International Financial Standards and Codes: A Synthesis[1]

1. Regulating the Financial Sector

Why Regulate:

As we seek to liberalise our economy, the role of the financial sector in economic development becomes even more critical. In a market economy, the financial sector performs a variety of tasks: it provides payment services that facilitate exchange of goods and services, mobilises savings and makes available credit and other forms of finance. In the process, financial intermediaries evaluate projects and monitor borrowers promoting efficiency in resource use and reducing information costs. In addition to these obvious functions, the system plays a critical role in allowing for the shifting and diversification of economic risk. However, it is this last function, which makes these systems also uniquely vulnerable. The financial system functions by pooling information and perceptions from a variety of market participants. Changes in perceptions and expectations can lead to swings in market outcomes. In such a situation, divergences in the time profile of assets and liabilities can create crises. While, traditionally banks with demandable liabilities are considered to be vulnerable to runs or failures, similar potential instabilities can also be seen in the emerging markets for securities and insurance.

The financial sector has significantly modernised and diversified and encompasses, in addition to traditional banks, a variety of non-bank financial intermediaries, equity and capital markets, insurance companies. Moreover, these entities have taken on overlapping functions and provide diverse services. The rapid growth of cross- border financial flows especially in the last twenty years have added to the complexity of this key intermediary sector. This has implied that the risk of failure arises not only out of the risk in one activity but also through the inter-linkage across activities and countries. Further, since the financial sector by its very nature plays a key intermediary role in a market economy, any instability in this sector has severe implications for the "real" sectors which depend on it for its services. Thus, as is often the case, financial crises have led to unemployment and reduced economic activity.

In view of its importance and vulnerability, ensuring the stability of the financial sector has also been a key objective of public policy through the process of development of the market economy in search of efficiency. This intervention has become more visible in recent years in view of technological developments accompanying integration of markets. Policy interventions have taken different forms covering regulation, direct public ownership and public support through special treatment in taxes and subsidies. These interventions have sought to promote inter-related objectives of, consumer protection, systemic stability market integrity and efficiency.[ii]

Consumer/Investor Protection

Customer protection in the financial sector has two dimensions, retail and wholesale. At the retail level, customers in financial markets must have a high level of confidence in the markets in which they participate, or else they will not entrust their funds to the financial intermediaries that deal in these markets. A key question in this regard is what should consumers be protected from? As we had noted earlier, risk is central to all economic activity, especially in the financial sector, thus the protection should not be from making losses or failure but rather to reduce the impact of asymmetric information, which leads to unfair outcomes.

To achieve this aim, rules must be drawn up to ensure that customers are dealt with fairly. The protection should be done in a manner that does not distort the incentives of any of the participants. For example, inappropriate forms of deposit insurance may increase the risk of moral hazard on the part of the depositors and inadequate evaluation of risk. Laws to prohibit unfair and criminal activity need to be developed and enforced. Disclosure standards along with promotion of competitive environment will lead to higher levels of consumer protection.

At the wholesale level, participants are typically larger and better informed, the requirements of protection are different; the primary concern here is one of providing adequate competition and uniform application of regulatory standards.

In designing regulatory measures it is important to maintain the distinction between retail and wholesale levels of operation and appropriate forms of protection.

Market Integrity

Market Integrity in broad terms refers to concerns of the integrity of price formation (i.e. they accurately reflect the forces of demand and supply), the prevention of manipulative behaviour, which deliberately attempts to distort this market price, providing a sound legal basis for financial dealings and adequate laws for customer protection. The need for these types of interventions arises because transactions in the financial sector are often conducted in a framework of both incomplete and asymmetric information. The former creates the problems of risk mentioned earlier, whereas the latter raises concerns of moral hazard and adverse selection. It is interesting to note that the early literature in these fields has its roots in the study of insurance and debt contracts. The aim of the regulatory structure is to promote transparency, predictable regulation and co-ordination across regulators to limit fraud and misuse of fiduciary information.

Traditionally, the discussion on regulation has highlighted the information dimension of market integrity. In recent years, with growing evidence of organised international crime, there is also an additional need to insulate financial markets from illegal activities. For instance, if the financial system becomes a conduit for laundering proceeds from drugs or other criminal activity, it will be vulnerable to destabilisation on account of law enforcement measures seeking to control such activity. Thus, from both the point of view of reducing illegal activity and not exposing the system to risks of instability arising from better law enforcement, it is best if mechanisms are put in place to prevent money laundering.

Systemic Stability

In worlds with uncertainty and incomplete information, risk is an essential element of decision-making. At the level of a firm or single decision maker, the implication could be disruption or even failure to take account of it adequately. But, individual failure is to be expected in a competitive market based system. The problem is when such individual failure spreads across the system, a classic example being where financial problems in one bank lead to a bank run which in turn undermines the confidence in the whole banking system. The phrase ‘Systemic Stability’ would refer to the elimination or reduction of risk. In financial markets, these risks arise from two major reasons, the operation of the payment and settlement systems, where a number of transactions can get interlinked through the operation of netting, and in the availability of liquidity as in the case of bank runs. In addition to problems posed by these, ineffective management of risks in banks and other financial intermediaries can create problems that have a potential to lead to systemic failure.

However, at the institutional level, eliminating risk would either be prohibitively expensive or require giving up some activities and reduce the systems ability to diversify risk from the primary enterprises. Thus, for instance, resorting to 100 per cent self-financing may eliminate some forms of risk but will also reduce the level of activity. The best strategy is to manage this risk in a manner that limits the effect of failure in one segment from significantly affecting or disrupting other markets or segments.

Efficiency

It may be argued that unregulated markets in general and by themselves will achieve efficiency but it is widely recognised that in the financial sector, this may not hold due to a variety of reasons such as asymmetric information, externalities, coordination problems due to multiple equilibria and even natural monopolies in the settlement process. Any or all of these factors could lead an unregulated market from attaining efficient outcomes and these factors justify public intervention in markets.

The regulatory challenge is to design interventions that seek to harmonise multiple objectives. While the objectives are not inherently contradictory, they need to be harmonised and inappropriate intervention that seeks to promote any of these objectives through an excessive or unnecessary curtailment of market forces has the unfortunate side effect of restricting economic activity as a whole. Over the years, practical experience and analysis has led to the creation of a broad consensus on the basic principles underlying good regulatory policy. These are:

? Transparency and incentives to ensure complete disclosure of private information to reduce costs associated with asymmetric information.
? Clarity and consensus in basic concepts and rules, as well as a uniform framework to conduct operations. This is primarily to promote consumer protection as well increasing predictability and reducing risk.
? Internalising externalities to reduce risk of market failure and promoting efficiency.
? Ensuring adequate opportunities for entry and exit and in general provide for effective competition.
? And finally, explicit regulation identifying a set of legitimate choices available to market participation.

These essential principles have become not only more critical given the pace of change in financial markets, including their applicability in the international context and, but also more complex and inter-linked. Thus, a major financial institution, which deals in only one jurisdiction or sells only one type of product, is increasingly rare. This has implied that not only most countries seek to improve their own management of the financial system, they must be concerned about the activities and developments in other countries and regions. Different or inconsistent regulation can give opportunities to arbitrate and may even lead to institutional failure with wide spread systemic effects. Thus, in addition to the basic principles noted earlier, there is an imperative need to ensure that standards in financial sector are used in consonance with international practise.

In this background, development as well as adherence to standards and codes (good or best practices or core principles) for strengthening the financial architecture aimed at reducing its vulnerability to financial market shocks have received particular emphasis in the international fora and also among developed and developing countries. Adoption of financial standards and codes by countries is expected to promote the quality and transparency of economic and financial policies and contribute to soundness, efficiency and stability of the financial system thereby supporting sustained economic development.

International Background

The breakdown of the Bretton Woods system in early 'seventies leading to floating exchange rates, growth of Euro-dollar markets and increased banking and private capital flows prompted consensus on banking supervision and regulatory standards among central banks. International institutions like the Bank for International Settlements (BIS), International Monetary Fund (IMF), the World Bank (WB), Organization for Economic Co-operation and Development (OECD) and other international standard setting agencies in areas like accounting and securities, derivatives and insurance markets are developing and monitoring best practices and standards applicable to many areas of financial markets and regulatory systems.

The background to the current emphasis upon an integrated corpus on standards and codes at the international level can be traced to the financial crises in Asia, Russia and Latin America. The crises were triggered by the fragility of the financial sector in these countries characterised, to some extent by non-transparency, lack of efficient supervisory and regulatory mechanisms, inappropriate market standards and inadequate legal and institutional infrastructure.

The experience of these financial crises also illustrated the risk of a crisis in one country spreading to regional or even global dimensions. The reaction to these crises has raised a variety of suggestions of institutional reform. The suggestions have included ideas like the Tobin Tax and International bankruptcy courts. However, these suggestions have tended to be somewhat impractical because they do not adequately address issues of sovereignty and institutional frameworks.

The aftermath of the Mexican crises led to a process of analysis of the nature of the international response to a financial crisis. The discussion has proceeded on two interrelated streams. First, the concern of what to do in and during a crisis (crisis management), and second, measures to prevent crisis (crisis prevention). The first set of issues led to changes in the IMF financing regimes and a fresh review of the nature and form of IMF condionalities. The second set emphasised the need for improvements in regulatory regimes and information systems. Towards this aim, the IMF developed the special (for countries that participate in Global markets) and general data dissemination standards.[iii]

In response to the crisis in East Asia, Finance Ministers and central bank Governors from 22 systemically significant economies met in Washington, D.C. in April 1998 to examine issues related to strengthening of the international financial architecture. The initiative was intended to complement the ongoing efforts in the IMF, the World Bank and other international institutions and to help develop a broad international consensus on these important issues. Ministers and Governors identified three key areas where action was needed: (i) enhancement in transparency and accountability; (ii) strengthening of national financial systems; and (iii) management of international financial crises. In response to these initiatives, 29 countries and multilateral institutions participated in the creation of the Financial Stability Forum (FSF).

The FSF has highlighted a set of twelve key standards, representing the minimum requirements for good practice that would contribute to a sound financial system and deserving of priority in implementation. These standards can be broadly classified under three major categories:

Firstly, the financial sector has traditionally been divided into three components namely Banking, Securities Market and Insurance[iv]. The first set of standards thus deal with regulation and supervision in these markets. In addition, since transactions in these markets are implemented through the payments and settlement systems in use, there are a set of standards to deal with these as well. Secondly, the financial system is an intermediary sector; it depends for its activities on the market and the functioning of the 'real' sectors. Performance in the sector, therefore, is critically dependent on the standards of performance and transparency in the 'real' sectors. In order to ensure efficient functioning of the financial sector, there is need to develop standards in three inter-related areas namely, corporate governance, auditing and accounting, and bankruptcy. Finally, the sector is critically dependent on the public policy framework in which government actions are taken and the information available about such actions. This has led to the formulation of standards in three interrelated domains of Transparency in Monetary and Financial Policies, Fiscal Policies and Data Dissemination. We have, therefore, classified our discussion in these three categories taken in reverse order adhering to the principle of general to specific, namely:

(a) Macroeconomic Policy and Data Transparency (covering Transparency in Monetary and Financial Policies, Transparency in Fiscal Policy, and Data Dissemination);
(b) Institutional and Market Infrastructure (covering Bankruptcy Laws, Corporate Governance, Accounting Standards, Auditing Standards, Market Integrity); and
(c) Financial Regulation and Supervision (consisting of Payment and Settlement System, Banking Supervision, Securities Market Regulation, and Insurance Regulation).

The work on improving standards needs to be complemented by public access to information on the evaluation and progress in the implementation of standards. Multilateral institutions have started paying equal attention to this. This is expected to help investors, lenders and borrowers, financial intermediaries and other economic agents to make use of the dissemination for better analysis of their risks and in developing appropriate strategies and expectations.

It is important to note that these standards differ from international treaties in that they typically do not have the same degree of binding associated with international treaties. Thus, for instance, international agreements under WTO have all the characteristics of (Hard) law including a mechanism for enforcement. These standards are more in the nature of guidelines or intentions and do not have the same degree of commitment. This has led some commentators to call them 'soft law."[v] In addition, it is not the case that such norms are unique because even amongst developed countries there are different patterns and practices, which have evolved. Thus, when seeking to reform a country's laws, such norms can at best be indicative. The application has to take into account the existing legal framework in the country and its economic structure.[vi] It is in this context that the Government of India undertook an assessment of the regulatory regime in the financial system.

Financial Sector Regulation in India

Government of India and the Reserve Bank, soon after the Asian Crisis, recognised the importance of the international financial standards and codes for India and embedding them as an integral part of structural reforms in the financial sector. Thus, the Indian efforts in this direction sought to complement and support the ongoing initiatives of the G-20 aimed at encouraging implementation of standards and codes among member countries. In order to facilitate positioning of international financial standards and codes in relevant areas of the financial system in India and to guide the overall process of implementation of appropriate changes in respect to various segments of the financial system, the Reserve Bank in consultation with Government of India, on December 8, 1999, constituted a `Standing Committee on International Financial and Codes' under the Chairmanship of Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India and Secretary, Economic Affairs, Government of India as Alternate Chairman (Annexure I). Monetary Policy Department and the Department of Economic Analysis and Policy of the Reserve Bank provided the secretariat to the Committee.

The Standing Committee was entrusted with the responsibility of identifying and monitoring developments in global standards and codes which are being evolved, particularly in the context of the international developments and discussions, as part of the efforts to create a sound international financial architecture, and to consider all aspects of applicability of these standards and codes to Indian financial system. The Committee had also been asked to consider plotting a road map for aligning India's standards and practices as necessary and desirable in the light of evolving international practices, periodically reviewing the status and progress in regard to the codes and practices; and reaching out its reports on the above to all concerned organizations in public and private sectors with the aim of sensitising public opinion and creating awareness in the concerned subject areas.

