Review of the Recommendations of the Advisory Groups Constituted by the Standing Committee on International Financial Standards And Codes: *Report on the Progress and Agenda Ahead*

The Report provides the assessment of the professional staff of the Reserve Bank. It does not necessarily reflect the views of the Reserve Bank, other regulatory agencies concerned or of the Government of India.

Reserve Bank of India
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Foreword

International Financial Standards and Codes emerged as one of the key responses to the challenge posed to the International Financial Architecture by the financial crises of the 1990s. Following the report by the Andrew Sheng Task Force, the Financial Stability Forum (FSF) identified twelve core areas where standards and codes were promoted by different standard-setting bodies. India responded to these developments in many ways. First, it actively participated in the debate and the work towards standard-setting and in some way influenced the course of developments. Second, where standards were set, it guided the process domestically. Third, it involved different stakeholders in the task of advising, implementing and monitoring the process of implementation domestically, making the implementation process self-driven which was supplemented by outside evaluation.

The Indian approach to standards and codes has been guided by the Standing Committee on International Financial Standards and Codes that was set up by RBI in consultation with the Government of India in December 1999, even before the Sheng Task Force completed its task. The Standing Committee subsequently constituted eleven Advisory/Technical Groups that broadly corresponded to the core areas identified by FSF. The Advisory Groups had members who were experts from outside RBI or the Government. The reports of these Groups were published and also placed on the RBI website, along with the Report of the Standing Committee in May 2002 that included a synthesis report that was prepared by an outside expert. Dr. Y.V. Reddy, in his capacity as the Chairman of the Standing Committee was instrumental in pioneering this approach. His interest in the work in this area helped set the foundation of our approach in many respects.

The recommendations made by the Advisory/Technical Groups have been followed up by various departments of RBI and other agencies concerned, which act as the nodal department/agency for their respective Groups. The

implementation process is now more than two years old and some stocktaking is necessary. As such, the present Report reviews the progress, provides the current status on the implementation, monitors new developments in the field of international financial standards and codes and provides a future agenda in this area. This Report is based on the inputs of the nodal departments and nodal agencies. Based on these inputs, a preliminary version of this draft report was discussed at a meeting of the nodal departments on January 8, 2004. The draft report was then circulated amongst an Advisory panel of external experts and a panel discussion was held on June 18, 2004.

The Advisory panel consisted of eminent experts in the field who had already served on the earlier Advisory Groups. This approach had its advantages, as it brought the knowledge and experience of the original Advisory Groups, which could help in more readily benchmarking the progress against their recommendations. Representatives from SEBI and IRDA, as key regulators engaged in implementation of standards and codes in their respective areas, were also requested to join the panel. The views expressed at the meeting and communicated subsequently by the Advisory panel members were found valuable and considered in further revising the draft report. The revised report was further discussed at the meeting of the nodal departments on September 22, 2004 and is now being placed in its final form in the public domain in accordance with the announcement made in the mid-term Review of annual policy Statement for the year 2004-05.

This Report provides an assessment of the professional staff of the Reserve Bank engaged in monitoring the implementation of recommendations. It does not necessarily reflect the views of the Bank or its Board. Though it is a staff Report, in a substantial way, the Report has benefited from the views of several inside and outside experts. While considerable effort has been made to present factually correct and up-to-date information, independent verification is advised as the Report covers a vast sphere comprising several diversified areas in which developments are taking place all the time. The Report has been

prepared to stimulate further discussions and improve awareness amongst various stakeholders.

The process of preparation of this Report has been long. I immensely enjoyed being associated with this process by chairing the Advisory panel and all the meetings of the nodal officers. I take this opportunity to thank all those who contributed to this process, specially the members of the Advisory panel for their time, attention and interest. I also compliment all the nodal officers and associated officers who were involved in the preparation of the Report. I would like to place on record the excellent secretariat support provided by the Monetary Policy Department in preparation of the Report. I would particularly like to thank Shri D. Anjaneyulu, Shri Deepak Mohanty and Dr. Mridul Saggar for their interest in drafting this Report and steering the process. Though implementation of standards and codes is an on-going process, it is hoped that this Report would serve to focus greater attention and strengthen the implementation process.

(Rakesh Mohan)
Deputy Governor
October 30, 2004

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List of Abbreviations

AFI	Annual Financial Inspections
AMFI	Association of Mutual Funds in India
AS	Indian Accounting Standards
ASB	Accounting Standards Board
BCBS	Basel Committee on Banking Supervision
BFS	Board for Financial Supervision
BIS	Bank for International Settlements
BPSS	Board for Payment and Settlement System
CACs	Collective Action Clauses
CAG	Comptroller and Auditor General
CBDT	Central Board of Direct Taxes
CCIL	Clearing Corporation of India Ltd.
CCLs	Contingent Credit Lines
CCP	Central counterparty
CDBMS	Central Database Management System
CDR	Corporate Debt Restructuring
CGFS	Committee on the Global Financial System
CII	Confederation of Indian Industries
CLB	Company Law Board
CLS	Continuous Linked Settlement
CPC	Cheque Processing Centre
CPSS	Committee on Payment and Settlement Systems
CSO	Central Statistical Organisation
CRAR	Capital to Risk-weighted Assets Ratio
CVC	Central Vigilance Commission
DCA	Department of Company Affairs
DCA	Debtor-Creditor Agreement
DBOD	Department of Banking Operations and Development
DBS	Department of Banking Supervision
DEAP	Department of Economic Analysis and Policy
DEIO	Department of External Investments and Operations
DIP	Debtor-in-possession
DSBB	Dissemination Standards Bulletin Board
EAD	Exposure at the time of default
EBG	Electronic Banking Group
ECS	Electronic Clearing Services
EL	Expected losses
EMBI	JP Morgan's Emerging Market Bond Index
FATF	Financial Action Task Force on Money Laundering
FIMMDA	Fixed Income Money Market and Derivatives Association of India
FMC	Financial Markets Committee
FOMC	Federal Open Market Committee
FRBM	Fiscal Responsibility and Budget Management
FSAP	Financial Sector Assessment Programme

FSF	Financial Stability Forum
GASAB	Government Accounting Standard Advisory Board
GOI	Government of India
HLCCFCM	High Level Co-ordination Committee on Financial and Capital Markets
HLI	Highly Leveraged Institutions
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICA	Inter-Creditor Agreement
ICAI	Institute of Chartered Accountants of India
ICP	Insurance Core Principle
IDMD	Internal Debt Management Department
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commission
IRB	Internal Ratings-Based
IRDA	Insurance Regulatory and Development Authority
ITEs	Intra-group Transactions and Exposures
KYC	Know Your Customer
LGD	Loss given default
MICR	Magnetic Ink Character Recognition
MPC	Monetary Policy Committee
MOU	Memorandum of Understanding
MPD	Monetary Policy Department
MSS	Market Stabilisation Scheme
MWGED	Multi-disciplinary Working Group on Enhanced Disclosure
NAB	New Arrangements to Borrow
NCAER	National Council for Applied Economic Research
NCLAT	National Company Law (Appellate) Tribunal
NCLT	National Company Law Tribunal
NCMP	National Common Minimum Programme
NEFT	National Electronic Funds Transfer
NSDP	National Summary Data Page
OCC	Oil Co-ordination Committee
OECD	Organisation for Economic Co-operation and Development
OFCs	Offshore Financial Centres
PCA	Prompt Corrective Action
PD	Probability of default
PDAI	Primary Dealers Association of India
PF	Provident Fund
PFRDA	Pension Fund Regulatory Development Authority of India
PKI	Public-key Infrastructure
PML	Prevention of Money Laundering
QFAs	Quasi-Fiscal Activities
QIS	Quantitative Impact Studies

RBI	Reserve Bank of India
RBS	Risk Based Supervision
ROSC	Report on Observance of Standards and Codes
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest
SCRA	Securities Contract (Regulation) Act
SDDS	Special Data Dissemination Standards
SEBI	Securities and Exchange Board of India
SROs	Self-Regulatory Organisations
SSS	Securities Settlement Systems
STP	Straight Through Processing
TAC	Technical Advisory Committee on Money, Forex and Government Securities Markets
TIN	Tax Information Network
UL	Unexpected losses
UNCITRAL	United Nations Commission on International Trade Law

The objective of this Report is to (i) provide current status and a brief account of the progress in respect of the recommendations of the 11 Advisory/ Technical Groups of the Standing Committee on International Financial Standards and Codes, (ii) monitor new developments in these areas since the publication of the earlier reports, with a view to further national positioning in this regard, and (iii) suggest a future agenda in respect of progress on International Financial Standards and Codes. The Report provides the assessment of the professional staff of the Reserve Bank. It does not necessarily reflect the views of the Reserve Bank, other regulatory agencies concerned or of the Government of India. The Report has been prepared with a view to stimulating further debate and thoughts on this subject and to improving public awareness in this field. While considerable effort has been made to present factually correct information, new developments are taking place all the time and rules and regulations are being revised. Therefore, possibility of inaccuracies or missing more updated information cannot be completely ruled out. As such, readers are cautioned not to rely on the statements of laws and regulation in this Report, but to verify independently or to retain private legal counsel to verify the status of the laws and regulation in the respective areas and under jurisdictions of various regulators.

