VI | REINFORCING FINANCIAL STABILITY

6.1   Financial stability has to be an important goal of public policy, particularly after the experiences of currency and financial crises in the 1990s in Mexico and some of the East Asian countries. Fragilities in the financial system could arise on account of several factors. Financial instability, broadly speaking, could arise due to weak fundamentals, institutional failures resulting in banking panics or information asymmetries (Box VI.1). In some cases, all the factors could be at work, making it difficult to determine in crisis situations, at least in the very short run, as to which factor is the dominant one. As a result, corrective actions often have to be broad-based. Most countries, therefore, take pro-active measures before hand to safeguard financial stability. Cross-country initiatives in this context are instructive. These experiences show the importance that central banks in industrialised countries attach to dissemination of their analyses of developments in the financial sector and assessments of vulnerabilities to market participants (Box VI.2). In order to ensure stability of the financial sector, in India too, a wide array of measures has been undertaken by the Reserve Bank and the Government in close co-ordination with one another. These include prudential norms for banks and other intermediaries, restructuring of banks, enforcement of increased competition in the banking sector and promotion of transparency and good governance in the banking sector that could enhance credibility of the banking policies.

6.2   A certain amount of volatility is an integral part of the development and gradual integration of the financial markets, depending upon the nature of trades and extant regulatory and supervisory framework, as reviewed in Chapter IV. Excessive volatility, however, could turn out to be destabilising and engender serious risks. At the macro-level, such volatility impacts investment and real activity, through a variety of channels – wealth, bank lending and balance sheet channels. Of these, the wealth effect is fairly straightforward. Asset holders gain or lose in terms of wealth due to volatility of asset prices

and would, depending on the outcome, revise their consumption-saving plans. The other two channels emerge mainly due to information problems in credit markets. In the bank lending channel, expansionary monetary policy increases the quantity of bank loans available. Given banks' special role as lenders to various classes of borrowers, this leads to rise in investment and possibly consumption spending. In case of the balance sheet channel, expansionary monetary policy causes a rise in equity prices and raises the net worth of firms, which reduces the adverse selection problem (since, in effect, lenders have greater collateral for their loans). This leads to higher investment spending and therefore, raises aggregate demand. If the transmission channel does not function efficiently, there would arise a need for not only maintaining orderly conditions in the asset markets but also ensuring financial stability in the form of smooth functioning of institutions, markets and infrastructure that comprise the building blocks of the financial system. While the external issues in financial stability, *inter alia*, relate to the appropriateness of the exchange rate regime and the optimum levels of foreign exchange reserves and external debt, the domestic issues pertain to the strengthening of the financial system, through institution of prudential norms and transparent observance of internationally accepted standards and codes.

6.3   The macroeconomic consequences of excessive volatility and financial stability are inter-linked in many ways and fragilities in either of the two feed into the other. On these considerations, India has been pursuing the twin-pronged strategy of ensuring price stability as well as financial stability. Safeguarding financial stability, in the Indian context, is based on three inter-related strategies of improving the robustness of the linkages across institutions and markets (macro-prudential level), promoting soundness of institutions through prudential regulation and supervision (micro-prudential level) and also ensuring the overall macroeconomic balance.

Prudential Indicators

6.4   As part of regulation and supervision, the Reserve Bank has been monitoring several macro and micro-prudential indicators. As part of macroeconomic monitoring, the Reserve Bank has, in particular, paid special attention to bringing out analyses of the latest fiscal, monetary and financial and external sector positions in considerable detail in its Annual Reports. Besides, the Reserve Bank has been focussing on details of developments in the commercial and the co-operative banking sectors and in the areas concerning the development financial institutions (DFIs) and non-banking financial companies (NBFCs) in the Report on Trend and Progress of Banking in India. This publication provides commercial bank-wise details of prudential indicators as also aggregated prudential indicators for the commercial banking system as a whole (Box VI.3). The Reserve Bank has set up an Off-site Surveillance and Monitoring System (OSMOS) to monitor micro-prudential indicators, both at an aggregate and individual levels.

Bank Soundness

6.5   The cornerstone of the strategy to tackle the weaknesses in the Indian banking system was the institution of prudential norms relating to income recognition, asset classification and provisioning requirements and incentive-based regulation through the prescription of capital-to-

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Box VI.1
Theories of Financial Stability

The occurrence of periodic episodes of financial turmoil has often been attributed to external shocks or various forms of aberrant behaviour. However, recent interest in financial stability has been driven by two major considerations. Recent advances in finance have provided a coherent macroeconomic foundation about the observed phenomena of financial instability. From the policy perspective, the growth and integration of world financial markets and the systemic repercussions that failures might engender, have increased the importance of policy actions to safeguard financial stability.

Theories emphasising debt and financial fragility consider financial crises to be a key feature of the turning-point of many business cycles, as response to previous 'excesses' of borrowings that can occur in financial markets. This explanation is based largely on observations of periods of financial instability up to and including the Great Depression. These theories pinpoint the concept of 'displacement' – an exogenous event leading to improved opportunities for profitable investments, which triggers the cyclical upturn. Second, they highlight financial innovations (*e.g.*, new forms of bank liability).

The monetarist approach emphasises contagious banking panics, which may cause monetary contraction. Banking panics arise from a public loss of confidence in banks' ability to convert deposits into currency. This may be caused by failure of an important institution, which may, in turn, arise from failure of the authorities to pursue a predictable monetary policy.

Bank runs may be seen in terms of the 'liquidity insurance' that banks provide to depositors by pooling risks; banks' assets are mainly long-term and illiquid, and so banks engage in maturity transformation. This feature gives an incentive for panic runs on banks even if they are solvent, because of imperfect information regarding the banks' assets and the inability of banks to sell or cash illiquid assets (*i.e.*, loans) at par. The risk that other depositors may withdraw can cause a panic regardless of the underlying financial position of the bank, and may affect both other banks (*via* contagion) and borrowers without access to other sources of funds.

There are, on the other hand, theories of crisis which focus on uncertainty. Responses to uncertainty may be to apply subjective probabilities to uncertain events (such as the occurrence of a policy regime shift). But agents often tend to judge such probabilities by the action of others ('herd behaviour') that can collectively lead to systemic financial instability. In presence of such uncertainties, adverse surprises can trigger shifts in confidence, affecting markets more than what seems to be warranted by their intrinsic significance; and therefore, lead to crisis situations.

Asymmetric information and agency cost theory suggest that the well-known problems of debt contract, *viz.*, moral hazard and adverse selection arising from the informational asymmetry between the borrower and the lender, can also account for sharp contractions of credit, engendering financial instability. For example, if interest rates rise, there may be a sharp increase in adverse selection (only the low-quality borrowers would be willing to borrow), thereby leading to a decline in the supply of credit. Higher uncertainty (by making screening of borrowers by lenders more difficult) increases adverse selection, and may reduce supply of credit. And borrowers with low net worth (due to the asset price collapse) present greater moral hazard to lenders, as they have less to lose by default.

References

1. Davis, E.P., (1995), *Debt, Financial Fragility and Systemic Risk*, Oxford University Press, London.

2. Guttentag, J.M. and R.H. Herring, (1984), "Credit Rationing and Financial Disorder", *Journal of Finance*, 39, 1359-1382.

3. Mishkin, F., (1991), "Asymmetric Information and Financial Crises", in R.G.Hubbard (*ed.*), *Financial Markets and Financial Crises*, University of Chicago Press, Chicago.

Box VI.2
Financial Stability: Cross-Country Experiences

United Kingdom: Under the 1997 Memorandum of Understanding between the United Kingdom treasury, the Bank of England (BoE) and the Financial Services Authority (FSA), the Bank of England is responsible for the stability of the financial system as a whole. A Standing Committee of the Treasury, the BoE and the FSA meets monthly to discuss developments relevant to financial stability. One of the tasks that the BoE undertakes to discharge its responsibility is the surveillance of financial stability conditions, including the assessment of actual or potential shocks and of the system's capacity to absorb shocks. The Financial Stability Area of the Bank of England undertakes a monthly assessment of financial stability and produces a variety of focused notes. A detailed review of the financial stability conjecture and outlook is undertaken every six months and an abridged version is published in the Bank of England's Financial Stability Review. As stated, the aim of the Review is (i) to encourage informed debate on financial stability issues, domestically and internationally, (ii) to survey potential risks to financial stability and (iii) to analyse ways of promoting and maintaining a stable financial system.

United States: The three institutions that have responsibility for different aspects of banking supervision - Federal Deposit Insurance Corporation (FDIC), the Federal Reserve (Fed) and the Office of the Comptroller of Currency (OCC) –have, over time, developed similar models and indicators aimed at assessing the overall health of individual banks based on summary data submitted by banks as part of their off-site supervision exercises. In general, the variables used in the assessments of the future health of individual banks by the supervisory institutions in the US are proxies for the various factors taken into account when assigning a full *ex-post* CAMELS rating. As an extension of the assessment of the current health of individual banks, the supervisory authorities have also developed models for assessing the current riskiness of banks, based on which they can generate probabilities of future failure and undertake corrective action in respect of those banks judged to be at the highest risk. The computerised statistical system that supports the work of these three agencies permits joint collection of information on income, operating activity and balance sheet for individual banks so as to discern changes in the health of individual institutions for safeguarding financial stability.

Norway: The Norges Bank produces a report on the situation and outlook for the financial sector since 1995. The work includes analyses of developments in financial institutions, primarily the banking sector and the relationship between financial sector developments and the macro-economy. The approach adopted is to generate an initial assessment of the trends in macroeconomic indicators (MEI) that are of relevance to the financial sector, in general, and to the earnings of financial institutions, in particular. These variables include economic growth, interest rates, credit growth and sectoral debt levels. Following this analysis, a range of aggregated micro-prudential indicators (AMPI) of the banking system are incorporated in the assessment (*i.e.*, capital adequacy ratios, credit growth rate, trends in overdue loans and operating cost). Specific attention is paid to the banks' exposure to the real estate sector and the enterprise sector and the ability of firms in that sector to cope with unexpected deterioration in their financial condition and thereby to stay current with their debt servicing.

Sweden: The surveillance by the Sveriges Riksbank's is directed towards systems and therefore, complements the supervision of the banking system by the Swedish Financial Supervision Authority, which is primarily aimed at individual institutions. The views of the Riksbank on the banking system are published on a semi-annual basis. The major objective of the reports is to raise the financial sector's awareness of vulnerability issues. The method is to assess risks to aggregate banking sector profits based on information from the markets, on a sector-by-sector basis. The assessments are carried out by looking at three categories of risks that impact bank's abilities to generate profits: (i) strategic risks, or factors affecting profits in the medium-term, (ii) credit risks, or risks to profits over the medium-term, and, (iii) counter-party and settlement risk, or risks that impinge upon profits in the short-run. In addition, a range of MEI, including growth rate of aggregate lending, inflation rate, inflationary expectations, and the real interest rate as well as several banking sector variables (profits, loan performance by sector, bankruptcies, *etc.*) are also used for the assessment purpose.