The Committee, soon after its constitution, undertook a detailed review of the international financial standards and codes so as to identify and suitably group them for detailed study with regard to their relevance and applicability to India. Out of the set of twelve subject areas identified by the FSF for which standards and codes have been prescribed by international financial institutions and other standard setting bodies pertaining to the financial system, the Standing Committee identified ten core subjects (encompassing eleven areas as identified by the FSF) for immediate attention and assessment. These were: (1) Transparency in Monetary and Financial Policies, (2) Fiscal Transparency and (3) Data Dissemination in the category of macro-economic policy and transparency; (4) Payments and Settlement System, (5) Accounting and Auditing (6) Bankruptcy Laws, and (7) Corporate Governance pertaining to strengthening of institutional and market infrastructure, and (8) Banking Supervision, (9) Securities Market Regulation, and (10) Insurance Regulation in the broad area of financial regulation and supervision. The only subject area which was not directly covered was 'Market Integrity' associated with the forty recommendations of the Financial Action Task Force (FATF) on Money Laundering. RBI has subsequently prepared a Technical Report on the issue and we will summarize the major issues of that report in this report as well.

In view of the enormity of the tasks as also of its varied nature, the Committee felt that the best way to realise the objectives of the Committee would be to use the expert pool of resources available within the country to make the detailed study and assessment about the standards. Accordingly, the Committee decided to constitute Advisory Groups consisting of non-official experts in respective subject areas to assist the Standing Committee.

The Advisory Groups constituted by the Standing Committee on International Financial Standards and Codes in ten core subject areas pertaining to the financial system were entrusted with the task of studying, in detail, the present status, applicability, relevance and compliance with relevant standards and codes. The Groups were to review the feasibility of compliance and the time-frame over which this could be achieved given the prevailing legal and institutional practices. In making their recommendations all the Groups compared the levels of adherence in India, *vis-à-vis* in industrialised and also emerging economies.

The Advisory Groups chaired by eminent experts evolved their own procedures to evaluate the issues under their remit. They were provided secretarial support by the Monetary Policy Department and Department of Economic Analysis Policy of the Reserve Bank and nodal officers drawn from related departments of RBI. A list of Advisory Groups, their constitution and officials connected with the Groups as special invitees or nodal officers are provided in Annexure II. This independent arrangement, kept the job of the Advisory Groups outside the sphere of activity of the present regulatory structure, and allowed them to make critical assessment of relevance as well as state of compliance with standards and codes and make objective recommendations with regard to the appropriateness of compliance and the approaches to achieving best practices in the areas covered by them.

The reports are made available by the Reserve Bank on its Website (www.rbi.org.in). All these reports have now been separately published by the Standing Committee and also released to the public.

The purpose of this report is to describe the major recommendations of these groups, examine their interrelations and implications for follow-up and action as well some of the subsequent developments. We also provide three annexures which detail the major legislative changes recommended by the groups both in terms of the Acts and laws covered (Annexure III) as well as by Groups (Annexure IV) and some of the major non-legislative changes in procedures, rules and practices highlighted by the different groups (Annexure V). These lists are not comprehensive and do not substitute for the detailed descriptions available in the reports of the Groups.

Major legislative changes recommended by the Groups and included in Annexure III cover amendments to existing laws and proposals for new legislation. Amendments relate to the RBI Act, BR Act, SCR Act, Companies Act, Negotiable Instruments Act, Information Technology Act, Income Tax Act, Insurance Act, IRDA Act and Chartered Accountants Act. Proposals for new legislations include FRBMB (under processing), Payments and Settlement System (initiated), Financial Fraud (under discussion), and Payment Obligations (Netting, Clearing and Settlement) Act (being drafted).

Different Advisory Groups have also identified certain non-legislative proposals which are listed out in Annexure V. The non-legislative proposals are in the nature of sub-ordinate legislation/rules, regulatory instructions and guidelines, internal re-organisation/procedures of the regulator and suggestions for improvements in the existing regulatory/government practices. Such follow up actions required specifically by the Reserve Bank of India, Government of India, the Institute of Chartered Accountant of India, IRDA, SEBI, etc. have been identified for implementation. Illustratively, the Reserve Bank has to make non-legislative changes like internal re-organisations, and improvements in the existing regulatory framework in respect of setting up a seven member Monetary Policy Committee and disclosure of adverse supervisory action, respectively. In case of the Government of India, certain improvements in the existing practices of the Government instructions and guidelines, etc. are required for reporting revenue loss from major existing and new tax concessions, disseminating a list of major quasi fiscal activities (QFAs) for the earlier years in the Economic Survey, etc. Like wise, the Institute of Chartered Accountants of India has to bring in some sub-ordinate legislations/rules for the issuance of standards comparable to international accounting standards in the areas of disclosure in financial statements, recognition and measurement of financial instruments, etc. In addition, institutional agencies like IRDA have to bring in certain internal re-organisations/procedures for ensuring uniformity in the designing of the products, terms and conditions and marketability.

2. A Review of the Reports of Advisory Groups

The Groups as we had noted earlier can be classified into three main areas covering the policy framework, market institutions and systems and the regulatory systems of the financial sector.

A. The Policy Framework

(i) Transparency in Monetary and Financial Policies

Transparency in Monetary and Financial Policies is a key ingredient in promoting effective and stable financial system. Transparency not only facilitates good governance and promotes credibility and integrity, but also acts as a positive contribution for the operations of financial institutions on a sound footing. The International Monetary Fund, in this context, evolved a Code of Good Practices on Transparency in Monetary and Financial Policies, which was adopted by the interim committee in September 1999 and recommended for its adoption by various member countries.

Besides scrutinising the IMF code, the Advisory Group surveyed the experience of select countries in putting in place "best practices". After making an assessment of India's compliance with international standards, the Group has recommended a road map indicating how India could move towards conforming to these codes.

In its approach to the concept of transparency, the Group defined transparency to refer to an environment in which the objectives of policies, its legal, institutional and economic framework, policy decisions and their rationale, data and information relating to monetary and financial policies and the specific accountability of different agencies are provided to the public in a comprehensive manner and on a timely basis. The Group felt that transparency should be viewed in a systemic *post facto* fashion as it is not always possible or desirable for the authorities to share with the general public, sensitive view points and issues or releasing advance information on policy action. Thus the group notes the objective is “not merely transparency but to improve the underlying content and quality of policies.”

The clarity in the objectives of monetary policy is a prerequisite for any meaningful transparency in monetary and financial policies. Although, various factors may provide for legitimate caution in disclosure by the central bank, the emphasis should be on making available to economic agents as much information as possible without disrupting the market or individual entities. Consequently, the monetary policies objectives, within the ambit of broad economic policy set by the Government with the Parliament's endorsement should be transparently set out in clear terms. In the words of the Advisory Group, "transparency would bring appreciation by markets on central bank strategies and help in economic agents playing an effective role in equilibrating markets".

Even though RBI's policies and operations largely conform to the IMF Code, there are still some areas where we could see some improvement in order to become fully compliant with the IMF Code. The Group notes that in an area as complex as this, a mechanical assessment of compliance with any set of standards is not meaningful but rather it seeks to make a holistic appraisal of the structure in terms of international "best" practice. We will briefly describe these below:

Statutory Basis for Monetary Policy

The preamble to the RBI Act entrusts the Bank with core objectives of (i) issue of bank notes, (ii) keeping of the reserves to securing monetary stability and (iii) operating the currency and credit system to the country's advantage. The RBI Act enjoins responsibilities to the Board on the maintenance of government accounts, the management of public debt, exchange management and control, formulation and implementation of monetary and credit policy, regulation and supervision of banks and non-bank financial intermediaries. While the Act provides adequate powers to the RBI to use various instruments of monetary policy, there is no provision for a systematic and transparent setting of objectives of monetary policy. In the absence of a clear-cut legislation on the process of setting out monetary objectives, what has evolved is a system of vague and opaque objectives that, quite often, conflicts with other arms of overall economic policy. Under the present system, the setting of objectives by the Government to the RBI is not made public, and in fact is not even set out in a confidential exchange of written correspondence. The Advisory Group emphasises that the present RBI Act is anachronistic and there should be an early move to amend the RBI Act to give sharper focus to the objectives of monetary policy. Transparency in monetary policy and greater responsibility and accountability for the RBI will be meaningful only if there is legislative amendment of the RBI Act to provide the necessary autonomy to the RBI to fulfil its responsibilities. In addition, even at the operational level, a number of changes are needed in the RBI Act to give greater operational flexibility to RBI. These amendments have in fact been processed and recommended to the Government.

Objectives of Monetary Policy

The Group discussed the issue of single versus multiple objectives for monetary policy. While it recognised the inherent complexity involved in such a choice, the committee also noted that with a mix of objectives for the Reserve Bank of India, there is a risk of obfuscation of objectives and loss of transparency and as such accountability could suffer. So, on balance, they felt that it would be useful to set out a clear single objective, *viz.*, the inflation rate, as has been done by a number of governments abroad, for monetary policy formulated in some explicit medium term macro-economic framework. Thus, the Group notes that "Illustratively, the Government can, as is done in the UK and New Zealand, unequivocally set out to the RBI a medium-term inflation objective, say over a prospective three year period, and while fixing this objective take cognisance of other objectives and the government can retain the right, with Parliamentary endorsement, to reset the single objective in the light of evolving developments. *What is important, however, is that the initial* *statement and consequent resetting of the objective should be done transparently and the rationale of the change should be fully explained*." (emphasis added)

With a clear objective, the Group then emphasised the importance for a transparent and objective framework for policy formulation. Here, the recommendation was for the setting up of a Monetary Policy Committee (MPC) on the lines of the Board for Financial Supervision (BFS), but more importantly, suggested disclosing the facts and the discussion leading up to decisions. They recognised that this would have to be done in a phased manner as the system matures. The Group recognised that it may not be possible to transit to a full-blown framework of transparency immediately but it is essential that a beginning be made and an explicit roadmap spelt out. Some suggested guidelines are detailed in the report.

Clarity of Roles

The Group felt that it is important that the different roles of the RBI need to be separated. The large monetisation of the fiscal deficit and below market clearing interest rates on government paper significantly affected the effective functioning of monetary policy. This led to a situation of monetary policy function becoming somewhat subservient to debt management. Debt management function puts RBI in a situation of direct conflict of interest. As interest rates are one of the most powerful instruments of monetary policy, the determination of interest rates should be left to the choice of RBI as part of the conduct of monetary policy. Thus, they recommend divesting RBI from its role in public debt management. A necessary though not sufficient pre-condition for this is to ensure a measure of fiscal balance and thus the committee would recommend the passage of the pending Fiscal Responsibility and Budget Management Bill. The government should set up its own independent debt management office, which would take over, in a phased manner, the functions of debt management presently discharged by the Reserve Bank.

Transparency in Other Financial Policies

The Group also emphasised the need to separate the supervisory dimension from the monetary policy dimension. Thus, they noted that "a cardinal principle of sound regulation/supervision should be that it should never be varied over the business cycle. It is entirely a monetary policy function to deal appropriately with the business cycle. *Per contra*, monetary policy should not be diluted to make it less costly for financial intermediaries to comply with prudential norms".

Further, the supervisory regimes on banks and financial institutions should be made more transparent. Depositors need to be provided with relevant information on performance of the institutions. The regulatory regime should be rule based with minimum of discretion and any regulatory forbearance should be undertaken transparently. In its recommendation, the Group has suggested that transparency on adverse supervisory action should be introduced in a phased manner, which would help all stakeholders. The Advisory Group stresses that with predominant public ownership, it is important to avoid the pitfalls of regulatory capture and this would, to some extent, be avoided by disclosure of adverse action. In fact, with public ownership of banks, such disclosure reduces the risk of regulatory capture. Further, as the fact of public ownership provides an anchor against panic reactions, disclosures *per se* are unlikely to be dislocative; on the contrary, disclosures could have a salutary effect of strengthening the overall system by putting such information in the public domain. In this connection, the group endorsed the RBI's discussion paper on Prompt

Corrective Actions (PCA) which recommended that a Prompt Corrective Action (PCA) regime be put in place soon.

To sum up, the Group emphasised the need to continue and deepen the reforms begun after the 1987 Report of the Working Group on the Money Market. The Advisory Group was of the view that for an effective transmission of monetary policy, the changes in the various segments of the financial markets should be allowed to traverse freely through different segments of the financial markets.

(ii) Fiscal Transparency

Fiscal transparency is important because fiscal soundness is one of the core requirements for financial stability and transparency is needed for markets to be able to assess fiscal soundness accurately. Further, fiscal and monetary policies are the two pillars of public policy. Ensuring transparency in the policy framework would require both systems to be in sync. The executive board of the IMF in May 2001 approved a “Code of Good Practices on Fiscal Transparency” (hereafter referred to as the Code). The Advisory Group used this version as the benchmark against which the degree of fiscal transparency in India has been evaluated. The Code is based on four general principles, which are further elaborated into more detailed guidelines and practices. The four principles are:

? Clarity of roles and responsibilities within government and between governments and the rest of the economy.
? Public availability of information on fiscal outcomes.
? Open and transparent budget preparation, execution and reporting.
? Assurances of integrity, including those relating to the quality of fiscal data and the need for independent scrutiny of fiscal information.

The Group has examined the extent to which fiscal practices in India comply with each of the detailed guidelines on the Code keeping in mind the clarifications and elaborations in the Manual. Where the existing practices do not comply, or comply only partially, the Group attempted to assess whether full compliance is desirable and feasible, and if desirable, indicated a time frame for compliance.

The overall assessment that emerges from the Group’s review is that current fiscal practices at the central government level satisfy the minimum requirements of the Code on Fiscal Transparency in many areas, though there are some important deficiencies, which need to be addressed. The position at the state government level is much less satisfactory with most states being well behind the standards achieved by the central government. However, at present the Code as formulated is to be applied only at the national government level; non-compliance at the state level would not amount to non-compliance with the Code. But, in terms of policy, that is an area of concern that we need to address. A summary assessment of these issues highlighting the areas where current practice is deficient and the recommendations of the Group for necessary action are presented in the following paragraphs.

Clarity of Roles and Responsibilities

Most of the requirements of the Code in this area are fully met. The roles and responsibilities of the central and state governments are well defined and there is a clear legal framework governing the management of the budget and extra-budgetary funds. The division of expenditure and tax powers is complex, with areas of overlapping responsibility and multiple channels for resource transfers, but the basic requirements of transparency are met.

In the interest of transparency, the Group recommended that the institutional table for India in the Government Finance Statistics, IMF, should be revised to make it comparably detailed with the entries for other countries. For example, various central government institutions, which have their own budgets outside the central government budget, could be identified e.g., the employees provident fund, central universities, the Indian Institutes of Technology, central research institutions could be shown separately.

