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Volume I

Executive Summary

INDIA'S FINANCIAL SECTOR
AN ASSESSMENT

Volume I

Executive Summary

Committee on Financial Sector Assessment

March 2009

भारत सरकार
GOVERNMENT OF INDIA

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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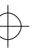

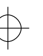

Report of the Committee on Financial Sector Assessment

EXECUTIVE SUMMARY

Contents

Section No.	Title		Page No.
I.	**INTRODUCTION**		5
	1.1	Background	5
	1.2	Framework and Approach	6
II.	**MACRO-ECONOMIC ENVIRONMENT**		9
III.	**ASPECTS OF STABILITY AND PERFORMANCE OF FINANCIAL INSTITUTIONS**		12
	3.1	Commercial Banks	12
	3.2	Co-operative and Rural Banking	27
	3.3	Non-banking Financial Companies	31
	3.4	Housing Finance Companies	36
	3.5	Insurance Sector	39
	3.6	Concluding Remarks	41
IV.	**FINANCIAL MARKETS**		45
	4.1	Equity Market	46
	4.2	Foreign Exchange Market	48
	4.3	Government Securities Market	51
	4.4	Money Market	53
	4.5	Corporate Bond Market	55
	4.6	Credit Risk Transfer Mechanism	56
	4.7	Concluding Remarks	57
V.	**FINANCIAL INFRASTRUCTURE**		59
	5.1	Regulatory Structure	59
	5.2	Liquidity Infrastructure	64
	5.3	Management of Capital Account	67
	5.4	Market Integrity	68
	5.5	Accounting Standards	68
	5.6	Auditing Standards	69
	5.7	Business Continuity Management	69

5.8 Payment and Settlement Infrastructure 70
5.9 Legal Infrastructure 75
5.10 Corporate Governance 80
5.11 Deposit Insurance 82
5.12 Review of Anti-money Laundering/Combating Financing of Terrorism 84
5.13 Concluding Remarks 84

VI. TRANSPARENCY ISSUES 88
6.1 Transparency in Monetary Policy 88
6.2 Transparency in Financial Policies 93
6.3 Fiscal Transparency 94
6.4 Data Dissemination 101
6.5 Concluding Remarks 104

VII. DEVELOPMENT ISSUES IN THE SOCIO-ECONOMIC CONTEXT 106

List of Acronyms

AASB	Auditing and Assurance Standards Board
AML	Anti-money Laundering
ASB	Accounting Standards Board
BCM	Business Continuity Management
BCPs	Basel Core Principles
BPLR	Benchmark Prime Lending Rate
CBLO	Collateralised Borrowing and Lending Obligation
CCIL	Clearing Corporation of India Limited
CCP	Central Counterparty
CFSA	Committee on Financial Sector Assessment
CFT	Combating Financing of Terrorism
CPI	Consumers' Price Index
CRAR	Capital to Risk Weighted Assets Ratio
CRR	Cash Reserve Ratio
CRT	Credit Risk Transfer
CSO	Central Statistical Organisation
DICGC	Deposit Insurance and Credit Guarantee Corporation
DMO	Debt Management Office
DRT	Debt Recovery Tribunals
DvP	Delivery versus Payment
FC	Financial Conglomerates
FEDAI	Foreign Exchange Dealers' Association of India
FEMA	Foreign Exchange Management Act
FFMC	Full-fledged Money Changers
FRBM	Fiscal Responsibility and Budget Management
FSAP	Financial Sector Assessment Programme
HFC	Housing Finance Companies
HLCCFM	High-level Co-ordination Committee on Financial Markets
IAPC	International Auditing Practices Committee
IASB	International Accounting Standards Board
ICAI	Institute of Chartered Accountants of India
IFRS	International Financial Reporting Standards
IIP	Index of Industrial Production
IOSCO	International Organisation of Securities Commission
IRDA	Insurance Regulatory and Development Authority
ISA	International Auditing Standards
KYC	Know Your Customer
LAF	Liquidity Adjustment Facility
MSE	Micro and Small Enterprises
MSS	Market Stabilisation Scheme
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-banking Financial Companies
NCLT	National Company Law Tribunal
NEFT	National Electronic Funds Transfer
NHB	National Housing Bank
NPAs	Non-performing Assets

NSCCL	National Securities Clearing Corporation Limited
OMO	Open Market Operations
OTC	Over-the-Counter
PCA	Prompt Corrective Action
PMLA	Prevention of Money Laundering Act
PN	Participatory Note
PSB	Public Sector Banks
RAROC	Risk Adjusted Return on Capital
ROSC	Report on the Observance of Standards and Codes
RRB	Regional Rural Banks
RTGS	Real Time Gross Settlement
RWA	Risk Weighted Assets
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act
SDDS	Special Data Dissemination Standards
SEBI	Securities and Exchange Board of India
SRO	Self-regulatory Organisation
STR	Suspicious Transactions Report
TACMP	Technical Advisory Committee on Monetary Policy
UCB	Urban Co-operative Banks
WoS	Wholly-owned Subsidiary
WPI	Wholesale Price Index

Report of the Committee on Financial Sector Assessment

EXECUTIVE SUMMARY

I. INTRODUCTION

1.1 Background

The Financial Sector Assessment Programme (FSAP) is a joint initiative of the International Monetary Fund (the Fund) and the World Bank (the Bank) that began in 1999. It attempts to assess the stability and resilience of financial systems in member countries. The programme includes assessments of the status and implementation of various international financial standards and codes in the regulation and supervision of institutions and markets, financial infrastructure in terms of legal provisions, liquidity management, payments systems, corporate governance, accounting and auditing; transparency in monetary, financial and fiscal policies; and data dissemination. An FSAP enables identification of the scope for strengthening resilience and fostering financial stability in a country and is designed to promote smoother integration with global markets.

India first participated in an FSAP in 2001 and also associated with independent assessments of standards and codes by the Fund/Bank since then. It also conducted a self-assessment of compliance with international standards and codes in 2002 and another review in 2004. This assessment draws upon the earlier FSAP and the IMF's Report on the Observance of Standards and Codes (ROSCs) as needed and relevant. Since the last FSAP in 2001, India has undertaken a series of ongoing reforms in the financial sector aimed at improving its soundness, resilience and depth. The reforms have borne fruit: the country has reached a higher growth trajectory; savings have increased and investment in productive activities has expanded significantly; credit has expanded as a proportion of GDP; financial markets have gained in depth, vibrancy and efficiency; and capacity building overall is embedded in the system.

In September 2005, the IMF and the World Bank jointly brought out a Handbook on Financial Sector Assessment. This detailed the techniques and methodologies for FSAP that could, *inter alia,* serve as a reference point for countries themselves to undertake self-assessments.

Based on India's experience in the FSAP and self-assessments, the Government of India, in consultation with the Reserve Bank, decided in September 2006 to constitute the Committee on Financial Sector Assessment (CFSA) to undertake a comprehensive self-

assessment of India's financial sector. The CFSA, in turn, decided to assess financial stability and also compliance with all financial standards and codes so that a compact roadmap could evolve with a medium-term perspective for the entire financial sector.

The CFSA has followed a comprehensive, constructive and transparent approach to self-assessment, especially since such a self-assessment needs to be seen as a rigorous and an impartial exercise to command credibility.

Overall, the assessment has found that the financial system is essentially sound and resilient, and that systemic stability is robust. Compliance with international standards and codes is generally satisfactory, and India is broadly compliant with most of the standards and codes. The assessment documents the areas of non-compliance, partial or otherwise.

Single-factor stress-tests for credit and market risks and liquidity ratio and scenario analysis carried out showed no significant vulnerabilities in the banking system. But, systemic multi-factor stress tests could not be carried out owing to the lack of data and appropriate models for carrying out such stress tests. The CFSA has recommended institutional arrangements to carry this work forward.

The CFSA has identified, based on some existing gaps, areas for further improvement. One of the serious gaps is in respect of adequate compliance with regard to timely implementation of bankruptcy proceedings. The average time taken in India for winding-up proceedings is one of the highest in the world. Improvements in effective enforcement of creditor rights and insolvency systems are critical for strengthening market efficiency and integration and for enhancing commercial confidence in contract enforcement. A quick resolution of stressed assets of financial intermediaries is essential for the efficient functioning of credit and financial markets.

1.2 Framework and Approach

The CFSA has followed a forward-looking and holistic approach to self-assessment. It is based on three, mutually reinforcing pillars: financial stability assessment and stress testing; legal, infrastructural and market development issues; and an assessment of the status of implementation of international financial standards and codes. The first pillar is essentially concerned with stability assessment. It utilises standard analytical tools for quantifying the risks and vulnerabilities in the financial sector. It also encompasses an assessment of the systemic risks at the macro and sectoral levels. The second pillar focuses on developmental issues in the financial sector. It concentrates on the legal and institutional infrastructure for prudential regulation and supervision of the institutions and markets, the payment and settlement system, liquidity management and the crisis-mitigating financial safety nets. The third pillar encompasses a comprehensive assessment of the status of implementation of various international financial standards and codes.

Taking into account the legal, regulatory and supervisory architecture in India, the CFSA felt the need for involving, and associating closely, all the major regulatory institutions in the financial sector, *viz.*, the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA). Depending upon the sectoral/functional distribution, several other regulatory and supervisory agencies in the financial system were also associated, besides the concerned departments in the Government of India. Direct official involvement at different levels brought about enormous responsibility for, ownership of and commitment to the assessment process, thus ensuring constructive pragmatism while addressing, in particular, the contentious issues.

Since the assessment required comprehensive technical domain knowledge in the various areas examined, the CFSA initially constituted Technical Groups comprising officials with first-hand experience in handling the respective areas from the regulatory agencies concerned as well as the Government to undertake the preliminary assessment and to prepare technical notes and background material in the concerned areas. This ensured that officials who are well-conversant with their own systems and are aware of the existing weaknesses could identify the best alternatives for finding solutions.

Thereafter, to ensure an impartial assessment, the CFSA constituted four external independent Advisory Panels, comprising non-official experts drawn from within the country. These Panels made their assessments after thorough debate and rigorous scrutiny of inputs provided by the Technical Groups. The Advisory Panels were:

- The Panel on Financial Stability Assessment and Stress Testing –covered macro-prudential analysis and stress testing of the financial sector;
- The Panel on Financial Regulation and Supervision – covered banking regulation and supervision, securities market regulation and insurance regulation standards;
- The Panel on Institutions and Market Structure – covered standards regarding bankruptcy laws, corporate governance, accounting and auditing, and payment and settlement systems; and
- The Panel on Transparency Standards – covered standards pertaining to monetary and financial policies, fiscal transparency and data dissemination issues.

For further strengthening the credibility of this assessment, the Advisory Panels' assessments were peer reviewed by eminent experts who were mostly drawn from other countries, and the comments and suggestions of the peer reviewers were discussed in two brainstorming sessions interfacing the peer reviewers with the Panel and CFSA members. The Advisory Panels considered the peer reviewers' comments and modified their assessments, as appropriate. The CFSA then drew up its own overview report at the final stage, drawing upon the assessments, findings and recommendations of the Advisory Panels and the comments of the peer reviewers. The assessments and recommendations comprise six volumes, consisting of the Executive Summary, the Overview Report of the CFSA and the reports of the four Advisory Panels mentioned above. These six volumes should be viewed as a package complementing one another.

Section I

Introduction

The unfolding of the ongoing global financial and economic crisis since mid-2007 made the task of the CFSA and its Advisory Panels more complex. The CFSA is aware that there is considerable international discussion and debate underway on the issue of financial regulatory architecture, and on the changes that are needed to make the global financial system more resilient.

Thus, it is with a sense of utmost humility that the CFSA presents the results of the assessment of the India's financial sector along with a set of recommendations meant for the medium term of about five years. The accent in this assessment is on transparency. Thus, where conflicting views have emerged among the Panels, the peer reviewers, and even among the members of the CFSA, they have been reported transparently. Regulation and development of the financial sector is a complex affair and there is room for constant debate and discussion, as shown particularly by the debate that is now being conducted in the wake of the ongoing global financial crisis. The approach taken in this assessment is to provide general directions and excessive specificity has been eschewed.

The key assessments and recommendations under major heads are summarised in the sections that follow.

II. MACRO-ECONOMIC ENVIRONMENT

Macroeconomic developments and shocks can have an enormous impact on the financial sector. Financial stability analysis, therefore, attaches great importance to ascertaining potential macro-economic vulnerabilities in the system.

India's financial sector, in terms of institutions, markets and infrastructure has expanded and acquired greater depth and vibrancy as a result of the ongoing reforms initiated in the early 1990s. In view of the current turmoil in global financial markets, the overall assessment of economic trends and the related issues arising for India have undergone a shift from a benign and optimistic outlook to a relatively more cautious and guarded one in the face of many downside risks. However, the overall assessments remain intact. Indicators of financial soundness, including the results of stress tests of credit and market risks, suggest that the banks are healthy and robust. The liquidity ratio analysis of the banking system has, however, shown a few concerns that need to be addressed.

India's financial markets have gained depth, liquidity and resilience over time. The performance of the Indian economy has been impressive over the past two decades, with high real GDP growth accompanied by a decline in population growth and associated with consistent trends of increasing domestic savings, investment and productivity. Since 2003-04, there has also been significant bank credit growth. Merchandise exports have become increasingly broad-based in terms of destinations and composition, reflecting India's growing integration into the global economy. Despite the widening trade deficit, the current account deficit has remained modest, due largely to high levels of private transfers and service sector exports. The low debt-to-equity ratio in the Indian corporate sector points to higher internal accrual and buoyancy in their revenues and profitability. Recent times have, however, seen a sharp correction in the valuations of listed firms as also in their profitability, as has happened globally. To that extent, there could be some reversal in the declining debt-to-equity ratio in the Indian corporate sector in the current context. While there would be some moderation in rates of growth in the immediate future due to uncertain global market conditions, it is felt that India would return to its trend of eight per cent plus growth rate over the medium term as economic normalcy returns in the global economy. This would, however, depend upon certain critical areas, such as agriculture, infrastructure and fiscal consolidation being addressed.

In tune with global trends, inflation rates in India were low for most of the current decade. Although there was a spurt in early 2008, there has been a sharp decline in recent months due to the cooling down of energy and commodity prices in particular. The pass-through of international oil prices to domestic prices has been partial due to the administered pricing policy in the oil sector. Given India's high exposure to oil imports, coupled with the

widespread impact in times of higher oil prices on the economy, a more efficient use of oil products is warranted. Another major concern, both domestically and globally, has been the rise in food prices. However, the recent correction in global prices, along with the series of measures already taken by the Government on the supply side, have begun yielding results. There is a need to improve both the forward and backward linkages in agriculture through better credit delivery, investment in irrigation and rural infrastructure, improved cropping patterns and farming techniques, and development of the food processing industry and cold storage chains across the entire distribution system.

In the meantime, uncertainty in the global financial markets deepened further and entered a new turbulent phase from about the middle of September 2008. Consequently, global economic growth is expected to slow down significantly; indeed, most advanced economies are already in recession. This has severely affected confidence. As a consequence, there has been a reversal of capital flows and, based on the duration of the crisis, India could continue to face a lower level of net inflows, causing strains in domestic liquidity. The Reserve Bank's armoury of policy instruments for maintaining liquidity has, however, been effective in managing the current situation. Overall, during 2008-09, the rupee was volatile and the volatility was greatly accentuated from mid-September 2008 onwards. The Reserve Bank and the Government have been active in taking a range of measures to meet shortfalls in rupee as also foreign exchange liquidity. It may be noted that among the countries surveyed by the Bank for International Settlements (BIS), the Indian foreign exchange market volumes have shown the fastest growth during 2004 to 2007. The foreign exchange market in India has continued to function well even during this time of turmoil.

India has been a net recipient of FDI and FII inflows consistently from 1990 onwards. Though the global financial turmoil has led to a significant slowdown in net capital inflows in 2008-09 with net portfolio outflows, it is expected that, overall, India will still record net capital inflows, though modest, this year. India's approach in regard to the capital account has consistently made a distinction between debt and equity, with greater preference for liberalisation of equity markets *vis-à-vis* debt markets. There is a broad consensus that fuller capital account convertibility is desirable, but the migration should be gradual, well sequenced and undertaken concomitant with achieving a balance in the external and fiscal sectors along with low inflation.

The binding constraint on growth in recent years has been the infrastructure deficit. Sustained growth in private sector infrastructure investment can take place in only those sectors that are financially viable, and which exhibit adequate future returns. With a view to attracting private capital to bridge the gaps in the public funding of infrastructure, emphasis has shifted to public-private partnerships (PPPs). However, the development of an active corporate bond market is critical for the success of this shift. Along with other developments

in the institutional infrastructure, this requires the active development of domestic institutional investors. Reforms in the pension and insurance sectors will help in such institutional development so that pension funds and insurance companies can progressively acquire adequate size to become substantial investors in the domestic corporate bond market. Development of the municipal bond market, mortgage backed securities and the like would also be needed.

The global crisis has not left the fisc untouched. The implementation of a rule-based fiscal correction process, based on the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 was commenced by the Central Government in July 2004. However, given the current pressures to maintain growth at a reasonably high level, it was not be possible to resume the fiscal correction path after the current financial turmoil. The Government has in fact, deviated from its fiscal reform path and the FRBM targets have been relaxed to allow for higher spending, as well as to absorb the impact of lower revenue growth in 2008-09 and 2009-10. The Government has announced that it will return to FRBM targets, once the economy is restored to its recent trend growth path.

Going forward, it is essential to continue with focused attention on achieving a balance between financial development and financial stability. Also, for the growth momentum to be sustained, it is necessary to return to the path of fiscal prudence at both the central and State Government levels. The key to maintaining high growth with reasonable price stability lies in rapid capacity additions through investments, productivity improvements, removal of infrastructure bottlenecks and amelioration of skill shortages.

III. ASPECTS OF STABILITY AND PERFORMANCE OF FINANCIAL INSTITUTIONS

The assessment of the institutions has been carried out both from the stability perspective, as also the perspective of their adherence to international standards and codes. The assessment of the regulatory and supervisory environment of financial institutions has been done with reference to the Basel Core Principles (BCPs). The assessment of regulation and supervision in the insurance sector has been done with reference to IAIS Core Principles. Though the BCPs are strictly applicable only to commercial banks, the Advisory Panel on Financial Regulation and Supervision decided to extend the assessment of BCPs to the Urban Co-operative Banks, Rural Co-operative Banks, Regional Rural Banks, Non-Banking Financial Companies and Housing Finance Companies. The assessment of the BCPs with reference to these entities has been done with the intention of identifying areas where improvements can be made. The assessment of BCPs would throw up developmental issues which, if implemented, could strengthen the regulation and supervision of these entities. The assessment becomes relevant in the current context because of the inherent linkages that such institutions have and their consequent impact on the stability of the financial system. Further, in light of the recent turmoil wherein some NBFCs, though not akin to banks, faced problems, this exercise has helped to identify gaps in the practices they follow.

3.1 Commercial Banks

The Indian commercial banking system has shown itself to be sound. This is important because commercial banks are the dominant institutions with linkages to other segments in the Indian financial system, accounting for around 60 per cent of its total assets and, hence, stability assessment of commercial banks is most important from the systemic point of view. In recent years, competition has increased across bank groups as also within the public sector.

The global financial turmoil has had repercussions on the Indian financial markets, particularly in the equity and foreign exchange segments. However, the banking sector has not been significantly impacted. This is evident from its comfortable capital adequacy, asset quality and profitability indicators even for the half-year ended September 2008 and the third quarter ended December 2008. Commercial banks continue to show a healthy growth rate and exhibit overall improvement in areas of capital adequacy, asset quality, earnings and efficiency indicators. With a slowing economy, however, asset quality can be expected to undergo some stress.

Banking Legislations

Apart from the BR Act which governs all the scheduled commercial banks, there are various other legislations governing different bank groups. The nationalised banks are

governed by two Acts, *viz.*, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980. The State Bank of India and the subsidiaries of State Bank of India are governed by two legislations, *viz.*, State Bank of India Act, 1955 and State Bank of India (Subsidiary banks) Act, 1959, respectively. IDBI Bank is governed by the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003. The private sector banks come under the purview of the Companies Act, 1956. The overall regulation of the banking sector is governed by the BR Act. The CFSA notes that since the origins of the banks have been historically different, they continue to be governed by different legislations. It also notes that the Government at various points in time has been considering the possibility of a single banking legislation to cover all public sector banks (PSBs). The CFSA feels that while a single legislation for all PSBs could be the first step forward, the Government could consider subjecting all commercial banks to a single banking legislation in a medium-term perspective.

There have been some developments that have taken place since the last assessment undertaken by the IMF and the World Bank. The Banking Regulation (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Act, 2006 provides for (a) an increase in the number of whole-time directors of nationalised banks from two to four; (b) the director to be nominated by the Government on the recommendation of the Reserve Bank to be a person possessing the necessary experience and expertise in regulation or supervision of a commercial bank, (c) removal of the provision for nominee directors from amongst the officials of SEBI/NABARD/Public Financial Institutions; (d) nomination of up to three shareholder directors on the boards of nationalised banks on the basis of percentage of shareholding; (e) elected directors to be persons having 'fit and proper' status as per the criteria notified by the Reserve Bank from time to time; and (f) the Reserve Bank to appoint one or more additional directors, if necessary, in the interests of banking policy/public interest/interest of the bank or the depositors. In addition, the amendments empower such banks (a) to raise capital by public issue or private placement or preferential allotment of equity as well as preference shares, subject to the guidelines to be laid down by the Reserve Bank, as also (b) empower the Central Government to supersede the board of nationalised banks on the recommendation of the Reserve Bank and appointment of administrator.

In the area of dispute settlement, the Legal Services Authority Act, 1987 has conferred statutory basis on the *Lok Adalats* (people's courts).The Reserve Bank has consequently issued guidelines to commercial banks and financial institutions to make increasing use of the forum of Lok Adalats. As per the earlier guidelines, banks could settle disputes involving amounts up to Rs.5 lakh through the forum of Lok Adalats. This was enhanced to Rs.20 lakh in August 2004. Further, banks have also been advised by the Reserve Bank to participate in the Lok Adalats convened by various DRTs/DRATs for resolving cases involving Rs.10 lakh and above to reduce the stock of NPAs.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), effective from the date of promulgation of the first Ordinance, *i.e.*, June 21, 2002, has been extended to cover co-operative banks by a notification dated January 28, 2003. The Enforcement of Security Interest and Recovery Debts Laws (Amendment) Act, 2004 has amended the SARFAESI Act, Recovery of Debts due to banks and financial institutions Act, 1993 and the Companies Act, 1956. By this amendment, the SARFAESI Act has been amended, *inter alia,* to (a) enable the borrower to make an application

before the debt recovery tribunal against the measures taken by the secured creditor without depositing any portion of the money due; (b) provide that the debt recovery tribunal shall dispose of the application as expeditiously as possible within a period of 60 days from the date of application and (c) enable any person aggrieved by the order by the debt recovery tribunal to file an appeal before the debt recovery appellate tribunal after depositing with the appellate tribunal 50 per cent of the amount of debt due to him as claimed by the secured creditor or as determined by the debt recovery tribunal, whichever is less.

The Credit Information Companies (Regulation) Act, 2005 is aimed at providing for regulation of credit information companies and to facilitate efficient distribution of credit. The Act provides for establishment, supervision and regulation of credit information companies that can undertake the functions of collecting, processing and collating information on trade, credit and financial standing of the borrowers of credit institutions which are members of the credit information company. This enactment will now enable the introduction of credit information bureaus in India within a suitable regulatory framework.

Financial Soundness Indicators

It is a matter of some satisfaction that capital adequacy ratios across bank groups have remained significantly above the regulatory minimum and, even better. NPA ratios have shown a significant decline. But it should be noted that there has been an increase in the growth of off-balance sheet exposure in recent years, particularly in the case of foreign banks and new private sector banks. Questions are sometimes asked about how the PSBs are faring in relation to the new private sector banks, which are generally regarded as being more efficient and customer-friendly. Over the years there has been a marked convergence in key financial indicators across bank groups. Though efficiency as measured in terms of the business-per-employee ratio is lower for public sector banks (PSBs), the cost-income ratio shows a significant degree of convergence with other bank groups.

The Herfindahl-Hirschman Index for India indicates that the Indian banking sector is not highly concentrated. Despite the increase in competition, the PSBs continue to dominate the commercial banking arena. [In this context, one member of the CFSA held the view that the high percentage of government ownership of commercial banks could potentially affect competition.]

Ownership Issues

An important issue relates to the government ownership of banks. While the stridency of the debate on this issue has abated somewhat in recent months in the wake of the actions taken by the Governments in the UK and the US, the issue is important in the Indian context where governance issues have a different hue. The government ownership of banks augurs

well for systemic stability and plays an important role in financial inclusion. If it leads to any specific regulatory forbearance, it can lead to higher fiscal costs in the medium term when such forbearance eventually leads to the need for recapitalising the banks as well. The cost of recapitalisation of Indian public sector banks has, however, been lower than most other countries.

There is no conflict of interest in Government's role as owner of banks and its relationship with the regulator. The Reserve Bank is an independent regulator and neither its powers to regulate PSBs decrease nor is any regulatory forbearance exhibited by it towards these banks because of government ownership. The same set of regulations are applicable to all banks, irrespective of their ownership, across the board. All banks are subject to annual financial inspections and the findings of the inspection are placed before the Board for Financial Supervision. However, there are some government sponsored schemes implemented by Public Sector Banks for which the amount of subvention, if any, is borne by the Government. The Government as the owner of the PSBs also conducts quarterly review of the performance of PSBs against the statement of intent submitted by these banks.

As mentioned, the cost of recapitalisation of PSBs has been relatively low as compared with other countries. Given that the Government has been the owner of PSBs, any suggestion advocating that the Government must exit its monitoring function and leave governance entirely to a duly-constituted board is unrealistic in the present environment and such a move might be undesirable as well.

Capital Augmentation by the Government

There is some apprehension that PSBs' growth could be potentially constrained relative to other players in the banking system, given that some PSBs are touching the statutory floor of 51 per cent of shareholding by the Government. The problem could get exacerbated in view of the impending need to implement Basel II guidelines, which could require more capital. The Government has, in the past, shown willingness to contribute capital and the growth of PSBs has so far not been constrained because of a lack of capital. However, given the medium-term projected growth rate of the economy at 8 per cent and assuming the consequent growth of Risk Weighted Assets (RWAs), the capital requirement to maintain the expected momentum of credit growth is likely to increase. This emergent problem needs to be addressed so that the capital required by public sector banks for supporting growth is assured. If the annual growth in RWAs is within 25 per cent, the additional capital requirement from the Government is assessed to be manageable.

If the Government is not able to contribute its share of capital needed for the growth of the public sector banking system, it will need to reduce its shareholding below 51 per cent. This requires legislative changes. However, pending enactment of enabling legislation to reduce majority ownership, and keeping in mind the synergies, one option for the Government could be to consider amalgamating banks that are on the borderline of 51 per cent shareholding with banks where government ownership is significantly higher than the stipulated minimum of 51 per cent. Amalgamation should only be done if there are positive synergies and complementaries in the regional spread of the banks proposed to be amalgamated.

Capacity Building

In order to give more flexibility in the functioning of PSBs, there could be a need for an enabling environment for the Government to reduce its majority shareholding. This would, among other things, not constrain the PSBs from attracting and retaining talent as their incentive structure would then not be limited by the government pay structure. This would also enable them to have lateral recruitment of experts with appropriate skill sets. It would also facilitate technology upgrading which is even more necessary given the implementation of Basel II guidelines and needs considerable investment in technology and capacity building. Associated with this issue is the structure of incentives, especially financial incentives in PSBs. There is an urgent need for an upward revision of the remuneration and incentive structure of PSBs, commensurate with responsibility and more in alignment with the changing times. The recent crisis has also highlighted the role of managerial remuneration structures in the financial sector that have led to excessive risk taking and adverse selection problems. At the same time therefore, there is a need to ensure that the incentives for top management and key executives are monitored and linked to their performance over a longer-term economic cycle, in private sector and foreign banks as well.

Corporate Governance

An important issue with regard to corporate governance in banks is the role of professionals on bank boards. Given the transformation that is taking place in the banking sector, there is a clear need for more professionals on bank boards. Though there are concerns about the composition and professionalism of the boards of PSBs regarding the attraction of board members with adequate talent, corporate governance principles should essentially be the same across bank groups. To improve governance in PSBs, therefore, there could be a requirement for ensuring proper quality of directors by adhering to the fit and proper criteria both in letter and spirit; and improving flexibility in decision making, unhindered by government interference.