References

1. Bank of England, (2000), *Financial Stability Review*, June, No.8, London.

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risk-weighted assets ratio (CRAR) (Table 6.1). A strategy to introduce the attainment of risk weighted capital adequacy of 8 per cent in a phased manner was put in place. Initially (*i.e.,* in 1992-93), banks were required to raise their CRAR from 4 per cent in the initial year to 8 per cent over a period of three years, *i.e.,* by end-March 1996. Banks with an international presence were required to attain the prescribed CRAR of 8 per cent in 1993-94, while new private sector banks and foreign banks were required to attain the prescribed CRAR in the first year itself.

Box VI.3
Macro-prudential Indicators and Financial System Surveillance

Macro-prudential indicators (MPIs) comprise macroeconomic indicators (MEIs) and aggregated micro-prudential indicators (AMPIs). MEIs include sets of indicators, on the real economy, fiscal and monetary sectors, the external sector and some asset prices. AMPIs include indicators on capital adequacy, asset quality of lending and borrowing entities, management soundness, liquidity, sensitivity to market risk and some market-based indicators.

Available literature on leading indicators of crises as well as country experiences suggest that information on a core set of MEIs could provide early warning signals and thereby help in identifying vulnerabilities in pursuing forward looking policies to attain the objective of financial stability. Since MEIs alone cannot fully capture the strengths and weaknesses of the financial system, MEIs need to be monitored along with AMPIs. Unlike MEIs, academic research on AMPIs are limited (largely due to non-availability of long time-series information) and the recent initiatives focus only on developing a core set of AMPIs which appear to be relevant when seen in the context of the recent episodes of financial crises. One commonly used framework for analyzing the financial health of an individual institution is the CAMELS. AMPIs represent aggregation across all banks/financial institutions comprising the financial system and include such indicators as capital ratios, sectoral credit concentration, non-performing loans and provisions, connected lending, leverage ratios, return on assets, expense ratios, the maturity structure of assets and liabilities, liquid asset ratios, sensitivity to market risk, foreign-currency denominated lending, *etc.* Besides AMPIs and MEIs, MPIs also include market-based indicators like credit ratings, sovereign yield spreads and market prices of financial instruments.

The key challenge for developing an MPI based surveillance of the financial system is to compile a reasonably long time series database on AMPIs, which alone can help in evaluating how developments in AMPIs over time can be related to the developments in the MEIs. Furthermore, in the case of macroeconomic indicators, the linkages based on economic theory help in sound application of judgment, while operating with a multiple indicator based surveillance system. The lack of any established theoretical/empirical framework to explain the interactions between AMPIs and MEIs, as also the range of webs through which financial system instability impinge upon the macro-economy suggest that the internal surveillance process based on MPIs would take time to stabilise. To begin with, establishing the right link between AMPIs and MEIs may be difficult. For example, deterioration in the capital adequacy position of the banking system could be a sign of vulnerability; but to know as to how exactly that could affect the macro-economic variables is important from the standpoint of country surveillance. Similarly, increase in the leverage (debt/equity ratio) of the corporate sector as a whole is an early indication of vulnerability; but again how exactly that could affect the macroeconomic variables is not clearly known. A MPI based surveillance system, therefore, could evolve only over time, more from experience than any theoretical underpinnings.

Like the causal linkages running from AMPIs to MEIs, it is also important to identify the linkages running from MEIs

to AMPIs. Changes in the exchange rate or interest rates could affect the balance sheets of banks, which in turn, may get reflected in AMPIs. (Stress tests could help in identifying such impact resulting from any policy/market shock). Similarly, during economic booms, bank profitability may increase and NPAs may decline. The reverse may happen during recessions. Moreover, solvency and the liquidity position of a bank could be comfortable during a particular macro-economic condition but may prove inadequate in another macro-economic scenario.

Despite the importance of a framework to study the interactions between AMPIs and MEIs, switching over to a model-based surveillance mechanism is fraught with the danger of sending wrong signals because, firstly, the interactions between AMPIs and MEIs are yet to be properly studied by the international community and hence not very clear, and secondly, model-based analyses of MEIs that occasionally guide conventional macro-monitoring are not very reliable, even after the proliferation in both theoretical and empirical research helping in continuous refinements. The key findings of such research, as documented in Berg *et al.* (1999), show that: (a) models perform much better in-sample than out-of-sample, (b) most of the models signal vulnerabilities but they often provide false alarms, (c) timing of a crisis is much harder to predict, (d) the determinants of crisis episodes vary significantly over time and across countries, (e) models could be useful in identifying countries which are more vulnerable in a period of international financial turmoil than others, (f) signals from the early warning models should be calibrated with sound judgment to minimize the costs associated with any policy action guided by false signals, (g) sound fundamentals may not be enough to avoid a self-fulfilling or contagion driven crisis, but they are essential to ensure success in defending an attack and in achieving a faster restoration of normalcy after the attack and (h) since the indicators with varying degrees of predictive abilities could be many, at least the important indicators must be monitored constantly.

Due to the nascent stage of current initiatives on MPIs, most of the central banks have preferred constituting separate working groups to study the relevance of MPIs and to suggest measures to establish a system for collecting timely information on such indicators. The European Central Bank has instituted a working group on Macro-prudential analysis and has recently completed a "gap-exercise" helping it in identifying the existing data gaps constraining compilation of information on MPIs. The Bank of Finland has put in place a framework for forecasting banking sector developments and with improved availability of desirable information on MPIs which would be linked to their macro-forecasting model. The Bank of England now regularly publishes a Financial Stability Review, based on indicators (and not a model) and aims at placing greater emphasis on AMPIs in such reviews. The variables used by the Federal Reserve's Financial Institutions Monitoring System to assess the health of banks resemble AMPIs. Norway's present assessments of its MPIs are mostly for internal use. Aggregation across a number of banks/financial institutions may fail to capture the structural weakness of individual banks/institutions. But

(Contd...)

(...Concld.)

at the macro-level, formulation of policies may require aggregated information on the financial sector, leaving the institution-wise details to the supervisors. Preventing failure of each bank/ institution in the system should be the objective, and hence monitoring of individual institutions is essential. But for identifying vulnerability of the financial systems as a whole and also to enable inter-country comparability, developing a system to collect information on AMPIs may be warranted.

References

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2. Evans, Owen, Alfredo M. Leone, Mahinder Gill and Paul Hilbers, (2000), "Macroprudential Indicators of Financial System Soundness", *IMF Occasional Papers,* No. 192.

6.6 Based on the recommendations of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham), the minimum CRAR was raised to 9 per cent, effective March 31, 2000. Other measures introduced based on the recommendations of the committee included: (i) an additional risk weight of 20 per cent for investment in Government guaranteed securities issued by PSUs; (ii) 20 per cent risk weight on state government guaranteed advances which remain in default as on March 31, 2000 and 100 per cent weight in the case of continued default after March 31, 2001; (iii) risk weight of 2.5 per cent to account for market risk for Government and approved securities; and (iv) 100 per cent risk weight on the foreign exchange open position limit.

6.7 As regards asset classification, the earlier system of eight 'health codes' was replaced by the classification of assets into four categories, *viz.,* standard, sub-standard, doubtful and loss assets in accordance with international norms. Provisioning requirements were prescribed for sub-standard, doubtful and loss asset categories. Provisioning requirements of a minimum of 0.25 per cent were also introduced for the standard assets from the year ended March 31, 2000. Banks have also been required to progressively 'mark-to-market' their holdings of Government securities, with the marked-to-market proportion rising from 30 per cent in 1993 to 75 per cent by 1999-2000. In the recent Mid-term Review of the Monetary and Credit Policy for 2000-01, banks

Table 6.1: Changes in the Regulatory Framework

(Per cent)

Variable	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000
1	2	3	4	5	6	7	8	9
1. CRAR								
Domestic Banks with International Business	4	8	8	8	8	8	8	9
Other Domestic Banks	4	4	4	8	8	8	8	9
Foreign Banks	8	8	8	8	8	8	8	9
2. Non-performing Assets (period overdue in quarters)								
Sub-standard Assets	4	3	2	2	2	2	2	2
Doubtful Assets	8	8	8	8	8	8	8	8#
3. Provisioning Requirements								
Sub-standard Assets	10	10	10	10	10	10	10	10
Doubtful Assets (Secured portion)	20-50	20-50	20-50	20-50	20-50	20-50	20-50	20-50
Doubtful Assets (Unsecured portion)	100	100	100	100	100	100	100	100
Loss Assets	100	100	100	100	100	100	100	100
4. Mark to Market	30	30	30	40	50	60	70	75

Note: The concept of past due (grace period of 30 days) would be dispensed with effective April 1, 2001.
   # Reduced to 6 quarters effective March 31, 2001.

have been advised to classify their investment portfolio (comprising SLR and non-SLR securities) under three categories, *viz*., Available for Sale, Held for Trading, and Held to Maturity categories and provided the flexibility to decide the extent of holdings under 'Available for Sale' and 'Held for Trading' categories[1].

6.8 In order to strengthen banking supervision, an independent Board for Financial Supervision (BFS) under the aegis of the Reserve Bank was constituted in November 1994. The Board is empowered to exercise integrated supervision over all credit institutions in the financial system including select DFIs and NBFCs relating to credit management, prudential norms and treasury operations. A comprehensive rating system based on Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems (CAMELS) methodology has been instituted for domestic banks. As regards foreign banks, the rating system is based on Capital Adequacy, Asset Quality, Compliance and Systems (CACS). This has been supplemented by a technology-enabled quarterly off-site surveillance system.

6.9 The status of banks with regard to their attainment of CRAR and the levels of their Non-Performing Assets (NPAs) over the last several years are presented in Table 6.2 and 6.3, respectively. Over the last four years from 1996-97 to 1999-2000, the capital base as a ratio of risk-weighted assets has improved for all major categories of banks. All the banks belonging to the SBI Group now have a CRAR exceeding 10.0 per cent. Amongst other public sector banks, all banks have met the enhanced CRAR norm of 9.0 per cent with the exception of Indian Bank. Four of the 34 Indian private sector banks had a CRAR below the prescribed norm of 8 per cent in 1996-97. In 1999-2000, three of 32 such banks had a CRAR below the enhanced norm of 9.0 per cent. All the 42 foreign banks operating in India in 1999-2000 had a CRAR exceeding the 9.0 per cent norm. As such, the capital position of banks operating in India is comfortable at present.