The Group observed that the most important deficiency relates to the prevalence of quasi-fiscal activities (QFAs) undertaken by the banking system and by non-financial public sector enterprises, which are not transparently identified and quantified. These included control over interest rates, and directed credit, etc. However, even with directed credit, it is not easy to quantify the extent of QFA involved since it is difficult to determine how far the directed credit requirement actually leads to lending, which would not take place otherwise because the directed credit target is only an aggregative target which the bank must meet, leaving the bank free to decide on individual credit decisions. In the case of public non-financial sector, the scope for QFAs is large since they can deviate from commercially sound market practices for a variety of reasons. For example, non-financial public enterprises may suffer from inefficiency, poor work culture and poor management quality, all of which leads to certain types of "non-market behaviour" which is reflected in lower profits or losses. Such losses should not be viewed as QFAs. The Group, therefore, suggested a restricted definition of non-market behaviour, which is specifically mandated by the Government, by virtue of its ownership and control, with the objective of meeting an explicit fiscal purpose such as providing a subsidy to a particular Group in society. However, even this is not quantified and so is difficult to estimate**.** The classic example is of course that of the railways which engages in a substantial degree of cross-subsidisation of passenger traffic by freight and also engages in cross-subsidisation within freight categories by overcharging some categories and undercharging others. Similar examples can be found in a number of other public agencies. The problem of lack of transparency about QFAs is even more important at the state level where there are many public sector organisations, which act in a non-commercial manner. The best example would be the state electricity boards.

An area where current practice could be improved relates to the prescription that the basic principles of budget management should be embodied in a general budget system law, which should have constitutional, or near constitutional status. Although the scope of the budget has been defined by the Constitution and clear budget procedures have evolved over time, India does not have a budget system law. Hence, the Advisory Group recommended that the government could consider amplifying the scope of the Fiscal Responsibility and Budget Management Bill (FRBMB) to include the essential elements of a budget law. Further, given the importance of State Governments in public expenditure, it would be desirable if we can move to a system of uniform budgetary practices at the state level as well.

Another area of concern relates to the issue of transparency in tax laws. Although the principle that taxes must be levied on the basis of explicit legal authority is strictly complied with, our tax laws are lacking in transparency. The complexity of the tax structure, especially the large number of exemptions, creates room for uncertainty and administrative discretion. Administrative procedures are archaic and involve direct interaction between the assessee and the tax administrator, which creates the possibility of case by case determination of tax liability. Therefore, the Group felt that a major effort at simplification, and greater use of information technology, especially electronic filing, is urgently needed.

Government involvement in the private sector through regulation and equity ownership is exercised on the basis of clear legal authority. However, the criteria to be used in the exercise of executive authority are not always very clear. The Group recommended that the recommendations of Organisation for Economic Co-operation and Development (OECD) relating to the characteristics of transparent regulations, be treated as indicators of best practices and existing rules and regulations be systematically reviewed in the light of these guidelines.

Public Availability of Information

There are significant gaps in this area between current practice and the requirements of the Code.

Indian practice complies fully with international standards regarding public availability of information for the year for which the Budget is presented and also for preceding years. However, forecasts of key fiscal magnitudes are not provided. Best practice as indicated in the Manual requires projections for 5-10 years ahead, but this is not feasible in our conditions. However, a projection of major categories of expenditure and revenue two years ahead is feasible and should be implemented. The FRBMB would, if enacted into law, make this mandatory. Therefore, the Group has recommended that the proposal should be implemented in the Budget for 2002-03 irrespective of whether the Bill is passed by then.

Information provided on contingent liabilities of the central government is inadequate. The Budget documents provide information on loan guarantees but not on other contingent liabilities, e.g. the government guarantee on dues to all LIC policy holders and the liability arising out of the exchange risks related to the Resurgent India Bonds and the India Millennium Deposit scheme. Liabilities on account of letters of comfort, which fall short of legal guarantees but are effectively almost identical, are also not shown. The implicit burden on the government for recapitalisation of public sector banks is also not reported, nor is the potential liability associated with implicit government guarantees of other public financial institutions, such as the Unit Trust of India that received some support recently. The Group recognized that explicit quantification of implicit liabilities might be counter-productive. However, ignoring these elements completely clearly understates the potential fiscal risk. Therefore, the Group recommended a review of the current policy on disclosure of contingent liabilities with the objective of moving to fuller disclosure. In addition, the absence of data on forward projections is a major weakness and an impediment to any effort to assess fiscal sustainability. Thus, they recommend that a start should be made by giving a forward projection for two years ahead of the budget; again passage for the FRBMB Bill will address this lacunae.

No information is provided on tax expenditures. While this is a difficult area, and practice varies considerably across countries, the Group recommended we could start by reporting the revenue loss from major existing and all new tax concessions.

The basic requirement of fiscal transparency is that a statement on QFA be included in the budget, which indicates the public policy purpose of each QFA, its duration and the intended beneficiaries. The Group recommended that a start may be made towards this objective by listing the major QFAs in the system. Initially, these estimates could be provided in the *Economic Survey* for earlier years.

At present, the information presented in budget documents on the financial assets of the government is limited to the opening cash balance. No information is provided on government equity in public sector enterprises and outstanding loans to these enterprises. The Group recommended that this information should be made available. Since the information typically becomes available with a lag, it may be appropriate to provide it in the *Economic Survey* presented just before the Budget.

The guidelines on debt reporting are substantially met, though there are gaps that need to be filled. The external liabilities reported in the Receipts Budget are valued at historical exchange rates. The Group hence recommended that the basis of reporting should be changed to the market exchange rate.

Given the scale of fiscal activity and the size of state level fiscal imbalances, it is important to highlight the consolidated position at the time of discussion of the budget in the Parliament. The Group recommended that the *Economic Survey* should incorporate a fuller discussion of recent trends in the consolidated position of central and state governments especially regarding trends in capital expenditures and in the basic fiscal balance measures, fiscal deficit, primary deficit, revenue deficit, etc.

Open Budget Preparation, Execution and Reporting

This part of the Code seeks to make the assumptions underlying the budget and the rationale of budget policy more open and available for scrutiny by the legislature and the public. There are significant deficiencies in current practice in this area, which need to be corrected though many of these will be substantially addressed once the FRBMB is enacted. However, until that is done, the Government should start providing the information on macroeconomic parameters and assumptions on a voluntary basis.

Assurances of Integrity

This part of the Code is substantially complied with. The institutional mechanisms for independent audit of fiscal data are very strong. The accounts of both the central government and the state governments are audited by the CAG, which has developed an enviable reputation for high standards of independent and strict scrutiny.

The main deficiencies in this area are the following:

"Fiscal marksmanship" is difficult to achieve in a period when structural change is taking place, but the transparency standards in the Code require that the specific method used for revenue forecasting should be indicated.

Another area of non-compliance relates to assessment by independent experts. Here too, the FRBMB if passed or even if its provisions are voluntarily complied with, then the implied disclosure of information will ensure an adequate basis for an independent and open assessment through the academic and research community.

The recommendations and review by the Advisory Group mirrors the assessments of the IMF review on India's observance of this standard[vii]. "India has achieved a reasonably high level of fiscal transparency, especially as regards the amount of fiscal information that is made available to the public. The passing of fiscal policy legislation currently before parliament would result in the publication of statements that address the current lack of background information and analysis in connection with the central government budget. However, there would still be need to pay more attention to reporting on general government finances, to providing information on contingent liabilities and QFAs, and to the analysis of fiscal risks".

Inter-governmental fiscal relations could be simplified and clarified, particularly with a view to clearly establishing the role of central government in enforcing fiscal discipline on the states. The sharing of tax powers between central and state governments is also a source of complexity, and the expenditure framework needs to be strengthened by clearly distinguishing between current and capital spending and by placing more emphasis on performance audit.

Transparency Issues at the State Level

Fiscal practices at the state level are generally behind the standards achieved at the central government level and there are many gaps in comparison with the requirements of the Code. Since the Code is not being applied at present below the national level, non-compliance at the state level does not constitute non-compliance with the Code. However, from a substantive point of view, it is obviously important that fiscal transparency should be extended to state government levels also, since the scale of fiscal activity at the state and local levels is very large.

In the absence of full fiscal transparency at the level of states, it is obviously difficult to evolve a consistent approach to fiscal policy at the state level. Therefore, the Group recommended that the Finance Secretaries Forum could review the Report of the Advisory Group on Fiscal Transparency and determine a set of minimum standards on transparency which all state governments should achieve within a three year period. In particular, the state governments should be encouraged to increase the extent of reporting on contingent liabilities and at least major tax expenditures and QFAs (especially losses of State Electricity Boards).

(iii) Data Dissemination

During the early 1990s, free or near free movement of capital across the boundaries of nations accelerated the process of globalisation in financial markets. With the integration of different financial markets worldwide and with more and more new innovations, international financial activities took myriad shape. The world economy, during this time, also experienced several crises. One of the major reasons behind the crises was identified as the lack of adequate, timely and reliable information in a standardised form, obscuring financial weaknesses and imbalances in countries. Internationally, an urgent need was, therefore, felt for introducing a standardised information and dissemination system to minimize the possibility of market participants acting on misinformation or misinterpretation of available information.

With such considerations in view, in March 1996 the International Monetary Fund (IMF) established the Special Data Dissemination Standard (SDDS) for its member countries. Though subscription to the SDDS was voluntary, India was one of its early subscribers with the subscription starting from January 1, 1997. The availability and quality of data dissemination in compliance with SDDS was considered a desirable aspect.

The Advisory Group undertook a detailed study of the requirements of the IMF under SDDS, comparing the compliance of India and other subscribing countries as well as the problems encountered in complying with some of them. The Group did not confine to issues pertaining to SDDS alone. It examined the scope for further improvement in regard to data gathering and data dissemination in India and provided a separate set of recommendations on India’s financial sector.

The Group observed that thanks to its more advanced information base built over decades, there were a large number of data categories under which India had been disseminating information more frequently and with a shorter time lag than those prescribed by the IMF under the SDDS. Thus, the Group found that " … India’s record of SDDS compliance based on original specifications for the coverage, periodicity and timeliness of the data, as also for the dissemination of advance release calendars, is truly commendable" (para 4.5). In fact, developments after the Group’s report have led the IMF recently on its website to comment “India meets the SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars.”[viii]

However, the Group identified some grey areas. Among these, the Group observed that India had chosen to exercise the flexibility option available under the SDDS in respect of the following two categories:
i) Labour market (real sector) seeking data on employment/unemployment and wages/earnings.
ii) General government or public sector operations (fiscal sector).

The Group held the view that considering the complex structural features of the Indian economy, data presently generated and disseminated by India on its employment-unemployment trends were sufficiently scientific and well received. In this context, the Group indicated that the kind of quarterly data that the SDDS proposed on labour market (employment, unemployment and wages/earnings) using the ILO’s sophisticated concepts, definitions and classifications, was impossible to generate, if only, because of the large agricultural sector and also of sizeable unorganized segments in the non-farm sector. Therefore, the Group concurred with the position taken by the official agencies in opting for the "flexibility" option pertaining to the data on labour market.

With regard to general government or public sector corporation’s category, the Group visualized that the local bodies would emerge as a growing segment of general government particularly in response to decentralization measures being undertaken in different parts of the country. Irrespective of its size, the Group felt that it would be necessary for the policy-making bodies as well as the public at large to have an insight into the overall size of the local body finances. Therefore, the Group suggested the Government of India, the State Governments, RBI and the Central Statistical Organisation (CSO) to co-ordinate their data gathering activities in these respects, especially pertaining to public sector undertakings and local bodies. In this regard, the Group also suggested to put forward a time-table for the dissemination of data for general government operations (or total public sector operations) including the data for these two sub-sectors.

Further, in regard to Data template on international reserves and foreign currency liquidity, the steps taken by RBI, after the Groups report, have ensured compliance.

The Group observed that India was not fully compliant with the standard on international investment position (IIP) required in the SDDS. It, however, examined the progress vis-à-vis the IMF deadline and noted that if the data on IIP could be made available before September 30, 2002, India would be fully compliant with respect to this category.

Besides the above areas, the Group also pointed out a few other minor limitations in the Indian data dissemination standard. First, it observed that so far, India had not disseminated any information under the data category 'Forward looking indicators', classified as an 'encouraged' component under the SDDS. The Group suggested that forward-looking indicators should be disseminated in certain areas *viz.* the surveys of business expectations. The Group also observed a few lacunae in the dissemination of the National Summary Data Page (NSDP) under the SDDS. It pointed out that the NSDP was updated only monthly, while for some of the data categories appearing on the NSDP, information should be incorporated in weekly/ fortnightly basis. It also observed that India's NSDP site had no hyper-link with the IMF's electronic bulletin board (DSBB). The Group recommended that hyperlink from the DSBB to the NSDP of India should be established quickly and the system of hyper-link should be further extended to take care of the links with more disaggregated information.

The Group also noted that SDDS prescribed that subscribing members would provide a summary description of methodology for each data category on the DSBB, including statements of major differences from international guidelines. In this context, it pointed out that India had given summary methodology for the data category only in respect of 'producer prices' in the real sector. The Group suggested that summary methodologies should be presented for all the data categories by the respective authorities.

B. Strengthening Institutional and Market Infrastructure

(i) Accounting and Auditing

Accounting standards represent the grammar (set of rules) of accounting to be followed in preparation of the financial statements. The generally accepted accounting principles (GAAP) encompass conventions; rules and procedures necessary to define accepted accounting practices at a particular point in time. The discussion of standards refers to the work by standard setting entities, *viz.*, International Accounting Standards Committee (IASC), International Auditing Practices Committee (IAPC), United States' Generally Accepted Accounting Principles (US GAAP) and Accounting Standards Board (ASB) in India. For purposes of international compliance the IASC and IAPC serve as relevant benchmarks. The reference to US GAAP is necessary in view of the growing interest in raising resources through US GDRs and listing in US exchanges.