The question of voting rights is also important. While there is merit in allowing voting rights to be proportionate to share holding, any shareholding in excess of the threshold 10 per cent should continue to need the prior approval of the Reserve Bank as proposed in the amendment to the BR Act in Parliament.

An aspect closely linked to voting rights is the issue of substantial interest. As per Section 10A (2) (b) of the BR Act, directors specified under Section 10A (2) should not have substantial interest in a company or a firm. The definition of substantial interest in the BR Act needs to be revised upwards to attract appropriate talent and professionalism in the banks' boards (Section 10 (A) (2) of the BR Act read with Section 5(ne)). The present quantitative ceiling of Rs.5 lakh could be removed and an appropriate per cent of paid-up capital can be stipulated.

Though the scope of influence of external agencies like the Central Vigilance Commission (CVC) over the years has also undergone a change and the existing arrangement has worked well, there is still a need for redefining the scope of work of these agencies. There may be a requirement to come out with a separate CVC manual in this regard.

Roadmap for Foreign Banks

Currently, foreign banks are permitted to establish their presence by setting up branches, setting up a wholly-owned subsidiary (WOS), or converting existing branches into WOS. During this phase, eligible foreign banks converting can be permitted to acquire shareholdings in Indian private sector banks, which would be limited to banks in need of restructuring.

Though there is a widely-held perception that the entry of foreign banks would enhance the overall efficiency of the banking sector through adoption of new technologies, products and management techniques, it needs to be noted that the new private sector banks currently operating in India have also adopted new technologies, offer varied products and have good management techniques in place which are comparable with the foreign banks.

The Reserve Bank's regulatory approach towards foreign banks has generally been liberal compared to global standards, which are characterised by a single class of banking licence, no restrictions in setting up non-banking financial subsidiaries in specified activities, uniform deposit insurance, uniform prudential norms and lower priority sector requirements. India has also been fairly liberal in according branch licences to foreign banks relative to its commitments to the World Trade Organisation. Generally, more than the committed 12 branch licences have been given per year.

The CFSA, therefore, feels that the entry of foreign banks needs to be gradual and consistent with the overall financial policy strategy and the transition should happen smoothly without causing serious imbalances. A detailed cost-benefit analysis of the impact of the entry of foreign banks on the Indian financial sector would be useful as decisions are taken on the matter. The Reserve Bank's approach on the roadmap for foreign banks is due for a review after March 2009 concerning the extension of national treatment to Wholly-Owned Subsidiaries (WoS), dilution of stake and permitting mergers/acquisitions of any private sector bank in India with foreign banks. The CFSA recommends that the following need to be taken into account while reviewing the roadmap for entry of foreign banks:

- They can operate in the country either through branches or the subsidiary route subject to reciprocity.
- Branch licensing policy could be broadly structured on the lines of that followed in new private sector banks, consistent with the country's WTO commitments, but licensing of branches would continue to be based on reciprocity.
- In case they adopt the subsidiary route, the foreign shareholding should not exceed 74 per cent. All regulatory guidelines and norms applicable to private sector banks could also be made applicable to them.
- The Indian subsidiaries of these banks should be listed in the Indian stock exchanges.

- There is a need to have independent members in the board of directors for Indian subsidiaries of foreign banks to protect the interests of all stakeholders.
- The expansion in operations of foreign banks should not affect the credit flow to agriculture and small and medium enterprises (SMEs). If there is a policy-mandated requirement of funding such entities, there should be no discrimination between foreign and domestic banks, as exists at present.
- Subsidiaries of foreign banks would be subject to all requirements that Indian banks are subject to.

Prompt Corrective Action (PCA)

Over the course of economic and business cycles, any financial entity is likely to undergo financial stress. The Reserve Bank has had in place a scheme of Prompt Corrective Action (PCA) since December 2002, which is applicable to scheduled commercial banks (except RRBs). The scheme is in place to undertake 'structured' and 'discretionary' actions against those banks that exhibit weaknesses in certain pre-determined financial and prudential parameters. Given the potential for systemic linkages between entities like co-operative banks, systemically important NBFCs, mutual funds and insurance companies, it is desirable in the interests of financial stability that such a scheme may also be evolved and implemented by the Reserve Bank for co-operative banks and systemically important NBFCs, as well as by SEBI for systemically important mutual funds and IRDA for insurance companies.

Off-balance Sheet Items

The hallmark of the past decade or so has been innovation in financial products. This brings to the fore issues related to product appropriateness and capacity building. Most banks do not strictly adhere to the suitability and appropriateness policy for derivatives products, despite the recent guidelines issued by the Reserve Bank. Though ICAI has issued AS 31 (disclosures and presentation of financial instruments) and AS 30 (recognition and measurement of financial instruments), which will be adopted for implementation effective on voluntary basis from April 1, 2009, there is a need for better understanding of off-balance sheet liabilities of banks and better systems of accounting and disclosures along with a centralised netting, collateral custody and clearing system.

Consolidation

Consolidation can take place through strategic alliances or partnerships. Besides helping banks to achieve economies of scale and augment the capital base, it could help market players in other ways to strengthen their competitiveness. Alternatively, strategic alliances and collaborative approaches could be attempted to reduce transaction costs through outsourcing, leveraging synergies in operations and strengthening the work culture. A holistic view needs to be taken in regard to consolidation keeping the respective pros and cons in

mind. While the ability of Indian banks to fund large loan requirements hinges on their having a 'critical size', consolidation could lead to greater concentration, thereby posing systemic risks. The gains from consolidation and the synergies needed should be clearly quantified by the management and it is important for bank boards to track whether these gains are, in fact, being realised. It would prove useful provided suitable progress could be made on HR and, more importantly, issues of industrial relations.

The imperatives of consolidation in Indian banking exhibit certain country-specific considerations. Salient considerations include the need for a larger capital base to support, *inter-alia*, customer growth and larger needs, leveraging of information technology and communications networking and the blurring of the distinction between financial institutions. In this context, however, it should be noted that banks in India are heterogeneous in character and in their operations. This presents potent problems in the integration of infrastructure and business process/delivery mechanisms, which may lead to increases in post-merger costs. Also, the differences in approaches to human resource management and industrial relations between the entities proposed to be merged would need to be factored in at the time of merger/amalgamation and the process of consolidation needs to be primarily market-driven; this could be supported by creating a regulatory environment which would continue to be more conducive to such market-driven amalgamations. This could be particularly relevant for old private sector banks which need to be further strengthened. The Reserve Bank needs to create a conducive environment to enable primarily market-driven amalgamation of these entities.

Competition (Amendment) Act, 2007

India has been aware of the need for a competition policy for several years and the new Competition (Amendment) Act, 2007 has been legislated. While serving an important national purpose, it nevertheless has certain provisions that could adversely impact the financial sector. For example, every person or enterprise proposing to enter into a combination via a merger or an amalgamation is required to give notice to the Commission before entering into a combination. The applicant then has to wait for a maximum period of 210 days. While reasonable in several cases, this provision, when applied to the proposal for the voluntary amalgamation of banks under Section 44A of the BR Act, could become a problem as the wait of 210 days may defeat the purpose of the proposed combination. The Reserve Bank can give its sanction to the amalgamation only thereafter which would delay the whole process and is also likely to raise regulatory conflicts. Similar would be the case with amalgamations under the schemes made by the Central Government in the exercise of its powers under Section 9(2) of the Nationalisation Acts, 1970 and 1980. There is, therefore, a need to re-examine the whole issue and, if necessary, the Central Government may grant the necessary exemption under Section 54 of the Competition Act. The CFSA notes that the matter has already been taken up by the Government.

Stress Testing and Risk Management

The resilience of the financial system can be tested by subjecting the system to stress scenarios. It may be noted that the stress tests are generally carried out with reference to a sudden shock and its instantaneous impact; in practice, when such shocks take place, banks get time to adapt and mitigate the impact.

Aspects of Stability and Performance of Financial Institutions

For the purpose of this assessment single-factor stress tests for the commercial banking sector covering credit risk, market/interest rate risk and liquidity risk were carried out. To test systemic resilience, the CFSA notes that stress testing needs to take into account co-related risks, i.e., the simultaneous occurrence of two to three problems. However, limitations on the availability of data and a model have precluded such an analysis. As a way forward, there is therefore a need to develop such an analysis over a period of time.

Going forward, it is necessary to develop a set of vulnerability indicators to facilitate model-building for providing early warning signals and linking the stress tests to appropriate macroeconomic scenarios/stress. An inter-disciplinary Financial Stability Unit, which could periodically monitor systemic vulnerabilities, should be set up in the Reserve Bank. Estimation of economic capital to help facilitate the adoption of Risk Adjusted Return on Capital (RAROC) methodology and dynamic provisioning could also be a way forward in prudential risk management.

A new source of risk to banks has arisen from the derivatives segment. Banks' exposures in the derivatives segment have raised issues relating to customer appropriateness and product suitability, as also the need for a better understanding of off-balance sheet liabilities and better systems of accounting and disclosures along with centralised netting, collateral custody and a clearing system. On-site examination of banks, as part of the supervisory process, should be supplemented by forensic 'follow the evolution of the product' approach, whereby the evolution of a derivative product is followed through its origination to final holder to check whether the financial institutions, infrastructure and trading, clearing and settlement, and risk management processes along the trading chain are adequate with sufficient due diligence and risk controls/audit trail.

The single-factor stress tests have revealed that the banking system can withstand significant shocks arising from large potential changes in credit quality, interest rate and liquidity conditions. These stress tests for credit, market and liquidity risk show that Indian banks are generally resilient.

Credit Risk

Stress testing for credit risk was carried out by increasing both the NPA levels and provisioning requirements for standard, substandard and doubtful assets. The analysis was carried out both at the aggregate level and individual bank level for end-March 2008 under three scenarios. The first scenario initially assumed a 25 per cent and 50 per cent increase in NPAs. It was subsequently felt that there is a possibility that the NPA levels could be impacted adversely due to the economic slowdown. Consequently, the shocks on NPA levels for Scenario I was increased from 50 per cent to 100 and 150 per cent. Accordingly, the first scenario assumed an increase of 25, 50, 100 and 150 per cent increase in NPAs. The shock imparted in the second scenario amounts to the maximum asset slippage experienced by

banks since 2001. The third scenario assumes a 50 per cent increase in retail NPAs. The results obtained from each stress scenario were then related to regulatory capital to assess the resilience of commercial banks, both at the system level and for individual banks.

Under Scenario I, when NPA levels were assumed to increase by 25 per cent, the CRAR for the entire banking system would reduce to 12.3 per cent from the existing 13.0 per cent. If the NPA levels were stressed by a 50 per cent increase, the CRAR would reduce to 12.1 per cent. Before the stress test, all banks were found to be able to meet the regulatory stipulation of 9 per cent in March 2008. However, in the event of an increase in NPAs by 25 per cent, the CRAR of five banks would fall below 9 per cent and, if the increase in NPAs is 50 per cent, the CRAR of the same five banks would remain below the required 9 per cent. At 100 per cent increase, the CRAR would reduce to 11.6 per cent affecting eight banks. Similarly, at 150 per cent increase, CRAR would reduce further to 11 per cent, affecting 12 banks.

In order to simulate the effect of an economic slowdown on the banks' advances portfolio, the maximum asset slippage experienced by banks between 2001 and 2008 was applied to the stock of gross loans under Scenario II. The system-level CRAR declined to 11.6 per cent after application of the shock. A total of 15 banks would have a CRAR of below 9 per cent in the altered scenario.

There has been very sharp credit growth from 2004-05, but, by and large, it has been devoid of any concentration risk. In the recent past, the increase in banks' credit portfolio was largely driven by expansion in retail credit. In contrast to the declining NPA levels for the aggregate credit portfolios of banks, the asset quality of retail assets has seen some deterioration, albeit marginally. Keeping this in view, Scenario III stressed the retail segment by increasing the NPAs of retail loans by 50 per cent. The system-level CRAR in this case reduced to 12.6 per cent. A total of two banks would have a CRAR below 9 per cent.

Given the recent global financial developments and their likely impact on the Indian economy, the stress tests were further conducted for the end of September 2008. The stress assumptions regarding all the scenarios were the same as in the case of March 2008.

The findings revealed that the impact of credit risk on banks' capital position continues to be relatively muted. Under the worst-case scenario (at 150 per cent increase under Scenario I), the overall capital adequacy position of the banking sector declined to 10.6 percent in September 2008 as against 11.0 per cent in March 2008. Thus, it may be noted that even under the worst case scenario, CRAR remained comfortably above the regulatory minimum.

There has also been growth in sub-BPLR[1] (Benchmark Prime Lending Rate) loans. The BPLR should be the rate which is charged by the banks to the most credit-worthy customers. It is, therefore, expected that ideally all bank loans should be disbursed at a rate either equal to or higher than the BPLR. However, the experience of Indian banks reveals that the increased credit off-take was accompanied by higher growth in sub-BPLR loans which comprised 27.7 per cent of total loans in March 2002 and stood at 76.0 per cent as at end-March 2008. Despite the increase in sub-BPLR loans, there has been no perceptible decline in the interest margins of

[1] The Benchmark Prime Lending Rate (BPLR) should be the rate which is charged by the banks to the most credit-worthy customers. Banks are expected to take into account their (i) actual cost of funds, (ii) operating expenses, and (iii) a minimum margin to cover the regulatory requirement of provisioning/capital charge and profit margin, while arriving at the BPLR. All other lending rates can be determined with reference to the BPLR arrived at, as above, by taking into account term premia and/or risk premia.

banks, though, some decline is observed in 2007-08. Thus, if banks are able to lend at sub-BPLR and also maintain the same interest margins, it suggests that there are unresolved issues relating to computation of BPLR and, hence, of transparency in banking operations.

There has also been an increase in the dependence on bulk deposits to fund credit growth. This could have liquidity and profitability implications. An increase in growth in housing loans, real estate exposure as also infrastructure has resulted in elongation of the maturity profile of bank assets.

Overall, credit risk is low at present, but continuous monitoring is required to avoid any unforeseen and significant asset quality deterioration over the medium term. Keeping in view the overall threats to the system, the Reserve Bank had cautioned banks on the need for proper risk assessments and a honing of risk assessment skills. Risk weights for retail, real estate and capital market exposures were enhanced as countercyclical measures. Provisions for standard advances on exposures to these sectors were also increased, in order to help cushion the negative fallout of a cyclical downtrend. These measures have yielded results in that the impact of the sub-prime turmoil in India has been subdued. They have also enabled the Reserve Bank to reverse them to a significant extent as a countercyclical measure in the current situation in order to sustain credit growth.

Market Risk

To test the banking system's resilience to market risk, interest rate risk stress tests were undertaken using both earnings at risk (EaR), as also the economic value perspective. In the EaR perspective, the focus of analysis is the impact of changes in interest rates on accrual or reported earnings. Changes in interest rates impact a bank's earnings due to changes in interest income and the level of other interest-sensitive income and operating expenses. In the EaR approach, the impact of changes in earnings due to changes in interest rates is related to net interest income (NII). Applying the EaR approach, it was observed in March 2008 that for an increase in interest rates the NII increases for 45 banks, comprising 64 per cent of the banking assets. This is because, typically, the banks' balance sheets are asset sensitive, and an increase in interest rate raises the interest income relative to interest expenses.

The banks have been actively managing their interest rate risk by reducing the duration of their portfolios. The duration of equity reduced from 14 years in March 2006 to around 8 years in March 2008 – a pointer to better interest rate risk management. Taking the impact based on the yield volatility estimated at 244 basis points (bps) for a one-year holding period showed, *ceteris paribus*, erosion of 19.5 per cent of capital and reserves. The CRAR would reduce from 13.0 per cent to 10.9 per cent for a 244 bps shock. The CRAR of 29 banks that account for 36 per cent of total assets would fall below the regulatory CRAR of 9 per cent. These results remained broadly robust for different plausible stress scenarios and

assumptions. Carrying out similar tests using the September data also had not shown any added vulnerability to the banking system[2].

Given the existing accounting norms as prescribed by the Reserve Bank, the impact of interest rate increase on the economic value of investment is expected to be significantly muted as a substantial portion of the banks' portfolio is immune to mark-to-market losses. The exposure of banks to the capital market remains low as a consequence of regulatory stipulations and direct equity exposure is small; hence, any adverse movement in this market has limited impact on banks, as has been seen in the recent period.

It may be noted that after the current financial turmoil, the International Accounting Standards Board (IASB) has changed the accounting rules. Against the practice of 100 per cent MTM, the IASB decided on October 13, 2008 that investments in the Trading category (other than derivatives) can be reclassified as Loans and Receivables to be carried at cost or amortised cost. Investments in the Available for Sale (AFS) category can also be classified as Loans and Receivables category.

Liquidity Risk

Liquidity risk originates from the potential inability of a bank to generate liquidity to cope with demands entailing a decline in liabilities or an increase in assets. The management of liquidity risk is critical for banks to sustain depositors' confidence. The importance of managing this risk came to the fore during the recent turmoil, when inter-bank money markets became illiquid.

Typically, banks can meet their liquidity needs by two methods: stored liquidity and purchased liquidity. Stored liquidity uses on-balance sheet liquid assets and a well-crafted deposit structure to provide all funding needs. Purchased liquidity uses non-core liabilities and borrowings to meet funding needs. While dependence on stored liquidity is considered to be safer from the liquidity risk perspective, it has cost implications. A balanced approach to liquidity strategy in terms of dependence on stored and purchased liquidity is the most cost-effective and optimal risk strategy. To assess the banking sector's funding strategy and the consequent liquidity risk, a set of liquidity ratios has been developed and analysed in detail. The analysis of this set of liquidity ratios reveals that there is growing dependence on purchased liquidity and also an increase in the illiquid component in banks' balance sheets with greater reliance on volatile liabilities, like bulk deposits to fund asset growth. Simultaneously, there has been a shortening of residual maturities, leading to a higher asset-liability mismatch. There is a need to strengthen liquidity management in this context as also to shore up the core deposit base and to keep an adequate cushion of liquid assets to meet unforeseen contingencies. It may also be worth considering a specific regulatory capital charge if the bank's dependence on purchased liquidity exceeded a defined threshold. There is also a need for the banks and the Reserve Bank to carry out periodic stress and scenario testing to assess the resilience to liquidity shocks in the case of some big banks, which have systemic linkages. This could then be extended to other banks.

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[2] The Duration of Equity (DoE) of bank's portfolio which was eight years in March 2008 increased marginally to 8.1 years by September 2008. Given a DoE of 8.1 per cent, a 244 bps increase in yield as on September 2008 would result in a 20 per cent erosion in capital and reserves. From an economic value perspective, the system-level CRAR would reduce to 10.5 per cent.

Assessment of Basel Core Principles

The development of criteria against which supervisory systems can be assessed took shape in the late 1990s with the work commissioned by the Basel Committee on Banking Supervision (BCBS). As a result, the first *Core Principles for Effective Banking Supervision* were issued in September 1997. The Committee revised the *Core Principles* in October 1999 which were refined further in October 2006 by placing greater emphasis on risk management and disclosure.

The FSAP conducted in 2001 by the Fund/the Bank in respect of commercial banks revealed that, based on essential criteria, India was fully compliant with 15 BCPs, largely compliant with eight and materially non-compliant with two, thus leaving none of the BCPs entirely non-complied with. The adherence to BCPs was assessed by the IMF based on the core principles methodology issued in October 1999. Concurrently, in order to guide the process of implementation of international standards and codes in India and to position India's stance on such standards, the Reserve Bank in consultation with the Central Government constituted on December 8, 1999, a Standing Committee on International Financial Standards and Codes. One of the Advisory Groups constituted by this Committee looked into banking regulation and supervision which evaluated the adherence to BCPs in respect of regulation and supervision of commercial banks. A review committee to monitor progress on recommendations emanating from the above exercise provided, *inter alia*, an update in September 2004.

Key Developments Since Last FSAP

The Reserve Bank has been continually reviewing the prudential supervisory framework, duly taking into account recommendations from earlier assessments. Some of the key developments in this regard include: a fit and proper test to evaluate directors and senior management, monitoring of significant shareholding, introduction of a Prompt Corrective Action (PCA) framework, tightening of income recognition and asset classification norms and issue of detailed guidelines improving the level of disclosure.

The present assessment of BCPs is based on the revised core principles methodology issued in October 2006 and, hence, it is not strictly comparable with the earlier assessment. Table III.1 provides principle-wise compliance position for commercial banks[3].

This assessment reveals significant compliance in respect of regulation and supervision of commercial banks. Thus the responsibilities and objectives of the supervisory authority are clearly defined; the arrangements are in place for sharing information with domestic

[3] At the time of assessment the Reserve Bank had not issued any guidelines on interest rate risk in banking book. Consequently, the principle was assessed as non-compliant. The Reserve Bank has since issued guidelines on interest rate risk in the banking book as part of its Supervisory Review Process. Consequently the compliance position is expected to improve.

Table III.1: Assessment of Basel Core Principles – Commercial Banks		
Sr. No.	Principle	Status of compliance
	Objectives, autonomy and resources	
1.	Objectives independence, powers, transparency and co-operation	LC
	Licensing criteria	
2.	Permissible activities	C
3.	Licensing criteria	C
4.	Transfer of significant ownership	C
5.	Major acquisitions	C
	Prudential requirements and risk management	
6.	Capital adequacy	C
7.	Risk management process	MNC
8.	Credit risk	LC
9.	Problem assets, provisions and reserves	LC
10.	Large exposure limits	C
11.	Exposure to related parties	MNC
12.	Country and transfer risk	C
13.	Market risk	MNC
14.	Liquidity risk	MNC
15.	Operational risk	LC
16.	Interest rate risk in banking book	NC
17.	Internal control and audit	LC
18.	Abuse of financial services	LC
	Methods of ongoing supervision	
19.	Supervisory approach	MNC
20.	Supervisory techniques	LC
21.	Supervisory reporting	LC
	Accounting and disclosure	
22.	Accounting and disclosure	LC
	Corrective and remedial powers	
23.	Corrective and remedial powers of supervisors	LC
	Consolidated supervision and cross-border banking	
24.	Consolidated supervision	LC
25.	Home-host relationship	MNC

C – Compliant; LC – Largely Compliant; MNC – Materially Non-Compliant; NC – Non-Compliant; NA – Not Applicable.

regulators; the licensing criteria and permissible activities are clearly defined; detailed guidelines on capital adequacy covering both on- and off-balance sheet items have been issued to banks; detailed guidelines are in place for credit risk, market risk, country risk and operational risk; and there is an adequate range of supervisory tools to bring about timely corrective action.

Way Forward

The assessment has, however, revealed some gaps in the areas of risk management process, exposure to related parties, market risk, liquidity risk, supervisory approach and home-host country co-operation. Given the diverse risk management techniques across the banking sector, the implementation of contagion risk techniques as regards liquidity risk could be undertaken in a phased manner.

There is also a need to put in place a mechanism whereby banks can report developments affecting operational risk to the Reserve Bank which, in turn, needs to issue guidelines whereby banks would be required to notify it as soon as they have any material information that negatively affects the fitness and propriety of a board member or a member of senior management.

The assessment has also revealed shortcomings in the human resource capability in banks and there is thus an urgent need for capacity building in respect of both banks and the Reserve Bank before banks embark on advanced models of credit and operational risk. There is a need to expedite the passage of the Banking Regulation (BR) Act (Amendment) Bill, 2005 which deals with the insertion of Section 29(A)[4] and which will empower the Reserve Bank to conduct consolidated supervision.

Globalisation, in the meantime, means that risks can arise from actions taken in financial systems outside a country's borders. The current global financial crisis has highlighted the importance of cross-border co-operation. Therefore, until a global agreement is reached in this regard, there is a need to examine the pros and cons of entering into Memoranda of Understanding (MoU) with foreign regulators as regards home-host country supervisory co-operation. Going forward, the issue relating to inter-regulatory co-operation in domestic arena would assume further importance in order to effectively address regulatory arbitrage issues relating to derivative products like Collateralised Debt Obligations when they gain prominence in the Indian financial markets.

The current crisis has brought to the fore another issue that needs serious consideration, namely, fair value accounting which can introduce pro-cyclicality. However, doing away with fair value accounting and going back to historical accounting may not be the correct option. Instead, capital adequacy and provisioning requirements could be made to take into account the cyclical effects of the economy by introducing higher provisions and higher capital adequacy during good times so that it would act as a cushion during bad times. This would require an enhanced role for supervisors who need to look into the risk profile of individual banks and suggest increased provisioning or capital requirement. Another option would be to increase the frequency of disclosures along with fair value accounting, so that stakeholders are fully aware of the pro-cyclical element in the balance sheet of the banks. Further, carrying out stress tests based on fair values of the balance sheet and disclosing these results would help.

The CFSA feels that the present global financial crisis has highlighted the limitations of the present Basel Core Principles inasmuch as the assessment does not cover areas like SIVs/

[4] The power to call for information pertaining to any entity of the banking group is being sought through the introduction of a new Section 29A in the BR Act, 1949.

NBFCs or aspects like dynamic provisioning and countercyclical norms. Hence, the CFSA feels that the Basel Committee on Banking Supervision should revisit the Basel Core Principles to cover new areas.

3.2 Co-operative and Rural Banking

The co-operative banking structure in India comprises urban co-operative banks and rural co-operative credit institutions. The size of the co-operative and the rural financial sector in India remains small compared to commercial banks. As might be expected, the financial performance of the co-operative sector has been found to be less than satisfactory in certain aspects.

Urban Co-operative Banks

Urban co-operative banks (UCBs) form an important part of Indian banking. Urban co-operative banks have a single-tier structure. The performance of UCBs has, however, shown improvement, with the number of financially stronger UCBs increasing in recent years. The asset impairment ratios, though high compared to commercial banks, have improved but the high accumulated losses remain a cause for concern. There is a need to pursue consolidation in this sector in a non-disruptive manner.

There is dual control of UCBs, inasmuch as the regulatory and supervisory responsibilities are shared between state registrars of co-operative societies (the central registrar of co-operative societies in the case of multi-state co-operative banks) and the Reserve Bank. Though supervisory oversight of the Board for Financial Supervision (BFS) extends to UCBs, there is a multiplicity of command centres and an absence of clear-cut demarcation between the functions of State Governments, Central Registrar of Co-operative Societies (CRCS) and the Reserve Bank. The 'Vision Document for the UCB Sector' formulated in March 2005 to address the issue of dual control provides for a two-track regulatory framework and a Memorandum of Understanding (MoU) between the Reserve Bank and the other regulators, *viz.*, the State Governments and CRCS.

Rural Co-operatives[5]

Rural co-operative credit institutions have a two- or three-tier structure, with some states having a unitary structure for state-level banks operating through their own branches, and others presenting a mixed picture that incorporates both unitary and federal structures. The rural co-operatives are at district and state level, or at state level with branches. This sector comprises primary agricultural credit societies (PACS), district central co-operative banks (DCCBs) and the state co-operative banks (StCBs). Several concerns beset the rural co-operative banking segment. These institutions are fraught with low resource bases, inadequate business diversification and recoveries, high levels of accumulated losses, weak management information systems (MIS) and poor internal controls. As a result, this sector remains one of the weak links in the Indian financial landscape. The present assessment of rural co-operatives covers StCBs and DCCBs.

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[5] The rural co-operatives have both short-term and long-term institutions. The long-term credit co-operatives which include State Co-operative Agriculture and Rural Development Banks and Primary Co-operative Agriculture and Rural Development Banks have not been covered in detail in the assessment.

Like the urban co-operative sector, this sector is also subject to dual regulatory control. Regulatory powers are vested with both the Reserve Bank and the Registrar of Co-operative Societies (RCS).The supervisory power is vested with NABARD and these institutions are not within the supervisory oversight of the Board for Financial Supervision (BFS) constituted by the Reserve Bank. There is, however, a Board of Supervision constituted independently by NABARD, which is kept abreast of the supervisory concerns that emanate from the functioning of rural co-operatives and other rural financial institutions. While the supervisory function is carried out by NABARD, its limitation of powers to enforce satisfactory compliance by inspected banks on inspection observations needs to be corrected.