Chapter I

Global Initiatives and Genesis of the Standing Committee and its Advisory/Technical Groups

Global Initiatives on International Standards and Codes

What are Standards and Codes?

1.1 Standards are widely accepted good principles, practices or guidelines in a specified area. They are sometimes called codes to reflect that they have a legal status or are accepted, signed or ratified by members of concerned multilateral agencies. Standards and codes are framed for various sectors, such as banking, securities, insurance, corporate sector, fiscal or monetary areas. Standards and codes are sometimes classified in relation to relevant functional areas like risk management, payment and settlement, governance, accounting, regulation and supervision.

1.2 Standards and codes are meant to be implemented, either in their entirety or in phases, considering the country-specific circumstances. Flexibility has been considered as an essential ingredient of the recipe for the success of the initiative in this regard. Implementation is undertaken by setting out principles, practices or methodological guidelines that form the common unified whole but not necessarily binding in all respects at all times for all countries.

Why were Standards and Codes Developed?

1.3 The internationally accepted economic, financial and statistical standards, developed in the aftermath of the Asian financial crisis, were considered imperative for strengthening the international financial architecture. The standards were expected to contribute to the following two main areas:

(i) promoting financial stability within the countries by fortifying the domestic financial systems through sound regulation, effective supervision, greater transparency, more efficient and robust institutions, markets and infrastructure; and

(ii) promoting global financial stability by facilitating timely and more uniform information dissemination to all market participants, improving market integrity, and reducing the risks of financial distress and contagion.

1.4 It was recognised that standards were necessary but not sufficient condition for ensuring financial stability. It was also recognised that apart from economic and financial factors, political, social, legal and institutional factors were also relevant for financial stability. However, the international community decided to focus on setting economic and financial standards, as they had a direct bearing on the global economy. It was considered important to codify certain standards so that its implementation would have greater relevance with some legal and rule-based foundation. Adoption of standards and codes set by various standard-setting bodies and their implementation by multilateral agencies was viewed as the best way forward in the effort to restore confidence in the international financial system.

Who Sets Standards?

1.5 International standards and codes are being set by some standard-setting bodies. Table 1 provides a bird's eye view of standard-setting bodies and their work domain.

Table 1: Standard-Setting Bodies and Their Work Domain

Standard-setting body	Work-domain
(i) Basel Committee on Banking Supervision (BCBS)	Set up by G-10 central banks; formulates broad supervisory standards and guidelines and recommends best practices in banking.
(ii) Committee on the Global Financial System (CGFS)	Set up by G-10 central banks; developed general principles and specific policy recommendations for creation of deep and liquid government securities market.
(iii) Committee on Payment and Settlement System (CPSS)	Set up by G-10 central banks; formulates broad supervisory standards and guidelines that cover relationship between payment and settlement arrangements, central bank payment and settlement services and the major financial markets.
(iv) Financial Action Task Force on Money Laundering (FATF)	Set up by G-7 Paris Summit of 1989; now has a programme of 49 recommendations to combat money laundering and terrorist financing.
(v) International Association of Insurance Supervisors (IAIS)	Set up in 1994; a body of regulators and supervisors from more than 100 jurisdictions; developed Core Principles, Insurance Concordat and several other standards.
(vi) International Accounting Standards Board (IASB)	Based in London; an independent, privately funded accounting standard setter that has developed and approved 41 International Accounting Standards (IAS).
(vii) International Auditing and Assurance Standards Board (IAASB)	A Committee of the International Federation of Accountants (IFAC); sets principles to improve the uniformity of auditing practices and related services.
(viii) International Monetary Fund (IMF)	The multilateral organisation works in collaboration with other standard-setting bodies. It has prescribed data dissemination standards and put in place codes on transparency in the area of fiscal, monetary and financial policies.
(ix) International Organisation of Securities Commission (IOSCO)	The organisation, which represents national regulators of securities and futures markets, promotes standards in these areas to establish and maintain efficient and sound markets.
(x) Organisation for Economic Co-operation and Development (OECD)	OECD encourages practices of good governance for corporates and others and promotes convergence of policies, laws and

	regulations covering financial markets and enterprises.
(xi) CPSS-IOSCO Task Force on Securities Settlement Systems (SSS)	Building on the earlier work, this task force has made recommendations on the securities settlement system.
(xii) BCBS Transparency Group and IOSCO TC Working Party on the Regulation of Financial Intermediaries	This joint initiative aims at providing sufficient and transparent information through public disclosures on trading and derivatives activities.

1.6 It may be added that Table 1 provides information about the work domain of standard-setting agencies only in respect of standards and codes. In most cases, their overall work-domain is much larger, though their initiatives in respect of standards and codes have largely evolved in areas of their respective mandates reflecting their experience and expertise in those areas.

Are there Limits to Standard-Setting?

1.7 There are no clearly defined limits to setting of the international financial standards and codes by the standard-setting bodies. Standard setting is an on-going process. They started as the international community's response to international financial crises. A large number of standards by several standard-setting bodies covering diverse areas of financial sector have emerged over the last decade or so. Substantial follow-up work after setting of these standards has been done, while implementation still remains to be completed in many respects. The standards themselves are evolving to changing needs and have been modified and replaced by new standards in some cases, apart from new areas getting covered. There cannot be a time limit for standard-setting exercise or its implementation in all cases. As such, standard-setting bodies as well as countries intending to subscribe to these standards need to constantly monitor developments and shape responses, periodically revisiting and assessing their progress.

1.8 There are no absolute limits for the number or the extent to which standards can be prescribed. However, one may appreciate that this is essentially a collaborative exercise in which the multilateral and national

standard-setting bodies, national governments, domestic regulators and supervisors, financial sector institutions, market players and general public are all stakeholders as well as active participants. As such, each stakeholder has to act within the domain that is laid down by the political and economic process. Standards are essentially prescriptive in nature and cannot override sovereign limits. Any attempt to do so would defeat the very objectives of these standards. It also needs to be recognised that there are limits to which standards and codes can prevent financial crises. Setting them, adopting them, implementing them and monitoring them entails economic costs in terms of expenditures and human resource deployment. These costs should not be underestimated and need to be kept in view while making progress on standards and codes.

Have Standards and Codes Helped Strengthen Financial Stability?

1.9 International financial standards and codes, on the whole, are understood to have strengthened financial stability across the globe[1]. International financial architecture was found deficient in meeting the challenges posed by the financial crises of the 1990s. There was an increasing clamour for institutional changes to bring about a new financial architecture. In this context, radical suggestions were made such as those for an international bankruptcy court (Sachs, 1995), controls on capital outflows (Krugman, 1998), a world central bank with a new global currency (Garten, 1998), an international deposit insurance corporation (Soros, 1998), a single global super-regulator (Kaufman, 1998), Chilean-style controls on capital inflows (Eichengreen, 1999), multilateral lending agency as international lender of the last resort without new currency issues (Fischer, 1999) and removing of legal and institutional bias for debt finance in the composition of capital flows to the developing countries (Rogoff, 1999). These suggestions on new international financial architecture caught attention because existing resources of the IMF were seen inadequate in face of the size of private capital flows (Jha and Saggar, 2000). The debate stirred up by these suggestions

[1] Clark (2000) provides a good review.

served to stimulate the global community to collectively work towards taking relatively smaller attainable steps[2]. The steps included enhancing IMF resources through enhanced quotas and New Arrangements to Borrow (NAB), introduction of Contingent Credit Lines (CCLs), involving private sector in crisis resolution and co-operative debt restructuring, etc. Perhaps, the single biggest step was the initiatives taken in respect of international standards and codes that actually took the form of an assortment of some very important incremental steps. They include the Bank for International Settlements (BIS) backed capital accord, IMF codes on fiscal and monetary and financial transparency as also data dissemination standards, IMF initiative on Report on Observance of Standards and Codes (ROSC) and the Fund-Bank initiative on Financial Sector Assessment Programme (FSAP).