The Group on Accounting and Auditing studied the present status of applicability, relevance and compliance in India of the relevant international standards and codes on accounting and auditing standards, reviewed the availability of various accounting standards in India and compared them with those of corresponding to International Accounting Standards (IAS). The Report, presented in nine sections, examined, *inter alia*, the basic objectives of GAAP, various accounting standards, the *modus operandi* of the International Accounting Standards Committee (IASC), major differences between the Indian Accounting Standards with those of IAS and a comparative analysis of US GAAP, Indian GAAP and IAS.

In India, the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) is responsible for setting accounting standards (AS). ASB of ICAI has so far issued 23 standards, which are on par with those of International Standards subject of course to differences arising from country specific characteristics. In the case of one of the standards, 'Guidance Notes' have been issued and in the case of other two standards, the Group felt that they are not relevant for India as of now. With regard to 9 other standards issued by IASC, corresponding Indian Accounting Standards are under preparation[ix].

The Auditing Practices Committee (APC) of the Institute of Chartered Accountants of India has issued 20 statements on Standard Auditing Practices (SAPs) and four additional statements on auditing. Nine standards are in the process of issuance. In addition, a number of Guidance Notes have been issued. The SAPs are anchored on the corresponding standards issued by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). IAPC has issued 36 standards and 12 statements.

The recommendations of this Group covered four principal themes:

The gap between the international and Indian standards

The Group noted that the gap is most pronounced in respect of standards relating to financial institutions and recommends issuing standards consistent with IAS 30 "Disclosure in Financial Statements of Banks and similar Financial Institutions"; IAS 32 "Financial Instruments: Disclosure and Presentation" and IAS 39 "Financial Instruments: Recognition and Management" on an emergency basis. As regards the general issue of harmonisation with International standards, it is important to note that the given divergence between domestic tax and other regulatory laws with those in other countries, there will always be difference in the corresponding accounting and auditing standards. But to enhance transparency, the Group recommended mandatory explanation as a note to the Indian standard giving the reasons for the departure from the international standard. The report does a detailed assessment of a number of standards and this can be the basis for a more complete exercise. In addition, given that a number of companies are seeking to voluntarily comply with international standards for purposes of listing or issuing depositary receipts, it would be useful to provide a roadmap linking the differences. Further, the issuance of Indian standards in conformity with international standards needs to be speeded up.

It should be emphasised that the standards in discussion are not fixed over time in either India or abroad. Thus, convergence is a dynamic process where the relevant standards both domestically and internationally are continually evolving. With a view to speed up the convergence process and yet maintain quality, the Group had recommended a restructuring of the Accounting Standards Board with greater representation to regulators. [x]

Convergence of corporate and tax laws to Accounting standards

The Group has identified a number of areas of concern which need to be discussed and addressed This would ensure both better compliance with the standards as well as lower levels of litigation. The report gives a number of examples, but formally it would be desirable if a process can be set up to ensure consistency and necessary amendments made to Income Tax and Company Laws.

Strengthen Department of Company Affairs (DCA) and Registrar of Companies (ROC) to ensure compliance

While the amended Companies Act provides for disclosure of non-compliance of standards by the company, the DCA through the ROC remains weak in its ability to enforce compliance. An appropriate way would require the creation of an empowered panel to which auditors can report violations. The Securities and Exchange Board of India (SEBI) has created a Standing Committee on Accounting Standards. This committee monitors the existence of relevant accounting standards and their harmonisation with the corresponding International Accounting Standards. It also mandates the adherence to standards and enforces the same through the listing agreements between the companies and stock exchanges. Therefore, at least in so far as listed companies are concerned, a better enforcement mechanism has been put in place.

The Group recommended the creation of an emerging issues task force to deal with situations not covered in the IASC standards. The presence of such a Group could also reduce the time taken in issuing new standards.

(ii) Bankruptcy Laws

Bankruptcy Law is one area where the Indian situation is far from satisfactory when evaluated against the best practice norms. India at the moment does not have a comprehensive or satisfactory legal framework. Further, there is considerable terminological confusion in the meaning and content of terms like bankruptcy, insolvency, liquidation, dissolution, etc. Bankruptcy as a system that encompasses restructuring and or liquidation of companies is virtually non-existent. In 1985, a quasi-judicial body, the Board for Industrial and Financial Reconstruction (BIFR) was established to secure timely detection of sick and potentially sick industrial companies, and the speedy determination by a Board of experts of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies. However, the open-ended character of this process as well its poor integration with the liquidation aspects have implied considerable opaqueness and delays. Dissatisfaction with the current system has led to numerous calls for reform.

Given this backdrop, the Advisory Group on bankruptcy law had to work somewhat differently from other Groups. They, therefore, analysed international practise as well as draft guidelines being developed at the IMF and prepared a comprehensive report on the structure of desirable bankruptcy system. They also developed an illustrative code entitled “Corporate Bankruptcy and Winding up Code, 2001” as an annexure to its report to highlight implementable characteristics. The salient features of this were:

? A comprehensive code to deal with corporate bankruptcy
? The concept of restructuring incorporated as part of bankruptcy
? Repealing the Sick Industrial Companies (Special Provisions) Act, 1985 i.e. SICA – Part VII to X of the Companies Act, 1956 and Part III and IIIA of the Banking Regulation Act, 1949
? Creation of a dedicated Bench of the High Court to deal with all sorts of bankruptcy matters
? Substitution of the institution of official liquidator with professional trustees
? Time bound bankruptcy proceedings – restructuring and winding up

- ? Special procedure for banking companies and adoption of general bankruptcy proceedings in respect of non-banking financial institutions, public corporations and government companies.
- ? Special chapter on cross boarder insolvency in line with the UNCITRAL model law.

The illustrative code suggested by the Advisory Group was framed by fixing the objective of bankruptcy as asset protection and maximization of their value. The illustrative code and the report emphasises bankruptcy as a process rather than a condition and includes the possibility of restructuring as a vital and initial step. The emphasis has been on timeliness, transparency, economic efficiency and predictability. The report also pointed out that preventive elements are associated with better corporate governance and have, therefore, been kept out of the formal purview of bankruptcy.

Independently, the Government concerned about the same issue, had also constituted a high level committee on law relating to insolvency and winding up of companies under the chairmanship of Justice Shri V.Balakrishna Eradi (retired Judge of the Supreme Court of India).

Based on the recommendations of this Committee, the Government has introduced the Companies (Amendment) Bill, 2001 in Lok Sabha on 30 August 2001. The salient features of the provision of that Bill are:

- ? Comprehensive amendments proposed to the Companies Act, 1956 to deal with the liquidation and winding up of companies.
- ? A separate chapter in the Companies Act to deal with the sick industrial companies.
- ? Creation of National Company Law Tribunal to take after the functions at present performed by the Company Law Board and the High Court in winding up matters.
- ? Application of the Companies Act provision in the winding up of insurance companies.
- ? Exclusion of the Banking Regulation Act in redefining of sick industrial company.
- ? Levy and collection of cess on turn over or gross receipts of companies for the formation of a fund for rehabilitation, revival or protection of assets of the sick industrial companies.
- ? Infusion of professionalism by permitting the body corporate/professional firms to be the official liquidators and enlarged powers.
- ? Provision for interim payment for dues of the workmen of the company, which has declared sick or is under liquidation.
- ? Along with the Companies (Amendment) Bill, introduction of the Sick Industrial Companies (Special Provision) Repeal Bill, 2001 on 30th August 2001 by Government.

The avowed object of the Companies (Amendment) Bill is to facilitate or expedite revival/ rehabilitation of sick companies and protection of workers' interest and where necessary, winding up of the companies.

Unlike other areas, the gap between India and the International best practise is so large that we will initially need to legislate a modern code. The proposed bill and the advisory group recommendations seek to do this in somewhat different ways. The comparison of these different approaches will be taken up in the next section.

(iii) Corporate Governance

Corporate governance mechanisms differ between countries. The governance mechanism of each country is shaped by its political, economic and social history as also by its legal framework. Despite the differences in shareholder philosophies across countries, good governance mechanisms need to be encouraged among all corporate and non-corporate entities. While a number of multilateral organizations and stock exchanges evinced keen interest in the subject of corporate governance, the OECD principles of corporate governance are internationally recognised as good reference benchmarks. The OECD corporate governance principles cover five major areas: (i) The rights of shareholders; (ii) The equitable treatment of shareholders; (iii) The role of stakeholders; (iv) Disclosure and transparency; and (v) The responsibilities of the board. The Advisory Group on Corporate Governance has compared the status of corporate governance in India vis-à-vis the internationally recognised best standards and has suggested a course of action to improve corporate governance standards in India. In addition to the Advisory Group report, the World Bank has issued an ROSC on corporate governance in India.

Globally, the process of convergence in corporate governance is gathering momentum due to growing international integration of financial and product markets. Foreign investors and creditors are more comfortable in dealing with economic entities that adopt transparent and globally acceptable accounting and governance standards. Companies that embrace high disclosure and governance standards invariably command better premium in the market and are thus able to raise capital at lower costs.

Traditionally, corporate governance practices are classified in terms of the ‘Insider’ and ‘Outsider’ models. The predominant form in India is much closer to the East Asian ‘insider’ model where the promoters dominate governance in every possible way. Indian corporates, which reflect the pure ‘outsider’ model with widely dispersed shareholdings and professional management control, are relatively small in number. An important feature of the Indian scene is the implicit acceptance that corporate entities belong to the ‘founding families’ though not necessarily as their private properties. Even today, the concept of industrial house popularised some time ago by the Dutt Committee and the Monopolies and Restrictive Trade Practices Act (MRTP) continues to be the commonly accepted reference points in most of the discussions on ownership patterns of industrial/business units.

The Companies Act primarily defines the detailed statutory framework of corporate governance. Most of the important requirements set out by the OECD principles are reasonably well defined in the Companies Act in India. These provisions have been further supplemented by SEBI recently. The SEBI guidelines will eventually apply to all listed companies, though at present are limited to large companies. It may be noted in this context that, the main instrumentality through which SEBI seeks to ensure implementation is the listing agreement signed by the companies with the stock exchanges. This is a relatively weak instrument as compared to the Companies Act as its penal provisions in the event of non-compliance are not hurting enough and the threat of suspension or delisting may hurt investors even more. The Group, therefore, recommended that the penal provisions of the listing agreement should be strengthened and the management of an erring company held responsible for all major violations in regard to the corporate governance norms.

However, unlisted companies would not be covered by these guidelines; thus it may be desirable to incorporate the requirements of good corporate governance in the Companies Act. It is also necessary to have effective penal provisions in the Companies Act so that the management of a company does not have any incentive to violate the required corporate governance norms.

Strengthening the Companies Act

1) The rights and treatment of shareholders

Most of the important rights of shareholders like right to ownership and conveyance of transfer, obtaining relevant information regularly, elect members of the board, etc. are reasonably well covered by the Companies Act. However, the rights of shareholders of banks and public sector undertakings stand considerably abridged. OECD principles emphasise that "structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed". In India, as of today, companies are not required to make any such disclosures about the aggregate holdings of the promoters and their group companies. Companies are required to file details of their shareholding to the registrar of companies. Listed companies are required to file a return with the stock exchanges where they are listed. The disclosed information is such that it is difficult to make out as to what is the actual or effective level of shareholding of the promoters who are in the management control of the company. Several promoter groups exercise their control through a pyramid of subsidiary and holding companies. It should be made mandatory on the part of the promoters to fully disclose their total direct holdings and indirect holdings in companies. In addition, it is important to improve standards of governance of institutional shareholders.

2) Disclosure and transparency

The quality of disclosures by most of the Indian companies in regard to several key areas is rather poor. There is scanty disclosure regarding structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their known equity ownership. Similarly, disclosures regarding intra-group company dealings, division-wise accounts, consolidated accounts, etc. are all rather very poor. Companies need to share their business goals and plans with the shareholders adequately. The risk factors and off-balance sheet items affecting company's future performance should all be disclosed to the shareholders. In short, the quality of financial reporting adopted by the companies in India needs to be substantially improved. The Group makes a number of recommendations to improve disclosure. To minimise the costs of disclosures and to make them less cumbersome, electronic filing of information should be encouraged. Such information can be easily hosted on a web site so as to minimise costs of storage of information and its quick retrieval. The disclosure should cover aspects of financial health of the company, the ownership structures, risk factors, etc.

3) The Responsibilities of the Board

India has adopted a unitary board structure. For unitary board structure to function efficiently, there should be a strong representation of non-executive independent directors who are capable of taking independent stand and are not cowed down by the full time directors or the promoters of the company. The board should be able to perform its task of monitoring performance of the full time directors satisfactorily. It should ensure that returns to the shareholders on their investments are maximised while not making any compromises with the provisions of law and the rightful interests of all the stakeholders. Since most of the Indian companies belong to the 'insider' model, the most important reform that should be quickly brought about is to make boards more professional and truly autonomous. They need to be restructured in such a way that majority of the directors are truly independent. An independent director is one who does not have any family relationship with any of the executive directors/promoters, does not have currently or during the last five years any material financial dealings with the company and is/was not, during the last five years, an employee of the company or other companies that have/had material financial dealings with the company.

It should be made mandatory that 50 per cent or more of the board members are really independent (not merely non-executive) and are under no obligations whatsoever either of the executive directors or the promoters. Unless there is a clear and unambiguous definition as to who really is an independent director, the term is likely to be misinterpreted conveniently by the promoter groups. SEBI recently has provided a definition as part of its listing requirements. We may consider implanting something like that through company law.

Public Sectors Units and Banks

Given the important place occupied by the public sector entities in the fields of industry and financial sector**,** any steps to improve corporate governance in the Indian economy would remain incomplete and half-hearted unless public sector units are also covered in this exercise. Multiple layering of 'principal-agent' chains in the case of government owned entities has important consequences for the corporate governance mechanisms that will be adopted in them. Often, the accountability chain is very weak in public sector units. The first important step to improve governance mechanism in these units is to transfer the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. The process of selecting directors should be made highly credible by entrusting the task to a specially constituted body of eminent experts with an independent and high status like the Union Public Service Commission.

The role and relationship of the administrative ministries should be limited to issuing of written guidelines/directives to units under their jurisdiction in so far as these instructions are expected to reflect the will of the ultimate owners viz., the voters as perceived by the concerned ministries. It is necessary that the rights of common shareholders should be recognised in the corporate governance mechanisms adopted by all the public sector entities. They should also adopt the system of setting up of the three important board committees viz., the audit committee, remuneration committee, appointment committee, and investment committee. While the body of the eminent experts prepares a panel of names, the appointment committees of the public sector entities should recommend to their boards the persons from such panels that could be considered for induction on their boards.