6.10 The position on the asset quality front has also improved over the last four years. Three of the eight SBI Group banks had NPA to net assets ratios exceeding 10.0 per cent in 1996-97. Their number increased to four in the following two years but declined to only one in 1999-2000. The

number of nationalised banks having NPAs exceeding the 10.0 per cent also declined from six in 1996-97 to four in 1999-2000. In the case of old private sector banks, this number increased from three to five over the same period, indicating some deterioration in their asset quality. In the case of foreign banks operating in India, the number of banks with NPAs exceeding the 10.0 per cent benchmark increased from three in 1996-97 to 14 in 1998-99 but declined to 11 in 1999-2000. None of the new Indian private sector banks have NPAs exceeding the 10.0 per cent. Along with reduction in NPAs, the provisioning and contingencies made against NPAs of all major bank groups, except foreign banks, have declined (Chart VI.1).

Chart VI.1: Bank Group-wise Provisions and Contingencies as percentage of Total Assets-1991-92 to 1999-2000
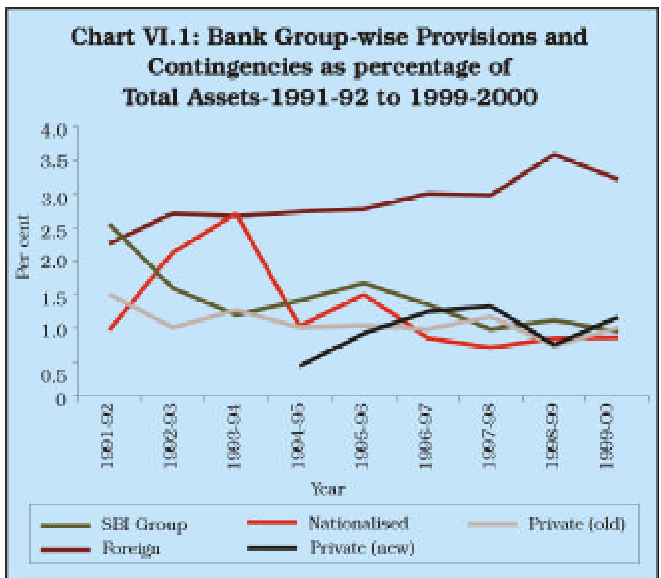
6.11 In India, banks' exposure to capital markets, direct and indirect, remain and limited and, therefore, to a large extent, stock market volatility does not impinge on monetary and banking stability. Scheduled commercial banks were allowed to subscribe to shares and debentures of corporate entities (including PSUs) up to 5.0 per cent of their incremental deposits of the previous year with a sub-ceiling of 1.5 per cent for corporate shares in October 1993. Investments in PSU bonds were excluded from the 5.0 per cent ceiling in January 1994. Further, they were allowed to purchase shares and debentures in the secondary market within the existing 5.0 per cent ceiling in October 1996. Preference shares/debentures/ bonds of private sector bodies were excluded from the 5.0 per cent

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[1] The holdings under the third category, 'Held to Maturity', are not to exceed 25 per cent of the total investments.

Table 6.2: Frequency Distribution of CRAR - Scheduled Commercial Banks

Year/Range	Public Sector Banks		Private Sector Banks		Foreign Banks
	SBI Group	Nationalised	Old	New	
1	2	3	4	5	6
1996-97					
Below 4%	-	2	3	-	-
4 % and up to 8 %	-	-	1	-	-
Above 8 % and up to 10 %	3	6	8	-	13
Above 10 %	5	11	13	9	26
1997-98					
Below 4%	-	1	2	-	-
4 % and up to 8 %	-	-	2	-	-
Above 8 % and up to 10 %	1	6	6	2	12
Above 10 %	7	12	15	7	30
1998-99					
Below 4%	-	1	2	-	-
4 % and up to 8 %	-	-	2	-	-
Above 8 % and up to 10 %	-	4	3	2	14
Above 10 %	8	14	18	7	28
1999-2000					
Below 4%	-	1	1	-	-
4 % and up to 9 %	-	-	2	-	-
Above 9 % and up to 10 %	-	4	2	1	5
Above 10 %	8	14	19	7	37

- Nil

Note: 1. The Bareilly Corporation Bank Ltd. was amalgamated with Bank of Baroda with effect from June 3, 1999.
2. The Sikkim Bank Ltd. was amalgamated with Union Bank of India with effect from December 22, 1999.
3. The Times Bank Ltd. merged with HDFC Bank Ltd. with effect from February 26, 2000.
4. The branches of the British Bank of the Middle East in India were amalgamated with HSBC with effect from September 25, 1999.

limit in the monetary and credit policy for the first half of 1997-98. As at end-March 2000, banks' investments in equity shares issued by public sector undertakings and private corporate sector amounted to Rs.2,841 crore and their advances to the capital market were limited to a mere Rs.4,890 crore. Banks have been required to publish their advances to the capital market in their balance sheets from 1999-2000.

6.12 The monetary and credit policy statement of October 2000 has revised guidelines on the bank financing of equities and investments in shares. First, bank boards are required to lay down a prudential ceiling on banks' aggregate exposure to the capital market keeping in view their overall risk profile. Second, bank's exposure to capital market by way of shares, convertible debentures and units of mutual funds (other than debt funds) should not exceed 5 per cent of the bank's total domestic credit as on March 31 of the previous

year. Third, banks may grant advances for subscribing to initial public offerings only to individuals subject to a maximum of Rs.10 lakh and finance extended by banks for IPOs should be reckoned as an exposure to the capital market. Fourthly, a minimum margin of 25.0 per cent inclusive of cash margin should be obtained by banks for issue of guarantees on behalf of share brokers. Finally, banks should also mark to market their investment portfolio in equities like other investments on a quarterly basis and should disclose the total investments made in shares, convertible debentures and units of equity oriented mutual funds as also aggregate advances against shares, *etc.,* in the 'Notes on Accounts' to their balance sheets from the year ending March 2001.

Non-bank Financial Intermediaries

6.13 The statutory responsibility for prudential supervision of select financial institutions was

Table 6.3: Frequency Distribution of Net NPAs to Net Advances - Scheduled Commercial Banks

Year/Range	Public Sector Banks		Private Sector Banks		Foreign Banks
	SBI Group	Nationalised	Old	New	
1	2	3	4	5	6
1996-97					
Up to 10 %	5	12	22	9	36
Above 10 % and up to 20 %	3	6	3	–	1
Above 20 %	–	1	–	–	2
1997-98					
Up to 10 %	4	13	21	9	34
Above 10 % and up to 20 %	4	5	4	–	6
Above 20 %	–	1	–	–	2
1998-99					
Up to 10 %	4	14	17	9	27
Above 10 % and up to 20 %	4	4	5	–	11
Above 20 %	–	1	3	–	3
1999-2000					
Up to 10 %	7	15	18	8	31
Above 10 % and up to 20 %	1	4	5	–	7
Above 20 %	–	–	1	–	4

- Nil

Note: 1. The Bareilly Corporation Bank Ltd. was amalgamated with Bank of Baroda with effect from June 3, 1999.
2. The Sikkim Bank Ltd. was amalgamated with Union Bank of India with effect from December 22, 1999.
3. The Times Bank Ltd. was amalgamated voluntarily with HDFC Bank Ltd. with effect from February 26, 2000.
4. The branches of the British Bank of the Middle East in India were amalgamated with HSBC with effect from September 25, 1999.

assigned to the Reserve Bank from April 1995. The scope and coverage of inspection of select financial institutions has since been broadened to take into account their developmental, co-ordination and supervisory roles. The task of designing an enhanced off-site monitoring system for select financial institutions has been introduced effective March 1999. The position with regard to CRAR and net NPAs of select DFIs over the last five years is presented in Table 6.4.

6.14 With the exception of IFCI and IIBI, all the other financial institutions have CRAR exceeding 10.0 per cent (Chart VI.2). The IFCI, IIBI and IDBI had net NPAs exceeding 10.0 per cent of net loans in 1999-2000. A significant deterioration in loan quality was observed in the case of IFCI in 1998-99.

6.15 The Reserve Bank was vested with comprehensive legislative powers only from January 1997. Some of the significant measures initiated by the Reserve Bank in recent years for regulation and supervision of NBFCs are as follows: (i) compulsory registration; (ii) higher entry norms of Net Owned Funds (NOF) of Rs.25 lakh (enhanced to Rs.2 crore for new NBFCs

which seek registration with the Reserve Bank and commence business on or after April 21, 1999); (iii) stricter prudential norms; (iv) enhanced capital adequacy standards; (v) requirement of credit rating; and (vi) commissioned audits through professional accountants at the behest of the Reserve Bank.
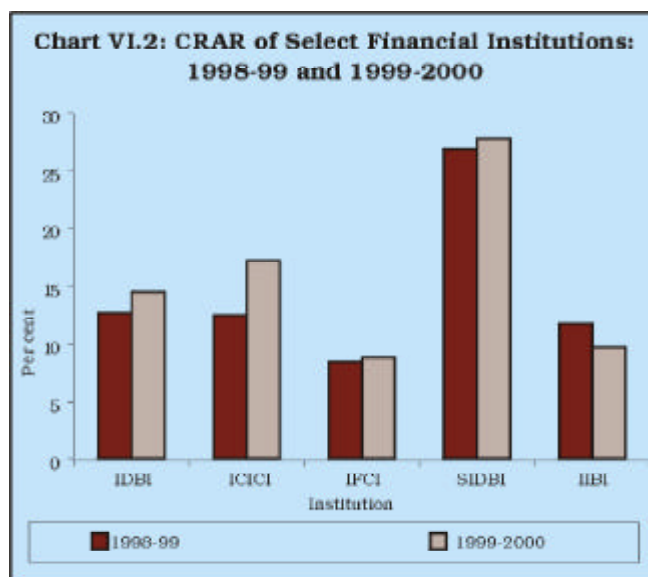

Chart VI.2: CRAR of Select Financial Institutions: 1998-99 and 1999-2000

Table 6.4: CRAR and Net NPA of Select Financial Institutions

(Per cent)