1.10 Vasudevan (2001) notes that the link between implementation of standards and codes and financial stability by itself is not established empirically as yet. Therefore, the link may have to be set out from an analytical angle, while the theoretical underpinnings are yet to be established, analytics indicate that observance of standards and codes in many areas could yield growth as a by-product and financial stability could follow, but the latter cannot be automatically guaranteed by growth. Some analysts point to the lack of theoretical and empirical evidence that standards promote financial stability. Such an observation stems from insufficient research in this area.

1.11 Overall scanning of literature on the subject seems to suggest that broad contours of theoretical evidence do exist. Most of the information asymmetry literature establishes a case for greater transparency and, by corollary, a case for disseminating information on standards and codes. The rationale for standards and codes, by itself, is available, though somewhat scattered. For example, the

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[2] See Kenen (2001) for a balanced view on radical and practical changes. Kenen argues that useful innovations in the existing architecture have taken place and these could be complemented by focussing IMF surveillance on exchange rates and debt profiles, narrowing the scope of IMF conditionalities, limit short-term borrowings and encouraging financial sector reforms in case of emerging markets, making IMF lending smaller but speedier and providing for private sector participation in crisis resolution through roll-over clauses in short-term debt contracts and collective action clauses in long-term debt contracts.

case for central bank independence, for fiscal rules, for capital standards is well-established. There is also considerable theoretical and empirical evidence on the merits of corporate governance. Accounting and auditing scandals and their impact on financial markets indicate an urgent need for appropriate standards in these respects. Bankruptcy law is a complex issue, but there is considerable inter-linkage between law and economic logic. The favourable impact of standards on growth, however, is less clear than on stability. There is a view that quest for stability through standards may lead to a trade-off with growth. Indeed, there is a need to step up research in this area so that clear evidence emerges on analytical issues relating to standards and codes. In this context, Reddy (2001b) points out that though standards have evolved in the context of international (financial) stability, they have enormous efficiency-enhancing value by themselves. He also adds that while transparency and financial stability appear fundamentally complementary, there could be a trade-off at some point.

1.12 Jha (2001) points out that the primary purpose of the standards is to provide stability to the international capital markets and early warnings for emerging crises. He opines that standards should be seen as an international public good since they would, potentially, benefit the entire international financial community. Moreover, consumption of this public good would be non-competitive. In that sense, non-rivalry and non-excludability characteristics are met. However, provision of this public good would necessarily be voluntary in the absence of the world government. Therefore, provision of this public good cannot be sufficiently mustered through voluntary collective action.

1.13 It is important to recognise that implementing standards and codes entail costs on financial market institutions and the regulators. They impose a fiscal burden on the subscribing countries' governments as well. Standards and codes are needed to a degree because of financial market frictions. They go a long way in reducing information asymmetries, promoting financial market efficiency and a more competent market microstructure. Standards have to be prescribed by agencies because private costs of failures in financial markets are less than their social costs. Individual failures can have systemic implications through

contagion. Global standards have emerged for the reason that contagion spreads across markets in different countries amidst open capital accounts and international financial integration. Multilateral organisations have also taken over the role of standard-setting agencies for the reason that political cycles and political economy considerations sometimes make domestic standard-setting incentive-incompatible for the government in power.

1.14 While standards and codes have contributed to the strengthening of financial stability and the international financial architecture, it is eventually subject to the law of diminishing returns. There are limitations of resources that domestic regulators can assign to this area and there are limitations of resources that the standard-setting bodies themselves can raise to monitor their observance. No estimates are available on how much might have been spent on this subject since the initiative of the G-7 Ministers and Governors that resulted in the creation of the Financial Stability Forum (FSF) in February 1999. Today the FSF recognises 12 key standard-setting agencies. Though originally they prescribed 12 key standards and codes, the rapid proliferation of standards has taken the number of standards and codes to about 80. Each code has several principles. So, in effect, the number of standards that need to be adopted, implemented and monitored have become so large that the operational aspects have become challenging. Furthermore, as Schneider (2003) points out, implementation of the standards and codes is a process and in some aspects it could be 15-20 years before standards are fully in place. Therefore, it is not possible to gauge its full impact on financial stability at the present juncture.

Standards and Codes – Flawed Approach?

1.15 There is an increasing recognition that standards and codes as they are being promulgated may not address all the relevant issues. A pervasive view has been that a “one-size-fits-all” approach may not be appropriate. Country-specifics are important and these details should also be taken into account, as best practices for one may not always be the best practice for another. In several cases, codes are based on best practices appropriate to industrialised countries

and their implementation imparts a further competitive edge to financial institutions of these countries. There is also a possibility that their implementation may trade off growth for financial stability in a manner that does not reflect the optimal choice for the developing countries seeking to converge faster. There has been an asymmetry creeping between the developed countries and the emerging markets in adoption of standards and their surveillance. For instance, several industrialised countries have been less transparent than their developing country counterparts in disseminating information such as the International Investment Position under the Special Data Dissemination Standards (SDDS). Reports on the Observance of Standards and Codes (ROSCs), till recently, were focussed on emerging markets, whereas they were initiated or publicly made available for several traditional OECD countries only later. In fact, some of the OECD members are yet to be covered under the ROSC framework. Similarly, FSAPs have largely focused on developing countries. Questions have sometimes been raised about imbalance in transparency obligations that these standards have imposed on emerging markets. However, on balance of considerations, there are important gains in stability as well as efficiency that standards and codes bring about. Reddy (2001a) advocates voluntary adoption, country ownership and gradualism as the best means of furthering progress in respect of standards and codes. Giovanoli (2000) opines that the standards currently monitored by the FSF have become rules that can be classified as "soft laws".[3] As they can influence credit ratings, the countries are under obligation to implement them, irrespective of the choices of national law. Reddy (2003) suggests that ROSCs should help national authorities to develop their own reform plans, assess compliance with international standards and codes and serve, if published, as a signal of their policies' enhanced transparency.

1.16 Standards and codes as they have evolved over the last decade have essentially focussed on making available information in a transparent manner to the private sector. However, there are two important questions in this regard.

[3] See also Reddy (2002).

First, is there enough incentive for the private sector to be partners in this venture when there is intense competition among the financial market participants to trade and profit on information asymmetries? Second, to the degree they do engage themselves in this, do they respond to information made available? There are no clear answers to these questions and taking a definitive position on these is difficult in the absence of adequate evidence. Standards and codes, to a substantial degree, are public goods that exhibit characteristics of non-excludability and non-rivalry. Private participants recognise that they themselves may be adversely affected in its absence. For instance, Cady (2004) presents econometric evidence to suggest that SDDS subscription reduces costs of borrowing for the emerging market economies (see also Section on Advisory Group on Data Dissemination). Though the general decline in bond spreads has not been explicitly modelled, the control variables do include US interest rates which declined. There is similar econometric evidence from other studies as well. IIF (2002) found a larger decline of 200-300 basis points in US dollar Eurobond spreads for emerging markets subscribing to SDDS, though there does appear to be a sample selection bias in the study. Christofides *et al.* (2003) found that spreads measured by JP Morgan's Emerging Market Bond Index (EMBI) reduced by 15 per cent as a result of SDDS subscription. Glennerster and Shin (2003) find that EMBI spreads decline by 20-60 basis points in the period following SDDS subscription, but do not sufficiently control for general decline in spreads. So, on the whole, there is some evidence that data dissemination standards improve the borrowing countries' access to funds in international capital markets, though the evidence is weak.