Both government and RBI need to bring about significant changes in the corporate governance mechanism adopted by banks and other financial intermediaries. As a matter of principle, RBI should not appoint its nominees on the boards of banks to avoid conflict of interests. Although it is not feasible to have a free market for take-overs in respect banks, there is a strong case for recognising the rights of the shareholders, especially of public sector banks and financial institutions. Today, the common shareholders are denied such basic rights as adopting annual accounts or approving dividends. They cannot also influence composition of the boards in any way. As per the Bank Nationalisation Act, the general superintendence, direction, and management of the PSBs vest with their boards. At the same time, the Act also empowers government to issue directions/guidelines in matters of policy involving public interest. Over the years, however, the nature of government directions has often exceeded the 'matters involving public interest' and includes the whole gamut of administrative and corporate activities of the PSBs.

As a part of strengthening the functioning of their boards, banks should appoint a risk management committee of the board in addition to the three other board committees viz., audit, remuneration and appointment committees. Since banks and institutions are highly leveraged entities, their failure would pose large risks to the entire economic system. Their corporate governance mechanisms should, therefore, be relatively much tighter. Current governance practices adopted by the PSBs have created an inequality among different types of directors. Special status amounting to veto powers given to government directors is not in the interest good corporate governance. Banks should have clear strategies for guiding their operations and establishing accountability for executing them. Banks should maintain high degree of transparency in regard to disclosure of information.

(iv) Market Integrity

While a number of the basic concerns of market integrity are covered in other recommendations concerning transparency, information disclosure and regulatory standards, they are inadequate for the purposes of dealing with criminal activity. There are two distinct issues involved in so far as India is concerned. The first relates to money laundering and related issues and the second to a clearer identification of criminal activity originating in the Financial Sector.

In so far as money laundering is concerned, the G7 countries had identified a set of 10 principles. These are:

? Maximum cooperation domestically among regulators and law enforcement authorities in matters of financial crimes.
? Clear definitions of the role, duty and obligations of all national authorities involved in combating illicit financial activity.
? Accessible transparent channels for cooperation and exchange of information on financial crime and regulatory abuse at the international level.
? Improving the quality of national cooperation between law enforcement authorities and financial regulators to secure fast and efficient indirect exchange of information.
? Ensuring spontaneous provision of information by law enforcement authorities and regulators in response to requests at the international level.
? Provide for laws and systems to enable foreign financial regulators to share information for the full range of their responsibilities subject to limitations enunciated at the outset.
? Provide for passing on the shared information on financial crimes or regulatory abuse, with prior consent to other such authorities in that jurisdiction.
? Provide for confidentiality on shared information and its use only for the purposes stated in the original request including observance of the limitations imposed on its supply.
? Ensuring that arrangements for supplying information within regulatory and law enforcement cooperation framework are fast, effective and transparent and also discuss reasons as appropriate with one another where information cannot be shared.
? Ensure review of laws and procedures relating to international cooperation so as to allow improvements and appropriate response in changing circumstances.

These are amplified in greater detail in the 40 recommendations of the financial action task force (FATF), which provides a comprehensive blue print of the action required to counter money laundering and terrorist financing. Many of the recommendations are similar to some of the principles contained in the Basel core principles for banking supervision and criteria in the methodology document of the IMF. The response to these principles will have to be multifaceted. Domestically, it would require laws to clearly define financial crimes and frauds, as also mechanisms to promote international cooperation. In the wake of September 11, these initiatives have taken on greater urgency. A detailed review has been undertaken in the Technical note on market integrity. We will briefly review some of its key findings.

Firstly, the existing Indian position in regard to the structure of controls and procedures for combating money laundering or regulatory abuse is contained in different Acts, regulations, policies and guidelines pertinent to both cross border and domestic financial transactions. Necessary legal action to ensure compliance with international efforts will require passage of the Prevention of Money Laundering Bill.

Secondly, we do not have as yet a well-articulated notion of criminal activity originating in the financial sector. The Government should develop laws and agencies to deal with these issues. The Reserve Bank, in 2001, set up an expert committee on Bank Frauds chaired by Professor N.L Mitra to suggest measures for countering the problem of bank frauds. The Report contended that there was a need to define 'financial fraud' as a crime and to undertake serious measures to deal with it. The definition proposed is comprehensive and will cover a variety of financial crimes. Further, this suggestion of the Committee will bring bank/financial frauds under the ambit of money laundering and thus enhance enforcement. The Committee suggested a two-pronged approach to handle bank and financial frauds focusing on both preventive and prohibitive measures.

In addition to these legislative measures, the existing framework against money laundering activities in India would need further strengthening by improving procedures and policies for preparing appropriate customer profiles. Further mechanisms for coordination and cooperation with regulatory and other authorities (other than those that have search and seizure powers vested by law) for sharing of information and reporting of suspicious activities would also need to be enhanced and strengthened.

C. Financial Regulation and Supervision

(i) Banking Supervision

The Advisory Group on Banking Supervision was constituted to study the present status of applicability, relevance and compliance in India of the international standards and codes relating to banking regulation and supervision, the feasibility of compliance and to chalk out a possible course of action for convergence to international standards. The advisory group had restricted its exercise to the commercial banking sector in view of its dominant role. The issue of application of these standards to Cooperative banks, Regional Rural Banks and Local Area banks was not examined but in view of both the scope for regulatory arbitrage and contagion effects, they did, however, recommend that RBI should separately examine the coverage, applicability and gaps with regard to international standards *vis a vis* such non-commercial banking enterprises. The Group took into account seven important areas in which internationally accepted best practices are already in place. These include (i) core principles, (ii) corporate governance, (iii) internal control, (iv) management of credit risk, (v) loan accounting, transparency and disclosures, (vi) financial conglomerates and (vii) cross-border banking.

Coverage and Stance

The recommendations of the Group are extremely detailed and do not lend themselves to easy condensation. However, we will briefly review some key issues, noting that this, as with other advisory groups, is not a substitute for the detailed report.

Core Principles for Effective Banking Supervision

The core principles comprise 25 principles relating broadly to (i) pre-conditions for effective banking supervision (one principle), (ii) licensing and structure (four), (iii) prudential regulations and requirements (ten), (iv) methods of ongoing banking supervision (six), and (v) formal powers of supervisors (four). In respect of (i) preconditions for effective banking supervisions and (ii) licensing and structure, the banking system in India is largely compliant with international best practices. However, the Group felt that certain changes in the 52-year-old Banking Regulation Act, 1949 (BR Act), which forms the statutory basis for regulation of banks in India, are imperative to help achieve the objectives with which the Act was put in place. The group pointed a number of steps that RBI can put in place to improve effective supervision. The group also approved of the draft Prompt Corrective Action Framework proposed by the RBI and would recommend its implementation though they point out that the flexibility in the proposed framework must be exercised with care as "misplaced flexibility could delay the positioning of corrective actions and in producing required results". They also note that the framework cannot be viewed as permanent in nature and will need to be reviewed in light of developments in information technology, payments systems and in other such areas.

Enhancing Corporate Governance in Banks

The minimum benchmarks in this area relate to (i) strategies and techniques basic to sound corporate governance, (ii) organisational structure to ensure oversight by board of directors and individuals not involved in day-to-day running of business, as well as direct line of supervision of different business areas and independent risk management and audit functions, (iii) sound corporate governance practices, (iv) ensuring an environment supportive of sound corporate governance, and (v) role of supervisors.

With reference to public sector banks, which account for the largest share of business and assets of the banking sector in India, the Group asserted that the nature of a bank's ownership is not a critical factor in establishing sound corporate governance practices. The quality of corporate governance should be the same in all types of banking organizations irrespective of the nature of their ownership. The Group felt that the major areas where practices in the Indian banking sector fell short of international best practices related to the constitutions of boards, their accountability, and their involvement in risk management. The Group also stressed on enhanced transparency in the constitution and structure of the board and senior management and public disclosures regarding the same.

In respect of the role of the supervisor in ensuring adequate corporate governance, the Group noted that the overlap in the role of the Reserve Bank as the owner/ owner's agent and supervisor/ regulator needs to be corrected to preclude conflicts of interest and hindrance in its operations in the latter capacity. The Group further suggested that Government ownership of banks is not conducive to serious and urgent corrective action against any one of them. Limitations of the legal system also prevent strict enforcement of norms of corporate governance.

Internal Control

The core principles relating to internal control systems in banks are categorised under (i) management oversight and the control culture, (ii) risk assessment, (iii) control activities, (iv) information and communication, (v) monitoring activities and correcting deficiencies, (vi) evaluation of internal control systems by supervisory authorities and (vii) role and responsibilities of external auditors.

In respect of management oversight and the control culture, the Group noted that the systems of periodic discussions by the board with the management or follow-up of evaluation and review reports are not very well established in India. The attention paid at the board level to evaluation and review reports on internal control systems in banks is mostly routine and receives limited attention. Such reviews and evaluations are generally not used as important tools of management information and control. In the interest of greater internal control, boards of most banks, particularly public sector banks, would need to undergo an attitudinal change towards such evaluations/ reviews so that they have a better and firmer say in the maintenance and improvement of internal control systems in banks. In-depth discussions on periodic reports on internal control systems of banks between the management and their boards should be institutionalised.

Systemic risk assessment, which constitutes an important component of internal control, is still at the initial stages in most Indian banks and this is one of the areas where Indian banks fall short of international best practices. The availability of adequate and comprehensive internal financial, operational and compliance data as well as external market information about events and conditions that are relevant to decision making is an essential criterion for effective internal control. Quality and timeliness of management information systems is another area where Indian banks fall short of international best practices.

Credit risk

The core principles for management of credit risk relate to (i) establishing an appropriate credit risk environment, (ii) operating under a sound credit granting process, (iii) maintaining an appropriate credit administration, measurement and monitoring process, (iv) ensuring adequate controls over credit risk and (v) the role of supervisors.

With regard to measurement and monitoring of credit risks, the Group highlighted certain aspects of risk management practices in Indian banks requiring urgent review, as the gap between these practices and the corresponding international benchmarks is substantial. The highlighted aspects are as follows:

(a) The formulae-based determination of provisions for loan losses in Indian banks detracts attention from specific risks attendant to individual credits as also to specific sections of the total credit portfolio.

(b) The information systems in Indian banks are not currently being used to capture and keep in focus risks attached to off-balance sheet activities.

(c) The likely adverse impact of potential changes in the economic scenario on individual credit portfolios under conditions of stress are most often not examined by Indian banks. This denotes a certain degree of unpreparedness and lack of strategy on the part of the banks for managing such risks.

Risk management on scientific basis is a recent phenomenon in Indian banks and clearly stated strategies for risk management do not form part of most lending policies. This reveals inadequacies of the risk management policies applied hitherto by banks in India as well as the limitations of the MIS on which these systems have been built. Banks in India have to pay attention to improving their MIS as well as the credit risk management systems and strategies within as short a time-frame as possible.

Loan Accounting, Transparency and Disclosures

Sound practices for loan accounting and disclosures come under three categories, viz., (i) foundations for sound accounting; (ii) accounting for loans, comprising (a) recognition, derecognition and measurement, (b) impairment – recognition and measurement, (c) adequacy of overall allowance and (d) income recognition; and (iii) public disclosure comprising (a) accounting policies and practices, (b) credit risk management, (c) credit exposures and (d) credit quality.

The Group noted that loan classification in India is currently based on record of recovery of interest and principal coupled with current assessment about their realisability. The present system of graduated provisioning may result in under-provisioning in some cases, a loophole that needs to be plugged in view of the limitations in the legal system in the country for realisation of collateral. The Group suggested that the extant rule-based provisioning requirements need to be tightened and gradually brought at par with the internationally accepted standards in this regard. For a group of small homogenous loans, banks should be asked to adopt portfolio-based approach and determine impairment on that basis as well. In such cases, a higher provisioning even on standard loans comprising a particular portfolio should be considered. Migration to a more scientific provisioning system based on analysis of arrears, ageing of balances, migration analysis or use of various statistical methodologies can be achieved in the next two financial years, i.e., by the end of March 2003 and Reserve Bank of India should attempt to lead banks towards that.

With regard to transparency, the Group suggested that the levels of disclosure in the balance sheets of Indian banks need to be improved further. On examination of the current practices in comparison with the standards suggested by the Basel Committee on Banking Supervision, it was felt that several changes are required in disclosure practices, particularly in the areas relating to: (i) balance sheet presentation, (ii) internal control and management system, (iii) management of credit risk and (iv) management of risks in general. The list of specific disclosures recommended by the Group is given in pages 42-45 of the Report.

Financial Conglomerates

According to the Group, the main supervisory concerns in respect of financial conglomerates include: (a) the risk of contagion from non-banking entities which are members of the group and may or may not be regulated, (b) risk of excessive exposure to such financial conglomerates, (c) transparency of legal and managerial structures, (d) quality of management in individual units and across the group, (e) access to and sharing of prudential information, (f) consolidation of financial reports and (g) moral hazard arising from the impression that non-regulated entities are also being monitored.

The emergence of financial conglomerates with regulated entities engaged to a significant extent in at least two out of the three activities of banking, insurance and securities business is rather recent in India. Principles and systems for their regulation as entities in a conglomerate and for coordination between the concerned different regulators are also to be developed as yet. Urgent attention would need to be paid to develop suitable mechanisms in order to detect and provide for situations of double gearing and other similar problems posed by financial conglomerates.

It would be desirable to put in place arrangements for applying fit and proper tests on all shareholders with shareholdings beyond a specified threshold, say 10 per cent. Further, such tests need to be applied on a continuous basis so that occurrence of any event which raises any doubt about fitness and propriety of a manager, director or a shareholder (with shareholding beyond a specified level), results in the test being applied.

The Advisory Group suggested that the RBI may consider introducing the concept of primary supervisor. In the context of almost all major banks going in for insurance as well as securities business, designating one of the supervisors as the primary supervisor will substantially improve much needed co-ordination between different supervisors (regulators) and add to the scope and quality of the overall supervision of the conglomerate.