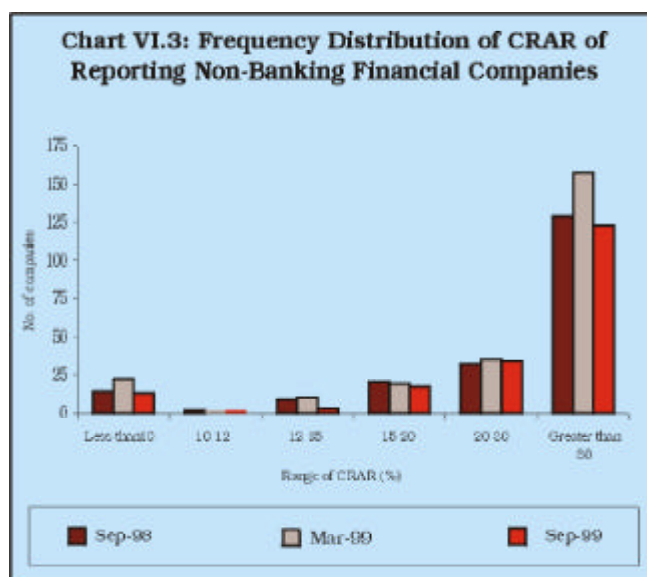| Institution	1996-97	1997-98	1998-99	1999-2000P
1	2	3	4	5
CRAR				
IDBI	14.7	13.7	12.7	14.5
ICICI	13.3	13.0	12.5	17.2
IFCI	10.0	11.6	8.4	8.8
SIDBI	25.7	30.3	26.9	27.8
IRBI (IIBI)	10.6	12.8	11.7	9.7
NABARD	40.4	52.5	53.3	44.4
Net NPA/ Net Loans				
IDBI	10.3	10.1	12.0	13.4
ICICI	7.8	7.7	7.8	7.6
IFCI	13.9	13.6	20.8	20.7
SIDBI	2.5	2.0	1.4	1.3
IRBI (IIBI)	19.3	13.1	14.0	16.9
NABARD	0.9	1.5	4.2	3.5

P: Provisional
Note : 1. CRAR is as per cent of risk weighted assets.
2. Figures for IIBI for 1996-97 are as on March 26, 1997. The IRBI was renamed as Industrial Investment Bank of India Ltd. (IIBI) with effect from March 27, 1997.
Source : Report on Trend and Progress of Banking in India.

Chart VI.3: Frequency Distribution of CRAR of Reporting Non-Banking Financial Companies

The assessment has shown that most of the Core Principles were already enshrined in the existing legislation or current regulations. Gaps had been identified between existing practices and principles mainly in the areas of risk management in banks, inter-agency co-operation with other domestic/international regulators and consolidated supervision. Internal working groups were set up to suggest measures to bridge these gaps and their recommendations are in the process of being implemented. Guidelines on Asset Liability Management (ALM) of banks were issued in February 1999. Banks were advised to put in place an ALM system, effective April 1, 1999. These guidelines were subsequently
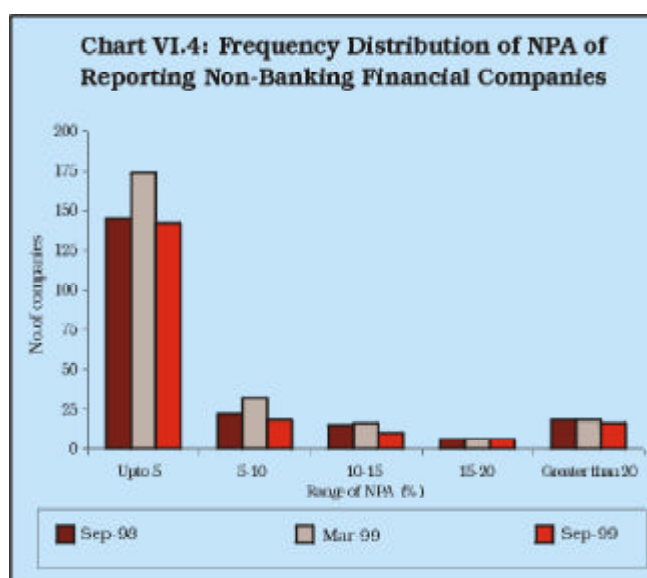
6.16   Under Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, issued in January 1998, NBFCs are required to achieve a minimum 12 per cent CRAR on or before March 31, 1999. The frequency distribution of CRAR of companies with an asset size of Rs. 10 crore and above for the half-years ended September 1998, March 1999 and September 1999, respectively, is presented in Chart VI.3. Most of the companies had CRAR above the stipulated minimum. As regards NPAs, Chart VI.4 shows that the majority of the companies had NPAs within a reasonable limit.

6.17   During the first half of 1999-2000, there was a reduction in gross NPAs of NBFCs by Rs.259 crore, due mainly to reduction in sub-standard and loss assets. The ratio of gross NPAs to total credit, therefore, declined from 12.9 per cent to 12.2 per cent (Table 6.5).

6.18   A detailed self-assessment of the Core Principles for Effective Banking Supervision has been issued by the Reserve Bank in October 1999.

Chart VI.4: Frequency Distribution of NPA of Reporting Non-Banking Financial Companies

Table 6.5: Non-Performing Assets of NBFCs

(Rupees crore)

As at end of	Total Credit	Assets				Gross NPAs (Per cent)
		Standard	Sub-standard	Doubtful	Loss	
1	2	3	4	5	6	7 [(4+5+6)/2]
September 1998	21,752	30,399	1,499	693	319	11.5
March 1999	22,184	31,658	1,623	775	465	12.9
September 1999	21,309	29,159	1,362	854	388	12.2

extended to cover select financial institutions in December 1999. Detailed guidelines on risk management systems have also been issued to banks in October 1999. A beginning has been made towards consolidated supervision by advising banks to not only voluntarily build in risk-weighted components of their subsidiaries into their own balance sheets on a notional basis and earmark additional capital in their books beginning with 2000-01, but also to annex the balance sheet of the subsidiaries (for public sector banks) to their balance sheets beginning from the year ending March 31, 2001. In addition, to guard against regulatory forbearance and to ensure that regulatory intervention is consistent across institutions, the Reserve Bank has prepared a Discussion Paper delineating a framework for Prompt Corrective Action (PCA) with various trigger points for prompt responses by the supervisors.

Restructuring the Banking Sector

6.19 The Union Budget 2000-01 announced the institution of a Financial Restructuring Authority (FRA) in a modified form in respect of any bank which is considered potentially weak, on the lines of the model suggested by the Working Group (Chairman: Shri M.S. Verma) for the revival of weak public sector banks. Over the period 1993-94 to 1998-99, the Government has extended recapitalisation facility to the extent of Rs.5,694.3 crore for the three weak banks as identified by the Verma Working Group. The restructuring plans of the three weak banks are under active consideration. The FRA, comprising experts and professionals, would be given powers to supercede the Board of Directors on the basis of the recommendations of the Reserve Bank.

6.20 With the objective of dealing pro-actively with the non-performing assets (NPAs) of the banking sector, a menu of options has been offered to banks to restructure bad assets through Debt Recovery Tribunals (DRTs) and Settlement Advisory Committees (SACs), as well as through explicit recapitalisation from the budgetary provisions. Till 1999-2000, an amount of Rs.20,446 crore had been expended towards recapitalisation of 19 nationalised banks. Guidelines on SACs were subsequently revised in July 2000, in order to provide a simplified, non-discriminatory and non-discretionary mechanism for the recovery of stock of NPAs of all sectors. Recognising that the high levels of NPAs in public sector banks can engender financial system instability, the Union Budget 2000-01 announced the setting up of seven more DRTs, in addition to those already established, for speedy recovery of bad loans. An amendment in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, was effected to expedite the recovery process. Consequent upon the various measures undertaken, the gross NPA levels of public sector banks came down from 23.2 per cent of gross advances as at end-March 1993 to 14.0 per cent as at end-March 2000 (Chart VI.5).

Transparency and Policy Credibility

6.21 In recognition of the increased cross-border financial integration and in respect of its obligations as a member of the IMF, the World Bank and the BIS, India has been actively participating in the deliberations on reforming the international financial architecture (IFA). While academic proposals on new international financial architecture have generated substantial theoretical debate, efforts are underway to improve the existing system through increased transparency, better governance and credible practices. India has been closely associated with

Chart VI.5: Gross NPA of Public Sector Banks - 1993 to 2000
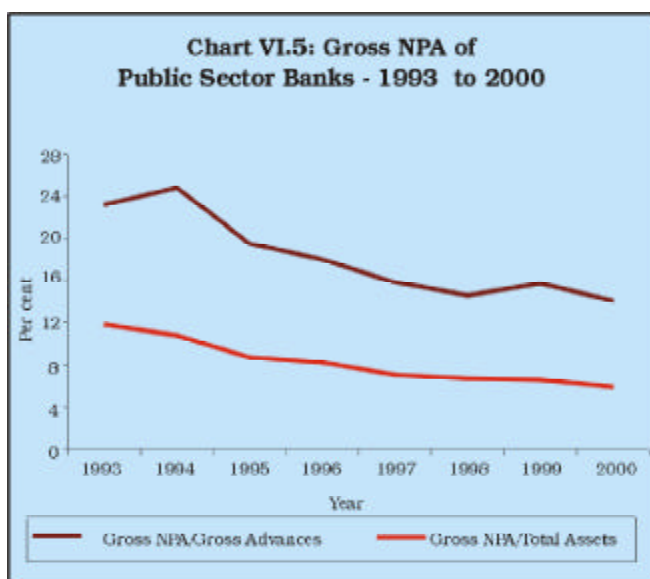
the development of codes of good practices, international financial standards and codes and initiatives for improved data dissemination. Generally, standards and codes in India compare with the international best practices, especially in the financial sector.

Disclosure Norms

6.22   India is a member of the Group of 20 (G-20) countries that advises the Financial Stability Forum (FSF) and the Core Principles Liaison Group set up by the Basle Committee on Banking Supervision (BCBS) to promote and monitor principles of banking supervision and the Working Group on Capital, which discusses proposals for revising the capital adequacy framework. India is also an early subscriber to the Special Data Dissemination Standards (SDDS) and one of the first countries to accept the Financial Sector Assessment Programme (FSAP) of the IMF and the World Bank.