1.17 Considering the various aspects of the initiative of international financial standards and codes, it can be stated that the effect on financial stability has been encouraging and all stakeholders have benefited. Emerging markets debtors seem to have lowered risk-premia, while creditors would benefit from lower default probability. International financial institutions are in a better position to effect surveillance of the system. Gains to governments could take the form of saved fiscal costs of bailouts that are, however, difficult to quantify. Financial

sector participants benefit because negative externalities and spillovers of losses are reduced and they are able to make better risk-return choices. Public, at large, has also gained from considerably improved transparency and consequently lower adverse information costs. Finally, international financial architecture has been reinforced and the global financial system today appears more stable and resilient to shocks than it looked amidst the financial crises of the 1990s.

The Indian Initiative

Constitution of the Standing Committee

1.18 In order to guide the process of implementation of international standards and codes in India as also to position India's stance on such standards, the Reserve Bank of India (RBI) in consultation with the Government of India (GOI), constituted, on December 8, 1999, a 'Standing Committee on International Financial Standards and Codes' under the Chairmanship of Deputy Governor, RBI and Secretary, Department of Economic Affairs, Ministry of Finance, Government of India (GOI) as Alternate Chairman.

1.19 The Committee was assigned the task of tracking the global developments in this field and considering all aspects of the applicability of the standards and codes being evolved by the international standard-setting bodies. This included the task of aligning India's standards and practices in the light of evolving international practices, periodically reviewing the status and progress of its implementation in India and disseminating information in this area to concerned organisations.

Constitution of Advisory/ Technical Groups by the Standing Committee

1.20 The Standing Committee subsequently constituted ten Advisory Groups keeping in view the 12 core areas identified by the Financial Stability Forum (FSF). These areas were: (i) transparency in monetary and financial policies, (ii) fiscal transparency, (iii) insurance regulation, (iv) bankruptcy laws, (v) corporate governance, (vi) data dissemination, (vii) payment and settlement

system, (viii) banking supervision, (ix) securities market regulation, and (x) accounting and auditing. Later, an internal Technical Group on market integrity was set up as the 11th Group. These 11 Groups submitted their Reports which were placed on the RBI website for wider dissemination and comments. A list of the Standing Committee and its 11 Advisory/Technical Groups is given in Annex I. A list of their Reports is provided in Annex II.

The Report of the Standing Committee

1.21 Based on the recommendations of the Advisory Groups, the Standing Committee prepared its Report in May 2002. The Report included an outside expert's Synthesis Report presenting the views and recommendations of all the 11 Advisory/Technical Groups (henceforth called the Advisory Groups). The recommendations of these Groups were followed up by concerned departments of RBI and other concerned agencies. Subsequently, the Heads of the concerned departments have been designated as nodal officers for the purpose of monitoring and implementation. In case of insurance, the Insurance Regulatory and Development Authority (IRDA) acts as a nodal agency. In respect of securities market regulation, the recommendations relate to both the government securities market and the securities trading on stock exchanges. While RBI regulates the former, the latter is regulated by Securities and Exchange Board of India (SEBI) and as such becomes the nodal agency for pursuing recommendations relating to that market. The RBI nodal department co-ordinated with SEBI in this respect. SEBI has also examined corporate governance issues in detail and this has been reflected in the assessment of implementation in this area. In respect of accounting and auditing standards, the RBI nodal department has been in touch with the Institute of Chartered Accountants of India (ICAI), which acts as a nodal agency in this area. Based on the inputs of the nodal departments and nodal agencies, a review of the progress so far is undertaken in this Report.

The Progress Report

1.22 Against this backdrop, this Report reviews the progress and provides current status. This exercise would facilitate identification of areas that can be implemented within the existing legal and institutional framework and areas that need further legislative and policy changes. The Progress Report also provides an idea of the approaches to implementation in India. It brings out the areas where new developments in setting international financial standards and codes have taken place since the Report of the Standing Committee in May 2002, so that appropriate position and follow-up action could be taken from the Indian standpoint. It also provides, in brief, an assessment of relevance of standards and codes as framed by international bodies. A draft Report was prepared based on the inputs of the nodal departments/agencies, which was discussed at a meeting chaired by Dr. Rakesh Mohan, Deputy Governor. Nodal officers of various groups and their associated officers participated in the meeting. Comments received at the meeting and updated inputs provided by nodal Departments/ agencies, including those received from IRDA and SEBI helped revise the earlier draft. The revised draft was circulated amongst members of an Advisory panel constituted for the purpose. The panel consisted of eminent experts in the field. The members of the Advisory panel have been listed in Annex III. Chairmen of the earlier Advisory Groups who were locally available in Mumbai were requested to be on panel, and in their absence a member of the Advisory Group was requested for the same. This approach has its advantages, as it brings in the tacit knowledge in addition to the codified knowledge of the original Advisory groups. Besides, it serves to facilitate a stringent evaluation of the progress, so that areas of failings and fragilities in implementation are brought to the fore and a corrective process is put in place. Representatives from SEBI and IRDA, as key regulators engaged in implementation of standards and codes in their respective areas, were also requested to join the panel. The Advisory panel met formally on June 18, 2004 where the draft report and related issues were deliberated. Nodal officers and officers associated with the work of nodal Department also participated in the meeting. The views expressed at the

meeting and communicated subsequently were found valuable and considered in revising the draft Report. The list of the nodal officers and associated officers, who also contributed to the Report, is given in Annex IV.

Chapter II

A Review of Progress So Far

Some General Observations on Implementation

2.1 With regard to the implementation of the recommendations of the 11 Advisory/ Technical Groups constituted by the Standing Committee, the following general observations are made:

1. The agencies for implementation of the recommendations of the Standing Committee and its Advisory Groups have been identified. In case of the Advisory Group on Accounting and Auditing, most of the recommendations fall under the jurisdiction of the ICAI. Similarly, the recommendations of the Advisory Group on Insurance Regulation, by and large, fall under the purview of IRDA. In case of securities market, several of the recommendations fall under the purview of SEBI. In most other cases, the RBI and the GOI have a predominant role. It would be useful to further enhance inter-agency co-ordination amongst all concerned with the implementation of standards and codes. The status of the Standing Committee may also be reviewed with reference to the office memorandum of December 8, 1999.

2. Time-frame for implementation is difficult to prescribe as the implementation of the standards and codes is a process that keeps on evolving with new practices and new standards to cover them, and also because implementation requires not just issue of guidelines and regulations, but development of institutions and expertise that takes time. In some cases a time-frame has been considered by the nodal departments/ agencies, but it has not always been possible to prescribe a clear time frame. However, based on this Report, the Standing Committee could focus more closely on the recommendations made and also consider if a reasonable and illustrative time-frame could be set by concerned nodal departments/agencies.

3. In several cases, legislative action is required to step up implementation of standards and codes. Reddy (2002) notes that the issues arising out of the reports of the Advisory Groups pose a daunting agenda for legal reforms. Amendments are required in RBI Act, Banking Regulation Act, Companies Act, Income Tax Act, Chartered Accountants Act, etc. There are also aspects that need to be clarified in the context of domains for various regulators, though with the strengthening of co-ordination amongst regulators, these problems have been substantially mitigated.

4. In several cases, action has been completed or no further action is deemed necessary, while in several others substantial progress has been made in implementation. Areas where progress has been impressive include fiscal transparency, data dissemination, banking supervision, securities regulation and payment and settlement systems. Actions taken by regulators have been instrumental in covering substantial ground in these areas. However, new global developments take place from time to time. Standards evolve in response to the changes financial market practices, and in turn have a bearing on the practices themselves. Future action, therefore, become necessary even where the requirements on standards have been fully or near-fully met at a point of time.

Area-wise Progress in Standards and Codes

2.2 The progress in respect of each of the 11 Advisory/ Technical Groups is reviewed below. They have been organised in terms of functional domains. The first three groups relate to macroeconomic policy and cover monetary, fiscal and financial policies as well as transparency relating to macroeconomic data. The next three groups are associated with financial regulation and supervision and cover banking, securities markets and insurance, respectively. The five groups that follow relate to institutions and market infrastructure. They cover bankruptcy laws, corporate governance, accounting and auditing, payment and settlement systems and market integrity.