At present, RBI shares information with other supervisors more with the force of set practices and conventions than with the support of clearly stated legal provisions. In order to place the arrangement on firmer footings and in keeping with the currently accepted international practices, the desirability of suitably enacting these powers needs to be considered. The Group felt that a scheme of formalised co-ordination between different regulators and designation of one of the regulators involved as a co-ordinator with clearly assigned roles and responsibilities is essential.

In respect of risk concentration principles, RBI should consider issuing appropriate guidelines requiring banks to ensure that they and their subsidiaries and joint ventures put in place adequate risk management processes covering group-wide risk concentrations. Risk management systems that are being put in place in banks need to take into account the special risks posed by 'Intra-group Transactions and Exposures'.

Cross-border Banking

The Group's major observations in respect of cross-border supervision are categorised as: (a) Issues relating to nature of supervision, (b) Issues relating to information sharing and (c) Suggested changes in approach and methods of supervision.

On the nature of supervision, it was felt that for supervision of subsidiaries of foreign banks which have branches in India as also for subsidiaries of Indian banks abroad, RBI would need to develop a more proactive and focused policy. A major obstacle in respect of consolidated supervision is the multiplicity of regulators on mutually exclusive basis. A suitable mechanism to co-ordinate their approaches will have to be developed. RBI should also encourage Indian banks and foreign entities operating in India to submit to consolidated supervision. Further, country-wise analysis will have to be undertaken and suitable action taken where RBI faces constraints in its efforts to exercise consolidated supervision of the global activities of Indian banks on account of local laws which do not permit the home supervisor to conduct onsite inspection/examination of records. The Group also felt that RBI should have greater interaction with the home supervisors of foreign banks operating in India.

With regard to information sharing too, the Group emphasised greater sharing of material information between home and host country supervisors on the basis of full reciprocity. In respect of confidentiality of supervisory information, it was felt that the present legal provisions in India in respect of confidentiality of information available with the home supervisor (RBI) do not seem to be providing sufficient protection of information. More clearly defined laws would be needed for this purpose. In addition to legal changes, there are a number of suggestions, which may be implemented at the regulatory level as well.

While the Group focussed largely on the shortcomings of the Indian system vis-à-vis international best practices in making its recommendations, it was of the view that given the level of complexity and development of the Indian banking sector, the level of compliance with the standards and codes is of a high order. Wherever there are significant gaps, these can be remedied within a reasonable time frame and, as such, are not causes for immediate concern provided that necessary amendments to laws, wherever required, are put in place without delay. The group identifies reasonable timeframes in most of these cases to implement these different changes.

(ii) Securities Market Regulation

The Advisory Group on Securities Market Regulation has in its Report, provided a brief overview of the securities market regulation outlining the nature of pre-reform equity and debt markets as well as the reform measures initiated in these markets in the 1990s. The Report also evaluated the existing regulatory frame-work, broadly using the principles laid down by the International Organisation of Securities Commissions (IOSCO) as criteria, and attempted to identify some important lacunae and issues - regulatory, legal, market including mutual funds - that need to be addressed by future reform initiatives.

Regulatory Issues

The regulatory responsibility of the securities market is vested in the SEBI (which is also the apex regulatory body for the securities market), RBI, and two government departments - Department of Company Affairs and Department of Economic Affairs. Although, there is a clear division of regulatory responsibilities between RBI and SEBI, the distribution of regulatory responsibilities among a number of institutions, the report observed, could give rise to confusion among the regulated.

As regards enforcement powers of SEBI, while SEBI has powers of direct surveillance of the stock exchanges, members of stock exchanges and other market intermediaries registered with it, SEBI has lesser powers over companies listed on stock exchanges. Further, the present penalty levels are not always high enough to deter market players from regulatory violations. The Group believed that there is a need to vest SEBI with enhanced authority and disgorgement powers. On the issue of limited success in action taken against fraudulent and vanishing companies, the Group felt that it is necessary to streamline the procedures to quickly detect frauds. There is also a need to streamline the procedures relating to due process. These recommendations are in line with what we have already noted in the discussion on corporate governance and financial frauds.

With the increasing integration of the financial markets, and emergence of financial supermarkets, there are increasing instances of the same market intermediary coming under the purview of multiple regulatory bodies. These factors have raised the potential for regulatory gaps as well as overlaps, thereby underlining the need for greater co-operation among various regulators. Currently, co-ordination among domestic regulators is undertaken through the High Level Committee on Capital Markets (HLCCM) comprising RBI, SEBI, the IRDA and Finance Ministry. There is scope, however, to further strengthen the co-ordination efforts by giving it a legal status, arrange for more frequent meetings and making its functioning transparent. Also, a system needs to be devised to allow designated functionaries (not necessarily only at the top level) to share specified market information on a routine and automatic basis. As regards co-ordination with regulators in other countries, while the RBI has put in place a system of exchange of need-based information, the powers of SEBI to assist foreign regulators are not explicitly provided by legislation. Hence, the Group was of the view that necessary legislative changes need to be made to enhance SEBI's powers in this regard.

On the issue of self-regulation**,** the Group noted that self-regulation by stock exchanges is not always effective, because the current ownership and governance structures of many stock exchanges allow scope for conflicts of interest. Elimination of such conflicts of interest through demutualization, which implies separation of ownership of exchange from the right to trade on it, can promote fairness and reinforce investor protection. The Group also suggested that SEBI should assist the Association of Mutual Funds of India (AMFI) to develop into a full-fledged self-regulatory organisation (SROs). In money and government securities markets, the RBI is engaging the emerging SROs - Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) - in a consultative process to facilitate their emergence as full-fledged SROs; this process needs to be further intensified. On their part, to promote integrity of the markets, FIMMDA and PDAI need to establish a comprehensive code of conduct and best practices in securities transactions and also have a mechanism to enforce such codes. The Report suggested that RBI could play a supportive role here.

As regards prudential issues, while several measures have been taken to contain risk, secure market integrity and protect the interest of investors, one lacuna that continues, relates to the absence of margin requirement for institutional trades. The Group recommended that this lacuna be addressed.

Legal Issues

The legal framework constrains the RBI from exercising uniform powers vis-à-vis different groups of players, even though the activity regulated is the same, because of a peculiar legal arrangement. The amended Securities Contract Regulation Act (SCRA) has conferred broadly on the RBI, the responsibility of regulation of government securities and money markets, but not the necessary enforcement powers. To regulate these markets, RBI resorts to its regulatory authority over the major participants in these markets such as banks, financial institutions and primary dealers through separate institution-specific frameworks. This underlined the need for (a) the same legislation to include both regulatory responsibilities and the authority to carry them out and (b) the focus to shift from institution-specific regulation to market-specific regulation.

The problem of multiplicity of regulators, as referred to earlier, emerges from the existence of multiplicity of Acts governing securities market regulation. Although the scope of the Acts is well defined, problems of interpretation have led to confusion. There is, therefore, a need to simplify and streamline the legal framework. In this context, the Group believes that consolidating the SCRA and the SEBI Act in line with the recommendations of the Dhanuka Committee will be very helpful.

Market issues

It is important to recognize the trade-off between benefits of regulation and costs of over-regulation and high cost of compliance. To dilute this trade-off, it is important to modernise the market microstructure that will facilitate attaining the regulatory objectives.

The equities market has witnessed a quantum improvement in trading technology during the 1990s that has increased transparency in trading and facilitated the integration of different trading centres into a single trading platform. In contrast, the debt markets are largely negotiated markets and are lagging behind the equity market in transparency[*]. SEBI has taken initiatives to foster transparency by prohibiting negotiated deals on the exchanges in respect of listed corporate debt securities and prescribing that all such trades would be executed as in the case of equities. However, negotiated deals are still continuing, albeit outside the exchange, and there is no market dissemination of information on such transactions. As regards deals in government securities market, the Group notes that transparency would get a boost with the current initiative to put in place an electronic negotiated dealing system for the SGL participants, which will disseminate information on a near real time basis.

Although the process of compulsory dematerialization is nearing completion, its full benefits have not been reaped because of slow progress in introduction of rolling settlement on account of (a) lack of availability of electronic funds transfer across the country and (b) a general apprehension that such a move will reduce liquidity in the market. Even though a more effective payment and clearing system through a wider availability of Electronic Funds Transfer (EFT) is important for switch-over to rolling settlement, the Group expressed the view that even the current payment infrastructure could support a faster phasing-in. The Group also suggested that RBI and SEBI expedite their scrutiny of the recent recommendations made by the joint task force of IOSCO and BIS on securities settlement system, for early implementation.

The Group noted that in regard to Mutual funds, SEBI had put in place an effective regulatory framework. But some important gaps still remain. The primary problem was with regard to the ambiguous status of UTI with four of its principle schemes not subject to SEBI regulation; here it was felt that it was important to bring these schemes under SEBI as well. A second lacuna was regarding valuations of thinly traded securities in Mutual fund NAV's. Here the Group felt it was necessary to develop regulations to ensure uniform practices. Prudential norms for mutual funds would also need to be evolved, as there is still considerable variability in these practices.

A clearing corporation, which creates a settlement guarantee fund to ensure settlement of trades irrespective of default by trading members, guarantees financial settlements and nearly eliminating counter party risk has given a tremendous boost to investor confidence in India. In contrast to the current Indian system of each stock exchange having its own clearing corporation or clearing bank, it may, however, be appropriate to have, perhaps, only two clearing corporations in line with international practice, which would support many stock exchanges. Such an arrangement would allow the clearing agency to have an overall view of gross exposures of traders across the stock exchanges and would be much better geared to manage risks. On the issue of payments and settlement, the Group concurred with the recommendations made by the Advisory Group on Payments and Settlement Systems discussed later.

With a view to enabling investors to take informed decisions as well as to promote transparency, regulations have become more stringent by requiring corporate disclosure to be more frequent and wider in scope. Here, the recommendations in corporate governance on disclosure would be critical. A number of these measures have already been initiated and an enumeration of these is provided in the annexure.

(iii) Insurance Regulation

The Advisory Group on Insurance Regulation has submitted its report in two parts based on a decomposition of the issues in Insurance regulation into a) licensing of new companies and b) supervision of existing companies. Part I of the Report, which was submitted on September 23, 2000, dealt with licensing of new companies in India. The Part II of the Report, which was submitted on February 14, 2001, deliberated on solvency and actuarial issues.

The Indian insurance industry is now at a turning point following the recent liberalisation. The recommendations of the Group could be analytically viewed through the three inter-related angles of financial stability, economic efficiency and product innovation.

It will be recognised that given the backdrop of past failures of private insurers, the formulation of insurance regulation naturally accords the highest priority to financial stability, sometimes entailing stipulations that are in excess of international standards. The Indian standards in respect of national incorporation, foreign insurers, minimum capital and deposit requirements, business plan, reinsurance stipulations, estimation of liabilities of life insurance companies, investment restrictions, asset valuation, solvency margins and taxation of life insurance companies are in line with international standards and cross country practises. Besides, the external liberalisation of the insurance sector, in line with the experience in emerging market economies, has also been strategic, designating the GIC as the mandatory national reinsurer although international standards argue against compulsory domestic cessation of risks. However, this prescription may be continued till a satisfactory solution is found for the problem of international reinsurers converting local insurance companies into brokers.

The Group has, also, at various points favoured efficiency enhancing initiatives over time essentially in two forms: replacing (and gradually scaling down) across-the-board stipulations with business-specific requirements in terms of balance sheet restrictions including business capital requirements and provisioning of technical reserves, in consonance with particular risk and claims characteristics, and enlarging economies of scale and scope in the Indian insurance industry, through enlargement of company objectives, outsourcing, etc.

The role of insurance regulation in product innovation is two-fold: in terms of encouragement as well as in terms of building safeguards. The Group has favoured measures that encourage product innovation, such as the entry of co-operatives (to enhance the rural orientation) and business-specific stipulations. At the same time, the Group has emphasised the need to set up adequate supervisory mechanisms for i) the superannuation business and ii) new products such as unit-linked insurance (essentially through inter-regulator co-ordination) and appropriate provisioning in case of emerging businesses, such as longer-term general insurance business.

A number of recommendations of the Group are already under consideration. For example, entry of co-operative societies in insurance is already envisaged in the proposed Insurance Amendment Bill. On inter-regulator co-ordination the Chairman, IRDA has been inducted as a member of the High-level Committee on Capital Markets, chaired by the Governor, RBI with the Chairman, SEBI as member; IRDA has submitted a report on Institution of pension funds regulator to the Government suggesting that IRDA may be designated as the regulator. However, here there is a difference of opinion between the IRDA proposal and Group's report, as the Group had felt that an independent regulator may be more desirable.

It must be emphasised that a large number of the recommendations of the Group hinge on a more detailed classification of insurance business in line with international best practices as against the present binary classification (life and general) in Section 10(2A)) of the 1938 Indian Insurance Act. Other statutory changes, *prima facie*, include Amending Clause 7A of the Indian Insurance Act(1938), as amended in 1999, in line with Section 6(2)h of the LIC Act, to broaden company objectives with a view to permitting insurers to take up related activities. Changes in taxation laws to change taxation practices of life insurers and non-life insurers (especially if pre-tax transfers to the catastrophe reserves are to be allowed).

Some other issues

There is no uniform international practice as regards the design of products. The IRDA proposes to practice the UK model of "file and proceed" system. In the interest of transparency, the certificate, including the basis of premium, given by the actuary may be treated as a public document and be made available, on demand, to other companies and any practicing actuary. Further, the premium rate table and the benefit design may also be treated as "Published Information". A similar procedure could be considered for group business and also for general insurance business.

The IRDA regulations on Actuaries and Auditors require that life insurers should employ dedicated individuals (and not an actuarial firm) as appointed actuaries although general insurers could appoint actuarial firms as appointed actuaries. A firm of consulting actuaries may be considered for acting as appointed actuaries as per the practice obtaining in most countries. Furthermore, the condition that a "certificate of practice" has to be obtained each year from the professional body, the Actuarial Society of India, is not present in respect of any other profession.

However, on overall assessment, the Group is unequivocal in concluding that Indian standards on Insurance regulation are on par with international standards. In fact they may in some cases exceed them. However, the standards and rules need to be redeveloped to allow for greater diversity in the business.