6.23 The transparency and disclosure standards recommended in the International Accounting Standards have been implemented in a phased manner for the banking system. The formats of commercial banks' Balance Sheet and Profit and Loss Account Statements were revised in 1992 in order to bring about greater transparency. Disclosure requirements have been gradually broad-based and banks have been advised to disclose the key business ratios in the 'Notes to Accounts' from the year ended March 31, 1998. These ratios include (i) capital adequacy ratio with tier-I and tier-II capital separately; (ii)

percentage of shareholding of Government of India in nationalised banks; (iii) percentage of net NPA to net advances; (iv) amount of provision made towards NPA, depreciation in the value of investments and income tax during the year; (v) amount of subordinated debt raised as tier-II capital; (vi) the gross value of investments in India and outside India, the aggregate provisions for depreciation separately on investment in India and outside India and the net value of investments in India and outside India; (vii) interest income as a percentage of average working funds; (viii) non-interest income as a percentage of average working funds; (ix) operating profits as percentage of working funds; (x) return on assets; (xi) business (deposits plus credit) per employee; and (xii) profit per employee. In order to further enhance the transparency of banks' balance sheets, banks have been advised to disclose maturity pattern of deposits, borrowings, investments and advances and foreign currency assets and liabilities, movements in NPAs and lending to sensitive sectors (*e.g.*, capital market, real estate and commodity sector) with effect from March 31, 2000. The total exposure to sensitive sectors as on March 31, 2000 by scheduled commercial banks stood at Rs.19,669 crore, comprising 4.4 per cent of total advances as a whole. Exposure to these sensitive sectors is well diversified among commodities, real estate and capital market (Chart VI.6).

6.24   The Reserve Bank has also released its views on the New Capital Adequacy Framework in April 2000 with a view to generating a national debate. The views of the Reserve Bank can be

Chart VI.6: Scheduled Commercial Banks' Lending to Sensitive Sectors - 1999-2000
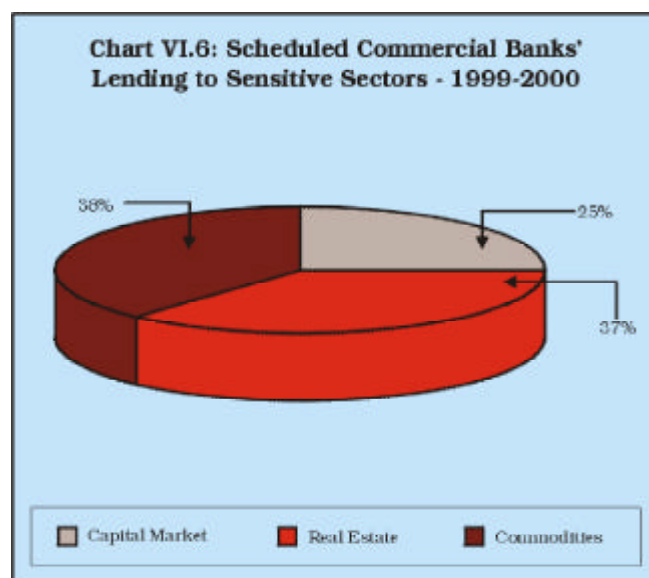
broadly summed up as follows. First, where banks are of simple structure and have subsidiaries, the Accord could be adopted on a stand-alone basis with the full deduction of equity contribution made to subsidiaries from the total capital. Secondly, for assigning preferential risk weights for book assets (excluding claims on sovereign), preference should be given to assessments made by the domestic rating agencies as opposed to external rating agencies. The skepticism about the role of external rating agencies is based on the premise that different external rating agencies not only employ different sets of parameters, but also have varied and non-standardised mixes and weightage of objective and subjective factors. Thirdly, the risk weighting of banks should be de-linked from that of the sovereign in which they are incorporated and instead, preferential risk weights in the range of 20-50 per cent, on a graded scale could be assigned on the basis of risk assessments by the domestic agencies.

Data Dissemination

6.25   Over the last few years, sustained efforts have been made, both by the Government and the Reserve Bank, to improve data dissemination. Besides prescribing improved disclosure norms for financial institutions, the Reserve Bank, on its own part, has taken several steps to improve data quality and data dissemination. It began revaluing gold at close to international prices at the month-end and its foreign currency assets every week. The Reserve Bank also initiated disclosure of month-end data on forward liabilities. Besides, it has been publishing high frequency financial data through its many publications and at its website. With regard to scheduled commercial banks, the annual Report on Trend and Progress of Banking in India provides bank-wise details of several key ratios, including capital adequacy ratios, NPA ratios (both absolute as well as percentages to total assets as well as gross advances) and their consolidated income and expenditure statements and data on off-balance sheet activities (Table 6.6). The Statistical Tables Relating to Banks in India publishes the detailed balance sheets of scheduled commercial banks, including those of regional rural banks (RRBs). This publication has introduced data on movements in NPAs (excluding RRBs), maturity profile of selected items of liabilities and assets (excluding RRBs) as well as bank-wise details of contingent liabilities of scheduled commercial banks for the year 1999-2000.

6.26 The integrity of the data has been periodically reviewed in order to align the compilation of monetary and balance of payments (BoP) statistics in line with international standards. The BoP data are compiled in accordance with the IMF's Balance of Payments Manual (5th edition). With a view to compiling quarterly balance of payments statistics in line with the commitments made to the SDDS, the Sub-Group on Reporting of Foreign Exchange Transactions by Authorised Dealers (Chairman: Shri S.P. Paniyadi)

Table 6.6: Off-Balance Sheet Exposure of Different Bank Groups - 1998-99 and 1999-2000

(Rupees crore)

Bank Group	Forward Exchange Contract		Guarantees given		Acceptances, Endorsements	
	1998-99	1999-00	1998-99	1999-00	1998-99	1999-00
1	2	3	4	5	6	7
SBI Group	42,572.2	56,680.7	17,670.1	17,616.8	16,564.5	22,798.7
Nationalised Banks	64,608.3	85,157.8	24,321.5	25,220.8	23,710.7	26,769.5
Private Sector Banks (Old)	11,270.4	15,313.2	2,540.4	2,906.9	2,062.8	2,685.6
Private Sector Banks (New)	23,663.4	35,357.4	4,116.0	5,741.2	4,223.4	4,836.2
Foreign Banks	1,92,645.0	2,47,472.9	14,166.6	15,878.4	13,956.7	20,004.7
Total	**3,34,759.3**	**4,39,982.0**	**62,814.6**	**67,364.1**	**60,518.1**	**77,094.7**

recommended the collection of data on purpose-wise details of foreign exchange transactions by electronic media from critical size authorised dealers. The BoP statistics are now published with a lag of just one quarter. The Technical Group on External Debt (Chairman: Shri M.R. Nair) has proposed compilation of external debt on both original and residual maturity basis in line with international norms. The Status Report on External Debt of the Ministry of Finance has published estimates of India's short-term external debt by residual maturity for December 1999. The Working Group on International Banking Statistics (Chairman: Shri N.K.Puri) has recommended the introduction of a comprehensive return that would facilitate effective monitoring of the international claims and the liabilities of the banking system as well as India's participation in the international banking statistics. The Reserve Bank's Working Group on Money Supply: Analytics and Methodology of Compilation (Chairman: Dr.Y.V. Reddy) has re-defined monetary aggregates on residency basis, introduced credit and liquidity aggregates and proposed a financial sector survey in view of financial reforms and in line with the IMF's draft Manual on Monetary and Financial Statistics. New monetary aggregates have been introduced in the October 1999 issue of the RBI Bulletin. Liquidity aggregates were introduced in the November 2000 issue of the RBI Bulletin.

6.27 International standards and codes have come to be regarded as benchmarks for national efforts to improve transparency and governance. The main recommendations as approved by FSF and subsequently endorsed by the G-20 as well as the IMF's International Monetary and Financial Committee pertain to 12 areas (Box VI.4). In general, the Reserve Bank and the Government of India have welcomed the international approach to the issue of implementing standards and codes. The Reserve Bank has appointed a Standing Committee on International Financial Standards and Codes to examine the applicability of international standards and codes to Indian conditions (Box VI.5).

Box VI.4
International Financial Standards and Codes

In the backdrop of a series of financial crises in various parts of the world in the 'nineties, several initiatives were taken to strengthen the international financial architecture. These initiatives were first given prominence at the 1995 Halifax Summit of the G-7 countries. In response to the financial crisis in parts of East Asia in 1997-98, these efforts were renewed with added thrust. In April 1998, Finance Ministers and Central Bank Governors of systemically significant economies met in Washington, D.C. to examine issues related to the stability of the international financial system. In accordance with the action agenda set at the meeting, working groups were set up in three areas: enhancing transparency and accountability, strengthening domestic financial systems and managing international financial crises. The Working Group on Enhancing Transparency and Accountability recommended that priority be given to compliance with and enforcement of high-quality accounting standards. It also recommended national standards for private disclosures that reflect timeliness, completeness, consistency, risk management and audit and control processes. The Working Group on Strengthening Financial Systems endorsed a broad international consultative process for the development and refinement of sets of standards and sound practices. The Working Group on International Financial Crises suggested several steps that could help reduce the frequency and limit the severity of international financial crises and also to promote the orderly, co-operative and equitable resolution of international financial crises.

As a sequel to these recommendations and those made by the Tietmeyer Report on International Co-operation and Co-ordination in the Area of Financial Market Supervision and Surveillance, the Financial Stability Forum (FSF) was set up by the Finance Ministers and the Central Bank Governors of the G-7 countries. The FSF brings together in a forum, the standards setting bodies, supervision agencies and national authorities, with a mandate to promote international financial stability, improve functioning of the markets and to reduce systemic risks through enhanced information exchange and international co-operation in financial market supervision and surveillance.

The FSF set up a Task Force (Chariman : Andrew Sheng) on Implementation of Standards relevant for a sound financial system presented its report in March 2000 and identified 12 key standards for a sound financial system *viz.,* monetary and financial policy transparency, fiscal policy transparency, data dissemination, insolvency, corporate governance, accounting, auditing, payment and settlement, market integrity, banking supervision, securities regulation and insurance supervision. The key standards in these areas were prescribed by 10 standard setting bodies, *viz.,* the IMF, World Bank, OECD, IASC, IFAC, CPSS, FATF, BCBS, IOSCO and IAIS. The Sheng Report also recognised that there has been good progress to-date in promulgating and assessing observance of international standards. The Fund-Bank experimental Reports on Observance of Standards and Codes (ROSC) provide framework for conducting these assessments, including by drawing on assessments conducted through the Fund-Bank Financial Sector Assessment Programme (FSAP).

Box VI.5
Standing Committee on International Financial Standards and Codes: Select Advisory Groups

India has supported the international initiatives on financial stability in various ways. It has also taken its own initiatives for improving transparency and accountability and for setting up international financial standards and codes. On December 8, 1999, the Reserve Bank appointed a Standing Committee on International Financial Standards and Codes (Chairman: Dr.Y.V. Reddy), in consultation with the Government, in order to (i) identify and monitor developments in global standards and codes being evolved especially in the context of international developments, and discussions as part of the efforts to create a sound international financial architecture; (ii) consider all applicability of these standards and codes to the Indian financial system, and as necessary and desirable, chalk out a road map for aligning India's standards and practices in light of the evolving international standards; (iii) periodically review the status and progress in regard to the codes and practices; and (iv) make available its reports on the above to all concerned organisations in public or private sector. The Standing Committee constituted ten Advisory Groups in the areas of accounting and auditing, banking supervision, corporate governance, data dissemination, fiscal transparency, insurance regulation, transparency in monetary and financial policies, payment and settlement systems and securities market regulation to examine the feasibility and time frame of compliance with international best practices. The Advisory Group on Monetary and Financial Transparency, Banking Supervision, Insurance Regulation, Payment and Settlement System and International Accounting and Auditing have submitted reports to the Standing Committee. The main recommendations of these groups are briefly given below.