Regional Rural Banks

Regional Rural Banks (RRBs) form the other important segment of the rural financial sector. They were conceived as institutions that combine the local feel and familiarity of the co-operatives with the business capabilities of commercial banks. They are a special category of banks formed under the Regional Rural Banks (RRBs) Act, 1976. The capital issued by an RRB is subscribed by the Central Government, the State Government and a sponsor bank which is generally a public sector commercial bank. The RRBs are also governed by the BR Act and RBI Act. The RRBs appear to present minimal systemic risk, owing to their small size (1.7 per cent of the assets of financial institutions as at end-March 2008). Efforts are on to improve the management information system by computerisation of branches of RRBs.

Licensing of Co-operatives

There is a need to draw up a roadmap for ensuring that only licensed banks operate in the co-operative space. A roadmap is also needed to ensure that banks which fail to obtain a licence by 2012 would not be allowed to operate. This will expedite the process of consolidation and weeding out of non-viable entities from the co-operative space.

Capital Adequacy

Urban co-operative banks, though compliant with the Basel I accord of 1988 in terms of risk-based capital requirements, have not implemented a capital charge for market risk in line with the amendment to the first capital accord in 1996. The Panel feels that as some of the scheduled UCBs are equivalent in size and systemic importance to medium-sized commercial banks, there is a need to assign duration-based capital charges for market risk for these entities.

Rural co-operative banks at present do not have any requirement of maintaining risk-based capital. The Panel is of the view that in respect of rural co-operatives, the migration to Basel I can be considered with the implementation of the revival package based on the Vaidyanathan Committee recommendations.

In 2005-06, the Government decided to amalgamate RRBs. Consequently, there has been a decline in the number of RRBs since 2005-06. There has also been an improvement in the performance of RRBs consequent to the amalgamation of various RRBs. There could be a phased introduction of CRAR in the case of RRBs, along with the recapitalisation of RRBs after consolidation of these entities.

Regulation and Supervision of Co-operatives

Dual control in the co-operative sectors affects the quality of supervision and regulation between the Reserve Bank/National Bank for Agriculture and Rural Development (NABARD) and the Government. This has been addressed to a certain extent in the case of UCBs through MoUs with almost all State Governments. However, there is a need to watch and further strengthen the MoUs on issues of regulatory co-operation, particularly in areas related to governance and management.

The role of NABARD as a Development Finance Institution (DFI) and regulator/ supervisor of rural financial institutions can be considered for segregation appropriately so that NABARD can function exclusively as a specialised DFI, while regulatory and supervisory powers are vested with a separate regulatory authority. Given the 'scheduled' status of RRBs, their supervisory responsibility should be entrusted to the Reserve Bank. As regards supervision of rural co-operatives, a separate regulatory and supervisory authority could be formed. [The Government, however, is of the view that the status quo may continue and that the present arrangement wherein NABARD and the Reserve Bank both have well-defined roles in terms of the RBI Act and RRBs Act, 1976, need not be disturbed].

Corporate Governance

The central issue is that borrowers have a significant say in the management of a co-operative bank. This makes governance difficult and there is a requirement to encourage the membership of depositors on par with borrowers. The best governance principles as enunciated by the World Council of Credit Unions could be considered for introducing greater professionalism and as a best practices guide for corporate governance in co-operative institutions. *Pari passu*, the powers regarding appointment of auditors, simplification of the tiered structures of rural co-operatives to reduce costs, and bringing aspects related to management of co-operative banks within the ambit of the BR Act could be considered.

Assessment of Basel Core Principles

The assessment of BCPs as regards UCBs has revealed that they are compliant/largely compliant as regards major acquisitions, problem assets, credit risk, related parties and methods of ongoing supervision (Table III.2).

The assessment of BCPs as regards StCBs/DCCBs reveals that they are compliant/largely compliant as regards major acquisitions, large exposures, related parties, credit risk, problem assets and methods of ongoing supervision (Table III.3).

The assessment of BCPs as regards RRBs has revealed that they are compliant/largely compliant as regards permissible activities, major acquisitions, credit risk, problem assets, large exposures, related parties and methods of ongoing supervision (Table III.4).

Sr. No.	Principle	Status of compliance
	Objectives, autonomy and resources	
1.	Objectives independence, powers, transparency and co-operation	LC
	Licensing criteria	
2.	Permissible activities	LC
3.	Licensing criteria	LC
4.	Transfer of significant ownership	NA
5.	Major acquisitions	C
	Prudential requirements and risk management	
6.	Capital adequacy	C
7.	Risk management process	MNC
8.	Credit risk	LC
9.	Problem assets, provisions and reserves	C
10.	Large exposure limits	LC
11.	Exposure to related parties	C
12.	Country and transfer risk	NA
13.	Market risk	MNC
14.	Liquidity risk	MNC
15.	Operational risk	NC
16.	Interest rate risk in banking book	NC
17.	Internal control and audit	MNC
18.	Abuse of financial services	LC
	Methods of ongoing supervision	
19.	Supervisory approach	LC
20.	Supervisory techniques	LC
21.	Supervisory reporting	LC
	Accounting and disclosure	
22.	Accounting and disclosure	LC
	Corrective and remedial powers	
23.	Corrective and remedial powers of supervisors	LC
	Consolidated supervision and cross-border banking	
24.	Consolidated supervision	NA
25.	Home-host relationship	NA

Table III.2: Assessment of Basel Core Principles – Urban Co-operative Banks

C – Compliant; LC – Largely Compliant; MNC – Materially Non-Compliant; NC – Non-Compliant; NA-Not applicable.

However, the assessment of BCPs in respect of UCBs, rural co-operatives and RRBs reveals that there are several gaps in areas of risk management and internal control. The problems generated by dual control, in that these institutions come under the regulatory jurisdictions of different agencies, require urgent and serious attention.

Table III.3: Assessment of Basel Core Principles – State Co-operative Banks/ District Central Co-operative Banks		
Sr. No.	**Principle**	**Status of compliance**
	Objectives, autonomy and resources	
1.	Objectives independence, powers, transparency and co-operation	LC
	Licensing criteria	
2.	Permissible activities	LC
3.	Licensing criteria	LC
4.	Transfer of significant ownership	NA
5.	Major acquisitions	C
	Prudential requirements and risk management	
6.	Capital adequacy	MNC
7.	Risk management process	MNC
8.	Credit risk	LC
9.	Problem assets, provisions and reserves	LC
10.	Large exposure limits	C
11.	Exposure to related parties	C
12.	Country and transfer risk	NA
13.	Market risk	MNC
14.	Liquidity risk	MNC
15.	Operational risk	NC
16.	Interest rate risk in banking book	NC
17.	Internal control and audit	MNC
18.	Abuse of financial services	MNC
	Methods of ongoing supervision	
19.	Supervisory approach	LC
20.	Supervisory techniques	LC
21.	Supervisory reporting	LC
	Accounting and disclosure	
22.	Accounting and disclosure	LC
	Corrective and remedial powers	
23.	Corrective and remedial powers of supervisors	LC
	Consolidated supervision and cross-border banking	
24.	Consolidated supervision	NA
25.	Home-host relationship	NA

C – Compliant; LC – Largely Compliant; MNC – Materially Non-Compliant; NC – Non-Compliant; NA – Not applicable.

3.3 Non-banking Financial Companies

NBFCs have been competing with and complementing the services of commercial banks for a long time. Initially intended to cater to the needs of small savers and investors, NBFCs have developed into institutions that can provide services similar to those of banks. However, NBFCs are distinct from banks in that their regulation and supervision is much lighter as compared with banks. They are, for example, not subject to Cash Reserve

Table III.4: Assessment of Basel Core Principles – Regional Rural Banks		
Sr. No.	**Principle**	**Status of compliance**
	Objectives, autonomy and resources	
1.	Objectives independence, powers, transparency and co-operation	LC
	Licensing criteria	
2.	Permissible activities	C
3.	Licensing criteria	NA
4.	Transfer of significant ownership	NA
5.	Major acquisitions	C
	Prudential requirements and risk management	
6.	Capital adequacy	NC
7.	Risk management process	MNC
8.	Credit risk	C
9.	Problem assets, provisions and reserves	C
10.	Large exposure limits	LC
11.	Exposure to related parties	LC
12.	Country and transfer risk	NA
13.	Market risk	MNC
14.	Liquidity risk	MNC
15.	Operational risk	MNC
16.	Interest rate risk in banking book	NC
17.	Internal control and audit	MNC
18.	Abuse of financial services	MNC
	Methods of ongoing supervision	
19.	Supervisory approach	LC
20.	Supervisory techniques	LC
21.	Supervisory reporting	LC
	Accounting and disclosure	
22.	Accounting and disclosure	LC
	Corrective and remedial powers	
23.	Corrective and remedial powers of supervisors	LC
	Consolidated supervision and cross-border banking	
24.	Consolidated supervision	NA
25.	Home-host relationship	NA

C – Compliant; LC – Largely Compliant; MNC – Materially Non-Compliant; NC – Non-Compliant; NA – Not applicable.

requirements but unlike banks they also do not have deposit insurance coverage and refinance facilities from the Reserve Bank. These entities operate in the financial market and there are two broad categories of NBFCs, namely, NBFC-Deposit taking (NBFC-D) and NBFCs-Non-

Deposit Taking (NBFC-ND). The NBFCs as a whole constitute 9.1 per cent of assets of the total financial system.

While NBFCs-D have been regulated since 1963, an amendment to the RBI Act in 1997 gave powers to the Reserve Bank to regulate and supervise all NBFCs more comprehensively. NBFCs-ND, till recently, were subject to minimal regulation as they were non-deposit taking bodies. Recognising the growing importance of this segment, and their linkages to banks and other financial institutions, capital adequacy and exposure norms were made applicable to Systemically Important NBFCs (NBFCs-ND-SI) from April 1, 2007. The supervision of NBFCs falls within the ambit of the Board for Financial Supervision. NBFCs are regulated and supervised by the Reserve Bank under the provisions of Chapter IIIB of the RBI Act. They are also governed by the Companies Act, 1956 and action taken for violation of the Companies Act falls within the jurisdiction of the Ministry of Corporate Affairs.

There is a requirement of compulsory registration of NBFCs with the Reserve Bank. NBFCs-D need to maintain an SLR (investments in government and approved securities as a prudential liquidity requirement) which is 15 per cent of public deposits. All NBFCs are required to transfer at least 20 per cent of their net profits to a reserve fund. On the assets side, prudential norms in the form of income recognition, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy and credit/investment concentration norms akin to those applicable to commercial banks have been prescribed. Guidelines on Asset Liability Management were issued to a cross-section of NBFCs in 2001. Both NBFC-D and NBFCs-ND have played a very important role in the financial markets and any weaknesses in them could pose problems for financial stability. Hence, there is need for an appropriate structure for regulation and supervision of systemically important NBFCs with appropriate legislative authority.

Compared to stand-alone NBFCs, NBFCs which are part of a banking group are subject to stricter prudential norms in their scope of activities. For example, stand-alone NBFCs could offer discretionary portfolio management schemes, which cannot be offered by NBFCs within a banking group. At the same time, it must be appreciated that, unlike stand-alone entities, NBFCs which are part of a banking group have recourse to cheaper funding sources because of the parent bank's ability to raise low-cost deposits. From a prudential standpoint, the regulatory structure should duly recognise both the advantages and disadvantages of the operational environment of the respective NBFCs. The potential regulatory arbitrage in respect of NBFCs which are subsidiaries/joint ventures/associates of bank holding companies has been addressed to a significant extent through the introduction of consolidated supervision and stipulation of capital requirements for the banking group as a whole. It should, however, be noted that sister concerns, i.e., banks and NBFCs, or two NBFCs under the same holding company, do not fall within the ambit of consolidated supervision. To address this gap, the regulatory authorities, *viz.*, the Reserve Bank, IRDA and SEBI are developing a process for regulation and supervision of financial conglomerates. This process of forming an appropriate structure for regulation and supervision with the apposite legislative authority, which is under progress, needs to be expedited.

With the tightening of the regulation of deposit taking NBFCs (NBFCs-D), there has been a decline in the number of NBFCs-D. NBFCs-D have a high CRAR, low NPAs and comfortable

return on assets. However, recent times have seen the rapid growth of NBFCs-ND. Within this sector, NBFCs-ND-SI are growing at a rapid pace. They have a systemic linkage and in the light of experience with such institutions abroad in the recent crisis, it needs to be ensured that these entities do not pose any systemic risk to the financial sector.

Funding of NBFCs

The CFSA observes that there appears to be a significant convergence between deposit taking and non-deposit taking NBFCs as regards the source of funds. Both sectors are increasingly dependent on borrowings, which accounts for about two-thirds of their funding requirements. In addition to the lack of access to low-cost funds, deposit taking NBFCs also bear regulatory costs in the form of additional reporting requirements. The CFSA believes that a level playing field between banks and NBFCs may not be practical and that, over the medium term, it may in fact become increasingly difficult for deposit taking NBFCs to compete with banks, causing these entities to become unviable or be merged with banks. In this context, the Reserve Bank has given an option to the NBFCs to voluntarily move out of public deposits acceptance activity. Non-deposit taking NBFCs are growing rapidly and unsecured borrowings comprise their single largest source of funds (36.8 per cent), which includes a significant amount of borrowings from banks/FIs. Thus, they have a systemic linkage and need to be monitored closely to ensure that they do not pose any risk to the system. At the same time it should be ensured that excessive regulations do not stifle their growth. In this context, both the direct and indirect exposure to depositors needs to be taken into account. To the extent that they rely on bank financing, there is an indirect exposure for depositors. On the one hand, the concentration of funding has risks and, on the other, the caps on bank lending to NBFCs will constrain their growth. There is an urgent need for development of an active corporate bond market to address the funding requirement of NBFCs, which has begun to be addressed recently.

Assessment of Basel Core Principles

The NBFCs are compliant/largely compliant in areas relating to licensing criteria, permissible activities, capital adequacy, risk management process, credit risk, problem assets, large exposures, abuse of financial services, supervisory approach, supervisory techniques and supervisory reporting (Table III.5).

However, the assessment has revealed that there are several gaps in areas relating to home-host co-operation, transfer of significant ownership, major acquisitions, exposure to related parties, market, liquidity and operational risk, internal control and interest rate risk in the banking book.

The role of the owners of institutions can be critical in determining how the entity approaches corporate governance. In this context, it is worth noting that the Reserve Bank

Table III.5: Assessment of Basel Core Principles –Non-banking Financial Companies		
Sr. No.	**Principle**	**Status of compliance**
	Objectives, autonomy and resources	
1.	Objectives independence, powers, transparency and co-operation	LC
	Licensing criteria	
2.	Permissible activities	LC
3.	Licensing criteria	LC
4.	Transfer of significant ownership	NC
5.	Major acquisitions	NC
	Prudential requirements and risk management	
6.	Capital adequacy	C
7.	Risk management process	LC
8.	Credit risk	LC
9.	Problem assets, provisions and reserves	LC
10.	Large exposure limits	LC
11.	Exposure to related parties	NC
12.	Country and transfer risk	NA
13.	Market risk	NC
14.	Liquidity risk	MNC
15.	Operational risk	NC
16.	Interest rate risk in banking book	NC
17.	Internal control and audit	MNC
18.	Abuse of financial services	LC
	Methods of ongoing supervision	
19.	Supervisory approach	LC
20.	Supervisory techniques	LC
21.	Supervisory reporting	LC
	Accounting and disclosure	
22.	Accounting and disclosure	LC
	Corrective and remedial powers	
23.	Corrective and remedial powers of supervisors	LC
	Consolidated supervision and cross-border banking	
24.	Consolidated supervision	NC
25.	Home-host relationship	NC

C – Compliant; LC – Largely Compliant; MNC – Materially Non-Compliant; NC – Non-Compliant; NA – Not applicable.

does not obtain the names and holdings of all significant shareholders or those who exert a controlling influence on NBFCs, including the identities of beneficial owners of shares being held by nominees. However, details of 'substantial interest' of promoters, the chairman, managing directors and CEO are part of the Certificate of Registration application form obtained by the Reserve Bank. The application form should also obtain information on the names and holdings of significant shareholders of NBFCs who exert a controlling influence which could also be reported on an ongoing basis, through periodic off-site returns.

As a prudential measure, the Reserve Bank has defined 'group of connected counterparties' and set prudent limits on large exposures to a single counterparty or group of connected counterparties. However, it has not issued any instructions to NBFCs as regards the

review and reporting of material concentration to the board. There is a need to issue guidelines for establishing thresholds depending on their respective scales of operation and reporting the exposures above this threshold to the board which can be verified by the Reserve Bank during on-site inspection. There can also be confirmation, through on-site inspection, that NBFCs have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services including money laundering.

In the interests of better market discipline, and in the context of the increasing complexities of holding structures and multi-layering, apart from the diversified activities of NBFCs, the Reserve Bank should consider increased disclosures in the case of NBFCs, such as ownership structure, significant holdings and nature and types of activities and products.

3.4 Housing Finance Companies (HFCs)

The emergence of organised housing finance has been a relatively late development in India. When the National Housing Bank was set up in 1988, nearly 80 per cent of the housing stock in the country was financed from informal sources. The organised sources of housing finance included, *inter alia*, the housing finance companies which then numbered about 400 and were essentially NBFCs that were regulated by the Reserve Bank. These included small companies with operations restricted to localised areas and companies engaged in construction/development, which also offered housing credit. Several of the companies relied on public deposits for their resources. A notable exception was the Housing Development Finance Corporation (HDFC).

The setting up of the National Housing Bank (NHB) in 1988, as a fully-owned subsidiary of the Reserve Bank, marked the beginning of the emergence of housing finance companies as significant financial intermediaries in the country. Since then, the sector has grown with many new HFCs being set up, including several sponsored by banks and financial institutions; some of these with equity support from the National Housing Bank as part of its developmental mandate. This provided aspiring potential home owners access to housing finance and facilitated home ownership. HFCs are regulated and supervised by the National Housing Bank (NHB) as per the provisions of the NHB Act, 1987 and Housing Finance Companies (NHB) Directions, 2001. They are also governed by the Companies Act, 1956, which falls within the jurisdiction of the Ministry of Corporate Affairs.

While the financials of HFCs have shown improvement over time, there are concerns that increases in interest rates could elongate loan maturity and lead to loan delinquency. Though there was some decline from 2006-07, the HFCs were comfortably placed in terms of liquidity as indicated by their current ratio[6] till end-March 2008. However, most HFCs have been experiencing some liquidity problems from October 2008. This has been caused

[6] This ratio indicates current assets to current liabilities.

primarily by the overall liquidity shortage at the beginning of the year as also the increased reliance on short-term market borrowings which dried up during the current year due to liquidity problems faced by major investors, such as mutual funds. Strengthening the financial position of NHB, which is designated as a refinancing institution for housing, would partly address the issue of liquidity of HFCs.

The CFSA observes that there has been a decline in the number of HFCs (to around 43, with 12 of them doing 90 per cent of the business) and that scheduled commercial banks are currently the dominant players in the housing loan market. Given that HFCs are akin to NBFCs, their regulation should be vested with the Reserve Bank, leaving the National Housing Bank with only its developmental function to avoid any conflict of interest. [The Government is, however, of the view that the status quo may continue as there is no conflict of interest in NHB combining a developmental and regulatory role as has been done by many other regulatory agencies. It is felt by the Government that since the housing market in India is in its infancy, combining regulatory and developmental functions in one single agency, namely, the NHB, would be beneficial for the market.]

Development of Housing Price Index

Internationally, most countries employ house prices as part of their assessment of the likely short-term evolution of the economy and also to assess the asset price channel of monetary policy. Given the lack of data on housing prices in India, assessing the extent of activity in this segment becomes a challenging task for policymakers. Non-availability of a national housing price index hinders the objective calculation of a loan-to-value ratio for the housing finance sector. Hence the construction of both a national housing price index and local housing price indices is a priority. Initiating the process of having a pricing index for the housing sector, the NHB has developed a housing price index in the pilot phase for five cities, *viz.*, Mumbai, Bhopal, Bangalore, Delhi and Kolkata. Over time, it is expected to cover 63 cities with populations of more than 10 lakh. This should be supplemented by a 'housing start-up index' to provide insights on the elasticity of property supply to property prices as well as the cost of housing credit. In addition, the Reserve Bank, on its own, undertook two different surveys/studies to identify real estate price movements in Mumbai which covered the prices of residential and commercial properties, including rent and sale/resale transactions of six zones in Greater Mumbai and seven adjacent municipalities. This study developed separate price indices for sale/resale prices and rent of commercial and residential buildings. Given the recent developments in the housing market the world over, which have underscored the need for better monitoring of real estate prices, it has been decided to establish an appropriate statistical data collection system within the Reserve Bank for which it has constituted an expert group. The proposed 'Asset Price Monitoring System' is expected to cover in a timely manner the key essence of real estate price movements, including the sale/resale/rent of residential/commercial property in representative locations. Keeping in mind the importance of such an indicator for the central bank, the Reserve Bank constituted a Technical Advisory Group (TAG) for the development of housing start up index. The CFSA notes that the TAG in its report submitted in January 2009, has formulated a feasible methodology for the construction of a housing start-up index in India on a regular basis and proposed an institutional structure that would be responsible for its operationalisation. The National Buildings Organisation (NBO) under the Ministry of Housing and Urban Poverty Alleviation would play an important role in the compilation of the housing start-up index.

Development of a Secondary Mortgage Market

Mr. Andrew Sheng, the peer reviewer of the report by the Advisory Panel on Financial Stability Assessment and Stress Testing, had suggested that consideration could be given to creating one or two government-sponsored secondary mortgage vehicles (with private management and ownership participation) to develop a healthy mortgage market. The Advisory Panel on Financial Stability Assessment and Stress Testing, however, thought that in view of the fiscal implications involved, a government-sponsored/guaranteed secondary mortgage vehicle was not appropriate at this juncture.

The CFSA noted that Fannie Mae and Freddie Mac, which enjoyed an implicit government guarantee, have recently been taken over by the US Treasury. In light of these developments, as also the observations of the Panel, it felt that this is not an opportune time to bring into being these kinds of vehicles. However, the idea needs to be studied carefully in the interests of developing the housing finance market in the medium and long term.

Assessment of Basel Core Principles

The assessment of BCPs has revealed that HFCs are compliant/largely compliant in areas relating to capital adequacy, problem assets, credit risk, large exposure limits, supervisory approach, supervisory techniques, supervisory reporting, accounting and disclosure (Table III.6).

There are gaps in areas relating to home-host co-operation, permissible activities, exposure to related parties, risk management and internal control.

There is a need to reckon FIIs' investments as a part of the foreign shareholding of HFCs. However, this should not result in reduction in FDI limits. Instead, there should be strong regulations in place to guard against any external contagion.

There are some legislative issues that also need to be addressed. For example, the NHB Act should clearly define a housing finance company or housing finance institution, clearly delineating their permissible activities. Builders/construction companies should not be permitted to use the term 'housing finance' in their names. The NHB should also issue appropriate guidelines for establishing the responsibilities of the board and senior management with respect to corporate governance to ensure that there is effective control over an HFC's entire business. It also needs to lay down norms for acquisition or investment by an HFC, taking into account the entity's financial and organisational resources and the risks that could emanate from such acquisitions. Furthermore, it needs to issue guidelines for HFCs in a phased manner on market risk and operational risk along the lines of commercial banks. There should be asset classification and provisioning norms specified for off-balance sheet items.

Table III.6: Assessment of Basel Core Principles – Housing Finance Companies		
Sr. No.	Principle	Status of compliance
	Objectives, autonomy and resources	
1.	Objectives independence, powers, transparency and co-operation	LC
	Licensing criteria	
2.	Permissible activities	MNC
3.	Licensing criteria	LC
4.	Transfer of significant ownership	NC
5.	Major acquisitions	NC
	Prudential requirements and risk management	
6.	Capital adequacy	C
7.	Risk management process	MNC
8.	Credit risk	LC
9.	Problem assets, provisions and reserves	C
10.	Large exposure limits	LC
11.	Exposure to related parties	MNC
12.	Country and transfer risk	NC
13.	Market risk	NC
14.	Liquidity risk	MNC
15.	Operational risk	NC
16.	Interest rate risk in banking book	NC
17.	Internal control and audit	MNC
18.	Abuse of financial services	LC
	Methods of ongoing supervision	
19.	Supervisory approach	LC
20.	Supervisory techniques	LC
21.	Supervisory reporting	LC
	Accounting and disclosure	
22.	Accounting and disclosure	LC
	Corrective and remedial powers	
23.	Corrective and remedial powers of supervisors	LC
	Consolidated supervision and cross-border banking	
24.	Consolidated supervision	NC
25.	Home-host relationship	NC

C – Compliant; LC – Largely Compliant; MNC – Materially Non-Compliant; NC – Non-Compliant; NA – Not applicable.

Summary position of compliance

The summary position of compliance to BCPs by Commercial Banks, Urban Co-operative Banks, State Co-operative Banks/District Central Co-operative Banks, Regional Rural Banks, Non-Banking Financial Companies and Housing Finance Companies is given in Table III.7.

3.5 Insurance Sector

The insurance sector, which was nationalised in 1956 (life) and 1973 (non-life), has been an important participant in the financial development of the country. In the late 1990s it was decided to allow private participation in this sector. The enactment of the Insurance Regulatory and Development Authority Act in 1999 led to the opening of the insurance sector for private players.

Table III.7: Compliance at a glance – Assessment of Basel Core Principles

Institutions/ Assessment	CB	UCB	SCB/ DCCB	RRB	NBFC	HFC
Compliant	7	4	3	4	1	2
Largely Compliant	11	11	10	8	13	10
Materially Non-compliant	6	4	6	6	2	5
Non-compliant	1	2	2	2	8	8
Not applicable	–	4	4	5	1	–

CB-Commercial Banks; UCB-Urban Co-operative Banks; SCB-State Co-operative Banks; DCCB-District Central Co-operative Banks; RRB-Regional Rural Banks; NBFC-Non-banking Financial Companies; HFC-Housing Finance Companies.

During the past five years, the sector has grown in size and penetration. Deregulation has resulted in more diversified insurance product offerings, with a stress on marketing and distribution strategies. Though the concentration in the insurance sector is very high, it has shown a declining trend since the sector was opened to private participation. While the Government has been emphasising the need for enhancing FDI limits, owing to the global financial turmoil as also the absence of an enabling regulatory framework, the issue needs to be addressed in a medium-term perspective. The CSFA notes that the passage of the Insurance Laws Amendment Bill, 2008 and the Life Insurance Corporation (Amendment) Bill, 2008 are pending in Parliament.

The key indicators of the life insurance segment show a reasonably comfortable position as regards solvency and capital adequacy. However, the solvency ratio of the largest life insurance company is just at the stipulated regulatory minimum. However, there are no concerns as regards asset quality, profitability and liquidity. There is a general trend to increase link-based business in the life sector.

The non-life segment also displays comfortable solvency. But earnings and profitability as also liquidity are areas of some concern. The high ratio of net claims to net premiums point to the need for better quality control in respect of underwriting new business, better risk management and increasing reinsurance.

The main shock variables in the Indian context can be viewed as market-specific and insurance-specific. The former mainly includes interest rate risk and equity price risk. Mortality risk, expense risk and persistency risk may be included under insurance-specific risk variables, though market conditions impact persistency. In view of the environment in which the sector is working and the risks which are envisaged in this environment, only the life insurance companies have been subjected to the above shock variables. While the equity shock does not impact the solvency ratios of the companies significantly, increase in withdrawal experience results in improvement of solvency ratios as the release of reserves in these cases outweighs the reduction in assets associated with withdrawals. The solvency ratio

is sensitive to interest rate and expense variation. Life insurance companies need to pay more attention to expense management and to develop appropriate and timely Management Information Systems (MIS) in this regard. The long-term nature of assets of the life insurance industry is a pointer to the need to have in place appropriate asset-liability management guidelines.

Assessment of Insurance Core Principles

The assessment of Insurance Core Principles reveals that 18 principles are observed/ largely observed and the remaining 10 principles are partially observed. The regulatory framework for insurance supervision is placed against the background of the statutory framework which encompasses the legislative, regulatory and institutional framework, both for the financial sector and the economy at large. It provides enough flexibility to keep the current practices up to date to meet the needs of the industry. The legislative framework for the insurance sector is contained in the various Acts. The IRDA interacts with other supervisors/supervisors of other jurisdictions. The assessment revealed that there are gaps in compliance in the areas of corporate governance, internal control, group-wide supervision, risk assessment and management of derivatives and similar commitments (Table III.8).