***(iv)* Payment and Settlement System**

The Advisory Group on Payment and Settlement System submitted its report in three parts reviewing clearing-house operations, settlement in equities and debt markets, and settlement of foreign exchange transactions.

In Part I of its Report, it critically examined two issues viz., status of clearing house operations as well as responsibilities of the Reserve Bank in the light of the consultative report on "Core Principles for Systematically Important Payment Systems" released by the BIS in December 1999, followed by the revised version in July 2000. It recommended, *inter alia*, extensive legal reforms especially empowering the Reserve Bank to supervise the payment and settlement system, institution of a framework to enable at least the Lamfalussy standards for the deferred net settlement system (DNS) and to develop a suitable framework for the real-time gross settlement (RTGS) system and spread of electronic-based transactions through appropriate price incentives. Specifically, the group noted that to ensure the essential principle that at the very minimum, the system be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement exposure, there is a strong need to evolve a system of net bilateral, multilateral and system caps as also a loss sharing arrangements. Further, without proper institutional infrastructure, particularly an efficient communication backbone throughout the country, it may not be prudent to put forward a road map for switching over from paper-based instruments to non-paper-based electronic instruments of payment. As a interim measure, the Group recommended that RBI in its professed role as enabling the payment system to become efficient, should devote resources for conducting periodic survey on costing of various retail and wholesale payment instruments such that effective pricing and choice of these instruments could take place.

At present, a specific law does not govern Payment and Settlement systems; the Uniform regulations and Rules governing netting are primarily covered under the Indian Contract Act. In order to ensure predictability and reduce ambiguity, it is felt that having a specific law would be desirable. The Group was of the view that the Reserve Bank should eventually come out of the role of a payment system provider except for funds settlement. It discussed that there is a need for clearly defined procedures for management of credit risks and liquidity risks and appropriate incentives to manage and contain these risks. The introduction of cheque truncation would facilitate same day settlement of Magnetic Ink Character Reading (MICR) clearing subject to the concept of returns being delinked from the settlement process.

In Part II of the Report, the Group examined the status of existing payment and settlement systems in Indian equity and debt markets including government securities market and suggested ways for improvements in compliance with the G-30 recommendations on securities settlement system. It recommended, *inter alia,* introduction of rolling settlement in the liquid segment of the equity market; allowing current account facility with the Reserve Bank to clearing corporations for ensuring settlement facility on the books of the Reserve Bank as an interim measure pending eventual grant of limited purpose banking license to them with appropriate prudential guidelines thereon; building up of an institutional mechanism for centralised collection of information, their dissemination to market participants; and prudential guidelines for implementing cross margining across markets and lastly allowing institutions to borrow securities towards in both equity and debt segments of the system. These would facilitate dealing with problems arising from participants undertaking multiple exposures in various markets at any point of time.

In Part III of the Report, the Group critically examined the existing arrangements for settlement of foreign exchange transactions prevailing in India, deficiencies in the present system, international practices, etc. Based on the assessment that the proposed Clearing Corporation of India (CCI) would play a major role in risk mitigation in the forex area, the Group has recommended a set of actions which could be initiated by the CCI, such as, establishment of a Clearing Agent abroad by the CCI, institution of a separate guarantee fund for the forex clearing and appropriate integration between the participating banks and the CCI and their interface with the Real-time Gross Settlement (RTGS) system. The other recommendations covered meeting of minimum standards prescribed under Lamfalussy Report, taking adequate risk control measures, and exploring the possibilities of introduction of extended time zone to minimize the time lag between international markets.

3. Themes in Overlap and interlinkages

The reports of the different Groups involve a number of overlapping issues. The overlaps arise because of the inherently inter-connected nature of the subjects under review. In fact, in a number of places, the groups have noted the overlap and have emphasized the need for coordinated action. The various Advisory Groups' reports are in this sense complementary. Some key overlapping issues as noted in these reports are highlighted below:

Monetary and Financial Policies and Fiscal Transparency

Both Groups noted the interdependence of the issues being discussed. In particular, the importance of setting up an independent debt management office to take over, in a phased manner, the present debt management functions discharged by RBI has been addressed. It has felt that the debt management function has put RBI into a situation of direct conflict of interest between debt management and monetary policy. In order to do this, both Groups emphasised the importance of the proposed Fiscal Responsibility and Budget Management Bill. Further, the suggestions in FRBMB to reduce deficits are critical.

Corporate Governance and Banking Supervision Advisory Groups

Both Groups emphasize:

- ? Uniform quality of corporate governance in all types of banking organisations irrespective of their ownership.
- ? Streamlining the process of induction and orientation of directors into banks' boards.
- ? Boards setting and enforcing clear lines of responsibility and accountability for themselves, senior management and throughout the organisation.
- ? Establishing linkage between contribution and remuneration/reward and setting up compensation committees of the board for the purpose.
- ? Nomination committees to assess the effectiveness of the board and initiate the process of renewing and replacing board members.
- ? Introduction of a provision on the lines of Section 20 of the Banking Regulation Act, 1949, which prohibits loans and advances to directors and their connected parties, in respect of large shareholders also. Information on transactions with affiliated and related parties should be disclosed.
- ? Need for correction in the overlapping role of the Reserve Bank of India as owner/owner's representative and as the regulator/supervisor for good governance.

In addition to the concurrence of these Groups for improvements in standards in the above issues, the Advisory Group on corporate governance made some specific recommendations on common issues which are more specific:

? Restricting the number of banking companies for an individual director to 10.

? Training on board practices to be imparted to elected members, by setting up an Institute of Directors.

? Separation of the post of the Chairman of the Board from that of Managing Director and/or the Chief Executive Officer for the purpose of good governance.

? While the liability of non-executive directors should remain limited, the main responsibility and accountability should be raised with MD/CEO.

? The retirement age of whole time directors should be fixed at 65, while for the part time director it should be fixed at 75. Besides, independent directors should have a term of 10 years at a stretch.

Payment and Settlement System and Securities Market Regulation

The Groups had concurrent views on some key issues, particularly, on extending Electronic Funds Transfer (EFT) across the country and eliminating the constraint of the absence of Real Time Gross Settlement System (RTGS). Again, while discussing the trading cycle of rolling settlement both the Groups had similar views. The Advisory Group on Securities Market Regulation observed the current payment infrastructure can support a faster phasing in, even though a more effective payment and clearing system through a wider availability of EFT is necessary for switch-over to a rolling settlement.

The Groups also agreed on the need for improving the Payments and Settlement Systems for Delivery versus Payment (DvP). Further, they noted that all the prerequisites for the introduction of Straight-through Processing (STP) which involves verification through internet are as yet not available.

Accounting and Auditing and Banking Supervision

The Advisory Groups recommended that consolidated financial statement and accounting for investments in subsidiaries should be introduced for banking companies. The Reserve Bank has already initiated steps in this regard for commercial banks to introduce consolidated balance sheet.

Regulatory Overlap

The Groups on Payments Systems, Securities markets, Insurance Regulation and Banking Supervision had noted the issues arising out of regulatory overlap. These issues become critical with the rise of financial conglomerates. Further, these concerns were also highlighted in the discussion on market integrity. Multiplicity of regulators can lead to both conflicting regulations as well as regulatory gaps in cases of unclear demarcations of authority.

To deal with these problems, the suggestions by the Groups involved creating some formal mechanism. Thus, the group on payment systems noted the need for an institutional problem resolution mechanism when regulatory burden of different regulators e.g., the RBI the SEBI etc. impinges on the level playing field across participants. The group on securities market was more specific and suggested giving statutory status to the High-level Group on

Capital markets, while the group on banking supervision recommended the notion of a key regulator/supervisor.

In addition to these ideas, we will need to explore mechanisms to promote information sharing amongst regulators at operational levels. In addition to cooperation amongst regulators, mechanisms to promote cooperation with other agencies dealing with fraud, tax evasion and money laundering are also critical. In this connection, passage of the Prevention of Money Laundering Bill and steps to effectively define 'Financial Fraud' are essential. Further, strengthening liability provisions related to corporate governance and disclosure norms will also be required.

In addition to the overlaps in concerns, the groups had also recognised the importance of a coordinated program for implementation. Thus, the Bankruptcy Group in its deliberations had observed the critical role of corporate governance in promoting transparency and pre-bankruptcy remedial measures. In fact, the effectiveness of a bankruptcy process is critically dependent on the implementation of good corporate governance principles. In addition, both of these are critically dependent on the formulation of and compliance with adequate disclosure norms and standards of accounting and auditing. In a similar way, the Group on Securities Market Regulation had noted the need to extend international accounting norms to the Mutual Fund sector to promote stability and fairness. We had also noted the emphasis laid by the respective groups on the interdependence between transparency in Monetary and Financial Policies and that in Fiscal policy.

The interrelation between standards and the interrelation in the institutions and markets would in fact suggest a co-ordinated approach to reforms; an issue to which we now turn to in the next section.

4. Issues in Implementation and prospects for the future

The reports of these Groups were completed over a longish period spanning almost a year. Even as Advisory Groups were formulating reports, concurrent developments in policy and international events were changing some of the basis for the discussion. In this section, we examine the issues that arise out of such developments as well as concerns for implementation.

Monetary Policy

The appropriate objective to monetary policy tends to be a vexatious issue. The Advisory Group's recommendation of single objective of inflation gets complicated when we note that macroeconomic problems can also arise from asset price and exchange rate movements. We can see examples of this in the credit fuelled asset price bubble in Japan in the late 'eighties that had devastating effects on the banking system and in turn the real economy and still more recently, after the collapse of the bubble associated with tech stocks in the NASDAQ and elsewhere. All of these have occurred in periods of low inflation. This naturally leads to the question that could monetary policy have done something about this.[xi] Further, even within the context of an inflation target there is some disagreement as to what is optimal.[xii] The importance of an appropriate model in which arguments are made becomes even more critical. It is important, however, to stress that inspite of this diversity, there is virtual consensus in the profession that the central objective of monetary policy will have to be price stability. Further, with regard to the principal and ancillary objectives, there is a key point, which bears reiteration that the process of identifying the objective should be transparent and linked to an explicit macroeconomic framework or model, rather than through pre-commitment to single or multiple objectives. The Group's point that multiple objectives can imply opaqueness is central. This is especially the case when there is no clear *ex-ante* statement of objectives and a transparent mechanism through which they can be changed.

A more important concern relates to the autonomy provided to the Central Bank in choosing policy to implement its objectives. Here, the committee felt that ideally one should seek to give the RBI a constitutional status. At present, the RBI is under the executive legislative control of the central government by virtue of its inclusion in entry 38 of list I of schedule VII. This has meant the Bank and the Governors to function under the influence of the political executive. Even though in the last decade or so, the Bank has functioned with considerable autonomy, this has not always been the case. Further, the tenure of the Governors is also not statutorily protected. But, providing a constitutional status to RBI will raise a number of issues in the conduct of economic policy and macroeconomic management, which are beyond the scope of this exercise. Even if constitutional changes are difficult to do in the short run, similar results may be obtained by codifying these principles explicitly by modifying the RBI Act.

Fiscal Policy

Recently, the parliamentary Standing Committee on Finance has recommended that the provisions with regard to numerical ceilings as well as time frame set in the FRBMB Bill for reduction in revenue and fiscal deficits, the amount of guarantees to be given by the Central Government and the total liabilities of the Central Government, may be deleted and revenue and fiscal deficits may be kept/maintained at prudent levels. These would be a serious dilution of the recommendations. It should be noted that the ability to separate debt management from the RBI requires a more tightly controlled budget. Balanced budgets and fiscal discipline are essential to promote transparent and stable monetary policies as well. Further, helping to develop healthy and deep private primary and secondary markets in debt would require a reduction in the public foreclosure of savings. Thus, instead of giving up the goal completely, the government should voluntarily seek to pre-commit to some time-frame for achieving these targets. This is neither inconsistent with the standing committees recommendations nor with the Government's own long-term objectives, because the parliamentary committee has only objected to a statutory statement of limits and targets.

Data Dissemination

The recommendations of the Group have primarily focussed on the nature of India's obligations under the data standards. Data issues, however, also require us to examine the structure of the system in which data is generated and disseminated since the requirements of effective governance will require a capable institution for data generation. These longer run systemic dimensions to the statistical system have been extensively dealt with in the report of the National Statistical Commission. While it is difficult to include all relevant elements of that report, the basic requirement on independence of the statistical system and giving it a statutory frame is essential for ensuring reliability and credibility of the data provided. This would also be in consonance with a recommendation made by the IMF in evaluating India's observance of Fiscal transparency.[xiii] Thus, it is important for the Government to accept the report and set a time framework for implementation of its recommendations.

Bankruptcy and Insolvency Law: some concerns

In this vital area, we have two approaches to reform as outlined by the Advisory Group and that outlined in the proposed amendment to the Companies Act. Both these approaches seek to facilitate restructuring; both seek to develop a unified framework for the law as against the current two stage process. But, there are some important conceptual differences. In this section, we will explore these differences and their implications for policy.

1. The proposal in the Companies (Amendment) Bill for the creation of a fund for revival of sick industrial companies by imposing a cess on the turn over or gross receipts of the companies is likely to create problems. The existing moral hazard associated with sickness will remain; further it could add to the cost structure of healthy firms. The concern appears to be driven primarily be seeking to protect workers. This would be better done through the creation of an employment fund based on employer-employee contributions, which could assist in relocation. Rehabilitation or restructuring of a unit, should be, as suggested by the Advisory Group, left to market and economic forces to determine cost and allocate the burden upon stakeholders.

2. The Companies (Amendment) Bill proposes creating a new institution of National Company Law Tribunal vested with the powers of Company Law Board and the High Courts handling the winding up matters. The Tribunal would decide on the revival/rehabilitation of sick industrial companies replacing the Board of Industrial and Financial Reconstruction (BIFR). The multiplicity of adjudicatory (judicial) authorities under the Companies Act, 1956 are to be brought under one uniform institution with a definite and fixed time frame for expeditious disposal. On the other hand, the Advisory Group suggested for the creation of a dedicated division bench of the High Court as bankruptcy court leaving aside the corporate governance functions to the present company law board. The Advisory Group recommendations were in trying to avoid conflict with the existing judicial process and tribunals. Further, a dedicated bench of the High Court could also meet the need for a special and professional approach. The Group also proposed a time bound procedure for each stage of bankruptcy proceeding. Formally, Tribunals can be used as an alternative in this area; however, the Government would need to ensure that they adhere to strict time schedules and also that some of the weaknesses associated with Tribunals at present, especially relating to the quality, skills and incentives of the judicial and non-judicial members do not contaminate this process.