The Advisory Group on Monetary and Financial Transparency (Chairman: Shri M. Narasimham) has recommended that the Government should set out objectives to the central bank, with parliamentary endorsement and accord it the necessary autonomy to fulfill its responsibilities, if necessary by amending the RBI Act. The Group recommended that the Government of India should consider setting out a medium term objective for monetary policy, *viz*., the inflation rate to the Reserve Bank. In the view of the Group, a reasonable degree of fiscal responsibility is also necessary to provide the central bank reasonable headroom to operate monetary policy. The Group also recommended setting up of a monetary policy committee (MPC) comprising of Governor, Deputy Governors and three other members drawn from the Central Board who are knowledgeable in the areas of macroeconomics, monetary analysis, central banking policy and operations in banking and finance.

The Advisory Group on Banking Supervision (Chairman: Shri M.S. Verma) assessed the position of Indian banking in respect of four major areas of supervisory concern, *viz*., corporate governance, transparency, cross-border supervision and banks' internal rating systems. The Group expressed the view that there was an urgent need to follow best practices in the constitution and functioning of bank boards by streamlining the process of induction and fixing accountability. The Group felt that the levels of transparency in the balance sheets of Indian banks would need to be further enhanced by stipulating disclosure in terms of maturity and repricing structure of all assets and liabilities, including calculation of capital requirements for credit and market risks, cumulative provisions against loan losses,

impact of non-accrual and impaired assets on financial performance, effect of hedging activities on income and expenses and income effect of securitisation. As regards banks' internal rating systems, the Group proposed that banks should move to multi-dimensional rating systems from the hitherto uni-dimensional one, since the activities of the clients and the facilities enjoyed by them are themselves are manifold in nature. Finally, the Group was of the view that there is a need to strengthen management information systems in banks to ensure integrity and reliability in data collection and allow the use of statistical methods to arrive at informed policy making.

The Advisory Group on Insurance Regulation (Chairman: Shri R. Ramakrishnan) was of the view that the Indian position of allowing foreign companies to operate through joint venture arrangements with an Indian company with a shareholding not exceeding 26 per cent in the paid-up capital of the company, was not materially different from the international practices. Possibilities of expanding insurance coverage in rural areas through co-operatives could be explored. While the Indian requirements in respect of minimum capital requirements, deposit requirements, business plan and reinsurance were adequate, the Group recommended that minimum capital levels could be fixed for each class of business rather than on aggregate basis. The Group favoured the "file and proceed" requirements in respect of new insurance products, adopted in India, but recommended that the actuarial certification, premium rate tables and benefit design should be treated as public information, in the interest of transparency.

The Advisory Group on Payment and Settlement System (Chairman: Shri M.G. Bhide), in Part I of its report, critically examined two issues *viz.,* status of clearing house operations as well as responsibilities of the Reserve Bank in the light of the consultative report on "Core Principles for Systematically Important Payment Systems" released by the Bank for International Settlements (BIS) first in December 1999 followed by in July 2000. It recommended, *inter alia*, extensive legal reforms especially empowering the Reserve Bank to supervise the payment and settlement system, institution of a framework ensuring at least the Lamfalussy standards for the deferred net settlement (DNS) system and such suitable framework for the real time gross settlement (RTGS) systems and spread of electronic-based transactions through appropriate price incentives. The Group was of the view that the Reserve Bank should eventually come out of the role of a payment systems provider except for funds settlement. In Part II of the Report, the Group examined the status of existing payment and settlement systems in Indian equity and debt markets including Government securities market and suggested ways for improvements in compliance with the G-30 recommendations on securities settlement system. It recommended, *inter alia*, introduction of rolling settlement in the liquid segment of the equity market, allowing current account facility with the Reserve Bank to clearing corporations for ensuring settlement facility on the books of the Reserve Bank as an *interim* measure pending eventual grant of limited purpose banking license to them with appropriate prudential guidelines thereon, building up of an institutional mechanism for centralised collection of

(Contd...)

(…Concld.)

information, their dissemination to market participants and prudential guidelines for implementing cross-merging across markets in order to deal with problems arising from participants undertaking multiple exposures in various markets at any point of time and permitting securities borrowing and lending system for institutions in both equity and debt segment in India.

The Advisory Group on International Accounting and Auditing (Chairman: Shri Y.H. Malegam) reviewed the availability of various accounting and auditing standards in India and compared them with the corresponding international standards. In case of accounting standards, the US Generally

Accepted Accounting Principles (US GAAP) and the International Accounting Standards (IAS) served as the benchmark. With regard to auditing standards, standards issued by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC) served as the reference point. The Group noted that the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) has so far issued 19 standards, which are on par with those of international standards. The Auditing Practices Committee (APC) of the ICAI has issued 20 statements on Standard Auditing Practices (SAPs) and four additional statements on auditing which are anchored on the international standards.

Legal Infrastructure

6.28   Since 1993, efforts have been made to improve debt recovery by setting up special debt recovery tribunals. However, tribunals remain insufficient in number, in staffing and in other infrastructure. Progress in implementing debt recovery has also been constrained by several institutional impediments, especially the inadeqate legal system in place. The efforts to reduce NPAs would, to a large extent, depend on improving the legal infrastructure. The Expert Committee for Recommending Changes in the Legal Framework Concerning Banking System (Chairman: Shri T.R. Andhyarujina) had submitted its report to the Government in February 2000. The Committee had recommended, *inter alia*, the institution of a new law granting statutory power of possession and sale of security directly to banks and financial institutions and adoption of the draft Securitisation Bill. Efforts to improve debt recovery would need to be supplemented by efforts for improving credit assessment so that incremental NPAs are kept low. The proposed plan to set up Credit Information Bureau is, therefore, an important step in the efforts to reduce the sticky portfolios of financial institutions.

Deposit Insurance Reforms

6.29   India is among the few countries, which has a long standing tradition of bank deposit insurance as a safety net. About 97 per cent of the deposits of scheduled commercial banks are fully protected, with the coverage amounting to over 70 per cent of the deposit amount. The extent of coverage under deposit insurance is seen to have remained more or less stable in terms of number of accounts. The insurance coverage, nevertheless, has registered some rise during the

second half of the 1990s, *albeit* with some year-to-year fluctuations (Table 6.7).   Deposit insurance has a well-found rationale in economic theory and is viewed as a means to prevent banking panics in a financial market characterised by multiple equilibria.[2] However, mere provision of deposit insurance is neither a necessary, nor a sufficient condition for ensuring financial stability. Deposit insurance poses moral hazard risks that could invite imprudent behaviour by bank managements or poor choices by depositors. Therefore, what is of greater importance is to ensure that deposit insurance is provided on efficient lines and does not guarantee complete insurance. Despite the low probability of banking failure in the Indian financial system with predominant presence of state-owned banks, the issue of reforming the deposit insurance system has been accorded importance. There is a certain amount of consensus that the principal objective of a deposit insurance system is to protect small depositors and to contribute to the stability of the financial system. The Reserve Bank constituted a Working Group (Chairman: Shri Jagdish Capoor) to examine the issue of deposit insurance which submitted its report in October 1999. Some of the major recommendations of the Group are: (i) fixing the capital of DICGC at Rs.500 crore, contributed fully by the Reserve Bank; (ii) withdrawing the function of credit guarantee on loans from DICGC; and (iii) risk-based pricing of the deposit insurance premium in lieu of the present flat rate system. A new law in supersession of the existing enactment is required to be passed in order to implement the new recommendations. The task of preparing the

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[2]   The seminal contribution in this respect was made by Diamond, Douglas W. and Philip H. Dybvig, (1983), "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy*, 91: 401-19.

Table 6.7: Extent of Deposit Insurance Coverage in India

(Amount in Rupees crore)

Year	Number of Fully Protected Accounts (in million)	Total Number of Accounts (in million)	Coverage of Accounts [Percentage of (2) to (3)]	Total Amount of Insurable Deposits	Total Amount of Accessable Deposits	Coverage of Deposits [Percentage of (4) to (5)]
1	2	3	4	5	6	7
1970-71	30	31	96.8	4,224	6,801	62.1
1975-76	72	73	98.6	11,827	16,588	71.3
1980-81	137	138	99.3	25,859	35,004	73.9
1985-86	232	236	98.3	62,878	86,214	72.9
1990-91	298	309	96.4	1,09,316	1,56,892	69.7
1991-92	317	329	96.4	1,27,925	1,86,307	68.7
1992-93	340	354	96.0	1,64,527	2,44,375	67.3
1993-94	350	353	99.2	1,68,405	2,49,034	67.6
1994-95	496	499	99.4	2,66,747	3,64,058	73.3
1995-96	482	487	99.0	2,95,575	3,92,072	75.4
1996-97	427	435	98.2	3,37,671	4,50,674	74.9
1997-98	371	411	90.3	3,70,531	4,92,380	75.3
1998-99	454	464	97.8	4,39,609	6,09,962	72.1
1999-00	430	442	97.3	4,98,558	7,04,068	70.8

Note: 1. Number of fully protected accounts refer to those accounts with balance not exceeding Rs.30,000 till April 30, 1993 and Rs. 1,00,000 with effect from May 1, 1993.
2. Total amount of insured deposits represent deposits up to Rs. 30,000 till April 30, 1993 and Rs. 1,00,000 with effect from May 1, 1993.
3. Accessable deposits mean the entire amount of deposits including portion which is not provided insurance cover.

new draft law has been taken up. The relevant proposals would be forwarded to the Government for consideration.

Macroeconomic Co-ordination and Financial Markets

6.30 Macroeconomic stability and financial stability reinforce each other. Therefore, macroeconomic co-ordination that ensures macroeconomic and financial stability is an important consideration in framing monetary and fiscal policies. This has become even more important with the fiscal reforms and emergence of a more liberalised financial system. There are several possible dimensions for co-ordinated response. At core of this is the persistence of fiscal imbalances that have placed burden on fiscal sustainability, with implications for financial stability.

