fill up their quota under 80C. How many investors after filling up 80C quota of 1 Lakh, can really afford to invest Rs.50,000 in the stock market, after their taxes and regular expenses?

- **No risk Appetite for low income category**: Those in the 10% bracket are struggling hard to maintain their savings account with ever raising minimum balance of the bank accounts. Where are they going to find Rs.50,000 to invest in the stock market? How many of them will have appetite to invest in highly volatile and high risk Indian stock market?

- **KYC will be killing**: New investors will bear the torture to go through the KYC documentation. Very few investors can go through this Shaolin Temple tests and still get to the 36th Chamber!

- **Narrow Investment Period**: Stock Market is for long term investment. Allowing only one year of investment in stock market is stupid idea. Also when every one is recommending SIP as the way to get into the market, forcing investors to invest Rs.50,000 within two months (this has to be done before Mar 31, 2013), is really a bad idea.

- **Demat account is wrong idea**: Government should have allowed only mutual funds as the medium for stock market exposure and not demat account.

- **Buying mutual funds under demat account is another difficult thought**: Fund Expense cost and also brokerage cost have to be incurred.

- **Opens Avenues for Mis-selling**: If this one time lump sum investment does not do well, scruples Brokers may utilize this opportunity to divert small investors to invest in other risky stocks and derivatives with a primary objective to churn the portfolio and earn commission.

- **Asset Allocation**: Government should have recommended Only Mutual funds with 60/40 allocation of stocks and bonds for RGESS scheme. This is the only asset allocation a new investor in the market can live with.

**Conclusion**

**Our Take on Rajiv Gandhi Equity Savings Scheme**

This is a fantastic initiative from the Indian Government. This will encourage retail participation and bring in a bit more stability to the Indian Markets. Experts predict that this will encourage approximately 8000 to 10000 crores worth of investment from Retain Investors into the select blue-chip stocks each year. Usually blue-chip stocks give us an average of around 10-15% every year. If we club the tax benefits ranging from 10% to 30% the net returns could work out to be even more than the regular returns blue-chip stocks would give us. By restricting the amount one can invest (to claim to benefits) to Rs. 50,000/- the risk an investor is taking is only minimal. By also putting an upper limit
on the income to 10 lakhs, the government is trying to provide this benefit only to the middle income group Indian which is a welcome move. All in all, it is an excellent option which everyone must utilize. RGESS is a bold step for inclusive wealth creation. RGESS is an innovative initiative as it kills two birds with one stone – it boosts capital formation while encouraging more and more Indians to participate in equity-led wealth creation. In the long term, the scheme seeks to bring in a new class of investors whose savings will deepen the stock markets, help the government reduce its fiscal deficit and improve the prospects of the government’s disinvestment drive. RGESS is designed to benefit all the stakeholders: government, corporate, mutual fund (MF) industry as well as retail shareholders. Promoted as an alternative financial instrument, the scheme seeks to encourage investors to divest their savings from illiquid instruments such as gold. If this objective is achieved, the scheme will have a positive impact on the economy’s financial stability. It goes without saying that a healthy economy promotes financial inclusion. But is this enough to make first time retail investors embrace this scheme? To be sure, even though the scheme provides tax breaks, the benefits that RGESS offers may not be evident to those who have never invested in equities before. Moreover, since there are no guaranteed returns, a prime feature of other government-sponsored schemes, viz., post-office savings scheme, life insurance policies etc., investors may take time to convert.

Suggestions

- The retail investors should be given a choice to invest in the index oriented instruments rather than individual stocks. This will ensure that those who now come into the market through this scheme stay engaged with the equity markets in times to come and hopefully bring more of their kind, once they taste success.
- The cap on the INR 50,000 investment for 50% deduction from taxable income should be increased in order to lure more investors from the 10% and 20% tax bracket. Sure, the product may not work well at the individual level, but it is likely to gain popularity with MFs and ETFs, which would provide first-time investors with the much needed reassurance and encouragement.
- Ideally, investors should be allowed to participate in RGESS without enforcing any cap on the income level, as this will slow down deeper retail participation. The cap on the INR 50,000 investment for 50% deduction from taxable income should be increased in order to lure more investors from the 10% and 20% tax bracket. Sure, the product may not work well at the individual level, but it is likely to gain popularity with MFs and ETFs, which would provide first-time investors with the much needed reassurance and encouragement. This partnership can help the individual investors mitigate the inherent risk prospects of the scheme while maximizing its profitability potential.
- For the Indian MF Industry, which has witnessed rather low levels of investments in equity schemes over the last many quarters owing to the underperformance of the markets, the scheme comes as a harbinger of renewed hope and opportunities – it is likely to open an entirely unexplored market of prospective investors beyond the top 15 cities in the country, reaching out to semi-urban and rural populace in Tier II and Tier III cities. However, the ambiguities in the operational guidelines need to be quickly resolved by the government. The product requires some clarity on the lock-in period of the investment and management of the investment. Nonetheless, RGESS is a bold step by the Finance Minister to not only build confidence in making the Indian capital markets more robust but is a genuine effort to give a fillip to greater retail participation in the Indian stock markets, thereby creating a more inclusive and equitable wealth creation ecosystem. It is for India’s financial industry, especially mutual funds and ETFs, to quickly understand the finer points of the scheme better, create suitable products and awareness among retail customers, and match the policy actions of the government through smart business decisions.

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