Advisory Group on Transparency in Monetary and Financial Policies

2.3 The Advisory Group had made specific recommendations against the backdrop of the Code of Good Practices in Monetary and Financial Policies adopted by the IMF. It had noted that the RBI policies and operations largely conformed to the IMF code. The Group had, however, suggested greater transparency in the policy formulation process and on institutionalising the process of communicating the policy, *albeit* on a *post facto* basis. It had made recommendations concerning constitutional and legislative issues that covered instrument independence with monetary policy goal being prescribed by the Government after due Parliamentary deliberations.

2.4 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 2: Present Status of the Implementation of the Recommendations of the Advisory Group on Transparency in Monetary and Financial Policies

Sr. No.	Recommendation	Present Status
Monetary Policy		
1.	Amendment to RBI Act for autonomy, accountability and transparency.	A firm view is yet to be taken in RBI/ GOI. The prevalent opinion is that appropriate conditions need to be created. There is a view that its implementation in the immediate future is difficult since structural transformation is still under way. With transition and financial development, the role of the formal sector would expand and financial intermediation could gather further depth and efficiency. Monetary policy framework and operating procedures are evolving with these ongoing changes. While instrument independence exists, it needs to be considered more formally in a framework consistent with greater autonomy as well as greater monetary-fiscal co-ordination. Statutory changes could follow and could be cast in a manner that suits such a framework. Statutory change providing central bank freedom to set reserve requirements without a prescribed ceiling or floor could also be helpful additional step in view of the development of alternative market-based instruments of monetary control.
2.	Setting objectives of monetary policy by GOI after Parliamentary debate. Single objective, such as medium term inflation objective.	Objectives currently include price stability and growth with added emphasis on financial stability. Monetary policy, credit policy and regulatory policies are assigned to these roles with some inevitable overlaps[4]. As the economy is undergoing transition and effective transmission channels are still evolving, the general view is that setting a single objective by GOI will be difficult to implement. Though central banks seek to ensure price stability and provide a nominal anchor, other objectives are also pursued. As such, if possible, a consensus could be sought over a medium-term horizon, with a view to evolving a hierarchy of objectives that could be transparently communicated.

[4] Reddy (2004) states that RBI has three objectives, viz., growth, price stability and financial stability, which have their own interrelationships. It also has three instruments, viz., monetary

3.	Security of tenure to Top Management of RBI.	Implementation would require amendment to the RBI Act. The issue has not been flagged for consideration in RBI/ GOI so far.
4.	Separate debt management from monetary management. Monetary policy function to be to set interest rates.	Monetary and Credit Policy Statement of 2001-02 has highlighted the need for such separation. Such separation can be effected with improvement in the fiscal position and further development of financial markets. In this direction, progress has been made through the framing of the Fiscal Responsibility and Budget Management (FRBM) Rules, effective July 5, 2004 by Central Government, unveiling the road-map for fiscal consolidation. There have been efforts towards framing of draft model of fiscal responsibility legislation at the state level as well. Debt management separation could be effected with appropriate institutional and legal changes once the enabling conditions are created.
5.	Constitution of Monetary Policy Committee (MPC) and gradual increase in disclosures of its proceedings.	The issue has not been addressed so far. If MPC is to be constituted as a Committee of the Board of Directors, it could be done so without an amendment to the RBI Act.
Financial Policies		
6	Relevant information on performance to depositors in simple language subject to legitimate protection of propriety information.	RBI has taken several initiatives on increased disclosure through balance sheet and annual audited accounts in recent times.
7.	Minimum discretion in regulation. Transparency when there is regulatory forbearance.	RBI has mandated several qualitative and other disclosures which bring out regulatory forbearance.
8.	Disclosure of adverse supervisory action. No variation in regulatory/ supervisory framework over the business cycle.	In October 2004, RBI advised all banks that all cases of penalty imposed by RBI, as also strictures/directions on specific matters including those arising out of inspection will be placed in public domain.

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policy, credit policy and regulatory policies, which are used interchangeably to serve different objectives. One would, therefore, need to look at changing dynamics of this 3X3 matrix of objectives and instruments.

9.	Disclosure of maturity profiles of forward liabilities. Regular disclosure of direct and indirect forex interventions to enhance market efficiency.	India has become fully compliant with the disclosure required by the new template on international reserves and foreign currency liquidity under the SDDS. Disclosures regarding the maturity profiles of forward liabilities are also now being made in three buckets – up to 1 month, 1-3 months and more than 3 months. Forex market interventions (purchase and sales of foreign currency by the central bank) are being published.

2.5 Some recommendations of the Advisory Group regarding monetary policy formulation procedures would require enabling legislative changes and could be considered by the Government with necessary political consultations as part of the democratic process. Monetary policy formulation at present is being undertaken by the management of the Bank supported by a consultative process. Several initiatives have been taken by the central bank to enhance the transparency in monetary and financial policies through institutionalised consultative process. The Monetary Policy Department of the Bank organises annual Resource Management Discussions between the top management of the central bank and some commercial banks. It also holds monthly meetings with select major banks and financial institutions, which provide a consultative platform for issues concerning monetary, credit, regulatory and supervisory policies of the central bank. Decisions on day-to-day money market operations, including supply of liquidity, are taken by the Financial Markets Committee (FMC), which includes senior officials of the central bank responsible for monetary policy and operations. Deputy Governor and Executive Director(s) in-charge of the monetary policy and operations and Heads of three departments – Monetary Policy Department (MPD), Internal Debt Management Department (IDMD) and Department of External Investments and Operations (DEIO) – meet as part of the FMC meetings that take place every morning as financial markets open for trading. They also meet more than once during a day if the need arises. Besides FMC meetings, Monetary Policy Strategy Meetings take place once every month in which besides members of the FMC, Head of the Department of

Economic Analysis and Policy (DEAP) also participates. The strategy meetings take a relatively medium-term view of the monetary policy and consider key projections and parameters that can affect the stance of the monetary policy. In addition, a Technical Advisory Committee on Money, Forex and Government Securities Markets (TAC) comprising academics and financial market experts, including those from depositories and credit rating agencies besides RBI officials, provides support to the consultative process. The Committee meets once a quarter and discusses proposals on instruments and institutional practices relating to financial markets. Following the Governor's Statement on mid-term Review of the monetary and credit Policy for 2003-04, the Reserve Bank has also constituted a Standing Technical Advisory Committee on Financial Regulation. This new Committee institutionalises the consultative process in respect of the regulations covering banks, non-banks and other market participants.

2.6 The views of the Central Board, staff assessment and consultative discussion with bankers as also information obtained and analysed from a wide array of sources provide important inputs in the formulation of monetary policy. Broader consultations with government on several macro and micro concerns are also factored in by RBI in its decisions. The Board for Financial Supervision (BFS) plays an important role in deliberations and decisions in respect of supervision functions. With considerable monetary-fiscal co-ordination that has been put in place through Supplemental Agreements and the Memorandum of Understanding (MoU) on Market Stabilisation Scheme (MSS), RBI has been able to effectively pursue monetary policy objectives even while engaging in debt management. The extant monetary and financial policy formulation, procedures and practices have by and large worked well for the country, though further improvements in autonomy, accountability and transparency are possible, on the lines suggested, to further improve the efficacy of the central bank policies.

Advisory Group on Fiscal Transparency

2.7 The international standards on fiscal transparency were set with the adoption of "Code of Good Practices on Fiscal Transparency" by the Executive Board of the IMF in May 2001. The Code provided guidelines and good practices regarding: (i) clarity of roles and responsibilities within government and between governments and the rest of the economy, (ii) public availability of information on fiscal outcomes, (iii) open and transparent budget preparation, execution and reporting, and (iv) assurance of integrity including those relating to the quality of fiscal data and the need for independent scrutiny of fiscal information. IMF had, in February 2001, released a Report on the Observance of Standards and Codes (ROSC) for India, benchmarking India's fiscal transparency against the IMF Code. It observed that 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. It, however, suggested more attention to reporting on general government finances, providing information on contingent liabilities and quasi-fiscal activities, and to the analysis of fiscal risks. It also suggested simplification and clarification of inter-governmental fiscal relations. The Advisory Group on Fiscal Transparency also examined the extent to which fiscal practices in India were compliant with the Code and made recommendations in respect of all four pillars of the Code.