3. The Companies (Amendment) Bill retains the present institution of official liquidator but tries to infuse professionalism by enlarging the powers of official liquidators and permitting entry of the bodies corporate and professional firms. On the other hand, the Advisory Group recommends substituting the official liquidator with professional trustees having incentive oriented efficiency compatible remuneration. Professionalism could be infused through both the proposals. There are, however, some substantial differences; firstly remuneration should be incentive compatible as recommended in the Advisory Group. Secondly, the moral hazard risks of defaulting management staying in control would need to be addressed in the Companies (Amendment) Bill.

4. Both proposals would initiate proceedings on a default of Rs.1 lakh. The main difference is in that by maintaining an integrated structure, the Advisory Group's proposal would make failure to restructure as a ground to initiate winding up, while the draft bill would leave them as two distinct processes with possibilities of conflicts and gaps. Further, the Group has recommended that the restructuring/liquidation be done within a strict time-frame again there is no such requirement in the Draft Bill. Another difference is that the Companies (Amendment) Bill distinguishes between default in the context of winding up and that in sickness and whereas the Advisory Group makes no such distinction. This distinction between the two groups is not material provided sickness is not made into an open-ended process as at present.

5. The Companies (Amendment) Bill excludes from its applicability the Banking Regulation Act, 1949 in its totality. The Companies (Amendment) Bill, on the other hand, modifies the Insurance Act, 1938 to bring it within the ambit of the National Company Law Tribunal. Whereas, the Advisory Group recommends incorporating Part-III and IIIA of the Banking Regulation Act, 1949 to its fold by retaining its special features. Similarly insurance companies, non-banking financial companies, government companies and public corporations, were recommended to be included in the same procedure, with the special features of these enterprises being dealt with by vesting the power to appoint or name trustees with the regulator. The differences here are not substantive but allowing banking and financial companies into the accelerated procedure with regulatory participation may remove the current lacunae in the law. This issue is not material at the moment due to few cases of such failure. The difference may become significant in the long run with greater private sector participation in these sectors.

In short, while the proposed amendment will rectify a number of defects in the current scenario, it will need, however, some major structural modifications before it can meet the requirements of a fully incentive compatible system.

Implementation and Follow-up

The discussion on standards and codes raises a number of issues in implementation and follow-up. The detailed review of the Groups has thrown up a number of areas of legislative reform. These have been outlined in the discussion above and in the annexures. The annexes outline the changes both in terms of recommendations by each Group as well as by relevant Acts and laws. The implied reform will require action by both the Government as well as the various regulatory and standard setting agencies like the RBI, SEBI, IRDA and ICAI. The range of legislation could require some constitutional changes (as some have suggested for RBI autonomy, and Bankruptcy Tribunals) and extensive modifications to the RBI, SEBI and IRDA, Companies Act, amongst others. In addition, a variety of new legislation on Fiscal Responsibility, Prevention of Money Laundering (already proposed) and Financial Fraud (under discussion) will be required. This will involve a considerable effort in legislation. Setting or outlining time frames is not desirable or feasible, it is important that for purposes of credibility, pending legislation be taken up expeditiously.

Further, as we can see in Annexure V, considerable reform is possible even at the level of subordinate rules and practices of the various regulatory agencies. It is important that these are taken note of and the agencies encouraged to identify their own time frames of compliance. In addition to these reforms, effective implementation will require the participation of self-regulatory organizations (SROs) such as the Indian Banks Association (IBA), Fixed Income Money Market and Derivatives Association of India (FIMMDA), Association of Merchant Bankers of India (AMBI), Association of Mutual Funds of India (AMFI), Foreign Exchange Dealers Association of India (FEDAI), Primary Dealers Association of India (PDAI), clearing house associations, Industry associations among others, playing a critical role in developing codes of conduct, setting and maintaining standards for different segments of the financial system with a view to promoting and protecting interests of institutions, investors and depositors in India. Legislative reform will need to be accompanied by an active process of dialogue with these organisations to emphasise the issues and involving them in the process of better implementation.

In addition to the gaps within the existing regulatory frameworks, the developments of the past year or so have raised a number of issues that require detailed considerations:

(i) The recent bankruptcy filing by ENRON has raised a number of ethical issues relating to the role of auditors and internal control mechanisms in auditing and accounting firms. In the US, this has led to some suggestions to revamp their accountability structures. While this is not directly applicable to India, it is an area where we will need to evaluate our policies in the light of international evidence and developments. This is particularly important given the rapid convergence, which is taking place in our institutional structures. At present, the focus of international standards and codes relates to the standards as developed and applied in other sectors of the economy. However, given its importance to the financial sector, the standards of governance of the auditing profession would require periodic review. There is thus an ongoing need for ICAI as the regulator, to review their monitoring systems to ensure that such gross failures do not occur. Similar arguments can be made with reference to other SROs as well.

(ii) The current structure for stock exchanges and corporate listings envisages a diversified active set of regional exchanges. However, the developments in the past few years have meant that the regional exchanges have become defunct. This would mean changing both the regulatory framework as well as the listing requirements.

(iii) The markets for derivatives are as yet at a nascent stage, but future growth will raise regulatory concerns as well. For instance, the use of index funds raises quality issues relating to the underlying indices and their structure. Further, internationally a large part of the derivatives are linked to trades in commodities markets. These are as yet still very primitive and evolving. Issues related to these markets and derivatives based on them will require guidelines as such markets emerge.

(iv) The debt market is getting fragmented with private debt regulated by SEBI, govt. debt by RBI and so on. It may be better if Public Debt management is devolved away from RBI so that we can consider developing a uniform framework to regulate and supervise.

(v) A more troubling question relates to the nature and role of market regulators. At present, these are playing the role of both “rule maker” and “Judge” raising concerns of ‘natural justice”. Further, as with the case of SEBI and other new regulators, including the proposal in the proposed company law amendment, there is an attempt to bypass the courts by providing for an independent appellate body as well. This has a problem that it prevents the formation of a unified doctrine of law as well as creating scope for jurisdictional conflict and constitutional challenges. In other “common” law regimes, the jurisdiction of the courts is not sought to be supplanted.

There is an urgent need to undertake law reform examining these concerns as part of the initiative to reform and modernize the economy.

This list is not comprehensive but is merely an indication of the class of issues based on current experience that will need formal assessment as part of our program of reforms. Further, the current initiative on financial standards and codes represents a consolidated view of several interrelated standards. The international standard-setting bodies have existed for a long time, but each body was developing common codes and rules independently without perhaps fully appreciating or embedding the inter-linkages. The existing list of standards does not represent a closed final structure, rather it is in the nature of a collaborative process involving developed countries, emerging economies, international institutions, public and private sectors and regulators and market participants. Thus, we expect the standards to be continually added to and modified in light of experience and dialogue.

In this context, the reports of the Groups and action cannot be a one-off affair. Nor can we make implementation into strict sequenced process. In view of this, it is desirable that we create some permanent mechanism for monitoring and evaluating follow up, responding to new developments and coordinate with Government, Regulators, SRO's and other market participants on a continual basis. Independently, we have noted that a number of the Groups have recommended that High level Group on capital markets be given a formal legal status. The tasks can be merged by assigning this task of evaluation and supervision also to this Group. The analogy of creating a domestic Financial Standards Forum would not be inappropriate. Further, such a group or forum would need some secretariat, which could be located in the RBI, in view of the fact that it has already evolved a small professionally well-equipped group to assist the various Advisory Groups. The responsibility of this establishment would be to monitor both international and domestic developments in this regard and follow up with annual reports. Where required, similar non-official Advisory groups involving experts to assess and evaluate change can be set up from time to time. Further, increasingly, our performance under these norms will play an important role in determining the overall risk assessment. In this context, periodic reviews by independent experts will help in providing vital inputs for improved governance. All incidental benefit of such a formal structure is in terms of promoting greater international awareness of our efforts in this critical area as well as acting as a reference and pressure group for economic reform.

Concluding Observations

The Indian approach to the implementation of standards and codes has been recognised as noteworthy by international agencies in that it follows a systematic process. The process consists of the initial recognition, identification and taking on record of standards and codes in relevant areas. This is followed by in-depth assessment by independent experts of issues pertaining to the present status of applicability, relevance and the existing degree of compliance, the feasibility of compliance and the earmarking of the possible time-frame for transition given the prevailing legal and institutional practices. It is also common to seek comparison of the levels of adherence in India, *vis-à-vis* industrialized and emerging economies, particularly to understand India's position and to prioritise actions on some of the more important codes and standards. The process seeks to map out a comprehensive course of possible actions for achieving the best practices. Further, the process has been conducted in an open and transparent manner by prior publication of reports along with widespread public commentary. Further, as we had noted, the process is not a one-off exercise but rather a long run process of implementation, evaluation and development in each of the selected standards and codes. The challenge is to chart a course of reform domestically, consistent with international standards, which has built-in flexibility and is sensitive to market forces and social objectives.

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i. Prepared by Dr. T.C.A.Anant, Professsor, Delhi School of Economics, University of Delhi at the request of Standing Committee.

ii. We could do alternative classification in terms of unfair and restrictive trade practises and risk management.

iii. For a detailed discussion see "The International Financial Architecture: What's New? What's Missing?" by Peter Kenen 2001 IIE or at http://www.iie.com/publications/publication.cfm?pub_id=335

iv. This is close to an economist's functional classification of debt, equity and insurance.

v. See for instance the discussion in Mario Giovanali "International Monetary Law: Issues for the new millennium" Oxford 2000

vi. A formal argument of this can be found in 'Economic Development, Legality, and the Transplant Effect' by Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, William Davidson Institute Working Paper Number 308.

vii. The report is available on the internet at http://www.imf.org/external/np/rosc/ind/fiscal.htm

viii. The data on dates of compliance by different countries can be found at http://dsbb.imf.org/sddsindex.htm

ix. This number keeps changing and must be assessed directly from the Institute or its website.

x. However, since the submission of the report, National Advisory committee on Accounting standards has already been set up under the amended Companies Act. Further, RBI has in the mid term review of 2001-02 (para 4.3) decided to set up a working group comprising representatives from Banks, ICAI, and RBI to identify and recommend ameliorative measures for gaps in compliance with accounting and auditing standards by banks.

* Negotiated Dealing System has been operationalised since February 15, 2002.

xi. See "Changing Views on How Best to Conduct Monetary Policy: the last Fifty Years" by William R White, Economic Adviser, Bank for International Settlements Lecture given at RBI Dec 2001.

xii. The public response to the suggestions on optimal rate of inflation in the recently released Report on Currency and Finance by RBI is a good example of this diversity.

xiii. Report on the Observance of Standards and Codes (ROSC) India http://www.imf.org/external/np/rosc/rosc.asp

Synthesis Report of the Standing Committee on International Financial Standards and Codes

Abbreviations

AMFI	Association of Mutual Funds
APC	Auditing Practices Committee
ASB	Accounting Standards Board
BFS	Board for Financial Supervision
BIFR	Board for Industrial and Financial Reconstruction
BIS	Bank for International Settlements
BR Act	Banking Regulation Act
CA Act	Chartered Accountants Act
CAG	Comptroller and Auditor General of India
CCI	Clearing Corporation of India
CSO	Central Statistical Organisation
DCA	Department of Company Affairs
DNS	Deferred Net Settlement System
DSBB	Dissemination Standard Bulletin Board
DvP	Delivery Versus Payment
EFT	Electronic Funds Transfer
FATF	Financial Action Task Force
FEDAI	Foreign Exchange Dealers Association of India
FIMMDA	Fixed Income Money Market and Derivatives Association of India
FSF	Financial Stability Forum
FEDAI	Foreign Exchange Dealers Association of India
FRBMB	Fiscal Responsibility and Budget Management Bill
FCI	Food Corporation of India
GDR	Global Depository Receipts
GAPP	Generally Accepted Accounting Principles
GIC	General Insurance Corporation
HLCCM	High Level Committee on Capital Markets
IIP	International Investment Position

IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IAPC	International Auditing Practices Committee
ICAI	Institute of Chartered Accountants of India
IFAC	International Federation of Accountants
IMF	International Monetary Fund
IRDA Act	Insurance Regulatory and Development Authority Act
IOSCO	International Organisation of Securities Commission
IBA	Indian Banks Association
IT Act	Income-Tax Act
ILO	International Labour Organisation
IDBI Act	Industrial Development Bank of India Act
IPC	Indian Penal Code
LIC	Life Insurance Corporation
MRTP	Monopolies and Restrictive Trade Practices
MICR	Magnetic Ink Character Reading
MPC	Monetary Policy Committee
MD/CEO	Managing Director / Chief Executive Officer
OCC	Oil Co-ordination Committee
NSDP	National Summary Data Page
NAV	Net Asset Value
NASDAQ	National Association of Securities Dealers
NI Act	Negotiable Instruments Act
NHB	National Housing Bank
NABARD	National Bank for Agricultural and Rural Development
OECD	Organisation for Economic Co-operation and Development
OCC	Oil Co-ordination Committee
PSB	Public Sector Bank
PDAI	Primary Dealers Association of India
PCA	Prompt Corrective Action
PMLB	Prevention of Money Laundering Bill
POTO	Prevention of Terrorism Ordinance

QFA	Quasi-Fiscal Activity
RTGS	Real Time Gross Settlement
RBI	Reserve Bank of India
ROC	Registrar of Companies
SDDS	Special Data Dissemination Standards
SEBI	Securities and Exchange Board of India
SRO	Self-Regulatory Organisation
SBI	State Bank of India
SAP	Standard Auditing Practices
SICA	Sick Industrial Companies Act
SCR	Securities Contract Regulation Act
STP	Straight – through Processing
URR	Uniform Regulations and Rules for Bankers' Clearing Houses
US GAAP	United States Generally Accepted Accounting Principles
UTI	Unit Trust of India
WB	World Bank
WTO	World Trade Organisation