Debt Sustainability and Rollover Risk

6.31 The Government budget and the way it is financed impacts interest rates as well as inflation in the economy. Fiscal discipline is, therefore, important for financial market stability. The general trend observed in the budgetary performance of the Central Government is that, final account data, by and large, do not adhere to their original targets. Consequently, the fiscal deficit, more often than not, turns out to be far higher than the anticipated level. For instance, during 1992-99, on an average, the gross fiscal deficit in the final account, turned out to be higher by 22.4 per cent than the original budget estimates. On the receipt side, both tax revenue and total revenue receipts experienced shortfalls in the final accounts as compared to the budget estimates. This shortfall ranged between 2.1-12.6 per cent in respect of total revenue and 2.5-10.7 per cent in the case of tax revenue. As regards expenditure, the trend observed was that both revenue expenditure and aggregate expenditure exceeded the budget targets; the rise was to the extent of 2.6 to 6.2 per cent for revenue expenditure and 3.0 per cent to 8.0 per cent in

respect of aggregate expenditure. While the magnitude of the impact of fiscal deficit on interest rates and inflation depends upon the size of the fiscal deficit, overruns in government deficits have adverse macroeconomic impacts. A high and growing stock of public debt, which has implications for the sustainability of the fiscal situation, puts pressure on the absorptive capacity of the market and, thus, fuels interest rate expectations. In the Indian case, it is empirically found that despite the stability in the market debt, the overall fiscal situation is precarious because of potential instability in the non-market debt and due to large unfunded liabilities of the Central and State governments[3].

6.32   A readjustment in the maturity structure of Government debt has taken place after reforms. The share of short-term maturity bonds (*i.e.,* under five years) in total outstanding dated securities has recorded a sharp increase from 8.6 per cent to 41.0 per cent between 1991 and 1998. On the contrary, share of long-term bonds (i.e.,over ten years) declined rapidly to 18.2 per cent in 1998 from 85.8 per cent in 1991 (Chart VI.7). Shortening of maturities, however, led to some bunching of redemption of securities and the need for frequent rollovers from the market. The repayment profile witnessed steep humps in the medium-term on account of shortening of the average maturity of fresh issues of dated securities to 5.5 years in 1996-97 from 18.6 years in 1991-

92. In order to impart stability to the maturity profile of internal debt, debt management operations were re-oriented towards transforming the maturity structure to longer-term. As a result, the average maturity of dated securities steadily rose to 12.6 years in 1999-2000.
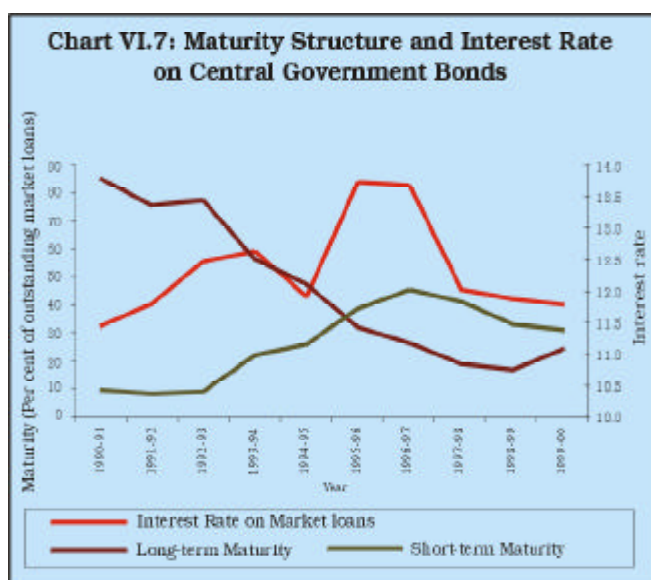
6.33   The fluctuations in maturity profiles and the yield curve have attracted attention for improving treasury management skills to cope with interest rate risks. Until recently, investors in the securities market were willing to take interest rate risks by locking themselves into long maturities, on the ground that their incomes would be higher if they invested at the longer end of the spectrum without giving due cognisance to risks of depreciation[4]. With the market orientation of interest rates, investors are required to make provisions for depreciation in their portfolio. Increased focus on asset-liability management, therefore, assumes importance. The Reserve Bank has taken several steps and provided guidelines to help market participants to initiate prudent trading activities that add to the strength and stability of the financial system.

Government Guarantees

6.34   Apart from debt accumulation, the growing size of guarantees extended by the Government affects public sector balance sheets and impacts the fiscal position. In the case of State governments, under a market-oriented borrowing system, the higher amount of guarantees without proper risk assessment has the potential of raising the risk premium on their bonds. As part of the effort for improved fiscal discipline, the outstanding guarantees for the Central Government has been brought down from 7.8 per cent of GDP as at end-March 1993 to 4.2 per cent as at end-March 1999 (Table 6.8). Such guarantees for the Centre and States (combined) also declined from 13.9 per cent as at end-March 1992 to 8.9 per cent of GDP as at end-March 1999. The reduction of such contingent liabilities has been lower in case of State governments.

Institutionalising Fiscal Discipline

6.35   In view of the budgetary imbalances, the imbalances on account of quasi-fiscal activities and the need to contain explicit and implicit

Chart VI.7: Maturity Structure and Interest Rate on Central Government Bonds

- Interest Rate on Market loans
- Long-term Maturity
- Short-term Maturity

[3]   Moorthy, Vivek, Bhupal Singh and Sarat Chandra Dhal, (2000), "Bond Financing and Debt Stability: Theoretical Issues and Empirical Analysis for India", *Development Research Group Study,* No. 19, Reserve Bank of India.

[4]   Tarapore, S.S., (1995), "Interest Rate Policy and the Managing of Risks in a Deregulated Environment", *Reserve Bank of India Bulletin*, December.

Table 6.8: Outstanding Government Guarantees

(Per cent of GDP)

End-March	Centre	States*	Total
1	2	3	4
1992	7.7	6.1	13.9
1993	7.8	5.7	13.5
1994	7.3	5.7	13.0
1995	6.2	4.8	11.0
1996	5.5	4.5	10.0
1997	5.1	4.7	9.8
1998	4.9	4.9	9.7
1999	4.2	4.7	8.9
2000	..	5.1	..

* Pertains to 17 major States.
.. Not Available

Note : Figures are ratio to GDP at current market prices.

Source : Finance Accounts, Government of India, CAG Reports and Budget Documents of State Governments.

Government guarantees, an institutional mechanism to support fiscal restraint would be useful. The Central Government and the Reserve Bank have been closely co-ordinating in this respect. In the Union Budget for 2000-01, the Government announced its intent to bring about Fiscal Responsibility Legislation (Box VI.6).

6.36 The Fiscal Responsibility and Budget Management Bill, 2000 was introduced in Parliament in December 2000. The Bill provides for the responsibility of the Central Government to ensure inter-generational equity in fiscal management and long-term macro-economic stability by achieving sufficient revenue surplus, eliminating fiscal deficit and removing fiscal impediments in the effective conduct of monetary policy. It also provides for prudential debt management consistent with fiscal sustainability through limits on the Central Government borrowings, debt and deficits, greater transparency in fiscal operations of the Central Government and conducting fiscal policy in a medium-term framework and for matters connected therewith or incidental thereto. The salient features of the Bill, *inter alia*, include laying the Medium-term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macro-economic Framework Statement by the Central Government before the Parliament, along with the

annual budget; elimination of the revenue deficit by March 31, 2006 and bringing down the fiscal deficit to 2 per cent of GDP in the same period; and prohibition of direct borrowings by the Central Government from the Reserve Bank after three years except by way of advances to meet temporary cash needs in certain circumstances.

External Debt Sustainability

6.37 Developing countries typically run current account deficits (CAD) to supplement their domestic savings to achieve higher levels of investment and growth without cutting their current consumption. In the borrowing countries, the accumulated current account deficits result in external debt and other liabilities that need to be serviced out of the country's current earnings. This raises the question of a sustainable level of external debt. India is classified as a less indebted country by the present value-GNP criterion and a moderately indebted country by the present value-exports criterion by the Global Development Finance (Table 6.10).

6.38 Measured in terms of conventional indicators of external debt sustainability, India's external debt position has undergone significant consolidation during the 'nineties as a part of the overall approach to external sector management (Chart VI.8). First, the current account deficit has been kept within sustainable limits, with the CAD/GDP ratio averaging at around 1 per cent since 1991-92 in contrast to an average of 2 per cent during the 'eighties. Secondly, as a result of a distinct shift in the policy framework in favour of equity as against debt in capital inflows, non-debt creating inflows have increased from a mere 1 per cent of total capital flows in 1990-91 to more than 50 per cent of the capital inflows. Thirdly, a transparent policy on external commercial borrowings with the stated objectives of prudent debt management has helped to consolidate India's external debt. The policy aims at lengthening of maturity while keeping a ceiling on approvals. Restrictions on end-use in the form of investments in stock markets/real estate have helped to avoid the pitfalls associated with unbridled external flows. Fourthly, in the case of non-resident deposits, withdrawal of exchange guarantees, alignment of interest rates with international rates, a minimum maturity prescription of 12 months in the case of foreign currency denominated deposits and promotion of non-repatriable deposits helped in consolidating non-resident deposits and making

Box VI.6
Rule-based Fiscal Responsibility

Any legislation on fiscal policy essentially focuses on the issue of rules *versus* discretion in policy formulation, implementation and enforcement. Fiscal rules should satisfy, in a specific context, certain objectives of fiscal policy, such as macro-stability, intergenerational equity, fiscal transparency and accountability, and autonomy of monetary policy (Kopits and Symansky, 1998). There are broadly three types of universally recognised fiscal policy rules, *viz*., balanced-budget or deficit rules; borrowing rules and debt or reserve rules incorporating one or several specific targets or ceilings or conditionality or even prohibitions. For the success of any specific rule, it must have statutory basis with an authority for monitoring/surveillance and enforcement of the rule/legislation and some in-built penalty clauses in case of non-compliance.

There is a well-documented literature on country-wise experiences relating to fiscal policy legislation (Table 6.9). The most common fiscal policy rule being followed is the budget-balance rule, that is, one relating to balance between Government revenue and expenditure. The borrowing rules are the oldest operating fiscal rules, which consist of prohibition of or limits on Government borrowing. Several advanced economies and some developing economies prohibit direct central bank financing to the Government sector and also to the rest of the non-financial public sector. The rule is not usually practiced in developing countries and transition economies on account of lack of market microstructure and infant debt markets. The debt rule consists of a limit on, or a target for, the stock of public debt as a proportion or ratio to the country's GDP. In some ways parallel to the debt rule is a rule, which may prescribe a target accretion of reserves (most probably in terms of liquid assets) for a future unforeseen event. Country experiences reveal that many countries have prescribed limits on Government access to central bank credit.