Some of the provisions of the Insurance Act, 1938 are outdated and need to be reviewed in the context of the changing economic environment. The proposals for amendments to the Insurance Act, 1938 and the LIC Act, 1956 have been made by the IRDA.

There is a need for an increase in the supervisory powers vested with IRDA as regards the constitution of a consultative committee, the enforcement of criminal penalties and winding up of an insurance company.

The regulatory position with respect to the exempted insurers is not clear. With a view to ensuring that all entities carrying on an insurance business are supervised by the IRDA, clarity of their reporting to the supervisor needs to be reinforced. A roadmap needs to be laid down by the Government/supervisor for the continuance or otherwise of these entities to address the concerns relating to protection of the interests of the policyholders covered by them.

IRDA should put in place systems to ensure effective group-wide supervision by formalising the relationship through an MoU with both home and foreign regulators. IRDA needs to address issues related to the policy framework that needs to be put in place for risks associated with dealing in derivatives by insurance companies. It also needs to make a beginning by introducing a risk-based capital requirement for the insurance sector in order to progress towards adopting a risk-based supervisory cycle for the insurance companies.

The Indian insurance industry faces an inadequate supply of specialised skilled professionals, particularly in the areas of treasury management and actuarial and underwriting skills in non-traditional areas. Adequate initiatives need to be taken in this regard. IRDA too needs to continue taking steps to enhance the skill sets as well as retain its skilled staff.

3.6 Concluding Remarks

The commercial banks have seen an all-round improvement in key financial indicators, particularly in areas of capital adequacy, asset quality and earnings. Even the financial position for the half-year ended September 2008 as also the quarter ended December 2008 reveals that

Table III.8: Assessment of Insurance Core Principles

Sr. No.	Principle	Status of compliance
	Conditions for effective supervision	
1.	Conditions for effective insurance supervision	LO
	Responsibilities of supervisor	
2.	Supervisory objectives	LO
3.	Supervisory authority	LO
4.	Supervisory process	LO
5.	Supervisory co-operation and information sharing	LO
	Form and governance of insurers	
6.	Licensing	LO
7.	Suitability of persons	LO
8.	Changes in control and portfolio transfers	O
9.	Corporate governance	PO
10.	Internal control	PO
	Actual practice of supervisors	
11.	Market analysis	PO
12.	Reporting to supervisors and off-site monitoring	LO
13.	On-site inspection	LO
14.	Preventive and corrective measures	LO
15.	Enforcement or sanctions	PO
16.	Winding-up and exit from the market	PO
17.	Group-wide supervision	PO
	Key financial and risk management processes	
18.	Risk assessment and management	PO
19.	Insurance activity	PO
20.	Liabilities	O
21.	Investments	LO
22.	Derivatives and similar commitments	PO
23.	Capital adequacy and solvency	O
	Distribution, consumer protection, disclosures and fraud	
24.	Intermediaries	O
25.	Consumer protection	O
26.	Information, disclosure & transparency towards the market	LO
27.	Fraud	PO
	Anti-Money laundering	
28.	Anti-money laundering, combating the financing of terrorism (AML/CFT)	LO

O – observed, LO – Largely observed, PO – Partly observed, NO – Not observed.

Memo Items

Assessment	Number
Observed	5
Largely Observed	13
Partly Observed	10
Not Observed	–

the key financial parameters do not reveal any discernable concerns. There has been considerable convergence of financial results and efficiency across bank groups within the sector. Competition within the sector has increased over time as evidenced by the declining share of PSBs and increasing share of NPBs in the banking business.

The single-factor stress testing in areas of credit, interest and liquidity risks shows that the commercial banks are reasonably resilient. But some improvements are required in the risk mitigation approaches of the banking sector in general and with particular reference to liquidity aspects, both from regulatory as well as internal risk control perspectives. This gains particular significance in the context of current international experience. Further, the present stress testing exercise has its limitations as it does not take into account co-related risks due to non-availability of data and a model for undertaking such an analysis. However, there is a need for developing such an analysis over a period of time. The stress testing exercise done with reference to September 2008 also does not reveal any additional cause of concern for the Indian banking system. A stronger banking sector would require more flexibility regarding the approach towards government ownership of commercial banks, more clarity in the stance towards enhanced presence of foreign banks, a more conducive environment for mergers/ amalgamations, improvements in corporate governance and more focus on capacity building and appropriate executive compensation structure. The ongoing global financial crisis has highlighted the importance of cross-border co-operation.

The financial results of the co-operative and rural banking structure show some degree of vulnerability, but they are systemically not very large. There is a need to address issues relating to governance and government overlap in the regulation of this sector. The regulatory structure requires a significant overhaul. While MoUs between the Government and Reserve Bank/NABARD have been a welcome attempt to circumvent the problems arising out of dual control of regulation of co-operative banks, the progress made in this regard should be continuously monitored so that it evolves with changing circumstances and withstands the test of time.

An analysis of the NBFC sector shows that it is the non-deposit taking NBFCs-ND which have become the frontrunners in this sector. This sector requires close monitoring particularly from the angle of its linkages with other financial institutions and markets. Also, though considerably reduced, there remains some scope for reducing arbitrage opportunities particularly in respect of those companies not falling within the ambit of any of the regulatory authorities at present, with suitable regulatory changes.

While the housing finance sector has witnessed a significant growth in recent years, the share of HFCs in the housing loan market has declined. There is also a need for taking up work relating to the housing price index at the earliest. Most HFCs have been facing liquidity problems from October 2008 caused by overall liquidity shortage at the beginning of the year as also increased reliance on short-term market borrowings which during the current year dried up due to liquidity problems faced by major investors, such as mutual funds. Strengthening the financial position of NHB, which is the designated refinancing institution for housing, would partly address the issue of liquidity of HFCs.

The growth of insurance sector has been impressive both in the life and non-life segments. While the financial results are generally satisfactory, there are some concerns relating to profitability and liquidity in the non-life segment. Stress testing shows that though

shocks in equity price, withdrawal and mortality experience do not have any material effect, the solvency ratios are sensitive to interest rate and expense variations.

The recent global financial turmoil has brought into sharp focus the liquidity and contagion risks facing the financial institutions. In this context, there is a requirement for an integrated risk management approach which takes into account all facets of risk and their contiguous properties and increased regulatory co-operation and information sharing.

Given the general robustness of the regulatory and supervisory environment complemented by a gradual approach towards financial sector reforms, India has remained relatively less affected by financial crises which have impacted the international financial system at different points in time, from the 1990s till date.

IV. FINANCIAL MARKETS

In keeping with evolving global financial developments and the ongoing Indian financial sector reforms, financial markets have, for a variety of purposes, emerged as a major channel of resource mobilisation. Overall, the gradual removal of structural bottlenecks and a shift away from the erstwhile administered interest rates have led to greater domestic market integration. This process has, however, tended to make the system more vulnerable to contagion risk.

The IOSCO Principles for Securities Regulation are generally applicable to the equities and corporate bond markets. However, taking into account their importance for systemic stability, the Advisory Panel on Financial Regulation and Supervision has also assessed the foreign exchange, money and government securities markets against IOSCO principles. The Advisory Panel on Financial Stability and Stress Testing has also examined the stability and development aspects of the financial markets and suggested ways for their improvement. The compliance position based on assessment of IOSCO principles across markets at a glance is furnished in Table IV.1.

The regulatory jurisdiction over financial markets is mainly divided between the Reserve Bank and SEBI. Over time, clarity of regulatory powers has been established through new legislations and amendments to existing legislations and notifications by the Government. The Reserve Bank of India (Amendment) Act, 2006 provides, *inter alia,* comprehensive powers to regulate the money, foreign exchange and government securities market. Accordingly, these amendments empower the Reserve Bank to deal in derivatives, to lend or borrow securities and to undertake repo or reverse repo transactions; remove the ambiguity regarding the legal validity of derivatives; determine the policy relating to interest rates or interest rate products and give directions in that behalf to all agencies dealing in securities, money market instruments, foreign exchange, derivatives and to inspect such agencies.

Table IV.1: Compliance at a glance – Assessment of IOSCO Principles

Markets/Assessment	Equities market	Foreign exchange market	Govt. securities market	Money market
Fully Implemented	20	16	19	19
Broadly Implemented	8	–	2	4
Partly Implemented	2	5	5	5
Not Implemented	–	–	–	–
Not Applicable	–	9	4	2

4.1 Equity Market

The last two decades have seen tremendous growth in Indian equity markets. There has been significant improvement in the market and settlement infrastructure, and major strides have been taken in areas of risk management which received a major impetus after the setting up of SEBI as the market regulator. The turnover in both the cash and derivatives markets, as well as market capitalisation and returns from stock markets, increased considerably until end-2007. But since early 2008 there has been considerable volatility, with a downward bias in market capitalisation and price-to-earnings ratios, largely due to global financial developments. The recent volatility has, however, not affected the smooth functioning of the stock markets and the settlement of trades. On the contrary, it has brought to the fore the resilience of the market infrastructure and its arrangements for risk management. This is also a pointer to the robust regulatory environment within which the equity market operates in India.

Assessment of IOSCO Principles

The assessment of IOSCO principles as regards regulation of the equity/corporate bond market reveals an overall significant level of compliance (Table IV.2). The responsibilities of SEBI are well-defined. It regulates market players through a combination of on-site inspection, off-site reporting, investigation and surveillance of the market and regulated entities; there is full, timely and accurate disclosure of financial results and information that are material to investors' decisions; the holders of securities are treated in a fair and equitable manner; capital requirements have been prescribed for market intermediaries; and there is ongoing supervision of exchanges and trading systems to ensure the integrity of trading.

The assessment has, however, revealed some gaps in areas of responsibilities of the regulator; operational independence and accountability of the regulator, inspection, investigation and surveillance powers; assistance provided to foreign regulators; minimum entry standards, capital and prudential requirements; internal organisation and operational conduct of market intermediaries; and the procedures for dealing with the failure of a market intermediary. The Advisory Panel on Financial Regulation and Supervision was of the view that there is significant overlap between SEBI and the Government, with the Government having the powers to issue directions to SEBI even in areas other than policy. Hence, it recommended that Section 16 of the SEBI Act could be amended, empowering policy directions to be issued only in the public interest. Further, it also felt that Section 5(2) of the SEBI Act, whereby the Central Government has the right to terminate the services of the Chairman or Member at any time by giving a notice of three months, appears to be in conflict with the tenor of other sections in the SEBI Act and could have implications for the operational independence of SEBI. Hence, it felt that Section 5(2) can be removed from the SEBI Act.

Sr. No.	Principle	Status of compliance
	Principles of regulator	
1.	Responsibilities of regulator	BI
2.	Operational independence and accountability	BI
3.	Power, resources and capacity to perform functions	FI
4.	Regulatory processes of regulator	FI
5.	Professional standards of staff of regulator	FI
	Principles relating to self-regulation	
6.	Regulatory regime	FI
7.	Regulators' oversight over SROs and standards adopted by SROs	FI
	Principles relating to enforcement	
8.	Inspection, investigation and surveillance powers	FI
9.	Enforcement powers	FI
10.	Use of inspection, investigation, surveillance and enforcement powers	BI
	Principles relating to co-operation	
11.	Authority to share information with domestic and foreign counterparts	FI
12	Information-sharing mechanisms	FI
13.	Assistance provided to foreign regulators	PI
	Principles relating to issuers	
14.	Disclosure of financial results	FI
15.	Treatment of holders of securities	FI
16.	Accounting and auditing standards	BI
	Principles relating to collective investment schemes	
17.	Standards for eligibility and regulation	BI
18.	Rules governing legal form and structure	FI
19.	Disclosure requirements	FI
20	Asset valuation and pricing and redemption of units	FI
	Principles relating to market intermediaries	
21.	Minimum entry standards	BI
22.	Capital and prudential requirements	BI
23.	Internal organisation and operational conduct	PI
24.	Procedure for dealing with failure of market intermediary	BI
	Principles relating to secondary markets and clearing and settlements	
25.	Trading systems	FI
26.	Regulatory supervision	FI
27.	Transparency of trading	FI
28	Detection of manipulation and unfair trading practices	FI
29.	Management of large exposures, default risk and market disruption	FI
30.	Systems for clearing and settlement of securities	FI

Table IV.2: Assessment of IOSCO Principles – Equities, Corporate Bond and Derivative Market

FI – Fully implemented; BI – Broadly implemented; PI – Partly Implemented; NI – Not Implemented; NA – Not applicable.

However, the CFSA differs and feels that checks and balances and accountability arrangements have to be part of a sustainable regulatory model since the regulator, with whatever degree of autonomy, cannot function in a vacuum. It also needs to be noted that the Government has never exercised these powers *vis-à-vis* Statutory Regulatory Authorities (SRAs). Further, it was felt that oversight by the Government is essential since this could provide breadth and depth to the market.

Some major issues that need to be addressed in the equity market are: an improvement in IPO processes, better risk management by market participants, enhancement of knowledge standards and strengthening of the inter-exchange cross-market surveillance. To enhance accessibility for investors, the Securities Appellate Tribunals should be strengthened by setting up regional branches. Certain organisations that currently function as trade and industry associations but perform some Self-Regulatory Organisation (SRO)-like roles, could be considered for being accorded SRO status.

Other issues that merit consideration are setting up a Central Integrated Platform (CIP) with multiple nodes to enable investors to apply electronically for public issues, simplifying the debt issuance process with a view to rationalising public issues, strengthening the inter-exchange cross-market surveillance to consider serious contagion risks and faster convergence of Indian Accounting Standards with International Financial Reporting Standards.

4.2 Foreign Exchange Market

The foreign exchange market in India is one of the fastest growing across countries, as is evident from both the spot and derivatives segments. The Indian foreign exchange market volumes have shown the fastest growth between 1998 and 2007 among the countries surveyed by the Bank for International Settlements (BIS). The total annual turnover increased from USD 1.3 trillion during 1997-98 to USD 12.3 trillion during 2007-08. The daily average turnover has seen a substantial pick-up from about USD 5 billion during 1997-98 to USD 49 billion during 2007-08. The forward and swap market as a per cent of total turnover continued to hover around 50 per cent. Apart from increased turnover, the low and stable bid-ask spread of the INR/USD market is an indicator of the deep liquidity and efficiency of the market. However, since September 2008, considerable volatility has been witnessed in the market.

Assessment of IOSCO Principles

The assessment of the foreign exchange market reveals that while most of the applicable principles relating to the regulator, enforcement, market intermediaries, secondary markets and clearing and settlement systems are fully implemented, there are gaps in areas relating to operational independence and accountability of the regulator, co-operation and detection of manipulation and unfair trading practices (Table IV.3).

Derivatives

As regards derivatives, some issues to be considered are the need for a uniform accounting regime across banks and corporates, the desirability of banks entering into complex derivatives transactions with only those corporates that adopt the revised accounting standards and the introduction of disclosure of forex derivative transactions by non-bank entities. Lack of appropriate standards could lead to institutions being unaware of the inherent risks in such derivatives exposure, which could result in over-leveraging. Therefore, there should be adequate monitoring and regulation.

Table IV.3: Assessment of IOSCO Principles – Foreign Exchange Market		
Sr. No.	Principle	Status of compliance
	Principles of regulator	
1.	Responsibilities of regulator	FI
2.	Operational independence and accountability	PI
3.	Power, resources and capacity to perform functions	FI
4.	Regulatory processes of regulator	FI
5.	Professional standards of staff of regulator	FI
	Principles relating to self-regulation	
6.	Regulatory regime	NA
7.	Regulators' oversight over SROs and standards adopted by SROs	NA
	Principles relating to enforcement	
8.	Inspection, investigation and surveillance powers	FI
9.	Enforcement powers	FI
10.	Use of inspection, investigation, surveillance and enforcement powers	FI
	Principles relating to co-operation	
11.	Authority to share information with domestic and foreign counterparts	PI
12	Information-sharing mechanisms	PI
13.	Assistance provided to foreign regulators	PI
	Principles relating to issuers	
14.	Disclosure of financial results	NA
15.	Treatment of holders of securities	NA
16.	Accounting and auditing standards	NA
	Principles relating to collective investment schemes	
17.	Standards for eligibility and regulation	NA
18.	Rules governing legal form and structure	NA
19.	Disclosure requirements	NA
20	Asset valuation and pricing and redemption of units	NA
	Principles relating to market intermediaries	
21.	Minimum entry standards	FI
22.	Capital and prudential requirements	FI
23.	Internal organisation and operational conduct	FI
24.	Procedure for dealing with failure of market intermediary	FI
	Principles relating to secondary markets and clearing and settlements	
25.	Trading systems	FI
26.	Regulatory supervision	FI
27.	Transparency of trading	FI
28	Detection of manipulation and unfair trading practices	PI
29.	Management of large exposures, default risk and market disruption	FI
30.	Systems for clearing and settlement of securities	FI

FI – Fully implemented; BI – Broadly implemented; PI – Partly Implemented; NI – Not Implemented; NA – Not applicable.

Unhedged corporate exposure in foreign exchange entails systemic risk and it is in the interests of the entire financial sector to add further options for hedging in respect of currency exposures of corporates. The Advisory Panel on Financial Regulation and Supervision was of the view that in the interests of systemic stability, all restrictions requiring underlying for hedging need to be abolished in a phased manner within a given time-frame.

The CFSA recognises that the concept of economic exposure has been accepted by the Reserve Bank to permit hedging. The Reserve Bank should, however, undertake an in-depth

examination of the pros and cons of this recommendation before doing away with the requirement of underlying altogether.

Trade Monitoring and Risk Management

Electronic trading platforms function as broking systems and as such do not require any approval from the Reserve Bank as authorised persons under the Foreign Exchange Management Act (FEMA). They perform activities similar to voice brokers, but use different channels of communication and technology. Hence, they should be subjected to the same regulatory discipline as brokers. Such trading platforms in India are not covered under the Payment and Settlement Systems (PSS) Act, 2007. Only in the event of such trades getting translated into payment instructions resulting in clearing/settlement and the same entity carrying out these functions would the provisions of the PSS Act get attracted. Currently, foreign exchange brokers in India are accredited by the Foreign Exchange Dealers Association of India (FEDAI) and the system has been working well. Therefore, there is no need for amending FEMA and bringing these entities under the regulatory ambit of the Reserve Bank.

The foreign exchange positions of banks are monitored by the Reserve Bank through Aggregate Gap Limits. There is a case for monitoring foreign exchange positions based on VaR, which captures the risks better and is more aligned to Basel II norms. All Over-the-Counter (OTC) trades should be compulsorily recorded and settled through a clearing corporation. The Reserve Bank has prescribed capital requirements for market intermediaries. Initial capital and risk-based capital requirements are specified separately for banks. There are capital requirements in terms of net-owned funds for Authorised Persons. Authorised dealers also have regulatory capital requirements which take into account their on-and off-balance sheet risks. There are no risk-based capital requirements for full-fledged money changers (FFMCs). Although there is no documented procedure for dealing with the failure of a market intermediary, there are various risk-mitigating elements in place. Banks are subject to prompt corrective actions that are based on triggers in relation to their key financial indicators. This has been stipulated in order to minimise the damage to investors and to contain systemic risk. As regards FFMCs, the only risk they pose is in respect of foreign exchange holdings that they retain overnight. But they do not pose systemic risk as they only buy and sell foreign exchange, routing their transactions through banks.

FEDAI

Some industry associations also perform SRO-like functions. The FEDAI is one such association. If it is to be made a full-fledged SRO the issues that would need to be addressed to resolve any conflict of interest would include: corporate governance such as the composition of its board and the independence of its directors, the independence and functioning of key committees of the board, and transparent disclosure practices. Furthermore, if FEDAI is made an SRO, it should also be brought under the regulatory purview of the Reserve Bank.

4.3 Government Securities Market

Given the important strategic intervention role that the Government is required to play in any country, the government securities market is one of the most important segments of the financial market. The market also serves as an important transmission channel for monetary policy. Without it, or with one that functions poorly, the regulatory power to intervene during times of crisis would be severely circumscribed. India has for long recognised this and always paid special attention to the development of the government securities market.

The new provisions of the Government Securities Act, 2006 enables development of practices and regulations taking into account new technology. In recent times, and consequent to the various steps taken to develop the government securities market, there has been tremendous growth in both the volume and liquidity in this segment. The outstanding stock of government securities increased from Rs.76,908 crore in 1991-92 to Rs.13,32,435 crore in 2007-08. The outstanding stock as a per cent of GDP increased from 11.8 per cent to 28.3 per cent during the corresponding period. Trade associations like Fixed Income Money Market Dealers Association (FIMMDA) have also played a crucial role in the development of the government securities market.

Assessment of IOSCO Principles

Though the overall applicability of IOSCO principles to the government securities market is not mandated, an assessment of this market with the IOSCO principles revealed that most principles relating to responsibilities and powers of the regulator, enforcement, collective investment schemes, market intermediaries, secondary market and clearing and settlement systems were fully implemented (Table IV.4).

The principles relating to operational independence and accountability of the regulators, home-host co-operation, disclosure of financial results and procedure for dealing with failure of a market intermediary are not fully implemented.

Under the existing mechanism, the Reserve Bank owns the trading platforms of government securities markets settlements, while the Clearing Corporation of India (CCIL) manages these platforms as the central counterparty. The Panel on Financial Regulation and Supervision recommended that the trading platforms should be hived off from the Reserve Bank in a phased manner. The CFSA feels that the Reserve Bank could take a considered view in the matter.

Given the calibrated movement towards fuller capital account convertibility and the increased need for foreign funds to develop social overhead capital, the Panel on Financial Regulation and Supervision felt that Central/State Governments can consider reducing the time lag in publication of audited financial results and increase the frequency of financial disclosures so that government debt can be appropriately rated. This would make government-issued paper more attractive to the international investor. In this context, CFSA notes that from 2006-07 onwards, the audited annual accounts of the Central Government are presented within a time lag of about 6 to 9 months. The Advisory Panel on Financial Stability and Stress Testing observed that, as fuller capital account convertibility takes place, investment in government securities by foreign entities would also require the strengthening of disclosure requirements. This is because with gradual progress towards fuller capital

Sr. No.	Principle	Status of compliance
	Principles of regulator	
1.	Responsibilities of regulator	FI
2.	Operational independence and accountability	PI
3.	Power, resources and capacity to perform functions	FI
4.	Regulatory processes of regulator	FI
5.	Professional standards of staff of regulator	FI
	Principles relating to self-regulation	
6.	Regulatory regime	NA
7.	Regulators' oversight over SROs and standards adopted by SROs	NA
	Principles relating to enforcement	
8.	Inspection, investigation and surveillance powers	FI
9.	Enforcement powers	FI
10.	Use of inspection, investigation, surveillance and enforcement powers	FI
	Principles relating to co-operation	
11.	Authority to share information with domestic and foreign counterparts	PI
12	Information-sharing mechanisms	PI
13.	Assistance provided to foreign regulators	PI
	Principles relating to issuers	
14.	Disclosure of financial results	PI
15.	Treatment of holders of securities	NA
16.	Accounting and auditing standards	NA
	Principles relating to collective investment schemes	
17.	Standards for eligibility and regulation	BI
18.	Rules governing legal form and structure	FI
19.	Disclosure requirements	FI
20	Asset valuation and pricing and redemption of units	FI
	Principles relating to market intermediaries	
21.	Minimum entry standards	FI
22.	Capital and prudential requirements	FI
23.	Internal organisation and operational conduct	FI
24.	Procedure for dealing with failure of market intermediary	BI
	Principles relating to secondary markets and clearing and settlements	
25.	Trading systems	FI
26.	Regulatory supervision	FI
27.	Transparency of trading	FI
28	Detection of manipulation and unfair trading practices	FI
29.	Management of large exposures, default risk and market disruption	FI
30.	Systems for clearing and settlement of securities	FI

Table IV.4: Assessment of IOSCO Principles – Government Securities Market

FI – Fully implemented; BI – Broadly implemented; PI – Partly Implemented; NI – Not Implemented; NA – Not applicable.

account convertibility, Indian Government bonds could be progressively accessed by prospective international investors. The CFSA feels that though increased transparency and disclosure standards are desirable objectives in respect of sovereign debt instruments, they need to be viewed independently of the issue of capital account convertibility.

Market Development

The major measures for the development of the government securities market include diversification of the investor base to non-banks and retail segments, availability of varied hedging instruments for effective mitigation of interest rate risk across the gamut of market participants, a gradual increase in the number of trading days for short selling in government securities along with appropriate borrowing/lending mechanisms in government securities, and capacity building to study the suitability of a derivative product and its appropriateness. Scaling down regulatory prescriptions for mandated investments in government securities and the introduction of AS 30 would result in an increase of tradeable assets.

The CFSA notes that the Banking Regulation (BR) Act was amended in 2006 which removed the statutory floor on SLR.[7] Any reduction in SLR should, however, factor in the pressure of expenditure and the consequent fiscal deficit as well as market borrowings under the Market Stabilisation Scheme, given that the SLR requirement prescribed for banks enables smooth conduct of the Government's borrowing programme. The SLR needs to be equally viewed as a prudential requirement to sustain the liquidity position and asset quality of banks. A reduction in SLR could increase the possibility of the banks acquiring more illiquid and low-quality assets. Also, there is a need to find alternate sets of investors in government securities that would buttress the demand for such instruments.

A Working Group constituted by the Reserve Bank has examined ways of activating the interest rate futures market. An RBI-SEBI Technical Committee is considering operationalisation of the recommendations of the report, and it is expected that products as per the recommendations of the Group shall be introduced in early 2009 along with supporting changes in the regulatory/accounting framework. The CFSA is of the view that exchange traded derivatives should be introduced at an early date and the settlement of all OTC derivatives should be routed through a clearing corporation.

4.4 Money Market

The Reserve Bank traditionally regulates the money markets. The Government Notification under Section 16 of the Securities Contract (Regulation) Act and the amendment to the RBI Amendment Act 2006 have further clarified the powers available to the Reserve Bank to regulate the money markets. The important components of the money market in India are inter-bank call (overnight) money, market repo, collateralised borrowing and lending obligation (CBLO), Commercial Paper (CP), Certificate of Deposit (CD) and term money market. Treasury bills constitute the main instrument of short-term borrowing by the Government. Historically, the call money market has constituted the core of the money market in India. However, the collateralised segments, *viz.*, market repo and CBLO have come into prominence in recent years. The market continues to be liquid with a low and stable bid-ask spread. A better trading and settlement infrastructure coupled with the introduction of financial market

[7] As per Section 24 of the BR Act the banks are required to maintain in the form of cash and unencumbered securities a percentage of their net demand and time liabilities. The amendment to the BR Act in 2006 has removed the statutory floor on SLR and empowers the Reserve Bank to flexibly prescribe SLR.

reforms have led to a decline in money market volatility. In the derivatives segment, the swap market (especially overnight index swaps) has been the active segment and is used by banks as well as other entities to manage their interest rate risk more than any other instrument. The notional principal outstanding in respect of Interest Rate Swaps has increased.

Assessment of IOSCO Principles

The assessment of compliance with reference to the IOSCO principles has revealed that the money market is generally compliant with the standards (Table IV.5). Most principles relating to the regulator, enforcement, issuers, secondary markets, clearing and settlement and collective investment schemes are fully implemented. Gaps, however, exist in the principles relating to operational independence and accountability, home-host co-operation and those relating to market intermediaries. One of the major gaps identified by the Advisory Panel on Regulation and Supervision pertains to the operational independence of the Reserve Bank since the reasons for the removal of the Governor/Deputy Governors have not been specified in the RBI Act, but this is a general issue related to the governance of the Reserve Bank and not specifically germane to the money market. Another issue relates to regulatory co-operation, whereby co-operation with foreign regulators is not formalised.

Market Development

Interest rate deregulation has made financial market operations more efficient, but it has also exposed the participants to increased risks. Interest rate derivative products could be an effective risk mitigant in this regard. Rupee derivatives in India were introduced in July 1999, when the Reserve Bank permitted banks/FIs/PDs to undertake interest rate swaps/ forward rate agreements. Currently, interest rate swaps are the predominant instruments. The swap market, especially the Overnight Indexed Swaps (OIS) market, has been very active in India and is used by banks as well as other entities to manage their interest rate risk more than any other instrument. However, the absence of a term money market, and therefore a 3- or 6-month benchmark rate, has led to market concentration on the overnight benchmark. The development of active interest rate futures market would contribute to the development of term money market. For the development of the IRF market, there is a case for permitting banks to take trading positions in the interest rate futures market as they are already allowed in the OTC interest rate swap market.