2.8 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 3: Present Status of the Implementation of the Recommendations of the Advisory Group on Fiscal Transparency

Sr. No.	Recommendations by the Advisory Group	Present Status
Clarity on Roles and Responsibilities		
1.	Institutional table for India in IMF's Government Finance Statistics may be made more detailed with information on central government institutions outside the central government budgets.	While the recommendation to begin the general government consolidation with central autonomous institutions can be taken up, a practical problem for the consolidation process could be the delay in finalisation of accounts of central autonomous bodies. Its implementation would require further consideration by GOI and consultation amongst different GOI Ministries.
2.	Quasi-fiscal Activities (QFAs) may be identified and quantified transparently. These would include directed credit and interest rate controls, operation of the Oil Pool Account, losses on account of poor management and non-market behaviour of public enterprises.	Some progress has been made on this issue. The Fiscal Responsibility and Budget Management Act stipulates that with effect from April 1, 2006, RBI's participation in primary issues of government securities stand withdrawn. QFAs arising out of the sale of petroleum products at below the market prices were earlier not included in the budget documents on account of cross subsidisation of petroleum products through an off-budget Oil Co-ordination Committee (OCC) Pool Account mechanism. Following the dismantling of the administered price mechanism, subsidies on PDS kerosene and domestic LPG are on specified flat rate basis from April 1, 2002 and are borne by the Consolidated Fund of India. The Union Budget 2004-05 has transparently quantified the same, by making a provision of Rs. 3,559 crore for petroleum subsidy. QFAs in respect of interest subsidies are difficult to quantify. This would require further consideration by the GOI and the RBI.

3.	Amplifying the role of Fiscal Responsibility and Budget Management (FRBM) Bill to include essential elements of Budget Law.	The Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act) received the assent of the President of India on August 26, 2003. The Government has also notified the Act and specified the Rules under it with effect from July 5, 2004. The Act and the Rules contain important provisions to improve fiscal transparency. As per the provisions of the Act, the Government shall lay before both houses of Parliament, the following documents along with the Annual Financial Statement: (1) Medium-term Fiscal Policy Statement; (2) Fiscal Policy Strategy Statement and (3) Macro-economic Framework Statement. The Union Budget 2004-05 presented on July 8, 2004 laid down the above three documents. Action may be considered completed.
4.	Uniform budgetary practices at the State level.	Government Accounting Standard Advisory Board (GASAB) under the Comptroller and Auditor General (CAG) is presently examining this issue.
5.	Tax procedures are archaic and, instead of electronic filing, depend on direct interaction between assessee and the tax administrator.	Tax reforms and modernisation of tax administration is an on-going process which has steadily been gaining momentum year after year. With effect from June 1, 2003, it has been made mandatory for all corporate entities to file their TDS returns in electronic form (e-TDS returns). E-filing of service tax returns is being extended to all taxable services. E-filing of excise returns has also been introduced since June 30, 2004. The Income Tax Department has also introduced Electronic Clearing Services (ECS) for refunds up to Rs. 25,000/- in cases of salaried taxpayers filing returns in Form 2E (Naya Saral). Action may be considered completed.

Public Availability of Information		
6.	Best practices indicated in the Manual require key fiscal magnitudes to be projected for 5-10 years ahead. While this is not feasible, projection of major categories of expenditure and revenue two years ahead is feasible and should be implemented. FRBM Bill, if enacted into law, will make this mandatory.	Under the FRBM Act, the Central Government is setting forth a 3-year rolling target for prescribed fiscal indicators with specification of underlying assumptions. These are set out in the Medium-term Fiscal Policy Statement laid down with the Union Budget on July 8, 2004. Action may be considered completed.
7.	Reporting the revenue loss from major existing and all new tax concessions.	As per the FRBM Rules, details of tax revenue raised but not realised as well as arrears in non-tax revenue are to be given at the time of the presentation of the Union Budget. This provision shall be complied with not later than the presentation of the Union Budget for 2006-07. The recommendation is under consideration of the GOI.
8.	Information in budget documents on financial assets of the Government is limited to opening cash balance. No information is provided on government equity in public enterprises and outstanding loans to these enterprises.	The statement on assets and liabilities included in the Receipts Budget document gives the book value of assets in terms of cumulative capital outlay and outstanding amount of loans given by the government. Further value addition in the format of this statement such as segregation of equity investment may be considered in future.
9.	External liabilities may be reported in the Receipts Budget at current market exchange rates and not at historical exchange rates.	At present, the data on external liabilities at current exchange rates are presented in Statement 14 of the Finance Accounts as well as in the GOI's Economic Survey. Furthermore, under the FRBM Rules, the ceiling on liabilities cover the external debt liabilities at current exchange rate. Thus, there is an in-built provision to monitor this aspect. Hence, action may be considered completed.

10.	Consolidated fiscal position of the Centre and State Governments should be highlighted at the time of discussion in Parliament on the Budget.	Highlighting the consolidated fiscal position at the time of discussion in the Parliament on the Union Budget may not be considered appropriate as the purpose is to present the Union Budget only. It may, however, be mentioned that the consolidated fiscal position of the Centre and State Governments as compiled by RBI is being published in RBI Bulletin as well as GOI's Economic Survey which is brought out just before the Union Budget. The Economic Survey also provides data on budgetary transactions of the Central and State Governments and Union Territories (including internal and extra-budgetary resources of public sector undertakings for their plans). The recommendation may be treated as complied with.
11.	Rationale for budget policy should be open and available for scrutiny of legislature and public.	The Fiscal Policy Strategy Statement placed under the FRBM Act contains, *inter alia*, the fiscal policy for the ensuing year and the rationale for policy changes. Action is completed.
Assurances of Integrity		
12.	Specific methods used for revenue forecasting in Budget should be indicated.	FRBM Act would give impetus to the process of more realistic budgeting. Indicating the specific methods used for revenue forecasting would require further consideration.
Transparency Issues at the State Level		
13.	Fiscal transparency should be extended to sub-national governments.	Individual states are making efforts in this direction. Five state governments have already enacted fiscal responsibility legislations, while another state government has introduced a Bill to that effect.[5] All these legislations enunciate certain fiscal management principles and measures for fiscal transparency. Furthermore, a group comprising State

[5] Karnataka, Kerala, Punjab, Tamil Nadu and Uttar Pradesh have already enacted legislations, while Maharashtra has introduced a bill.

		Finance Secretaries of Kerala, Karnataka, Maharashtra, Punjab and Tamil Nadu and a representative from the GOI was constituted in October 2003 to frame a model bill to facilitate faster adoption of the fiscal rule framework by the remaining state governments. The draft report of the group was placed and discussed at the 14th Conference of State Finance Secretaries held in August 2004. Also, following the recommendations of the Core Group on Voluntary Disclosure Norms for state governments constituted by the RBI, a number of state governments have already started publishing 'Budget at a Glance', which provides summary information on key fiscal variables. Further measures and progress on fiscal transparency could be considered by GOI, CAG and the State Finance Secretaries' Conference. Other forms of sub-national governments may also like to examine these issues.
14.	In the absence of full compliance with transparency, the Finance Secretaries' Forum could set minimum standards on transparency, emphasising on QFAs (specially on losses of State Electricity Boards).	CAG may examine the setting up of minimum standards and guide the state governments in this regard. The issue could also be discussed at the Conference of the State Finance Secretaries, with a view to evolving modalities and time-frame for implementation.

2.9 A significant development since the Group gave its recommendations in June 2001 has been the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in August 2003. With this, the concerns expressed in the ROSC and by the Advisory Group have been substantially addressed. The Union Budget for 2004-05 presented on July 8, 2004 laid down, for the first time, three important documents envisaged under the FRBM – Macroeconomic Framework Statement, Medium-term Fiscal Policy Statement and the Fiscal Policy Strategy Statement. As such, the documents are required to be laid before

Parliament under the FRBM Act. These documents contain rolling targets for prescribed fiscal indicators, details about various policies related to taxation, expenditure, market borrowings and other liabilities, assessment of the growth prospects of the economy, etc. These are now available in the public domain. The essential elements contained in the FRBM Act requires that the Government shall take appropriate measures to reduce the fiscal deficit and eliminate the revenue deficit within a specified time frame. It also prescribes annual targets for assuming contingent liabilities and prohibits borrowing from the Reserve Bank from April 2006-07 except under exceptional circumstances. The FRBM legislation covers most aspects of fiscal transparency and its implementation would provide the necessary impetus for adopting the best practices in fiscal transparency. Regarding Quasi-Fiscal Activities (QFAs), its quantification is generally difficult, but continued efforts need to be made in this direction so that more accurate information is made available over time.