The compliance with fiscal rules may have some disadvantages, despite the generally favourable macro-economic effects, because these may distort the composition of Government expenditure or accentuate tax increases. Secondly, fiscal rules may induce profusion of creative accounting practices and increased recourse to one-time measures. Thirdly, governments cannot eliminate fiscal stress by adhering to a set of rules, for reduction in stress levels requires that governments commit themselves to some sort of a funding constraint. Further, rules could be suspended or repealed through subsequent legislative action, hence the sanctity of rules itself depends upon the level of discipline the government is willing to impose upon itself.

The legislation in India needs to focus on rectifying the medium-term fiscal balance and complete elimination of the revenue deficit, reduction/stabilisation of public debt as well as the consistency of fiscal balance with debt target. However, in order to achieve convergence, some intra-year assessment of the financial position of the Government is necessary as budgeting is an annual exercise, and based on the assessment, the stance of fiscal policy should be modified. Depending on the chosen policy instrument, if there is significant deviation of the fiscal variables from the targets set, corrective actions should be taken to ensure adherence to targets. Instrument focus could be on the levels of borrowing and net RBI credit to Governments as these are high frequency data which are readily available.

The statutory provisions of the Act and the system of penalty in case of violation of the act also assume critical significance. In this context, the degree of flexibility granted to the fiscal authorities in the Act assumes greater importance. Putting an autonomous surveillance mechanism to monitor the fulfillment of the fiscal rule laid down in the Act would be an important pre-requisite for the success of the Act.

On the issue of the role of the Reserve Bank, the level of monetisation should always be at the initiative of the central Bank. There is the issue of imposing a borrowing rule possibly circumscribed by a debt-GDP ratio. However, that would hinge upon the separation of the debt management function from that of monetary management by the central bank. Whether the central bank should participate only in the borrowing programme of the Government in the primary market or withdraw from the primary and operate only through the secondary market is the main question to be addressed. There is also the question of the quantum of devolvement. A stringent precision rule based regime in the present Indian scenario, given the large overhang of debt and the huge borrowing programme of the Government, seems difficult to envisage. However, a corrective strategy capsulated as rules aimed at medium-term rectification of the fiscal imbalance would definitely be a responsive signal indicating and enhancing the credibility of the governments in their intent towards fiscal consolidation and facilitating macroeconomic balance.

References

1. Kopits, G. and S. Symansky, (1998), "Fiscal Policy Rules", *IMF Occasional Papers,* No.162, IMF, Washington.

2. Reddy, Y.V., (2000), "Legislation on Fiscal Responsibility and Reserve Bank's Role: Some Issues", *RBI Bulletin,* March.

them a stable source of external funding. Fifthly, short-term debt flows have been tightly monitored and are permitted only for trade related purposes given their volatility and the possibility of their non-renewal in times of crisis. Sixthly, the exchange rate policy, which has been market determined, helped in avoiding the excessive risk-taking that occurred in some of the South-East Asian countries that followed a policy of either a fixed exchange rate or a predictable exchange rate regime. Finally, since debt servicing has ultimately to be funded out of current earnings, the policy efforts have been aimed at achieving a commensurate growth in current receipts. It may be noted that in line with the current trend in the liability management, the Central Government has set up a high level steering

Table 6.9: Fiscal Policy Rules in Selected Countries

| Country	Target or Ceiling	Effective Period	Statutory Instrument	Government Level	Penalty for Non-compliance
1	2	3	4	5	6
Netherlands	Structural deficit limit	1961-74	Government policy	Central Government	Reputational
European Union (EU) members	Medium-term overall balance Yearly deficit limit (3 per cent of GDP)	Since 1997	International Treaty[1] (Stage 3 of EMU)	General Government	Reputational Financial (from 1999)
United States (US)	Yearly overall balance	Proposal	Constitutional amendment	Federal Government	Judicial
Costa Rica	Yearly deficit limit (1per cent of GDP)	Proposal	Constitutional Amendment	Public sector	judicial
Switzerland	Cyclically adjusted balance	Proposal	Constitutional amendment	Federal Government	Reputational
New Zealand	Medium-term operating balance	Since 1994	Legal provision	Public sector	Reputational
Germany	Yearly current balance	Since 1949	Constitutional amendment	Federal and sub-national Governments	Judicial
Japan	Yearly current balance	1946-75 and proposed from 2003	Legal provision	Central Government	Judicial
United States	Yearly current balance	Various	Constitutional amendment	Subnational Governments	Judicial
Canada	Overall balance or deficit limit	Since 1993	Legal provision	Subnational Governments	Judicial
Indonesia	No domestic borrowing	Since 1967	Government policy	General Government	Reputational
EU members	No borrowing from central bank	Since 1994	International treaty (Stage 2 of EMU)	General Government	Judicial
Argentina, US, Canada, Chile, Ecuador, Peru, Hungary, Japan	No borrowing from central bank	Various	Various	General Government	Judicial
Brazil, Egypt, Morocco, Philippines, Slovak Republic	Borrowing from central bank limited as fixed proportion of last year's revenue	Various	Various	General Government	Judicial or reputational
European Union members	Gross debt limit (60 per cent of GDP)	Since 1997	International treaty (Stage 3 of EMU)	General Government	Judicial

[1]Including Stability and Growth Pact and pertinent European Council Regulations.

Source: Kopits, G. and S. Symansky, (1998), "Fiscal Policy Rules", *IMF Occasional Papers,* No.162, IMF, Washington.

Table 6.10: External Debt Sustainability Indicators – Cross-Country Comparisons

Country	End-1998 (US $ billion)		1996-98 (per cent)	
	EDT	PV	PV/XGS	PV/GNP
1	2	3	4	5
Argentina	144	151	424	53
Brazil	232	220	347	28
China	155	135	67	15
India	98	84	147	20
Indonesia	151	145	238	84
Korea	139	135	83	31
Mexico	160	156	121	44
Russia	184	165	166	45
Thailand	86	85	116	58
Turkey	102	100	176	52

EDT: Total external debt PV: Present Value of external debt
XGS: Export of goods and services (including workers' remittances)
Source: Global Development Finance.

Chart VI.8: India's External Debt: Key Indicators
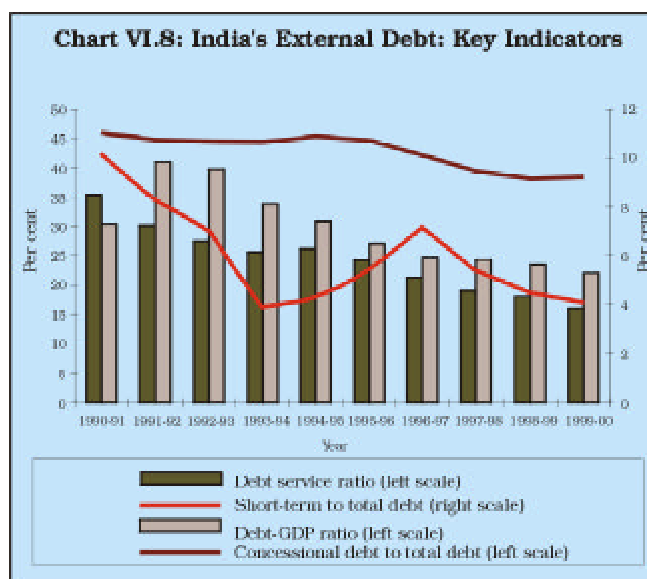
committee and a technical group to work out the modalities for more active sovereign external liability management in India. The Group in collaboration with the World Bank is developing a risk management model for sovereign external liability management in India.

6.39 Reflecting the above multi-pronged approach to external sector management, external debt has remained almost range-bound since 1995. The stock of external debt initially increased from US $ 83.8 billion as at end-March 1991 to US $ 99.0 billion as at end-March 1995. Subsequently, it declined to US $ 93.5 billion as at end-March 1997. As at end-March 2000, external debt at US $ 98.4 billion, was still lower than its March 1995 level. Notwithstanding the higher external debt stock as at end-Match 2000 as compared with the end-March 1992 level, the ratio of external debt-GDP has almost halved from a peak of 39 per cent as at end-March 1992 to 22 per cent as at end-March 2000 (Chart VI.8). Similarly, the debt-service ratio halved from 35 per cent in 1990-91 to 16 per cent in 1999-2000. The proportion of concessional debt in external debt declined from 46 per cent as at end-March 1991 to 39 per cent as at end-March 2000.

6.40 A more noteworthy aspect of external debt consolidation is the decline in short-term debt. Short-term debt, by original maturity, declined significantly from US $ 8.5 billion as at end-March 1991 to US $ 4.0 billion as at end-March 2000. As a result, short-term debt, as a proportion of total external debt, fell sharply from 10.2 per cent

to 4.1 per cent over the same period. In view of the importance of short-term debt by residual maturity as highlighted by the recent financial crises, the Status Report by the Ministry of Finance on India's external debt has started publishing data on short-term debt by residual maturity.

6.41 Recent events have also highlighted the need to monitor external contingent liabilities of the Government. In the Indian context, the Central Government provides guarantees on a selective basis on external borrowings by public sector enterprises, DFIs and in some instances, to private sector companies. These contingent liabilities are monitored by the Government and efforts have been made to reduce the magnitude of such guarantees. For instance, Government guarantees declined from US $ 12.2 billion as at end-March 1994 to US $ 7.5 billion as at end-December 1999, mainly on account of the decline in guarantees to public sector enterprises from US $ 8.6 billion to US $ 4.6 billion. Guarantees to the financial sector declined from US $ 3.3 billion to US $ 2.6 billion over the same period, Guarantees to the private sector have been insignificant at around US $ 0.3 billion. An important point to note is that since these guarantees have been provided to residents, the invoking of guarantees would only shift liabilities from residents to the Government and would not imply any additional liability for the country as a whole.

6.42 In sum, the Indian financial system is

reasonably stable. The banking system is well protected against risks with a median CRAR exceeding 11.0 per cent for the nationalised as well as the Indian private sector banks as at the end of 1999-2000. The CRAR for all-India DFIs is still higher. However, there are some weaknesses in the system that need to be addressed. These include the high level of non-performing loans in some banks and some DFIs. There are also disciplinary issues with regard to NBFCs that are being addressed by the regulators by putting in place a stricter supervision and regulatory system. There is also a need for ensuring greater transparency through disclosure norms for the mutual funds industry. Reinforcing financial stability would necessitate tackling these problems, as also problems of low asset quality through adequate recognition for impaired assets and adequate provisioning for losses. While external debt is moderate, the Governments' domestic debt and guarantees continue to be an area of concern from the viewpoint of macroeconomic stability. Although substantial progress has been made in addressing the areas of weaknesses, further improvements would be necessary.