There is a need to permit short-selling of different kinds of money market securities in a phased manner. In the interests of market development, broad-basing market repo by allowing AAA-rated corporate bonds to be repoable, with appropriate safeguards, should be considered. This would also require a reasonably well-developed corporate bond market along with a transparent and efficient clearing and settlement system. The commercial paper market has witnessed vibrant growth in the past three years. Though it is not obligatory on the part of financial institutions to provide any 'stand-by' facility to the issuers of corporate paper, the existence of an appropriate liquidity back-up is imperative for mitigating risks in the

Sr. No.	Principle	Status of compliance
	Principles of regulator	
1.	Responsibilities of regulator	FI
2.	Operational independence and accountability	PI
3.	Power, resources and capacity to perform functions	FI
4.	Regulatory processes of regulator	FI
5.	Professional standards of staff of regulator	FI
	Principles relating to self-regulation	
6.	Regulatory regime	NA
7.	Regulators' oversight over SROs and standards adopted by SROs	NA
	Principles relating to enforcement	
8.	Inspection, investigation and surveillance powers	FI
9.	Enforcement powers	FI
10.	Use of inspection, investigation, surveillance and enforcement powers	FI
	Principles relating to co-operation	
11.	Authority to share information with domestic and foreign counterparts	PI
12	Information-sharing mechanisms	PI
13.	Assistance provided to foreign regulators	PI
	Principles relating to issuers	
14.	Disclosure of financial results	FI
15.	Treatment of holders of securities	FI
16.	Accounting and auditing standards	FI
	Principles relating to collective investment schemes	
17.	Standards for eligibility and regulation	BI
18.	Rules governing legal form and structure	FI
19.	Disclosure requirements	FI
20	Asset valuation and pricing and redemption of units	FI
	Principles relating to market intermediaries	
21.	Minimum entry standards	BI
22.	Capital and prudential requirements	BI
23.	Internal organisation and operational conduct	PI
24.	Procedure for dealing with failure of market intermediary	BI
	Principles relating to secondary markets and clearing and settlements	
25.	Trading systems	FI
26.	Regulatory supervision	FI
27.	Transparency of trading	FI
28	Detection of manipulation and unfair trading practices	FI
29.	Management of large exposures, default risk and market disruption	FI
30.	Systems for clearing and settlement of securities	FI

Table IV.5: Assessment of IOSCO Principles –Money Market

FI – Fully implemented; BI – Broadly implemented; PI – Partly Implemented; NI – Not Implemented; NA – Not applicable.

commercial paper market. The Panel on Financial Stability Assessment and Stress Testing recommends that the rating of commercial paper should take into account the availability of an appropriate liquidity back-up.

4.5 Corporate Bond Market

The corporate bond market needs to develop as a critical segment of the financial sector. This has been strongly recommended as a key reform area by the Advisory Panel on Financial

Stability Assessment and Stress Testing as well as the peer reviewers. In India, however, it has failed to take off so far, largely because of lack of buying interest, poor transparency and an absence of pricing of spreads against the benchmark yield curve. An inadequate supply of paper from corporates, given the increased access to the offshore market for Indian corporates (though on the wane in recent times), large issuance of credit-risk-free government securities and low-risk subordinated debts by banks as part of their Tier II capital at attractive interest rates, and the absence of delivery versus payment (DVP) and tax deducted at source (TDS) systems for corporate bonds have also acted as impediments to the development of secondary market activities.

But change is long overdue and development of this market is essential to further facilitate the financing needs of the country. Therefore, effective and concerted regulatory and legislative initiatives are needed so that the market can develop to its full potential. These measures include the need to develop institutional investors, making corporate bonds repo-able in a phased manner, the introduction of DVP in corporate bonds and ensuring that settlement takes place through a clearing corporation, the consolidation of all trades reported in different reporting platforms and dissemination of the same to enhance transparency, the rationalisation of stamp duty, the abolition of TDS, reforms in pension and insurance sectors and having timely, efficient bankruptcy procedures. In short, there is a long way to go.

There remains the question of allowing foreign investors into the corporate bond market. However, given the interest rate differentials in India *vis-à-vis* international rates, without corresponding expectations related to the evolving inflation and exchange rates, opening up the Indian debt market to foreign investment could raise issues of financial stability. There is, therefore, a need to follow a cautious approach.

4.6 Credit Risk Transfer Mechanism

Financial markets require mechanisms that allow the smooth but transparent transfer of risk to voluntary and well-informed investors. In India the Credit Risk Transfer (CRT) mechanism needs to gain ground but the approach has to be gradual. Liquidity risks emanating from off-balance sheet items and the inter-linkages of CRT instruments with other markets need to be recognised. CRT instruments could be exchange-traded to enhance transparency and their transactions recorded and settled through a clearing corporation. Adequate disclosure norms need to be in place. The approach to the development of the securitised market should be gradual and calibrated.

Despite the benefits to financial resilience, changes in the credit markets have also led to concerns and unease, particularly in view of the recent financial turmoil. In the context of issues concerning credit risk transfer, one of the measures that could be considered before adopting regulatory incentives for the development of credit derivatives markets is a need for objective rating, within an appropriate regulatory framework for the credit rating agencies.

Further, financial institutions need to develop capacity to measure their exposure to risk in a less benign market and economic environment. Senior management and boards of directors must understand the limitations and uncertainty that pervade the tools used to assess these risks, try to better understand the potential scale of losses that the firm may face, carefully examine how well risk exposures reflect the overall risk appetite of the firm and the size of capital and liquidity cushion maintained in relation to those exposures. Market participants need to keep pace with changes in the market through continued investment in both risk management and processing infrastructure. Credit derivatives should be recorded and settled through a clearing corporation.

4.7 Concluding Remarks

Financial markets in India have evidenced significant development since the financial sector reforms initiated in the early 1990s. The development of these markets has been done in a calibrated, sequenced manner and in step with those in other markets in the real economy. The emphasis has been on strengthening price discovery, easing restrictions on flows or transactions, lowering transaction costs, and enhancing liquidity. Benefiting from a series of policy initiatives over time, greater domestic market integration has also been witnessed.

The equity, government securities, foreign exchange and money markets along with their corresponding derivatives segments have developed into reasonably deep and liquid markets and there has been significant increase in domestic market integration over the years. However, the credit derivative market is yet to take off in any significant manner. As regards corporate bonds, though the primary market has seen an increase in issuance, the secondary market has not developed commensurately.

The equity market has witnessed wide-spread development in infrastructure and its functioning is comparable to advanced markets. It has seen significant increase in growth and diversity in composition in the past two decades. Certain areas, however, could be further developed. Among some of the major steps to be considered are:

- According SRO status to certain trade and industry associations to enhance regulatory efficiency, subject to appropriate safeguards;
- Further improvements in infrastructure and risk management systems;
- More focused monitoring of market intermediaries; and
- Streamlining of issuance procedures and the enhancement of knowledge standards of the current and potential market participants through national investor education and financial literacy.

With the economy moving towards fuller capital account convertibility in a calibrated manner, focused regulation and monitoring of the foreign exchange market assumes added importance. In this context, there is a need to strengthen infrastructure, transparency and disclosure, and product range in the forex derivatives segment. Strengthening the trading infrastructure, market conduct, transparency of OTC derivatives in the forex market, accounting and disclosures in line with international practices, including disclosures by non-bank corporates, needs to be done on a priority basis. The recent introduction of currency futures is a step in this direction.

The government securities market has witnessed significant transformation in its various facets: market-based price discovery, widening of the investor base, introduction of

new instruments, establishment of primary dealers and electronic trading and settlement infrastructure. This is the outcome of persistent and high-quality reforms in developing the government securities market. There are still areas where further development need to be undertaken. Increased transparency and disclosures, gradual scaling down of mandated investments and development of newer instruments are some major areas which could be considered. Regulatory incentives to increase the size of trading book could be considered as a measure to further develop the government securities market.

The money market is an important channel for monetary policy transmission and India has generally conformed to being a liquid market. In the ongoing global financial crisis, whereas many money markets in advanced countries have experienced serious difficulties, the Indian money market has continued to function normally. The gradual shift towards a collateralised inter-bank market, phasing out of non-bank participants from the call and notice money market, policy direction towards reductions in cash reserve requirements, the introduction of new instruments such as CBLO, implementation of RTGS, significant transformation of monetary operations framework towards market-based arrangements and facilitating trading through NDS-CALL are some of the factors that have contributed to the development of a relatively vibrant and liquid money market. However, the inability of market participants to take a medium to long-term perspective on interest rates and liquidity, coupled with the absence of a credible long-term benchmark, is a major hurdle for further market development and needs to be addressed.

The development of the corporate bond market, could be a source of long-term finance for corporates. The development of this market currently suffers from a lack of buying interest, absence of pricing of spreads against the benchmark and a flat yield curve. It requires regulatory and legislative reforms for its development.

The unbridled proliferation of complex credit derivatives and excessive risk transfer by adoption of the originate-to-distribute model is recognised as one of the root causes of the current financial crisis. The recent credit turmoil has also underscored the importance of liquidity risk arising from off-balance sheet commitments, implicit or explicit, of the credit intermediaries. The Reserve Bank had put in place regulatory guidelines that were aligned with global best practices while tailoring them to meet country-specific requirements. While the development of markets for credit derivatives and asset securitisation products could play a critical role in furthering economic growth, this requires to be pursued in a gradual manner by sequencing reforms and putting in place appropriate safeguards before introduction of such products.

While financial market reforms need to be accorded appropriate priority, given the risks arising from cross-sectoral spillover of financial markets to other segments of the financial system, there is a need to be careful and nuanced in approaching financial market reforms in the interest of financial stability.

V. FINANCIAL INFRASTRUCTURE

A robust and secure financial infrastructure is the cornerstone of financial stability and development. The CFSA, taking into account the Indian institutional and market environment, looked into aspects relating to stability and development in the following areas as part of the financial infrastructure, *viz.*, regulatory structure, legal infrastructure, liquidity infrastructure, governance infrastructure, accounting and auditing, payment and settlement infrastructure, business continuity management (BCM), safety net and financial system integrity. A comprehensive assessment of adherence to standards relating to corporate governance, legal infrastructure, accounting and auditing, and payment and settlement systems was done, while a review of the AML/CFT standards was also undertaken.

5.1 Regulatory Structure

In India, different segments of the financial system are regulated by different regulators. The Reserve Bank regulates banks and NBFCs, and most of the financial markets, *viz.*, the government securities, money and foreign exchange markets. SEBI regulates the equity and corporate bond markets while IRDA regulates the insurance sector. The Pension Fund Regulatory and Development Authority (PFRDA) as a pension regulator for the pension sector is on the anvil. Though the Reserve Bank of India regulates all banks, NABARD supervises the rural co-operative banks and the RRBs. The Reserve Bank regulates Non-banking Financial Companies and NHB regulates the Housing Finance Companies.

Independence of Regulatory and Supervisory Authorities

The independence of the regulatory agencies is crucial for financial stability. Regulators provide a public good at a cost that underscores the need to maintain their financial independence. The financial independence of the Reserve Bank, SEBI and IRDA is assessed to be generally adequate. The Reserve Bank's governance structure is laid down clearly in various legislations and there is adequate openness and transparency in its decision making. SEBI is empowered to frame regulations without the approval of the Central Government and is able to operate and exercise its powers given under various statutes without external political and commercial interference. IRDA is an independent agency which reports to Parliament through the Ministry of Finance.

Regulatory Co-operation

The CFSA has noted that the existence of different regulators is consistent with this transitional phase of financial development. However, multiple and conflicting roles of the regulators could lead to an increase in the scope for regulatory arbitrage, which can be exploited by financial conglomerates. To prevent or minimise this, a high degree of co-

operation amongst the regulatory agencies is a must. Going forward, the issue relating to inter-regulatory co-operation will assume further importance in effectively addressing regulatory arbitrage issues related to derivative products, like Collateralised Debt Obligations, when they gain popularity in Indian markets.

In order to be able to regulate the sector effectively, effective and transparent regulatory co-ordination mechanisms are in place that aim at streamlining capital adequacy (like double/multiple gearing of capital), accounting standards, appropriate disclosure requirements particularly in relation to overall risk management, and financial policy transparency.

Over a period of time most overlapping issues have been resolved. However, according to the Advisory Panel on Financial Regulation and Supervision, ensuring the effective co-ordination of the financial policies by strengthening the existing institutional arrangements for regulatory co-operation and strengthening information-sharing arrangements, both within and across borders among the regulators, continues to be a contentious issue.

The CFSA is, however, of the view that the recent global financial crisis has highlighted the fact that rigid institutionalisation and formalisation of co-ordination arrangements may not be of much help and might even turn out to be counter-productive. A more appropriate solution could be a 'consensus' approach by the members of the High Level Co-ordination Committee on Financial Markets (HLCCFM) as is currently practised. The arrangements, however, would need to be continuously monitored and the effectiveness of the HLCCFM strengthened through greater exchange of information in a need-based and timely manner. [One member of the CFSA, however, felt that formalisation of the HLCCFM with a clear mandate would be desirable for timely and effective crisis resolution.]

There is the issue of the regulation of competing products issued by different sets of institutions falling under different regulatory regimes. This raises questions regarding a level playing field for marketing certain products. It is desirable that a co-ordinated view be taken in respect of overlap and conflict of regulatory jurisdictions, taking on board the various regulations in this regard. If required, appropriate amendments could be made to mitigate the conflicts arising from regulatory overlap.

An associated issue with respect to regulatory co-operation relates to inter-regulatory co-ordination with overseas regulators. This has gained importance in view of the increased need for the supervision of cross-border financial intermediaries in the context of greater integration with external markets. Early adoption of a suitable framework for cross-border supervision and supervisory co-operation with overseas regulators will be needed through appropriate interpretation of the existing statutes and undertaking legal amendments, if necessary.

Principles-based vs. Rules-based Regulation

There has been in recent times, been some debate over selecting principles-based regulation or rules-based regulation. It has been suggested by some that India should adopt the former.

Almost all countries follow a rules-based approach wherein the regulators attempt to prescribe in great detail what exactly the regulated entities can and cannot do. In principles-based regulation, the broad principles of regulation are articulated, essentially to avoid the codifying of details of allowable products, markets or business plans; in this system, how a principle would be applied remains at the discretion of the regulator.

India follows a model of regulation which is primarily rules-based. Over a period of time, India has built up a large repository of subordinate laws through a codification of detailed rules and regulations by specialised regulators, which detail the permissible features of financial products and services and also the functioning of the financial markets.

The CFSA notes that the Financial Services Authority, UK, one of the few countries which applies principles-based regulation, has a set of as many as 60 manuals or sourcebooks, each containing detailed rules. The CFSA further notes that principles-based regulation hardly exists as a common practice. Furthermore, principles-based and rules-based regulatory approaches can be complementary to each other in as much as principles also contain a set of rules. Hence, ideally it is desirable to identify a set of principles and then group the existing rules under them and consider validating the rules under these broad principles. This would also obviate the rules/regulations degenerating into *ad hocism.*

Supervision of Financial Conglomerates

While most financial supervisors have recognised that financial conglomerates require and deserve some form of specialised supervision, the regulatory approaches to this kind of supervision differ greatly in their responses to some of the underlying problems of conglomerate regulation.

The supervision of Financial Conglomerates (FCs) in India is in its early stages. While there is a monitoring and oversight framework for financial conglomerates, there are some legal impediments that prevent effective information sharing and joint inspections by regulators.

Currently, a monitoring and oversight framework is in place for them that complements the regular supervision of individual entities by the respective regulators, *viz.*, the Reserve Bank, SEBI, and IRDA. A system of Consolidated Financial Statements/ Consolidated Prudential Reporting is also applicable to the banks. The monitoring framework rests on three components:

- off-site surveillance through receipt of quarterly FC returns;
- reporting relevant concerns on financial conglomerates to the standing Technical Committee that has members from the Government, the Reserve Bank, SEBI, IRDA and PFRDA; and

- holding of periodic discussions by the principal regulator with the top management of the conglomerate in association with other principal regulators to address outstanding issues/supervisory concerns.

There is no legislation specifically permitting regulation of FCs and holding companies in India. The Reserve Bank could, in the interests of financial stability, be armed with sufficient supervisory powers and monitoring functions in respect of financial conglomerates. It needs to be examined whether, given the nature of financial conglomerates in India, an amendment to the existing legislation would be sufficient or whether there is need for a new legislation for supervision of financial conglomerates. CFSA is of the view that legislation of a new Act, similar to the 1999 Financial Services Amendment Act, or the Gramm-Leach-Bliley (GLB) Act of USA is required to empower the regulator (the central bank) to have regulatory jurisdiction of the holding company. The following recommendations should be considered for strengthening the regulatory and supervisory framework for financial conglomerates:

- In the case of an FC where the apex institution is a bank holding company, the responsibility for regulation and supervision of the concerned bank would lie with the Reserve Bank.
- In the case of an FC where the apex institution is a non-bank holding company (financial or non-financial) having a bank within its structure, the responsibility for regulation and supervision of such non-bank entities would lie with the Reserve Bank.
- In the case of an FC where the apex institution is a non-bank financial holding company whose activity is within the regulatory jurisdiction of the Reserve Bank, the responsibility for regulation and supervision of the apex body/non-bank financial entity would lie with the Reserve Bank, irrespective of whether there is a bank within its structure.
- In the case of an FC where the apex institution is a non-bank non-financial holding company, the apex body/non-bank non-financial entity should be explicitly within the regulatory outreach of the Reserve Bank to the extent that the Reserve Bank is empowered to obtain information as relevant from time to time, even if there does not exist a bank within the financial conglomerate structure.
- The interactive relationship between the Reserve Bank and the other regulators of the insurance, securities, commodities, and housing needs to be streamlined.

As regards the supervision of these entities, there could be a 'Lead Regulator' with supervision being conducted collaboratively by the regulators with the lead regulator co-

ordinating the supervision across various jurisdictions, subject to the parameters of co-ordination being well defined and ground rules being specified.

Entities within the financial conglomerates functioning in a regulatory vacuum should be brought under the regulatory reach of the lead regulator. Allowing 'intermediate' holding companies may not be feasible till an appropriate regulatory structure for such an entity is in place. In the interests of financial stability, there is a need for strengthening inter-regulatory co-operation and information-sharing arrangements, both within and across borders among the regulators.

Self-Regulatory Organisations

Self-Regulatory Organisations (SROs) are entities authorised by statute or an agency to exercise some delegated jurisdiction over a certain aspect of the industry or markets. They are non-government organisations which have a statutory responsibility to regulate their own members through the adoption and enforcement of rules of conduct for fair, ethical and efficient practices. There is a view that SROs could potentially enhance regulatory efficiency and optimise regulatory costs.

It is argued that SROs may have an inherent advantage in being able to respond more quickly and flexibly to changing market conditions than the regulator and to increase the pace of development since industry and the regulator would align their efforts towards a common goal. The self-regulation culture could help increase investor confidence, and help keep the momentum of market development at a steady pace. In India, though some associations/trade bodies perform SRO like functions, most of them are not formally recognised. There is a need to complement the existing regulatory structure by having SROs in various market segments.

The definitional ambiguities regarding SROs need to be sorted out. Formal oversight by the regulator in respect of SROs is, a necessity. As SROs are essentially trade bodies, issues relating to conflict of interest could arise; hence, it is necessary that issues like arm's length relationship of SROs with the associated trade bodies and their corporate governance policies be looked into by the regulator before according SRO status to any entity. Granting of SRO status to any institution would thus necessitate the fulfillment of certain preconditions, like introduction of transparent policies by the regulators for defining, identifying, and approving SRO status to institutions which are already performing implicitly or more explicitly self-regulatory functions in the financial sector. This could be the first step to pave the way for evolving a more generalised framework.

Co-ordination Between On-site Supervision and Off-site Monitoring

In order to reap the full benefits of synergies arising out of the complementarity of effective supervision, there is a need as well as room for the enhancement of co-ordination between on-site and off-site supervision.

Capacity Building

Given the innovations that have taken place in the banking arena coupled with new developments in areas like risk management and Basel II, the issue of capacity building, both from the perspective of the regulated and the regulator, has gained importance. The

regulator could aspire for an 'adequate' incentive structure that would enable it to attract and retain talent and qualified professionals. With the ongoing integration of financial markets and diversification of asset classes, capacity building also assumes importance in the insurance and securities markets.

With aspects like the need for financial innovations and improving risk management in the context of Basel II gaining prominence against the backdrop of increasing globalisation in the banking sector, commercial banks in general and PSBs in particular have to build their staff competence. Issues relating to incentive structure, recruitment, promotion, retention, training, transfer, and succession plans be addressed, which in turn could help alleviate the inherent constraints related to capacity building in the banking sector. The Reserve Bank, along with the other regulators cannot lag behind market players and they run a huge risk if they do not have expertise in areas of risk management, and which, going forward, would require supervisory validation of various models in the Basel II environment. Also, keeping abreast of market developments including understanding the implications of the existence of complex derivative products in the banks' portfolios is a *sine quo non* in this regard.

Likewise, in the case of SEBI, capacity building and skill enhancement are issues, particularly with various innovations and new developments in the securities market.

In the insurance sector, as recommended by the Panel on Financial Stability and Stress Testing, there is a need for insurance staff to develop their treasury function and investment management skills. In order to effectively monitor the sector, IRDA needs to take steps to strengthen its machinery in terms of adequate skills for its officials, which would require capacity building.

CFSA underscores the need for all regulators to take steps in capacity building, including improvements in compensation structure. Developing a second line of professionals and having an appropriate succession plan, thereby augmenting institutional memory, is also necessary.

5.2 Liquidity Infrastructure

Liquidity Management

Systemic liquidity infrastructure refers to a set of institutional and operational arrangements – including key features of central bank operations and money and securities markets – that have a first-order effect on market liquidity and on the efficiency and effectiveness of liquidity management by financial firms.[8] While aspects relating to financial

[8] Dziobek, C., Hobbs, J.K., and Marston, D. (2000) as quoted in *Handbook on Financial Sector Assessment,* World Bank and IMF, September 2005.

markets and liquidity position of banks are covered elsewhere, this section addresses issues relating to liquidity management by the Reserve Bank and related aspects of the management of capital account in the context of large inflows/outflows of capital.

Active liquidity management is an integral part of the Reserve Bank's monetary operations. Liquidity management has been rendered complex by large capital flows witnessed in recent years. Swings in capital inflows without offsetting changes in the current account balances can lead to large and possibly disruptive changes in exchange rates. Inflows of foreign currency have had major consequences for the liquidity of the domestic financial system.

Until the end of 2007, large capital movements necessitated the Reserve Bank to sterilise the excessive monetary impact of inflows, using the market stabilisation scheme (MSS), cash reserve ratio and Open Market Operations (OMO). The Liquidity Adjustment Facility (LAF), introduced in June 2000, enabled the Reserve Bank to manage day-to-day liquidity or short-term mismatches under varied financial market conditions to ensure stable conditions in the overnight money market. In the context of sustained large capital flows, large-scale OMO led to a decline in its holding of government securities. This and the legal restrictions on the Reserve Bank on issuing its own paper became constraints on future sterilisation operations. So, a new instrument called Market Stabilisation Scheme (MSS) was introduced in April 2004, wherein dated securities/treasury bills are issued to absorb surplus liquidity.

All aspects related to liquidity infrastructure from the stability perspective were analysed by the Panel on Financial Stability Assessment and Stress Testing. Some of the issues that have arisen in liquidity management and that have been highlighted by the Panel are listed below:

- The movement of overnight rates has often witnessed significant volatility at the end of each quarter due to advance tax payment, and at the end of the last quarter ,due to year-end considerations for banks. This volatility has been accentuated by the difficulties in estimating cash flows with any reasonable degree of accuracy in the government accounts, largely arising from difficulties in projecting the receipts and payments of Governments.
- A fallout of the introduction of LAF has been the passive role adopted by some banks in managing their day-to-day liquidity position. Also, its operations are constrained by the availability of securities with the Reserve Bank, when liquidity has to be absorbed, and with market participants, when they are in need of liquidity.
- CRR has been increasingly used as a tool to modulate growth in credit and as an instrument of monetary management. In a market-oriented financial system, a high CRR (which was at 9 per cent as on August 30, 2008), when unremunerated, causes distortion in the term structure of interest rates. [CRR has been reduced in stages since then to 5 per cent as of January 17, 2009.]. CFSA notes in this context that since liquidity carries a cost, it is important that market participants have an incentive to recognise and bear some of the cost.

- While the central bank has been absorbing liquidity through OMO, MSS and CRR on a term basis, there is no window available to provide liquidity to the market on a term basis except through emergency lending, which the banks can access only in times of deep distress.[Such window has been opened in the current circumstances utilising Section 17 (3) (b) of the RBI Act.]
- In the absence of any short-term liquidity window from the central bank, apart from the overnight LAF, there have been a few instances where the liquidity at the short end dried up, causing call rates and short-term deposit rates to witness steep hikes, even under overall benign liquidity conditions. It is noted that the Reserve Bank does have the option of also conducting a term LAF.

Some of the recommendations made by the Panel to further strengthen the liquidity management framework in India along with CFSA's comments where applicable are given below:

- Systems and procedures need to be developed for smoothing out well-known spikes in liquidity and call money rates arising out of quarterly tax payments. Hence, there is a need to strengthen management of government cash balances. The introduction of auction of Central Government surplus balances with the Reserve Bank in a non-collateralised manner could be considered, which would also make available the government securities in the Reserve Bank's investment accounts for its own market operations. The CFSA notes that a Working Group in the context of better cash management by the Government has been set up.
- There is a need for strengthening the asset-liability management of banks, including the development of the term money market as also the development of liquidity forecasting models. There is also a need to refine the indicators of liquidity. This is necessary both for better monetary/credit management and for minimising systemic risk and financial crisis propagation. There is a requirement of skill development of the market participants to assess their own liquidity requirements. Capacity building on the part of Reserve Bank is also required for strengthening its liquidity forecasting ability.
- Introduction of LAF has been a major step as regards money market operations. However, it has also led to a passive role adopted by some banks in managing their day-to-day liquidity position. Additional collaterals like high-quality AAA-rated paper for conducting repo may be explored over time.
- In the absence of any short-term liquidity window from the central bank, in a range of about 15 days to three months, banks find it difficult to lend short term when they perceive liquidity tightness due to tax outflows and large government borrowings. Though the Advisory Panel on Financial Stability and Stress Testing

felt that an appropriately designed term liquidity facility can provide powerful incentives to develop the term money market, the CFSA is not in favour of introducing a term liquidity facility since it is of the view that the existing instruments are adequate to address seasonalities and short-term uncertainties in liquidity conditions that cause volatility in overnight rates. Moreover, the Reserve Bank is free to introduce term repos as and when necessary within the LAF framework.

In the light of recent events following the sub-prime crisis, like the treatment of Northern Rock in the UK and Bear Stearns and American International Group (AIG) in the US, the Advisory Panel on Financial Regulation and Supervision highlighted the need for more careful management of liquidity risk. In this context the Panel suggested constitution of a Working Group with the specific mandate to examine the following:

- The powers available as per extant provisions with the Reserve Bank as LoLR.
- The scope of putting a mechanism whereby the same can be activated at the shortest possible time.
- The scope of expanding the instruments that can be permitted for providing liquidity.

The CFSA feels that the choice of tools in times of crisis would vary depending on the circumstances. The Reserve Bank's interventions should depend upon specific circumstances and judgment about contagion and systemic stability and it would not be practical to lay down upfront the extent to and circumstances under which it would play the role of the lender of last resort.

5.3 Management of the Capital Account

In the context of the management of the capital account, the key issue for the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or temporary and subject to sudden stops and reversals. There is a need to examine the likely implications of excessive inflows and outflows on monetary operations. Strategic management of the capital account would warrant preparedness for all situations.

The sub-prime turmoil caused the shock of reversal in capital flows combined with increase in spreads. Consequent to greater integration of financial markets, India has, in recent times, been experiencing the challenge of managing liquidity. The adverse impact on domestic rupee liquidity due to reversal of capital flows can be countered by the Reserve Bank by substituting net foreign exchange assets as a source of reserve money with net domestic assets in its balance sheet, so that the domestic primary liquidity is sustained adequately to meet the credit needs of the economy, consistent with growth prospects.