2.10 The Union Budget for 2004-05 has proposed to shift the target year for revenue deficit elimination to 2008-09 from 2007-08 through amendment to the FRBM Act, in line with the National Common Minimum Programme (NCMP) and taking into account the fiscal situation and the need for credible commitment to fiscal responsibility. The Budget also marks the first clear implementation of the proposals under the FRBM Act in many respects. The Union Government has also released on July 16, 2004, the Report of the Task Force on Implementation of the FRBM Act, 2003 set up under the Chairmanship of Dr. Vijay Kelkar. The Report provides a clear macro-perspective on fiscal consolidation. It discusses baseline scenario, policy proposals for reforms, fiscal projections under the reform scenario and the impact of achieving FRBM targets.

Advisory Group on Data Dissemination

2.11 Data dissemination has been recognised as an essential building block for strengthening international financial architecture in the aftermath of the financial crises in the 1990s. Delayed or inadequate data dissemination was considered to have played an important role in deepening the Mexican crisis and in creating a

shift in investor perception in the case of Thailand and Korea during the East Asian financial crisis. In the aftermath of the Mexican crisis of 1994-95, IMF established the SDDS as one of its key responses.

2.12 The Advisory Group on Data Dissemination which submitted its Report in May 2001, benchmarked data dissemination by India against the SDDS norms. It observed that India's compliance in respect of coverage, periodicity and timeliness of data dissemination, as also in terms of its advance release calendars, was "truly commendable". The Group agreed with the flexibility option in respect of labour market data, but suggested strengthening of data on general government. The Group also identified certain other deficiencies and made recommendations.

2.13 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 4: Present Status of the Implementation of the Recommendations of the Advisory Group on Data Dissemination

Sr. No.	Recommendation	Present Status
1.	Establishing hyperlinks from Dissemination Standards Bulletin Board (DSBB) to National Summary Data Page (NSDP).	India's NSDP with a link from IMF is maintained on the website of Economic Division, Ministry of Finance. It reflects the latest position in respect of data released by various agencies such as Ministry of Finance, Central Statistical Organisation (CSO) and RBI.
2.	Summary methodology for all data categories.	Methodologies have been provided for real sector and for a part of fiscal category, viz., central government operations. For other sectors, viz., financial, external, population and for public sector operations and central government debt under fiscal category, these are yet to be provided on the DSBB. Steps are required to be taken by the agencies concerned (RBI, Ministry of Statistics and Programme Implementation, Ministry of Finance) for implementation in a short span of time.
3.	Forward-looking indicators should be disseminated for certain sectors, e.g., surveys of business expectations.	The issue was examined by Working Group on leading Indicators set up by RBI. Business expectation surveys are being regularly conducted by independent agencies such as National Council of Applied Economic Research (NCAER), Confederation of Indian Industries (CII), etc. Results of these surveys are disseminated by the agencies concerned. RBI also conducts an Industrial Outlook Survey for its internal use.

4.	Data on public sector (non-banking) operations should be disseminated. Data on local finances should be part of general government operations.	GOI (Ministry of Statistics and Programme Implementation, Ministry of Finance) and state governments could consider steps that could be taken to implement this recommendation, so that a data-reporting system and database could evolve over the medium-term.
5.	Dissemination of Central Government debt data by original as well as residual maturity.	Long-term debt by residual maturity is not presently disseminated. RBI could follow up this in consultation with GOI, so that dissemination of such data could be made possible over the medium-term.
6.	Analytical accounts of banking sector.	Report on Trend and Progress of Banking in India provides an analytical coverage of the banking data with a review of the developments in this sector. Analytical accounts of banking sector are also available through dissemination of Banking Statistical Returns (BSR) data and Statistical Tables Relating to Banks in India. Annual Report of RBI, Handbook of Statistics on Indian Economy, Weekly Statistical Supplement and RBI Bulletin also cover banking sector data. All these data/publications are also disseminated by RBI on its website. No further action is considered necessary.
7.	International Investment Position	Data are disseminated as per requirements since September 2002. No further action is considered necessary.

2.14 In respect of data dissemination, some action points like providing summary methodology on all data categories could be implemented by the agencies concerned in a span of six months or so. Other items listed above require concerted efforts by concerned agencies to improve the data reporting and data generating systems, and could be taken up as medium-term agenda.

Advisory Group on Banking Supervision

2.15 Banking supervision is central to the public policy goal of financial stability. Keeping this in view, the Advisory Group on Banking Supervision went into applicability, relevance and compliance with international standards in respect of Basel core principles, corporate governance, internal control, credit risk, loan accounting, financial conglomerates and cross-border banking. It gave detailed recommendations on these aspects.

2.16 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 5: Present Status of the Implementation of the Recommendations of the Advisory Group on Banking Supervision

Sr. No.	Recommendation	Present Status
Core Principles		
1.	Powers of RBI to decide on capital requirements on a case-by-case basis needs to be clearly defined in law.	The issue of revision of minimum capital requirement and the supervisory process is under review. RBI could consider its legal, institutional and regulatory aspects in the context of discriminatory capital charge for proper risk management.
2.	A stricter view about objectives, philosophy and internal controls at pre-licensing stage, evaluating Directors on Board and making individual Directors accountable.	RBI is implementing this. Recommendations of the Consultative Group of Directors of Banks and FIs (2002) (Ganguly Committee) are also being implemented as per the circular issued by RBI in June 2002.

3.	Banks should obtain prior approval of supervisor for any proposed changes in ownership or exercise of voting rights over the threshold.	Guidelines issued in February 2004 provide for "acknowledgement" from RBI for acquisition/ transfer of shares. Such acknowledgement would be required for all cases of acquisition of shares which will take the aggregate holding of an individual or group to equivalent of 5 per cent or more of the paid-up capital of the bank. RBI while granting acknowledgement may require such acknowledgement to be obtained for subsequent acquisition at any higher threshold as may be specified. Incorporation of this aspect in the Banking Regulation Act, 1949 through appropriate amendment is under active consideration.
4.	Forbearance on capital requirements cannot be long-term.	RBI had introduced Prompt Corrective Action (PCA) in December 2002 to address this issue. The scheme, where one of the trigger points is minimum CRAR, was reviewed in December 2003 and it has been decided to continue with PCA in its present form.
5.	RBI should gradually move to setting bank-specific capital ratios based on their individual risk profiles; RBI may assist and guide banks on risk management.	RBI will address this issue during the course of implementation of Basel II norms. RBI has already issued comprehensive guidelines on ALM and other risk management systems and guidance notes on credit risk and market risk management. Implementation of these guidelines is being monitored closely through quarterly reports and Annual Financial Inspections (AFI) reports. RBI has also introduced Risk Based Supervision (RBS) on a pilot basis.
6.	Banks' risk management policies and procedures should be provided in publicly available documents.	Disclosure under Pillar 3 – Market discipline which provide for qualitative disclosures on management of risks will be considered at the time of Basel II implementation.
7.	RBI may issue suitable instructions for continued assessment of guarantees and strength of collateral.	RBI has already issued necessary instructions.

8.	A system of classification of off-balance sheet items on the lines of extant system of classification of funded exposure should be put in place.	Income Recognition and Asset Classification norms are being applied to off-balance sheet items, when they get crystallised. Even otherwise, risk weights as per the Basel Committee norms are applicable.
9.	‘Closely related groups’ need to be defined. Banks should monitor loans to connected and related parties. Such loans that are not fully collateralised should be deducted from bank’s capital to that extent.	In terms of Section 20 of the Banking Regulation Act, 1949, there are restrictions on banks granting loans and advances to its Directors, to any Company where Director of the bank is also a Director of the company, to individuals where the Director is a partner or a guarantor. As regards monitoring of loans to related parties, RBI has issued guidelines to banks on Accounting Standard (AS)–18 ‘Related Party Disclosures’. The guidelines require that the name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.
10.	Adopt rating of Board performance.	The evaluation of the performance of the Board is undertaken while arriving at supervisory rating under the component of 'Management' in the CAMELS approach. RBI could also consider further appropriate action, if necessary.
11.	‘Know Your Customer (KYC)’ guidelines should be verified by supervisor.	Guidelines have already been issued by RBI and IBA. Instructions have been issued to the Inspecting Officers of DBS to check the compliance by the banks with regard to ‘KYC’ norms during the AFIs and comment on the quality of compliance. In cases where violation of KYC guidelines have come to RBI’s notice, RBI has taken action against errant banks and even imposed penalty.