Monitoring of the unhedged positions of corporates by banks needs to be strengthened, since the currency risk has the potential to transform into credit risk.

The reversal of capital flows, difficulty in refinancing of external commercial borrowings and availment of trade credit despite buoyant FDI inflows has affected the equity market, and consequently mutual funds have faced redemption pressures during late 2008. This has also impacted the exchange rate due to FII outflows and the rupee has tended to

depreciate. The reversal of flows has also affected domestic liquidity as corporates, due to problems in availing finance from abroad, have started approaching the domestic market. The additional liquidity requirements have been met through a cut in the Cash Reserve Ratio, LAF injections, winding down or MSS buy-back and by providing general or sector-specific refinance facilities. The leeway available to the Reserve Bank will depend upon monetary and credit projections. It also has to take into account the potential inflationary pressures that it could create if actual liquidity injection becomes excessive.

Contrary to the perception that India was decoupled from global economic conditions, it has been seen that the disorderly unwinding of global imbalances, particularly in the current context of financial turmoil, has affected the Indian economy indirectly. Though the exposure of banks, corporates and households in India to the external sector is limited, there is a need to be alert to unforeseen domestic and global shocks and pro-actively manage the risks. Hence, there is a need to be vigilant and remain in a state of constant preparedness to meet any adverse consequences in the face of disorderly unwinding of global imbalance.

5.4 Market Integrity

Given the concerns about the origin and source of investment funds flowing into the country, there is a need to take suitable measures which would enhance the confidence of foreign investors and regulators alike in the Indian financial system.

One important concern in the context of market integrity is the foreign portfolio investment through the participatory note (PN) route by Foreign Institutional Investors (FIIs). The Government in this regard is of the opinion that since FIIs maintain records of the identity of the entity they issue PNs to and SEBI can obtain this information from the FIIs, there does not appear to be any cause for concern from the 'Know Your Customer' (KYC) angle. Further, PNs can be issued or transferred only to persons who are regulated by an appropriate foreign regulatory authority. The Reserve Bank's concern is that as PNs are tradeable instruments overseas, this could lead to multi-layering which will make it difficult to identify the ultimate holders of PNs. Furthermore, the transactions of the FIIs with the PNs are outside the real-time surveillance mechanism of SEBI.

5.5 Accounting Standards

Accounting standards and the integrity of its implementation lie at the heart of a successful market economy. It is a welcome feature of the Indian economy that Indian Accounting Standards are broadly in line with International Accounting Standards, which are now known as International Financial Reporting Standards (IFRSs). To be sure, there are still some gaps in areas relating to the convergence of Indian Accounting Standards with IFRSs in developing sector-specific guidance, authority for issuance of standards and the training of professionals. These issues are being addressed. The ongoing global financial crisis and

subsequent problems relating to derivatives transactions in India have brought to the fore the necessity for early adoption of accounting standards AS 30 and 31 relating to financial instruments.

The autonomy of the Accounting Standards Board (ASB) would be greatly enhanced if it is given the authority to issue the standards and the Council of Institute of Chartered Accountants of India (ICAI) confines itself to the administrative, but not the functional, control of the ASB. There is a need for the ASB to consider the development of standards on various subjects as also to provide sector-specific guidance. ICAI should constitute an independent Interpretation Committee. Awareness should be created about IFRSs among auditors and all others who are involved in the process. ICAI should also continue to conduct training programs and take steps to enhance and broaden the scope, possibly with regulators (to enhance resource availability), and to impart more formalised training to preparers of financial statements.

5.6 Auditing Standards

The International Auditing Standards (ISAs), devised by the International Auditing Practices Committee (IAPC) and later renamed the International Auditing and Accounting Standards Board (IAASB), are widely accepted in India following efforts by the Auditing and Accounts Standards Board (AASB) in India to develop similar auditing standards. Though ICAI has taken steps to align Indian auditing standards with ISAs, there are still some gaps which need to be addressed in areas relating to convergence with ISAs, implementation of auditing standards, strengthening the peer review process, access to working papers and independence of auditors. AASB should strive for convergence with ISAs and efforts also need to be made at the Institute level in this regard. Efforts should be made to issue Exposure Drafts by the AASB when they are issued by IAASB. ICAI needs to take proactive steps by bringing out more technical guidance and other literature to help SMEs understand new standards and aspects relating to their practical implementation. The Quality Review Board set up by ICAI needs to start functioning more effectively at the earliest. It should play a more proactive role as an independent oversight body for the auditing profession in India.[9]

There is a need to give functional independence to the AASB *vis-à-vis* the Council of the Institute by making it the final authority for drafting and issuance of the Standards, with the Council confining itself to administrative, but not functional, control of AASB.

The certification authorities/auditors should be made responsible to the respective regulatory authorities to the extent that they are involved in certifying/auditing entities that fall within the regulatory domain of the Reserve Bank/SEBI or any other regulator as applicable.

5.7 Business Continuity Management (BCM)

While information technology has revolutionised the way financial institutions and markets conduct their business, it has also significantly increased their vulnerability to

[9] The recent disclosure of massive falsification of annual financial statements and quarterly financial results submitted to the stock exchanges by a large public listed company audited by a 'Big-4' auditing firm reinforces the need for much greater strengthening of the peer review process. It also highlights the need for the Quality Review Board to immediately start functioning and for it to play a pro-active role as an independent oversight body for the auditing profession in India.

unexpected interruptions. Business Continuity Management involves arranging for emergency operations of critical business functions and for their resource recovery planning after natural or man-made disasters.

Banks need to continuously test and upgrade their BCM plans by incorporating new changes in their business and technology improvements. A BCM drill conducted by the Reserve Bank for participants in the payment systems revealed that some participants, in spite of having adequate systems to take care of Business Continuity, needed to ensure that these systems operated with ease in case of a contingency. Areas of concern remained, particularly in aspects related to human resource management and assessment of the business continuity processes of the vendors.

In addition to mitigating risks emanating out of IT-related issues on the lines as recommended by the Panel on Financial Stability Assessment and Stress Testing, issues relating to appropriate succession planning and proper delineation of duty in the event of a major operational disruption and continuous upgrading of training, particularly for the personnel operating in the alternate sites, are considered imperative for an appropriate BCM. Of equal importance may be issues relating to proper MIS to the top management and factoring in the BCM as an integral part of operational risk management for the institutions. Capacity building on the part of the regulators to assess the state of BCM in the regulated entities could also be a major area of focus.

5.8 Payment and Settlement Infrastructure

The smooth functioning of the payment and settlement systems is a pre-requisite for the stability of the financial system. In order to have focused attention on payment and settlement systems, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) was set up in March 2005 as a Committee of the Reserve Bank Central Board. The launching of Real Time Gross Settlement System (RTGS) has led to the reduction of settlement risk in large value payments in the country. The setting up of National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL) for the capital market settlements and Clearing Corporation of India Ltd. (CCIL) for government securities, forex and money market settlements has improved efficiency in market transactions and settlement processes. A series of legal reforms to enhance the stability of the payment systems, like the introduction of the Information Technology (IT) Act, 2000 that recognises electronic payments, and an amendment to the Negotiable Instruments Act, 1881 to enable cheque truncation and to define e-cheques have been carried out. While these amendments helped promote electronic payment, they could not provide an all-encompassing solution to the requirements of providing a legal basis for payment and settlement systems. Illustratively, the statutes did not provide for legal backing for multilateral netting. There was no legal basis for settlement finality. Also, the system did not provide for

any law for regulation and supervision of payment systems. In order to address these issues, the Payment and Settlement Systems Act was passed in 2007. The Securities Contract (Regulation) Amendment Act, 2007 has amended the Securities Contract Regulation Act, 1956 so as to provide a legal framework for trading in securitised debt, including mortgage-backed debt. These legal reforms undertaken since the last FSAP greatly contributed to the compliance of Indian systems to international standards.

The Panel's assessment of the Core Principles of Committee on Payment and Settlement Systems (CPSS) for systemically important payment systems, is that, in India, they operate cheaply and efficiently, with minimal systemic risk. A summary of the assessment of Core Principles is given in Table V.1.

The RTGS system is compliant with most principles covering, *inter alia,* legal basis, finality of settlement, governance and transparency principles, while gaps exist in risk management, efficiency and operational reliability. The High Value Clearing Systems are compliant with all core principles except those relating to risk management and timely completion of multilateral net settlement.

Some of the initiatives that could be considered for improving the RTGS and High Value Clearing Systems include: improving the risk management techniques in areas where the Reserve Bank does not operate the clearing houses; migrating all high value transactions to

Table V.1: Assessment of Systemically Important Payment Systems

	Principle	RTGS	High Value Clearing System
CP I.	Legal basis	O	O
CP II.	Clarity of rules and procedures	O	O
CP III.	Risk management	BO	BO
CP IV.	Finality of settlement	O	O
CP V.	Timely completion of multilateral net settlement	NA	PO
CP VI.	Settlement in central bank money	O	O
CP VII.	Security and operational reliability	BO	O
CP VIII.	Efficiency	BO	O
CP IX.	Public disclosure of participation criteria	O	O
CPX.	Transparency in governance arrangements	O	O
Responsibilities of central banks			
A	Transparency of roles and major policies	O	O
B	Compliance with Core principles	BO	BO
C	Oversight of Payment Systems	O	O
D	Co-operation with other central banks	O	O

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

Compliance Status at a glance

Assessment	RTGS	HV Clearing
Observed	9	11
Broadly Observed	4	2
Partly Observed	–	1
Not Applicable	1	–

secure electronic channels like RTGS and National Electronic Funds Transfer (NEFT) to eliminate settlement risk; and increasing the level of utilisation of the electronic payments infrastructure. Steps may be taken to optimise the utilisation of the electronic payments infrastructure and to reduce the charges for such transactions.

Retail Payment Systems

The retail electronic payment systems in India are the NEFT and the Electronic Clearing Service (ECS). NEFT is an electronic message-based payment system that provides a nation-wide, secure one-to-one funds transfer facility for bank customers, with centralised settlement of all transactions taking place at Mumbai. ECS is a retail payment system which facilitates bulk payments that can be classified as one-to-many and receipts that are many-to-one.

The two components of this system are ECS (Credit) and ECS (Debit). ECS (Credit) facilitates bulk payments whereby the account of the institution remitting the payment is debited and the payments remitted to beneficiaries' accounts. ECS (Debit) facilitates the collection of payments by utility companies. In this system, the accounts of the customers of the utility company in different banks is debited and the amounts are transferred to the account of the utility company.

The benefits of facilities like ECS are so far not trickling down adequately to the lower end of the customer segment. Though there has been significant improvement in retail payment systems, there is a continuing need to develop solutions that utilise new technologies and which would facilitate all segments of society to gain access to the benefits of new technology. Given the high level of software capabilities available in India, it is of utmost importance that this process be accelerated and that India leapfrogs intermediate steps and moves rapidly to IT-based systems. Deficiencies in retail payments at present mainly pertain to the inefficient outstation cheque collection process.

The current low utilisation of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to customers. The Reserve Bank should strive for 100 per cent computerisation of clearing house operations.

The development of a funds transfer or payment system through mobile phones would not only reduce transaction costs, but would also potentially allow these facilities to be used by a large unbanked segment.

Government Securities Settlement Systems

An assessment against the CPSS-IOSCO Recommendations for Securities Settlement Systems has revealed that the settlement systems in the government securities market are compliant with all the principles.

Equity Market Settlement Systems

The stock exchanges and the central counterparties (CCPs) (National Securities Clearing Corporation and the Bank of India Shareholding Ltd) are compliant with the relevant international standards. A summary of the assessment of the equities settlement and government securities settlement systems against the CPSS-IOSCO Recommendations is given in Table V.2 and that of CCPs is given in Table V.2.

With the screen-based online trading system, trades between direct market participants are confirmed online at the time of trade. The trades are settled on a rolling basis of T+2 days settlement cycle. In order to provide clarity on the applicability of insolvency laws and finality of settlement and netting for transactions made through Regional Stock Exchanges and clearing corporations in equities settlement, there is a need to incorporate specific clarificatory provisions to that effect in the Securities Contracts (Regulation) Act, 1956.

Table V.2: Assessment of Recommendations for Securities Settlement Systems

	Recommendation	Government Securities Settlement	Equities Settlement
1.	Legal basis	O	O
2.	Confirmation of trades	O	O
3.	Rolling settlement	O	O
4.	Benefits and costs of central counterparties	O	O
5.	Securities lending and borrowing	O	BO
6.	Dematerialisation of securities	O	O
7.	Elimination of principal risk	O	O
8.	Final settlement	O	O
9.	Risk management in deferred net settlements	O	O
10.	Credit risk in the cash leg of securities transactions	O	O
11.	Operational risk	O	O
12.	Accounting practices	O	O
13.	Governance arrangements for CSDs and CCPs	O	O
14.	Participation criteria for CSDs and CCPs	O	O
15.	Safety, security and efficiency of systems	O	O
16.	Communication procedures	NA	O
17.	Information on risks and costs	O	O
18.	Disclosure of responsibilities and objectives of settlement systems	O	O
19.	Risks in cross-border settlement	NA	NA

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

Compliance Status at a glance

Assessment	Government Securities Settlement	Equities Settlement
Observed	17	17
Broadly Observed	–	1
Not Applicable	2	1

Central Counterparties

The Reserve Bank took the initiative of setting up the Clearing Corporation of India (CCIL) with some of the major banks as its core promoters to upgrade the country's financial infrastructure in respect of clearing and settlement of debt instruments and forex transactions. CCIL currently provides guaranteed settlement facility for government securities clearing, clearing of Collateralised Borrowing and Lending Obligations (CBLO) and foreign exchange clearing.

The role of CCIL as the only CCP catering to money, securities and forex markets, leads to concentration risk. Though concentration of business with CCIL helps pool the risks and reduce the overall transaction costs for the system, the risk management systems in CCIL should be further strengthened. CCIL may endeavour to develop capacity to measure intra-day exposure and margin requirements (based on intra-day exposures) for government securities, CBLO and forex segments.

The assessment of NSCCL and BOISL/BSE in the equities settlement systems shows that they comply with all recommendations.

A summary of the assessment of CCIL against the CPSS-IOSCO Recommendations for CCPs is given in Table V.3.

CCIL is compliant with the recommendations pertaining to, among others, legal risk, participation requirements, operation risk management, governance and regulation and oversight. The major issues brought out in the assessment pertain to the lack of adequate financial resources, measurement and management of credit exposures, money settlements and default procedures.

Though the CCIL's risk management systems are satisfactory, concomitant with the increase in its business, its liquidity requirements have also increased. As part of its operations, CCIL also encounters intra-day liquidity shortfalls. To tide over the intra-day liquidity requirements, CCIL has availed of dedicated Lines of Credit (LoC) from a few commercial banks. Given the significant increase in the volumes of trade in the debt, money and forex markets and as the settlements at CCIL are effectively taking place at the end of the day, it would be very difficult for CCIL to raise liquidity from commercial banks equivalent to international benchmarks. The grant of a limited purpose banking licence will enable CCIL to avail of a repo window with another bank or from the Reserve Bank to fulfill the requirement of additional liquidity, when needed. Appropriate amendments in the legal provisions could be considered, making it easier to go ahead with issuing differentiated bank licenses for this purpose.

The CFSA notes that initially CCIL was operating with lines of credit facilities from various banks for up to Rs.400 crore, which were subsequently increased to Rs.1,300 crore, and

Table V.3: Assessment of Recommendations for Central Counterparties – CCIL; NSCCL & BOISL/BSE

	Recommendation	CCIL	NSCCL & BOISL/BSE
1.	Legal risk	O	O
2.	Participation requirements	O	O
3.	Measurement and management of credit exposures	BO	O
4.	Margin requirements	BO	O
5.	Financial resources	PO	O
6.	Default procedures	BO	O
7.	Custody and investment risks	O	O
8.	Operational risk	O	O
9.	Money settlements	BO	O
10.	Physical deliveries	NA	O
11.	Risks in links between CCPs	NA	NA
12.	Efficiency	BO	O
13.	Governance	O	O
14.	Transparency	BO	O
15.	Regulation and oversight	O	O

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

Compliance Status at a glance

Assessment	CCIL	NSCCL & BOISL/BSE
Observed	6	14
Broadly Observed	6	–
Partly Observed	1	–
Not Applicable	2	1

this is being further enhanced to Rs.1,600 crore. CCIL is also in the process of putting in place the concept of clearing member under which the settlements will be done only in the books of a few members, in which case the liquidity requirements in the CCIL system may come down automatically.

5.9 Legal Infrastructure

Effective insolvency and creditor rights systems play a vital role in helping to sustain financial soundness and in promoting commercial confidence. They enable market participants and stakeholders to price risks more accurately, and to manage and resolve the risks of default and non-performance. The legal framework for insolvency of banks, NBFCs and insurance companies and the general corporate insolvency regime in India are broadly compliant with the World Bank Principles for Effective Insolvency and Creditor Rights Systems. Even so, there are several gaps particularly in the implementation of the extant legislations.

Major legislative amendments in recent years were undertaken to strengthen the laws relating to debt recovery and enforcement of security which include:

- The Legal Services Authority Act, 1987 that has conferred the statutory basis to the Lok Adalats (people's courts).

- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), has been extended to cover co-operative banks. The Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2004 has amended the SARFAESI Act, Recovery of Debts due to Banks and Financial Institutions Act, 1993 and the Companies Act, 1956.
- The Credit Information Companies (Regulation) Act, 2005 is aimed at providing for regulation of credit information companies and at facilitating efficient distribution of credit.

The assessment of adherence to the World Bank Principles for Effective Insolvency and Creditor Rights Systems has brought out the fact that despite having well-conceived insolvency laws and institutional framework, the implementation of these laws leaves a great deal to be desired. The 'Doing Business Report' of the World Bank has highlighted India's low ranking in enforcing bankruptcy laws.

A summary of assessment of World Bank Principles for Effective Insolvency and Creditor Rights Systems is provided in Table V.4.

The assessment has brought out the complexities of legal and judicial systems in India, raising concerns about the long delays in the winding-up process. Whereas an amendment to the Companies Act, based on the recommendations of an Expert Committee, has been made which would enable the setting up of a National Company Law Tribunal (NCLT), this major proposal itself could not take off due to a pending law suit. The determination of the appeal pending against the amendment to the Companies Act will have a significant impact on the implementation of bankruptcy laws in India.

Legal Framework for Insolvency of Banks

Due to the complexity of the Indian banking sector, the legal frameworks applicable to insolvency of banks that are statutory corporations, nationalised banks and those in the co-operative sector have different legal principles applicable to them. The amendments to various legislations relevant to the financial sector have given greater legislative mandates to the regulators in discharging their regulatory and supervisory roles. There is a need to harmonise the legislative framework in India, particularly with regard to legislations in the financial sector.

The insolvency of financial institutions, if it occurs, has serious contagion effects and repercussions across the economic system, destabilising economic activity. Hence, a separate comprehensive insolvency regime for banks and other categories of financial institutions is critical in the context of financial stability.

	Table V.4: Assessment of Principles for Effective Insolvency and Creditor Rights Systems				
	Principles/Sub-Principles	**O**	**BO**	**PO**	**Total**
A.	**Legal Framework for Creditor Rights**				
	A1 Key Elements of Legal Framework for Creditor Rights	–	–	1	1
	A2 Security (Immovable Property)	–	1	–	1
	A3 Security (Movable Property)	–	1	–	1
	A4 Registry Systems	–	3	–	3
	A5 Commercial Enforcement Systems	–	2	–	2
	Total – A	**–**	**7**	**1**	**8**
B.	**Risk Management and Corporate Workout**				
	B1 Credit Information Systems	5	–	–	5
	B2 Director and Officer Accountability	1	–	–	1
	B3 Legislative Framework enabling Workouts	4	2	–	6
	B4 Informal Workout Procedures	3	–	–	3
	B5 Regulation of Workouts and Risk Management Practices	2	–	–	2
	Total – B	**15**	**2**	**–**	**17**
C.	**Legal Framework for Insolvency**				
	C1 Key Objectives and Policies	–	1	–	1
	C2 Due Process: Notification and Information	2	1	–	3
	C3 Eligibility	–	–	1	1
	C4 Applicability and Accessibility	2	–	2	4
	C5 Provisional Measures and Effects of Commencement	–	2	1	3
	C6 Management	2	–	–	2
	C7 Creditor and Creditors' Committee	–	–	2	2
	C8 Collection, Preservation, Administration and Disposition of Assets	1	1	1	3
	C9 Stabilising and Sustaining Business Operations	1	1	–	2
	C10 Treatment of Contractual Obligations	2	–	2	4
	C11 Avoidable Transactions	3	–	–	3
	C12 Claims and Claims Resolution Procedures	3	1	1	5
	C13 Claims Filing and Resolution	–	1	–	1
	C14 Re-organisation Proceedings	2	3	1	6
	C15 International Consideration	–	1	–	1
	Total – C	**18**	**12**	**11**	**41**
D.	**Institutional and Regulatory Frameworks**				
	D1 Role of Courts	–	1	–	1
	D2 Judicial Selection, Qualification, Training and Performance	–	1	–	1
	D3 Court Organisation	1	–	–	1
	D4 Transparency and Accountability	1	–	–	1
	D5 Decision-making and Enforcement of Orders	1	–	–	1
	D6 Integrity of System – Court and Participants	1	–	–	1
	D7 Role of Regulatory or Supervisory Bodies	–	1	–	1
	D8 Competence and Integrity of Insolvency Representatives	1	–	–	1
	Total – D	**5**	**3**	**–**	**8**
	Grand Total (A+B+C+D)	**38**	**24**	**12**	**74**

O – Observed; BO – Broadly Observed; PO – Partly Observed.

The Indian legal framework for insolvency of banking companies is in substantial compliance with emerging international standards. However, one major area in which there are no clear legal provisions in respect of bank insolvency is the formal legal mechanism for sharing of information with other regulatory bodies and overseas regulators and the extent of

co-operation between them. This is a general issue that is also receiving considerable attention in the wake of the ongoing global financial crisis and concomitant bankruptcies of large global financial institutions.

Competition Issues in Banking

The Competition (Amendment) Act, 2007, which has recently amended various provisions of the Competition Act, 2002, has conferred wide powers on the Competition Commission.

Though Section 21A of the Competition Act provides for the Commission to make references to a statutory authority when the issue before it relates to an Act whose implementation is entrusted to that statutory authority, the opinion of the statutory authority in such a case has not been given any binding effect on the Commission and the final decision has been left to the Commission. The provisions of the Competition Act, as amended, are likely to raise issues of regulatory overlap/conflict in future, and could potentially pose a serious problem to the financial sector. The provisions are also likely to become hurdles in the path of recovery of distressed banks. Under the provisions, every person or enterprise proposing to enter into a combination is required to give notice to the Commission before entering into a combination and wait for 210 days.

Other Aspects Relating to Insolvency

The contractual rights of creditors are recognised under the laws in India. Certain provisions in the law that give priority to the claims of the sovereign over that of the secured creditors cause concerns as regards their security interest. The law should provide that the priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors.

The lack of a registry, which keeps a record of the security interests created in respect of movable properties, is another lacuna in the system of registration of security interest. The Central Registry, which is provided for under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act (SARFAESI) Act, and which could take care of a major part of the transactions of banks and financial institutions, is yet to be set up. The Central Registry should be set up urgently to have a central and reliable record of all security interests created by banks and financial institutions. The Central Registry should also be allowed to register all transactions creating security interests (both in movable as well as immovable property) by entities/individuals in addition to those of banks/financial institutions. For this purpose, it may be appropriate to bring in a separate legislation in respect of the Central Registry. In the course of time, the Central Registry (with an adequate number of branches all over the country) should be the sole registry for registration of all security interests over properties, and the registries under various statutes should be wound up with

suitable amendments to the respective Acts dealing with registration of security interests. The Central Registry should be constituted to provide a good database and reliable record on the creation of security interests/charges under the SARFAESI Act.

Even though the legal principles governing the enforcement mechanism are adequate, there are delays in implementing these principles at the ground level. The recovery mechanism in the case of unsecured credit is less efficient and cases are pending for execution with the Debt Recovery Tribunals (DRTs) due to lack of information about the properties of the debtors. Even though the number of new cases filed in the DRTs has come down owing to the enactment of the SARFAESI Act, the number of pending cases is still large. In order to minimise the delay, the number of DRT benches should be increased and a separate bench should be formed to deal with cases of large unpaid debts involving Rupees 1 crore and above.

Some of the other issues that need to be highlighted are:

- Since there are no comprehensive credit guarantee scheme in the market, it would be worthwhile to improve the scheme notified under the DICGC Act, 1961.
- It would be worthwhile having a common legislation to deal with the creation and registration of security interests (collaterals), irrespective of the nature of the security and its location.
- There is a need to amend Section 14 of the SARFAESI Act to provide an enabling provision for the district magistrate to delegate his powers under the SARFAESI Act to other executive magistrates in the District, so that the delay in taking possession/control of the secured asset may be obviated.
- There is a need to grant priority (by statute) to the claim of banks or financial institutions in respect of the financial assistance given to rehabilitate a sick/weak company in financial distress. Such priority of claim should also extend while disbursing the assets in liquidation.
- The mechanism of rehabilitation through the Sick Industrial Companies Act (SICA) has not been effective. The new provisions introduced in the Companies Act vide the Companies (Second Amendment) Act, 2002 once brought into operation are expected to improve the rehabilitation mechanism.
- The law should provide for a creditors' committee at the initial stage of insolvency proceedings to consider the re-organisation of the borrowing entity. Such committees should be empowered to participate in the decisions along with the liquidator and to file a report independently to the court/tribunal for improving liquidation proceedings.
- The Companies (Second Amendment) Act, 2002 should be brought into operation quickly to empower the liquidator/Court to protect the assets of the company and to even sell the undertaking as a going concern.
- The lack of judicial time, lack of expertise and consequent lack of proper appreciation of issues pertaining to insolvency are causing delays in deciding court cases. This can be solved to a large extent if the NCLT and the National Company Law Appellate Tribunal are set up.

- There is a need to accord priority for the authorities to improve and rationalise the systems and procedures so that the huge loss inflicted on stakeholders on account of insolvency process in India can be substantially minimised. The need to have an efficient bankruptcy law for the financial sector is essential from the point of view of the efficiency of the systems as well as the stability of the financial sector.

5.10 Corporate Governance

There is a comprehensive corporate governance framework in India for listed companies and the listing agreement forms an important pillar in this framework. There are various legal and regulatory requirements pertaining to corporate governance in place. There are enabling provisions that allow shareholders to participate in and be informed of decisions concerning fundamental corporate changes. The quality of corporate governance in Indian companies would be a key determinant in affecting their ability to attract capital, business, global partners and quality manpower.

A summary assessment against the OECD Principles for Corporate Governance is given in Table V.5.

The assessment shows that most of the principles were fully or broadly implemented. Some of the recommendations made by the Panel for strengthening corporate governance practices in India are enumerated below:

Certain requirements of Clause 49 of the Listing Agreement were non-mandatory. Given the fact that listed companies are required to disclose the extent to which the non-mandatory requirements have been adopted, the listed companies may be required to also disclose the reasons for non-compliance of non-mandatory requirements. There is a need to strengthen the existing framework with regard to risk management in listed companies. While international practices and developments have apparently been factored into the evolution of the corporate governance framework in India, the corporate governance code should be constantly reviewed in light of the ever-changing global scenario. Introducing the requirement of having Risk Committees can be specifically explored in this regard.

Participation in Annual General Meetings

There are certain constraints which prevent shareholders from participating in Annual General Meetings (AGMs) due to their dispersed geographical spread. Though a number of initiatives have been taken in this regard, such as introduction of postal ballots for voting for some decisions and provision for proxy voting, there is a need to increase participation by shareholders. For this purpose, there is a need to consider various measures that would enable increased participation. It has also been suggested, for example, that initiatives could be explored, such as holding the AGMs where majority shareholders reside or using alternate

Table V.5: Assessment of OECD Principles of Corporate Governance		
Principle	**Description**	**Assessment**
I.	**Ensuring the basis for an effective Corporate Governance framework**	
IA	Enhancement of market integrity and promotion of transparent and efficient markets	BI
IB	Transparent and enforceable legal and regulatory requirements	FI
IC	Division of responsibilities amongst authorities	FI
ID	Efficient supervisory, regulatory and enforcement framework	FI
II.	**The rights of shareholders**	
IIA	Basic shareholder rights	FI
IIB	Rights to participate in fundamental decisions	FI
IIC	Shareholders' AGM rights	FI
IID	Disproportionate control disclosure	BI
IIE	Markets for corporate control should be allowed to function	BI
IIF	Cost/benefit to voting	PI
IIG	Consultation amongst shareholders, including institutional investors	FI
III.	**Equitable treatment of shareholders**	
IIIA	All shareholders should be treated equally	BI
IIIB	Insider Trading and abusive self-dealing is prohibited	FI
IIIC	Board/Managers disclose interests	FI
IV.	**Role of stakeholders in corporate governance**	
IVA	Stakeholder rights respected	FI
IVB	Redress for violation of rights	BI
IVC	Performance enhancement	FI
IVD	Access to information	FI
IVE	Free communication of unethical practices to the Board	PI
IVF	Enforcement of creditor rights	BI
V.	**Disclosure and transparency**	
VA	Disclosure standards	FI
VB	Standards of accounting & audit	FI
VC	Independent audit annually	BI
VD	Accountability of auditors	BI
VE	Fair & timely dissemination	FI
VF	Provision of professional advice	BI
VI.	**Responsibilities of the Board**	
VIA	Board acts with due diligence, care	FI
VIB	Treat all shareholders fairly	BI
VIC	Apply high ethical standards	FI
VID	The board should fulfill certain key functions	BI
VID	The board should be able to exercise objective judgment	BI
VIF	Access to information	FI

FI – Fully Implemented; BI – Broadly Implemented; PI – Partly Implemented; NI – Not implemented.

Compliance Status at a glance

Assessment	Number
Fully Implemented	18
Broadly Implemented	12
Partly Implemented	2

methods of voting which are convenient to shareholders. Investor associations can play an active role in providing a platform for co-ordination among investors.

Transparency

Institutional investors need to be encouraged to declare their voting policy and to participate effectively in corporate decision-making. There is a need to prescribe an upper limit on the tenure of independent directors. There is also a need for strengthening the disclosure mechanism to bring about greater transparency in ownership structures to address concerns arising from cross-holding and non-transparent structures.

Enforcement Mechanism

Ownership of companies through cross-holdings and the use of trusts and private companies for owning shares in group companies gives rise to opaque structures. There is, therefore, a need for strengthening the enforcement mechanism by focusing efforts on tracking defaulters or non-compliance by the company, which would act as deterrents for future non-compliance and also boost the confidence of investors in the system.

Appropriate penalties may be provided for in the law for non-compliance pertaining to related-party transactions. Penal provisions for fraudsters may be strengthened in corporate law by providing for the disgorgement of gains and confiscation of assets.

Corporate Governance Code for Unlisted Companies

Unlisted companies are a significant part of the corporate world in India. A number of Indian groups have deliberately moved into the unlisted sector, attracted by less onerous reporting and other requirements and presumably not deterred by potentially lower access to capital. While a strong corporate governance framework is in place for listed companies, there is a need for enhancing the focus on unlisted companies to strengthen the overall system.

Accordingly, it is recommended that a separate Corporate Governance Code for unlisted companies may be brought out under the Companies Act by the Ministry of Corporate Affairs, which takes into account the interests of stakeholders in such companies. Unlisted companies can voluntarily evolve and adopt a code of corporate governance. Trade and Industry Associations like CII, FICCI and ASSOCHAM can play an important role in this regard. The Ministry can also consider mandating, in respect of unlisted companies above a particular size, compliance with applicable provisions of Clause 49 of the Listing Agreement. The role and responsibilities of the Ministry of Corporate Affairs may be crystallised in the Companies Act itself, especially in the case of mergers and amalgamations.

5.11 Deposit Insurance

In India, deposit insurance is offered by the Deposit Insurance and Credit Guarantee Corporation (DICGC) that is fully owned by the Reserve Bank. Deposit insurance is mandatory and covers all banks (commercial/co-operative/RRBs/Local Area Banks (LABs).

Deposit Insurance Fund

To provide *de jure* independence to DICGC, the need for building up a standalone insurance fund assumes importance. A fund, financed solely through premiums paid by insured parties, would incentivise deposit insurance providers to not only perceive a direct stake in the financial health of the insurance system, but also motivate them to scrutinise deposit insurance operations and maintain industry self-policing.

A risk-adjusted premium could prove to be expensive for weak financial entities. An increase in ceiling of flat rate premia could, therefore, be considered to strengthen the deposit insurance fund.

Adequacy of the Deposit Insurance Fund

The adequacy of the Deposit Insurance Fund (DIF) is an important issue for ensuring solvency of the fund and maintaining public confidence in the deposit insurance system. It would be necessary to constantly monitor the DIF and perhaps, if the situation arises, there will be a need to take a view on the issue of raising the premium in order to strengthen the DIF. To ascertain the adequacy of DIF, stress tests were undertaken based on three scenarios for March 2007. The stress tests revealed that under each of the scenarios, the DICGC[10] will be in a position to meet the claims, although in the latter two scenarios the Designated Reserve Ratio (DRR) would drop sharply.

Exemption from Income Tax

Given that the DICGC is acting as a trust for the public at large and small depositors in particular, there is a case for providing exemption from income tax to the Corporation which could be considered by the Government.

Information Sharing

A Committee, comprising the regulatory/supervisory departments of the Reserve Bank and DICGC, should be constituted on a standing basis for regular sharing and exchange of information on regulated entities.

Settlement of Claims

The issue of whether DICGC needs to be involved in the resolution as part of the liquidation process to reduce the time frame to meet the claims of insured depositors needs to be deliberated upon. Delinking the settlement of DICGC's claims from the liquidation process by an amendment to the BR Act and DICGC Act should also be considered.

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[10] **Scenario I**: The average growth in claims settled during the last five years was applied to claims settled for 2006-07. **Scenario II**: Estimation of insured deposit of all the Grade IV UCBs if they were to be liquidated (Grade IV UCBs: banks meeting the following conditions: (a) CRAR less than 50 per cent of the prescribed limit; (b) net NPL of 15 per cent or more as on March 31 of the previous year). **Scenario III**: If the commercial banks which have been amalgamated (during 2003-2006) with other banks were to be liquidated. The assumptions underlying the analysis are as follows: (i) The liability of the Corporation will grow at a rate estimated on the basis of the past five years; (ii) total insured deposit has been taken as the liability of the Corporation on a particular year; (iii) around 60 per cent of the assessable deposit has been taken as the insured deposit, and (iv) while estimating the liability, it is assumed that the assessable deposit and, hence, insured deposit remains constant for the next period as well.

5.12 Review of Anti-Money Laundering (AML)/Combating Financing of Terrorism (CFT)

The financial sector has been brought under the purview of the KYC/AML regime consequent to the enactment of the Prevention of Money Laundering Act (PMLA), 2002 and guidelines issued by the respective regulators for entities regulated by them. Subsequent to assessment by the Asia Pacific Group in 2000, a number of initiatives have been taken by the Reserve Bank, SEBI and IRDA to plug the gaps like issuance of KYC/AML guidelines by the Reserve Bank to the co-operative sector, NBFCs and authorised full-fledged money changers. The recommendations emanating from the present review are: a need to maintain written records of Suspicious Transactions Records (STRs); need to bring money transfer agencies within the ambit of PMLA; need to make requisite amendments to PMLA Rules to make tipping off in the case of STRs a legal offence; and need to make suitable amendments to PMLA, whereby STR on attempted transactions are reported by various financial entities.

5.13 Concluding Remarks

Financial infrastructure contributes to the effective functioning of institutions and markets and thereby to stability; this serves as the foundation for adequate access to financial services and sustained financial development.

An efficient and robust regulatory structure is an essential prerequisite for the stability of the financial system. The current arrangements of the co-ordination among the domestic regulators are assessed to be adequate. But one of the members felt that that formalistion of HLCCFM with a clear mandate is important for timely and effective resolution of a crisis when it occurs. The systemic implications of increased cross-sectoral and cross-border conglomeration of financial companies highlight the need for increased focus on co-ordination and information sharing among regulators. The Reserve Bank could, in the interest of financial stability, be armed with sufficient supervisory powers and monitoring functions in respect of financial conglomerates. Legislation of a new Act to empower the regulator to have regulatory jurisdiction of holding companies is required. The recent international financial turbulence has shown that there is no single fool-proof method of financial regulation and that an ideal system would have elements of both principles-based and rules-based regulation.

There is a consideration that having SROs in the financial sector, albeit with proper safeguards, would add depth and expertise in market operations and reduce the overall cost of regulation. But, there is a need to avoid potential conflicts of interest through safeguards and to have a formal oversight of SROs.

Active liquidity management has been an integral part of the Reserve Bank's monetary operations and is being achieved through various instruments. However, the use of monetary

policy requires to be further honed in order to deal with the impact of external capital flows. Reduction in mandated SLR, acceptance of highly-rated corporate paper for repo and reverse repo purposes, better cash management by the Government and capacity building for better liquidity forecasting are some of the major steps recommended for consideration over time.

Indian Accounting Standards are generally in alignment with International Accounting Standards, except for some modifications to suit local customs, usages and level of development in the country. There has been significant progress in accounting standards; however, some issues remain to be addressed. ICAI needs to be made an autonomous body with its own staff and independent funding. There is a need for developing country- or sector-specific standards where similar standards are not being developed by IASB. Attempts need to be made by ICAI to attain convergence with IFRS at the earliest. Given that India has been a member of IASB since its inception, ICAI could contribute actively to the agenda-setting of IASB. There is a need to put in place mechanisms for monitoring compliance with standards, and ICAI needs to increase the scope and frequency of training programmes on implementation of accounting standards.

India is one of the earliest countries to have adopted International Auditing Standards by amending them to suit Indian requirements. There has been significant progress since ROSC-2004; however, there are some areas which need attention. AASB needs to take steps to attain convergence with International Auditing Standards. It needs to take proactive steps by bringing out more technical guidance and other literature to help small and medium practitioners to understand standards. The functioning of the Quality Review Board should start at the earliest and steps need to be taken to accelerate the process of making the Board of Discipline and Disciplinary Committee functional. The Quality Review Board needs to play a more proactive role as an independent oversight body for the auditing profession in India. The issue relating to non-acceptance of qualified reports from companies needs to be addressed. The principal auditor of the company should have access to the working papers of auditors. There is a need to give functional independence to AASB.

The increased dependence on information technology systems by financial institutions for transactions as well as record maintenance gives rise to a need for proactively managing business continuity. The assessment of compliance to business continuity principles, as applied to select banks, and the payment and settlements systems has indicated that, overall, the systems available in these institutions were in consonance with the requirements. However, certain issues like outsourcing applications, system maintenance and change control and incident response simulation are required to be monitored more closely from the BCM angle. Continuous upgrading of BCM processes as also capacity building of regulators remain areas to be under constant focus.

A smooth and efficient payment and settlement infrastructure plays an important role in maintaining stability in the financial sector. The CFSA acknowledges that significant progress has been made in improving the payment systems infrastructure in India with the introduction of RTGS, High Value Cheque Clearing System, setting up of CCIL as the central counterparty in the government securities, foreign exchange and CBLO segments as also in the settlement of equities transactions. The legal framework for payment and settlement has

also been strengthened by the recent notification of the Payment and Settlement Systems Act and Rules. This has made India largely compliant with international standards and codes in this area. The assessments have, however, highlighted some gaps in the system, particularly with regard to the adequacy of financial resources with CCIL and improving its risk management measures. The current low utilisation of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to customers, thus optimising the use of this infrastructure and achieving greater financial inclusion.

The CFSA notes that though there have been improvements in legal infrastructure in the financial sector like setting up of DRTs and the enactment of the SARFAESI Act, the major concern is that, despite the robust insolvency laws, the time taken for completion of liquidation proceedings is one of the highest in the world and the recovery rate one of the lowest. The operationalisation of the Companies Act (Second Amendment), 2002 will address the current problems relating to delays in completion of liquidation proceedings.

There is a need to review certain provisions in the Competition (Amendment) Act which are likely to raise issues of regulatory overlap/conflict in future and pose a serious problem to the stability of the financial sector. The CFSA considers that a separate insolvency regime for banks and other categories of financial institutions is vital in the context of financial stability, as any abrupt handling of insolvency of such institutions will have a serious contagion effect and repercussions across the economic system that will destabilise economic activity.

In India, there is a comprehensive corporate governance framework in place for listed companies and the listing agreement forms an important pillar of corporate governance framework. There is a need to strengthen the corporate governance framework with regard to risk management in listed companies. Listed companies need to disclose the reasons for non-compliance with non-mandatory requirements. Steps need to be taken to protect the interests of shareholders, such as equitable treatment of all shareholders including minority shareholders and alternate methods of voting, which are convenient for shareholders and in which investor associations can play a constructive role, need to be put in place. There is a need for strengthening the disclosure mechanism to bring about greater transparency in ownership structures and stringent penal action needs to be taken where such practices are unearthed. Penal provisions for fraudsters may be strengthened in corporate law by providing for disgorgement of gains and confiscation of assets. The corporate governance framework needs to evolve with the changing times and there is a parallel need to strengthen the corporate governance framework for unlisted companies.

The coverage limit of deposit insurance offered by the DICGC is comparable to international levels. Stress tests to ascertain the adequacy of the DIF shows that the DICGC

would be in a position to meet the claims even under a worst-case scenario. However, the delay in the failure resolution process and the non-involvement of the DICGC in the failure resolution process remain major concerns. In order to enhance the efficacy of the deposit insurance system in India, it is felt that the pros and cons of DICGC's involvement in the bankruptcy process need to be deliberated upon. Alternatively, delinking of DICGC claims from liquidation proceedings by amendments to the DICGC Act and BR Act should be considered.

Major areas where action needs to be taken to further strengthen AML/CFT practices and align them with international standards are the effective implementation of record-keeping requirements and a robust regime for submission of STRs and inclusion of money transfer agencies in PMLA.

VI. TRANSPARENCY ISSUES

The recent turmoil in the financial markets has brought to the fore the importance of enhanced transparency and disclosure of information to ensure financial stability and effective and smooth functioning of the markets. India has made significant strides in enhancing transparency in monetary and financial policies, fiscal transparency and data dissemination.

6.1 Transparency in Monetary Policy

India is largely compliant with the IMF's Code of Good Practices on Transparency in Monetary Policy. The roles, responsibilities and objectives of the Reserve Bank are well-defined. The Reserve Bank follows an open and consultative approach in formulating monetary policy. The channels of communication in disseminating the policy objectives have improved significantly, with the Reserve Bank's dissemination practices being fully compliant with the IMF's Special Data Dissemination Standards, The summary assessment is given in Table VI.1.

Some of the main issues, however, have come out of the assessment pertaining to review of legislation with regard to the objectives of monetary policy, the issue of operational independence, and the accountability of the Reserve Bank as also the separation of debt management from monetary management.

Review of Legislations

The Reserve Bank has explicit multiple objectives of monetary policy with changing relative emphasis. It also follows a multiple indicator approach, which has been reasonably effective. The present legislative framework provides enough room and manoeuvrability for the Reserve Bank to operate monetary policy in consonance with evolving needs and circumstances. The key element of the framework at present is the flexibility enjoyed by the Reserve Bank while going about its assigned task of maintaining the monetary stability of India. If this advantage is not to be lost, and it should not be, then the objectives ought not to be more stringently framed in legislation, since in that case it may not be possible for the Reserve Bank to adapt its policies flexibly as necessitated by evolving circumstances. Without invoking the rigour of statutory rigidity, which will strait-jacket the Reserve Bank's policies, the current flexibility, to determine the objectives and their relative importance within and consistent with the meaning of the Preamble of the RBI Act, will be a major factor in helping it to conduct monetary policy successfully. Though all of the Reserve Bank's powers are not derived from a single legislation, collectively there is no ambiguity about its role, functions and powers *vis-à-vis* the regulated institutions and markets. It has also been given additional powers through amendments to the RBI Act as well as other legislations, and any need for

Table VI.1: Summary of Assessment of Transparency in Monetary Policy		
No.	**Area/Practices**	**Assessment**
I.	**Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy**	
1.1	Objectives and institutional framework of monetary policy to be defined in legislation	PO
1.1.1	Public disclosure of objectives of monetary policy in legislation	BO
1.1.2	Responsibilities of the central bank to be defined in legislation	O
1.1.3	Legislative authority to the central bank to utilise monetary policy instruments	O
1.1.4	Public disclosure of institutional responsibility for foreign exchange policy	O
1.1.5	Modalities of accountability for conduct of monetary policy and any other responsibilities to be defined in legislation	O
1.1.6	Overriding of central bank policies by the Government	O
1.1.7	Legislative clarity on appointment of central bank top management	PO
1.2	Institutional relationship between monetary and fiscal operations	O
1.2.1	Public disclosure of conditions for granting credits, advances, or overdrafts to the Government	O
1.2.2	Public disclosure of amounts and terms of credits, advances, or overdraft to the Government and deposits of the Government	O
1.2.3	Public disclosure of procedures for central bank participation in primary and secondary markets for government securities	O
1.2.4	Public disclosure of central bank involvement in the rest of the economy	O
1.2.5	Public disclosure of allocation of central bank profits and maintenance of capital	O
1.3	Agency roles performed by central bank on behalf of the Government to be clearly defined	O
1.3.1	Public disclosure of other responsibilities of central bank like fiscal agent to the Government and management of foreign exchange reserves	O
1.3.2	Public disclosure of allocation of responsibilities between the central bank and the Government for primary and secondary issues of government securities	O
II.	**Open Process for Formulating and Reporting Monetary Policy Decisions**	
2.1	Public disclosure of framework, instruments and targets used to pursue objectives of monetary policy	O
2.1.1	Public disclosure of procedures and practices governing monetary policy instruments	O
2.1.2	Public disclosure of rules and procedures for central bank's relationship with counterparties in its monetary operations	O
2.2	Public disclosure of the composition, structure and functions of a permanent monetary policy-making body	NA
2.2.1	Public disclosure of advance meeting schedule of the policy-making body	NA
2.3	Public disclosure of changes in the setting of monetary policy instruments	O
2.3.1	Public disclosure of main considerations underlying its policy decisions	O
2.4	Issue of periodic public statements on progress towards achieving policy objectives	O
2.4.1	Central bank to present policy objectives to public specifying *inter alia* their rationale, quantitative targets, instruments and assumptions	O
2.4.2	Issue of a report on the evolving macroeconomic situation and its implications for policy objectives	O

2.5	Public consultations for proposed substantive technical changes to the structure of monetary regulations	O
2.6	Public disclosure of regulations on data reporting by financial institutions to the central bank	O
III.	**Public Availability of Information on Monetary Policy**	
3.1	Central bank data disclosures to be compliant with IMF's SDDS	O
3.2	Public disclosure of central bank balance sheet on a pre-announced schedule and information on aggregate market transactions	O
3.2.1	Public disclosure of summary central bank balance sheet on a frequent and pre-announced schedule	O
3.2.2	Public disclosure of information on central bank's monetary operations on a pre-announced schedule	O
3.2.3	Disclosure of emergency financial support by central bank	PO
3.2.4	Public disclosure of a country's foreign exchange reserve assets, liabilities and commitments by the monetary authorities on a pre-announced schedule	O
3.3	Central bank to maintain public information services	O
3.3.1	Central bank to have a publications programme including an Annual Report	O
3.3.2	Senior central bank officials to explain the institutional objectives to the public	O
3.4	Public availability of texts of regulations issued by the central bank	O
IV.	**Accountability and Assurances of Integrity by the Central Bank**	
4.1	Central bank officials to appear before a designated public authority to report on the conduct of monetary policy	O
4.2	Public disclosures of audited financial statements of its operations on a pre-announced schedule	O
4.2.1	Public disclosure of information on accounting policies and independent audit of the financial statements	O
4.2.2	Public disclosure of internal governance procedures	O
4.3	Public disclosure of information on expenses and revenues in operating the central bank	O
4.4	Public disclosure of standards for the conduct of the staff of the central bank	O
4.4.1	Public disclosure of information about legal protection for officials of the central bank	O

Memo Items:

Assessment	I	II	III	IV	Total
O	14	10	9	7	40
BO	1	–	–	–	1
PO	2	–	1	–	3
NA	–	2	–	–	2

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

additional powers may not require an overhaul of the present legislative framework but can be addressed through amendments as required. The Reserve Bank has wide-ranging statutory powers of extending central bank money to banks as the lender of last resort, including to any individual entity in extraordinary circumstances. Therefore, a legislative amendment to specify the objectives of monetary policy is not considered necessary at this juncture. However, one member of the CFSA felt that instead of multiple objectives, the Reserve Bank should primarily have the objectives of price stability, financial stability and growth.

The issue of regulatory overlap has come in for some discussion in recent times. It is argued that such overlap tends to confuse the markets. While the point is well-taken, it may nevertheless not be possible to fully remove the overlap in financial regulation and supervision *vis-à-vis* the Government, as the roles of the Government in these respects are founded in the Indian Constitution. If necessary, further amendments could be considered to the BR Act to bring it in alignment with modern banking and financial practices**.**

The presence of representatives of the Reserve Bank on the boards of the regulated entities may be avoided in normal circumstances, but they may need to be placed on the boards in the case of re-structuring, moratorium and other exceptional circumstances emanating from weakness of the entities. Hence, the legal provision, as an enabling provision for the presence of such representatives, needs to be retained.

Operational Independence

As far as the issue of operational independence of the central bank is concerned, the Reserve Bank enjoys independence *vis-à-vis* the executive arm of the state through conventions, agreements and MoUs in specific areas.

The specification of procedures and reasons for the removal of the Governor/Deputy Governor as also for supersession of the Board could potentially lead to the loss of well-established *de facto* independence. Any modifications that might be required to strengthen monetary policy as also the regulatory framework might be carried out by necessary amendments to existing legislations as needed, which would not call for a fundamental review of legislations or an overhaul of the existing legal framework.

The policies of the Reserve Bank need to be consistent with public policy and, where consultations with the Government are needed, the existing formal and informal arrangements for consultations ensure that in practice, the central bank is *de facto* independent. It would be impractical to record such processes of consultations and is also not desirable to do so. [One member of the CFSA felt that though the system of achieving operational autonomy through *de facto* means rather than *de jure* means has worked well so far, situations might arise when the independence and autonomy of the Reserve Bank may be circumscribed by the executive. To guard against such eventualities, the member recommended that all the issues relevant for securing *de jure* independence of the Reserve Bank may be considered for formalisation.]

Separation of Debt Management

Following the announcement in the Union Budget 2007-08, the Central Government is proceeding with the establishment of a Middle Office, as a prelude to setting up of a full-fledged Debt Management Office (DMO).

The Government is in favour of proceeding with the setting up a full-fledged DMO for the following reasons: (i) With the enactment of the FRBM Act, the basic source of conflict of interest has been removed. In the interest of prudent macro-economic and fiscal management, it is better for the Government to adopt a responsible fiscal policy and face the real market cost of funding. (ii) The stipulations with respect to mandatory investment in 'SLR' (government) securities, helps the Government to finance its fiscal deficit at costs that are perhaps lower than they would otherwise be. These mandatory requirements could also inhibit the natural development of the bond market. As the economy and financial markets develop over time, such requirements can be expected to come down. Government debt issuance and management will then need more intense engagement with the market participants and with investors in particular. Professional competence in a DMO will then be absolutely necessary. (iii) The issue of harmonising the functions of debt management and forex intervention in the interest of preserving financial stability can be addressed in the design of the DMO, by ensuring adequate, immediate and continuing channels of communication between the proposed DMO and the Reserve Bank. (iv) The development of the securities market has to be a collective effort between the Government, and all the financial market regulators. Though, it can be argued that the two roles of providing price and financial stability and of developing markets should be separated, mixing the two roles can lead to inadequate or tardy development of the government securities market. (v) As far as staffing issues are concerned, the DMO can hire from the Reserve Bank and from the market. (vi) Competition may improve public debt management. The states should be given a choice of debt managers: they can remain with the Reserve Bank or move to the DMO.

While most members of the CFSA concurred with the proposal to set up a DMO, one member felt that the DMO should be an independent body. The Chairman, personally viewed that the time is not ripe for the complete separation of debt management at the current juncture for the following reasons: (i) the high level of fiscal deficit along with an extremely high level of overall government debt to GDP ratio; (ii) setting up the DMO under the Government may lead to a conflict of interest between the Government's role as a debt manager and its status as the owner of a substantial portion of the banking sector; iii) even after separating the debt and monetary management roles, the management of government debt, regulation of the banks and monetary policy will continue to be inter-linked; (iv) the difficulty in harmonising the operations of debt issue redemptions, SLR maintenance and MSS, as is being done at present; (v) practical difficulties in setting up new government authorities; (vi) the Reserve Bank has the advantage of the large size of its staff and expertise developed in managing, *inter alia,* debt management operations; and (vii) it may not be appropriate for a Central Government authority to also do State Government debt management.

The Chairman, however, supported the need for a well-structured Middle Office that could help debt management, as a whole.

Price Index for Measuring Inflation

The accurate measurement of inflation is critical. The issue has come in for a great deal of discussion in recent years, both at the formal and informal levels. A suggestion has been made that India needs only one index of inflation rather than the multiple indices it currently employs. However, given the economic and demographic diversity that exists in India, a combination of different measures of inflation gives useful information on diverse aspects that is found to be meaningful in formulating an appropriate policy. Relying on a single index might result in loss of information on some crucial sectors and might be less useful in tackling the diversity of issues. Though price stability is a dominant objective of monetary policy, switching over to the CPI as the only inflation indicator is not an immediate imperative. In India, many data series such as on unemployment rate, labour productivity, capacity utilisation, inflation expectations and housing prices and volumes are yet to be made available. The weekly WPI data gives a feel of the economic dynamics with a shorter lag than the CPI. Until a system is in place to generate the above-mentioned data to help in monetary policy formulation, giving up the weekly compilation of WPI is not advisable.

Role of Technical Advisory Committee on Monetary Policy (TACMP)

Over the last decade or so, central banks have increasingly adopted a more consultative process for the formulation of monetary policy. India adopted this practice through structured pre-policy consultations with various stakeholders and the TACMP was set up in July 2005, keeping in mind that there may be a move towards collegial decision-making in future. The members of the Committee are not appointed on a full-time basis, and, as such, they cannot be made accountable for decisions. Furthermore, unlike many inflation-targeting countries, no particular decision like setting of a short-term interest rate rests with the Committee. The issue of making the discussions at the TACMP public can be considered and can be done when it is considered desirable. Under the current circumstances and given the ambit within which TACMP provides its advice, the need for strengthening the role of TACMP should be kept in view and practices/procedures towards this goal could be considered as it gains more experience.

Role of the Reserve Bank in the Foreign Exchange Market

In a globalised economy, the foreign exchange market plays a very important role. Whether or not a central bank should intervene in it has been the subject of academic debate and lay discussion for several years. Interventions made by the Reserve Bank in the foreign exchange market are mainly to contain excessive volatility. The policy on exchange rate management is transparently stated and it is consistent with current monetary policy objectives.

6.2 Transparency in Financial Policies

The assessment of transparency in financial policies has revealed that all three major regulators in the financial sector, namely, the Reserve Bank, SEBI and IRDA are compliant

with the relevant standards. No significant weaknesses have been identified with respect to transparency practices in banking supervision, securities supervision or insurance supervision. At present, co-operation and information-sharing between the Reserve Bank and other regulators is handled by a High Level Co-ordination Committee on Financial Markets (HLCCFM). Any move to institutionalise the HLCCFM could prove to be counter-productive as it could reduce flexibility in the formulation of financial policies; however, the present information-sharing mechanism could be improved. The summary assessment of transparency in financial policies is given in Table VI.2.

Most financial sector regulatory laws in India appear to be formulated in favour of transparency. In this regard, the laws governing SEBI and IRDA are relatively new and designed to provide a higher degree of operational transparency than the laws that are of older provenance.

Dispute Resolution Mechanism

In order to resolve disputes between participants in the government securities market, a formal dispute resolution mechanism needs to be put in place.

Information Disclosure

SEBI, along with the stock exchanges and other regulators, should invest in technology to ensure that all the information they receive from the companies, market intermediaries (such as brokers) and mutual funds are treated as public goods and disseminated on a real-time basis to the public without any privileges to any special bodies. Embargo for data releases, if any, should be for a specified time period and exceptions, if any, to this stance on information dissemination should be explained on the official website of the regulator.

6.3 Fiscal Transparency

Constitutional provisions govern the functional responsibilities and *inter se* relationships among different tiers of governments. There has been significant improvement in the practices adopted by the Centre and State Governments in enhancing fiscal transparency with the enactment of the FRBM Act in 2003 and the Fiscal Responsibility Legislations (FRLs) by the states. A summary assessment of adherence to fiscal transparency standards by the Central and State Governments is given in Table VI.3.

The Central Government is largely compliant with the IMF's Code of Good Practices on Fiscal Transparency, while the State Governments have some way to go before achieving full compliance with the standards.

The structure of the Government in India at the various levels, *viz.*, Centre, states and local authorities, their responsibilities and the relationship between the Government and the rest of the economy are clearly defined under the Indian Constitution and are publicly

Table VI.2: Summary of Assessments of Transparency in Financial Policies				
No.	**Area/Practices**	**Assessment**		
		RBI	**SEBI**	**IRDA**
V.	**Clarity of Roles, Responsibilities and Objectives of Financial Agencies**			
5.1	Objectives and institutional framework of financial agencies to be defined in legislation	O	O	O
5.1.1	Public disclosure of broad objectives of financial agencies in legislation	O	O	O
5.1.2	Public disclosure of responsibilities of financial agencies and authority to conduct financial policies	O	O	O
5.1.3	Public disclosure of modalities of accountability for financial agencies	O	O	O
5.1.4	Public disclosure of procedures for appointment and removal of members of the governing bodies of financial agencies	PO	O	O
5.2	Public disclosure of relationship between financial agencies	PO	O	O
5.3	Public disclosure of role of payment systems	O	NA	NA
5.3.1	Public disclosure of policy principles by agencies overseeing payment systems	O	NA	NA
5.4	Public disclosure of relationship between financial agencies and SROs	O	O	O
5.5	SROs performing regulatory and supervisory functions to be guided by same good transparency policies as specified for financial agencies	O	O	NA
VI.	**Open Process for Formulating and Reporting of Financial Policies**			
6.1	Transparency in conduct of policies by financial agencies	O	O	O
6.1.1	Public disclosure of regulatory framework and operating procedures governing conduct of financial policies	O	O	O
6.1.2	Public disclosure of regulations for financial reporting	O	O	O
6.1.3	Public disclosure of regulation for the operation of organised financial markets	O	O	NA
6.1.4	Public disclosure of structure of fees charged by financial agencies to financial institutions	O	O	O
6.1.5	Public disclosure of procedures for information-sharing and consultation between financial agencies	PO	O	O
6.2	Public disclosure of significant changes in financial policies	O	O	O
6.3	Issue of periodic public reports on how policy objectives are pursued by financial agencies	O	O	O
6.4	Public consultations before proposed substantive technical changes to the structure of financial regulations	O	O	O
VII.	**Public Availability of Information about Financial Policies**			
7.1	Issue of a periodic public report on the major developments of the sectors of the financial system by financial agencies	O	O	O
7.2	Public reporting of aggregate data related to jurisdictional responsibilities on a timely and regular basis	O	O	O
7.3	Public disclosure of balance sheet on a pre-announced schedule and information on aggregate market transactions	O	O	O

7.3.1	Public disclosure of emergency financial support by financial agencies	PO	NA	NA
7.4	Financial agencies to establish and maintain public information services	O	O	O
7.4.1	Financial agencies to have a publications programme including a periodic report on their principal activities	O	O	O
7.4.2	Senior officials to disclose institution's objectives and performance to the public	O	O	O
7.5	Public availability of texts of regulations and other directives issued by financial agencies	O	O	O
7.6	Public disclosure of deposit insurance schemes and other client asset protection schemes, its procedures and performance	O	O	NA
7.7	Public disclosure of information on consumer protection arrangements	O	O	O
VIII.	**Accountability and Assurances of Integrity by Financial Agencies**			
8.1	Officials of financial agencies to appear before a designated public authority to report on the conduct of financial policies	O	O	O
8.2	Public disclosures of audited financial statements on a pre-announced schedule	O	O	O
8.2.1	Public disclosure of information on accounting policies and independent audit of the financial statements	O	O	O
8.2.2	Public disclosure of internal governance and internal audit procedure	O	O	NO
8.3	Public disclosure of information on operating expenses and revenues	O	O	O
8.4	Public disclosure of standards for the conduct of the officials and staff of financial agencies	O	O	O
8.4.1	Public disclosure of information about legal protection for officials of financial agencies in the conduct of official duties	O	O	O

Memo Items:

Assessment	**RBI**	**SEBI**	**IRDA**
O	32	33	29
BO	–	–	–
PO	4	–	–
NO	–	–	1
NA	–	3	6

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable; NO - Not Observed.

Table VI.3: Summary of Assessments – Fiscal Transparency

No.	Area/Practices	Assessment	
		Centre	States
I.	**Clarity of Roles and Responsibilities**		
1.1	**Distinguishing the government sector from the rest of the public sector and rest of the economy**		
1.1.1	Clarity in structure and functions of government	O	O
1.1.2	Fiscal powers of executive, legislative and judiciary to be well-defined	O	O
1.1.3	Relationship and responsibilities of different levels of government to be clearly specified	PO	PO
1.1.4	Clarity in relationships between the Government and public corporations	O	PO
1.1.5	Clarity in government's relationships with the private sector	O	PO
1.2	**Clear and open legal, regulatory, and administrative framework**		
1.2.1	Comprehensive budget, tax, and other public finance laws for collection and use of public funds	O	O
1.2.2	Clarity of laws and regulations related to the collection of revenues	O	BO
1.2.3	Time for consultation about proposed laws and regulatory changes	O	O
1.2.4	Clarity in contractual arrangements between the Government and public or private entities	O	O
1.2.5	Legal basis for government's liability and asset management	O	O
II.	**Open Budget Processes**		
2.1	**Timetable for budget preparation**		
2.1.1	Budget calendar should be specified and adhered to	O	O
2.1.2	The annual budget should be realistic, and prepared and presented within a comprehensive medium-term macroeconomic and fiscal policy framework.	O	BO
2.1.3	Description of major expenditure and revenue measures	O	BO
2.1.4	Assessment of fiscal sustainability and clarity on assumptions about economic developments and policies	BO	BO
2.1.5	Clear mechanisms for the co-ordination and management of budgetary and extra-budgetary activities within the overall fiscal policy framework	O	O
2.2	**Clear procedures for budget execution, monitoring, and reporting**		
2.2.1	The accounting system should provide a reliable basis for tracking revenues, commitments, payments, arrears, liabilities, and assets	PO	PO
2.2.2	Presentation of timely midyear report on budget developments to the Legislature	O	BO
2.2.3	Presentation of supplementary revenue and expenditure proposals during the fiscal year to the legislature	O	O
2.2.4	Presentation of audited final accounts and audit reports to the legislature	O	O
III.	**Public Availability of Information**		
3.1	**Public disclosure of information on past, current, and projected fiscal activity and major fiscal risks**		
3.1.1	Budget documentation to cover all budgetary and extra-budgetary activities of the Central Government	O	O
3.1.2	Disclosure of forecasts and sensitivity analysis for the main budget aggregates for at least two years following the Budget	PO	PO
3.1.3	Nature and fiscal significance of Central Government tax expenditures, contingent liabilities, and quasi-fiscal activities to be part of the budget documentation	PO	PO
3.1.4	Receipts from all major revenue sources, including resource-related activities and foreign assistance, should be separately identified	O	O
3.1.5	Publish information on the level and composition of debt and financial assets, significant non-debt liabilities, and natural resource assets	O	PO
3.1.6	The budget documentation should report the fiscal position of sub-national governments and the finances of public corporations	BO	NO
3.1.7	The government should publish a periodic report on long-term public finances	O	PO
3.2	**Fiscal information should be presented in a way that facilitates policy analysis and promotes accountability**		
3.2.1	A clear and simple summary guide to the budget should be widely distributed at the time of the annual budget	O	O
3.2.2	Fiscal data should be reported on a gross basis, distinguishing revenue, expenditure, and financing, with proper expenditure classification	O	PO

3.2.3	The overall balance and gross debt of the general government, or their accrual equivalents, should be standard summary indicators of the government's fiscal position	O	NO
3.2.4	Results achieved relative to the objectives of major budget programs should be presented to the legislature annually	O	PO
3.3	**Timely publication of fiscal information**		
3.3.1	The timely publication of fiscal information should be a legal obligation of government	O	O
3.3.2	Advance release calendars for fiscal information should be announced and adhered to	O	PO
IV.	**Assurances of Integrity**		
4.1	**Fiscal data should meet accepted data quality standards**		
4.1.1	Budget forecasts and updates should reflect recent revenue and expenditure trends, underlying macroeconomic developments, and well-defined policy commitments	O	BO
4.1.2	The annual budget and final accounts should indicate the accounting basis used in the compilation and presentation of data	BO	PO
4.1.3	Data should be internally consistent and reconciled with relevant data from other sources. Major revisions to be explained	BO	PO
4.2	**Fiscal activities should be subject to effective internal oversight and safeguards**		
4.2.1	Ethical standards of behavior for public servants should be clear and well-publicised	O	O
4.2.2	Public sector employment procedures and conditions should be documented and accessible to interested parties	O	O
4.2.3	Procurement regulations, meeting international standards, should be accessible and observed in practice	O	PO
4.2.4	Purchases and sales of public assets should be undertaken in an open manner, and major transactions should be separately identified	O	O
4.2.5	Government activities and finances should be internally audited, and audit procedures should be open to review	O	O
4.2.6	The national revenue administration should be legally protected from political direction, and report regularly to the public on its activities	O	O
4.3	**Fiscal information should be externally scrutinised**		
4.3.1	Public finances and policies should be subject to scrutiny by a national audit body	O	O
4.3.2	The national audit body to submit all reports, including its annual report, to the legislature and publish them	O	O
4.3.3	Independent experts to assess fiscal forecasts, the macroeconomic forecasts on which they are based, and their underlying assumptions	PO	PO
4.3.4	A national statistical body should be provided with the institutional independence to verify the quality of fiscal data	O	O

Memo Items:

Assessment	**Centre**				**States**			
	I	**II**	**III**	**IV**	**I**	**II**	**III**	**IV**
O	9	7	10	10	6	4	4	8
BO	–	1	1	2	1	4	–	1
PO	1	1	2	1	3	1	7	4
NO	–	–	–	–	–	–	2	–

O – Observed; BO – Broadly Observed; PO – Partly Observed; NO – Not Observed.

disclosed. The budgetary process has a legal basis and follows the regulatory and administrative framework for fiscal management. There is a well-established internal audit system in all Central Government departments. The pre-Budget Economic Survey and Budget documents provide past, current and projected information on fiscal indicators. Under the FRBM Act, the Central Government is setting forth a one-year rolling target for prescribed fiscal indicators with specification of underlying assumptions.

Some of the major observations and recommendations following the assessment are:

(i) Functional overlaps by the Central Government on the functional domain of states in some important spheres like health and agriculture has led to a deterioration in the quality of governance, hampering timely responses to external shocks, and negates the purpose of defining separate spheres of responsibility. Such functional overlaps need to be minimised or properly institutionalised, so that the roles of the Central and State Governments are clearly defined in practice and accountability is appropriately established.

(ii) A clear channel needs to be established as part of the implementation process of the Finance Commissions' recommendations. To enhance transparency of Finance Commission awards, the revenue-sharing calculations must be placed in the public domain.

(iii) To reduce delays by the Governments in honouring payments to various entities and individuals, there is a need for formally including such provisions as part of legal contracts along with suitable recourse mechanisms. Public-private partnership (PPP) documents should include time-limits within which payment obligations should be honoured.

(iv) There are discrepancies in reporting of liabilities and deficit at various levels, particularly borrowings by public sector units (PSUs), and there is scope for improvement in transparent fiscal reporting on these matters.

(v) All states should set up State Finance Commissions and ensure timely submission of reports and report compliance, along with the rationale for rejecting any of the recommendations.

(vi) A common reporting framework for compensation and assignments to local bodies applicable to all states should be developed. Transfers of funds devolved to local levels should also be reported separately for rural and urban local bodies. State Governments should provide economic and functional classification of expenditures annually in a systematic manner. A Working Group needs to be set up to address the issue of discrepancies in fiscal data reported by various data disseminating agencies. The Group should also analyse the reasons for such discrepancy, like consistency in definition, approach or time lag.

(vii) The mode of calculating the fiscal deficit does not at present capture the impact of off-budget items or provide such figures separately. The gross fiscal deficit reported in the budget document needs to be accompanied by an augmented fiscal deficit to capture off-budget items, such as oil bonds, Food Corporation of India bonds and fertiliser bonds. The Thirteenth Finance Commission is looking into these issues.

(viii) The budget documents do not cover the actual audited expenditure statement, which comes out with a lag of about six to nine months. Efforts should be made by both Central and State Governments to reduce this time lag and increase the frequency of financial disclosures. Expenditure on all government-funded schemes, along with a description of what they propose to achieve, should be available on a yearly basis with progressive actual expenditure on each scheme. Though these details are available in the Annual Reports/Outcome Budgets of separate Ministries to which the schemes pertain, comparable time-series information should also be made available for the preceding years, so that it is not difficult to monitor yearly actual expenditure on these schemes.

(ix) The budgetary structure in India does not, at present, adequately convey the functional content of each budget head category. Consideration may be given to appoint a Working Group to restructure and rationalise the budget head structure for reporting expenditures. The revised budget head structure should be made binding on Central and State Governments.

Accrual-based Accounting

The CFSA notes that the recommendation of the Twelfth Finance Commission to move from cash-based accounting towards accrual-based accounting was in principle accepted by the Government. While accrual accounting provides more comprehensive, accurate and reliable financial information and promotes better transparency, switching over to accrual accounting requires a huge investment in skill development as also better availability of fiscal information.

There should not be any hasty move towards accrual-based accounting, which should be attempted only in phases after ascertaining the benefits and costs of so doing and preparing a strong ground in terms of skills and awareness at all levels. However, this should not preclude Governments from removing serious distortions caused by cash-based fiscal reporting on account of factors such as deferment of payment of subsidies through issue of bonds.

Fiscal Reporting and Monitoring

The fiscal reporting and monitoring at the Centre and at state-levels could be further enhanced by providing sensitivity analysis for fiscal projections, with respect to the underlying parameters assumed and quantification of fiscal risks.

There is a need to reconcile discrepancies in the fiscal data reported by various data disseminating agencies and also to restructure and rationalise the budget head structure for reporting expenditures.

The public capital outlay in any state is an aggregate of State Government-funded outlays, and outlays funded directly by the Central Government that are not all routed through the State Exchequer. There is a significant time lag in availability of the combined finance accounts for the Central Government and State Governments due to the delay in finalising the state accounts, which makes the public capital outlay in a state difficult to quantify. The Working Group on budget heads should also address this issue specifically.

6.4 Data Dissemination

India was among the first set of countries that subscribed to the IMF's Special Data Dissemination Standards (SDDS).

A Commission set up by the Government in January 2000 under the Chairmanship of Dr. C. Rangarajan recommended the setting up of the National Statistical Commission (NSC) to serve as a nodal and empowered body for all core statistical activities of the country, to evolve, monitor and enforce statistical priorities and standards and to ensure statistical co-ordination among the different agencies involved. The NSC was consequently set up in July 2006.

On assessment, it was found that India is compliant with the SDDS and exceeds the requirements under the code in several areas. A recent improvement in India's disclosures was in May 2007, when the Central Statistical Organisation (CSO) for the first time released quarterly estimates of expenditure components of the GDP in current and constant (1999-2000) prices. However, the assessment has highlighted the lacunae in certain areas in the official data collection machinery under the Data Quality Assessment Framework and has made recommendations to address these issues. A summary of compliance with the Data Quality Assessment Framework is given in Table VI.4.

Prior to liberalisation, statistical data were obtained by government agencies through powers and authority granted to the administrative machinery by various legislations. With the reform process initiated since the early 1990s, this aspect has weakened and data submission is mainly voluntary. There has also been a significant expansion in the role of the services sector in the economy, whose data is not adequately captured at present. There is a need for a collaborative arrangement between the Central and State Governments in generating accurate and reliable industrial data. The quality of the agricultural data has also become worse with the weakening of the land revenue system and the consequent unreliability of the estimates of land use. There is also a need to supplement the national statistics with state-level statistics, which would allow comparable analysis of economic problems and performance at the state level. Better co-ordination between the CSO and the central ministries involved in data collection, as also between the state statistical bureaus and the ministries in the states, is needed.

Central Statistical Organisation

There is a need to strengthen the CSO in the compilation of national accounts statistics and Index of Industrial Production (IIP). It should be well-supported by the legal and institutional environment.

With liberalisation and reforms, several of the traditional links that compiled and provided statistics to the CSO have deteriorated. Generally, the accuracy and reliability of the

Table VI.4: Data Quality Assessment Framework – Summary of Results

	Element	National Accounts	WPI	CPI-IW	Government Finance Statistics	Monetary Statistics	Balance of Payments
0.	**Pre-requisites of quality**						
0.1	Legal & institutional environment	LO	LO	O	LNO	O	LO
0.2	Resources	LO	O	O	LO	O	O
0.3	Relevance	LO	O	O	LO	O	O
0.4	Other quality management	O	O	O	O	O	O
1.	**Integrity**						
1.1	Professionalism	O	O	O	O	O	O
1.2	Transparency	O	LO	O	LO	O	O
1.3	Ethical standards	O	O	O	O	O	O
2.	**Methodological Soundness**						
2.1	Concepts & definitions	LO	LO	O	LNO	O	LO
2.2	Scope	LO	O	LNO	LO	O	O
2.3	Classification/Sectorisation	LO	O	O	O	O	O
2.4	Basis for recording	LO	O	O	O	O	O
3.	**Accuracy and Reliability**						
3.1	Source data	LNO	LO	LO	O	O	O
3.2	Assessment of source data	LNO	LNO	O	O	O	O
3.3	Statistical techniques	LNO	O	LO	O	O	O
3.4	Assessment and validation of intermediate data and statistical outputs	O	O	O	O	O	O
3.5	Revision studies	LO	O	O	LO	O	LO
4.	**Serviceability**						
4.1	Timeliness and periodicity	O	O	O	LO	O	O
4.2	Consistency	LO	O	O	O	O	O
4.3	Revision policy and practice	LO	O	LO	LO	O	O
5.	**Accessibility**						
5.1	Data accessibility	LO	O	O	LO	O	O
5.2	Metadata accessibility	LO	LO	O	LNO	O	O
5.3	Assistance to users	LO	LO	O	LO	O	O

O – Observed; LO – Largely Observed; LNO – Largely Not Observed; NO – Not Observed.

Compliance at a glance

Assessment	National Accounts	WPI	CPI-IW	Government Finance Statistics	Monetary Statistics	Balance of Payments
Observed	6	15	18	10	22	19
Largely Observed	13	6	3	9	–	3
Largely Not Observed	3	1	1	3	–	–
Not Observed	–	–	–	–	–	–

expenditure side of the GDP is much lower than that of the production side. There is a need to substantially improve the accuracy of expenditure-side statistics of the national accounts.

There are also several gaps in the statistical techniques used by the CSO. The statistical techniques need greater independent review, so that the CSO can make appropriate changes in its techniques. Advance notice may also be given for major changes in methodology, source data and statistical techniques. The CSO may study and analyse its revisions and make such studies public to help users understand the revisions better.

The CSO should assume direct responsibility for the generation of the IIP. It should create the frame, select the sample and collect the data directly from the units. In the process of consolidation of the source agencies, it should reduce its reliance on the administrative machinery and industry associations and strengthen its own direct capabilities. The CSO can further improve the transparency of the IIP if it also reveals the size (number) of units in the frame, the sample size and the monthly response rate for each item of the IIP. The IIP needs to adjust its basket of commodities and the weights assigned to these quicker than it currently does. The publication of the response rate with each release would also enable users to anticipate changes in the estimates and appreciate the revisions when they occur.

Central Government

There are multiple agencies involved in the measurement of employment, unemployment and wages in India. In spite of a proliferation of agencies, India does not provide a single comprehensive and reliable estimate of any of the three basic measures of labour markets – employment, unemployment and wages – on a regular basis with an acceptable periodicity or timeliness. The fragmented efforts in the compilation of statistics relating to the labour markets should be consolidated under one institution that is adequately empowered to undertake this task comprehensively and effectively. The CSO, as the premier statistical agency of the country, is the most appropriate agency to undertake this responsibility with the help of the National Sample Survey Organisation (NSSO).

Statistics should be compiled by professional statistical agencies that deploy appropriate statistical methodologies rather than by the administrative arms of the Government through voluntary or statutory compliance of legislations.

The Wholesale Price Index (WPI) provides only the index and not the price, which limits the utility of the WPI. In the interests of increasing the transparency and application of the WPI, the practice of providing the prices underlying the creation of the indices needs to be restored.

The Labour Bureau in the generation of the Consumer Price Index- Industrial Workers (CPI-IW) and the Office of Economic Advisor in the Ministry of Commerce and Industry in the generation of the WPI should improve their transparency substantially by revealing the number of respondents in the frame, the monthly response rates, the revision in the responses and the policies they follow with respect to revisions. This information may also be made public for a fair assessment of the credibility of the price indices.

The WPI suffers seriously from outdated weights. The base year used for compiling WPI is 1993-94. Infrequent updating of weights leads to the use of outdated weights in the

indices. It also often excludes new products for the same reason. There should be frequent updating of weights in the compilation of the WPI. The Abhijit Sen Committee, formed in 2004, has recommended a changeover to a monthly index in the WPI in line with standard practice in other countries. Accordingly, the Government plans to release a revised WPI with 2004-05 as the base year from 2009.

Reserve Bank of India

India does not provide any forward-looking indicators as part of SDDS. The Reserve Bank conducts quarterly surveys on capacity utilisation and order-book positions. This information could possibly be used to develop a full set of forward-looking indicators and disseminated.

There is no formal law or arrangement assigning responsibility for the collection, processing and dissemination of data relating to balance of payments with the Reserve Bank. Thus, data collection is a function of the regulations in force and is vulnerable to possible changes in the future. Data collection may suffer as it did in the case of the Index of Industrial Production and the WPI. Arrangements could be made by the Reserve Bank so that the data is collected through a more professional and sustainable system.

6.5 Concluding Remarks

The recent turmoil in the financial markets has brought to the fore the importance of enhanced transparency and disclosure of information to ensure financial stability and effective and smooth functioning of the markets. India has made significant progress in enhancing transparency in monetary and financial policies, fiscal arena and data dissemination. There are some areas where further transparency and disclosure can be achieved.

The main issues that have come out of the assessment of transparency in monetary policy pertain to the review of legislations with regard to the objectives of monetary policy, the issue of operational independence and accountability of the Reserve Bank and the separation of debt management and monetary management. The CFSA feels that an overhaul of legislation may not be appropriate at the current juncture. The CFSA endorses the move to set up the Middle Office as the DMO within the Ministry of Finance to conduct both internal and external debt management, as a measure that will improve risk management.

The Reserve Bank, SEBI and IRDA are compliant with the relevant standards in transparency in financial policies. Any move to institutionalise the HLCCFM could prove to be counter-productive as it could reduce flexibility in the formulation of financial policies; however, the present information-sharing mechanism could be improved.

The major area of concern arising out of the assessment of fiscal transparency is in the reporting of off-budget items, like oil bonds, and the need to have an augmented fiscal deficit figure to capture these items. Likewise, any move towards accrual accounting should also be attempted in a gradual manner.

There has been significant improvement in the data dissemination practices of various agencies, namely, the Central Statistical Organisation, the Office of the Economic Adviser in the Ministry of Commerce and Industry and the Reserve Bank. There is an urgent need to strengthen the functioning and data dissemination practices of the CSO, which had weakened after data submission became a voluntary process. There is also a need to consolidate the process of compiling labour data and this should be done by a professional statistical organisation. As far as price indices are concerned, updating the weights and inclusion of new products in the basket of goods needs to be expedited.

VII. DEVELOPMENT ISSUES IN THE SOCIO-ECONOMIC CONTEXT

A stability assessment of the financial sector should also address key development issues that have a bearing on the fair and efficient functioning of financial institutions and markets and the legal/institutional infrastructure. In India, there are broader development aspects in the socio-economic context, which affect social stability and have an indirect bearing on financial stability.

The social challenge of growth and development goes beyond aspects of human deprivation such as illiteracy, malnutrition, drinking water and sanitation to encompass elements related to economic deprivation which, in the context of the current assessment, are areas like financial inclusion, customer service, and access to finance for small-scale industries (SSIs). Thus, social stability is very important and has an indirect bearing on financial stability.

Financial inclusion is one of the major determinants of economic growth. Higher economic growth and infrastructure, in turn, play a crucial role in promoting financial inclusion. In order to achieve the objective of growth with equity, it is imperative that infrastructure is developed in tandem with financial inclusion, as this would facilitate and enhance credit absorptive capacity.

Bank nationalisation in India marked a paradigm shift in the focus of banking from class banking to mass banking. The co-operative sector and regional rural banks (RRBs) are other major conduits in the banking sector to promote financial inclusion. Post offices are another major institution that provide bank-like facilities to less affluent segments of the population. There is a need to expand access to insurance by the rural and urban poor.

The focus of financial inclusion in India has progressed from ensuring bare minimum access to a no-frills savings bank account for the unbanked population to the concept of 'Total Financial Inclusion'.

The entire range of recommendations of the Rangarajan Committee on Financial Inclusion needs to be reviewed and implemented in a phased manner in order to promote and achieve financial inclusion.

Financial inclusion can be enhanced through products tailored to the needs of small borrowers. However, for such initiatives to be successful, a credit culture needs to be imbibed by the unbanked population especially in semi-urban and rural areas through the creation of a conducive climate. Banks should scale up IT initiatives for financial inclusion at a greater speed, while ensuring that solutions are highly secure, amenable to audit, and follow widely-accepted open standards to ensure eventual inter-operability among the different systems.

Business correspondents (BCs) may be suitably incentivised to popularise the process by making them aware of intangible synergies, taking into account both risks and returns from a longer-term perspective.

A possible approach towards greater financial inclusion could be to explore new design principles by segregating customer handling, risk orientation, risk measurement, risk transfer and risk aggregation.

Exploitation of synergies between local financial institutions and national level financial entities would help achieve greater financial inclusion.

Mobile banking services can be used for micro-payment by extending financial services through virtual accounts. These have the potential to significantly lower transaction costs, while expanding outreach to rural areas.

Urban India has a huge population of poor migrants, who are denied basic banking facilities. For them to be provided with banking services, KYC norms may need to be further moderated. In order for banks to be effective conduits for achieving the goals of financial inclusion, they would also need to finance household and consumption expenditure to avoid non-institutional sources of borrowing.

There is a need for granting banks greater operational flexibility to enable them to fix interest rates in respect of small customers, achieve reduction in costs, acquire better risk assessment capabilities and ensure better flow of credit information to credit information bureaus.

Financial literacy and awareness need to be taken up in a big way. With the objective of mainstreaming the activity of money-lending as also strengthening the synergies between the formal and informal segments, the model legislation suggested by the Technical Group to Review the Legislation on Money Lending (2007) needs to be implemented.

It could be explored whether banks may be assessed on their performance relating to financial inclusion and rated accordingly. The Government has an important and crucial role in assisting financial inclusion through strengthening the rural infrastructure and facilitating the production and distribution of output.

The Micro and Small Enterprises (MSEs), despite their dominant numbers and importance in job creation, have traditionally faced difficulty in obtaining formal credit or equity funding. Lending institutions must improve their ability to provide financial services to MSEs through commercial mechanisms that lower the costs and minimise their risk exposure. Reducing the transmission cost of evaluating MSE credit could be a way of securing a level playing field.

In spite of various initiatives to improve customer service, there are gaps in the implementation of guidelines which give rise to customer grievance. Customer service by banks could be improved through measures like financial education, credit counselling and improvement in information dissemination. While there is a need for banks to develop customer databases so that they can tailor products and services in line with customer needs, the risks associated with maintaining the confidentiality of such data and the threat of identity theft need to be addressed through proper control mechanisms.

Sustainability combines environmental, social, ethical and governance factors. Banks need to develop a culture of Socially Responsible Investing (SRI).