12.	RBI may consider introducing meetings with banks' boards and external auditors. It should enhance the role of external auditors.	Exit level discussions are held by inspectors with the bank management. Further, in the case of private sector banks, the inspection findings are invariably discussed with the Chief Executive Officer and a few prominent Directors of the bank. The Banking Regulation Act provides for the role of the external auditors and the same has been enhanced by the BFS.
13.	Move towards consolidated accounting and supervision. In case of internationally active banks, MOUs with host country supervisors should be considered.	RBI has issued a circular in February 2003 on consolidated accounting to facilitate consolidated supervision. Accordingly, banks who have subsidiaries are required to file consolidated financial statements and half-yearly consolidated prudential returns to RBI. Exchange of information of supervisory interest with host country supervisors is need-based, though no formal MOUs exist.
14.	Co-ordination among regulators.	High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM) already exists. Recently three sub-committees have also been constituted, viz., Sub-Committee on RBI Regulated Entities, Sub-Committee on SEBI Regulated Entities and Sub-Committee on IRDA Regulated Entities. On the basis of recommendation made by JPC, a joint RBI and SEBI group was constituted to put in place an integrated system of alerts which would piece together disparate signals from different elements of the market. Accordingly, as recommended by the group, the process of exchange of alerts and information has been set in motion.
15.	Imposition of conservatorship to enable banks in difficulty to gain time.	Provision for moratorium for up to six months already exists under the Banking Regulation Act. In the recent past, there have been three cases of moratorium. Nedungadi Bank Ltd. was put under moratorium and later on was merged with Punjab National Bank. South Gujarat Local Area Bank was placed under moratorium and later merged with Bank of Baroda. Recently, Global Trust Bank was placed under moratorium and later amalgamated with the Oriental Bank of Commerce.

Corporate Governance		
16.	Quality of corporate governance should be same for all types of banks; make Boards accountable and streamline process of induction of Directors; steps for percolation of strategic objectives and values.	Recommendations of the Consultative Group of Directors of Banks and FIs (2002) (Ganguly Committee) are being implemented.
17.	Establishment of compensation committees to link remuneration/ rewards to contribution.	A few newly set up private sector banks have such Committees, though for public sector banks pay structures are based on negotiation at industry level.
18.	Prohibiting loans and advances to Directors/ connected parties.	Statutory restrictions on loans and advances to Directors and connected parties are already in place. However, making these norms applicable to major shareholders would require legal amendments. RBI could consult GOI on this for effecting appropriate legal changes.
19.	Overlap between RBI as owner and RBI as regulator/ supervisor.	The proportion of RBI shareholding in SBI has come down from 97.8 per cent to 59.73 per cent. Nominees on the Boards of banks are not posted from Supervisory Departments such as DBS and DBOD. RBI is also in the process of off-loading its stake in IDFC Ltd. A view on off-loading of RBI's stake on NABARD and NHB is yet to be firmed up.
20.	Government ownership not conducive for urgent corrective action by regulator.	PCA regime does not discriminate on the basis of ownership. GOI has concurred with the actions proposed under PCA.

Internal Control		
21.	Institutionalise discussion between Board and management on quality of internal control systems; improve risk management.	RBI issued risk-based internal audit guidelines in December 2002. These guidelines provide for the Board to approve policy for undertaking risk-based internal audit covering risk assessment methodology on which the audit plan could be based. The policy should lay down the maximum time period beyond which low risk business activities/location is not to remain unaudited. The Board of Directors has been made responsible for an effective risk-based internal audit system and the internal audit head is required to report to the Board in this respect.
22.	Promote greater awareness in regard to security, risk and controls in computerised environment.	Recommendations as contained in the Report of Committee on Internet Banking and Working Group Report on Information System on Security for Banking and Financial Sectors have been forwarded to banks. Banks have also been given detailed checklist for computer audit. In continuation of these efforts towards sensitising the banks regarding information system security, detailed guidelines / instructions relating to Information System Audit have been issued to the banks for implementation during the current financial year.
23.	RBI should engage external auditors for area audit/ inspection of banks.	The statute provides for engagement of external auditors. There are instances where RBI engaged external auditors for specific assignments.

Credit Risk		
24.	The gaps with regard to monitoring of credit risk relate to the formulae-based determination of loan-loss provisions, a somewhat lenient approach to off-balance sheet activities and inadequate attention to economic factors. Banks need to improve credit risk management.	RBI regulations are not formula-based. RBI has advised banks not to go through various stages of classification in cases of serious impairment. Stress is laid on adequate provisioning to take care of impairment of assets and graded provisions is required to be made in case of doubtful assets. It may be added that RBI issued guidelines on risk management systems in October 1999 itself which sufficiently address most concerns. RBI has also issued guidance notes on credit risk to banks in October 2002. Further, RBI had issued guidelines on 'country risk' in February 2003. Risk management is also assuming increased focus under the proposed Basel II Accord. Risk Based Supervision initiated by RBI is providing further impetus to enhance the risk management techniques in banks.
25.	Banks should capture elements of risk like probability of default (PD), loss given default (LGD) and exposure at the time of default (EAD).	RBI is, however, pursuing a standardised approach for implementation under Basel II. As such, at this point of time, these are not very relevant for most of the banks. However, banks could consider process of building up necessary MIS in this regard for future purposes.
26.	Banks should build historical database on portfolio quantity and provisioning/ charge-off.	This has already been made part of guidelines on risk management systems. RBI is monitoring implementation.
27.	Guidelines in respect of dealing with Highly Leveraged Institutions (HLI) should be put in place.	Banks are not allowed to lend to HLIs.
Loan Accounting, Transparency and Disclosures		
28.	As per extant guidelines, if a loan under doubtful category does not migrate to loss category, the account remains under-provided as after three years only a maximum of 50 per cent provision is created under the secured portion.	RBI has advised banks not to go through various stages of classification in case of serious credit impairment. RBI has also been impressing upon the banks to make adequate provisions to take care of impairment in assets. RBI has also announced graded provisions to be made in case of doubtful assets of more than three years from March, 2005 and to provide for fully in respect of fresh additions after this date.

29.	Increasing provision on the secured portion of doubtful debts beyond 50 per cent.	As part of the Annual policy Statement for the year 2004-05, an announcement has been made for introduction of a graded higher provisioning requirement (for secured portion) according to the age of NPAs, which are included under ‘doubtful assets’ for more than three years. This graded provisioning has been made applicable since end-March 2005.
30.	Level of disclosures to be gradually improved. Detailed discussions on operational, legal and strategic risks may be made mandatory in director’s report to shareholders.	RBI has stipulated standards of disclosure from time to time. It will work out guidelines for operational risk, legal risk and strategic risk in due course. RBI is monitoring implementation of disclosures stipulated.
Financial Conglomerates		
31.	Mechanisms for detecting and providing for double gearing problems with financial conglomerates.	RBI circular of February 2003 provides for half-yearly consolidated prudential returns in respect of banks which have subsidiaries. RBI is monitoring implementation. For computation of capital adequacy, double gearing has been addressed by providing fordeduction of capital of the subsidiary.
32.	RBI should ensure fitness for directors/ managers of the unregulated entities in a conglomerate.	RBI does not have jurisdiction over unregulated entities in a conglomerate. As such, it needs to be considered what further action can be implemented in this regard.
33.	Make arrangements for applying fit and proper tests on all shareholders with shareholding beyond a specified threshold.	RBI has issued circular specifying the relevant factors which are taken into account for determining whether the applicant (including all entities connected with the applicant) is ‘fit and proper’ to hold position of a shareholder. Amendment to Banking Regulation Act is also being considered to empower RBI to permit/ reject transfer of shares in a banking company above a threshold.

34.	RBI may consider introduction of the concept of primary supervisor.	The new framework for monitoring of financial conglomerate envisages a complementary strand to the already existing regulatory structure, wherein the concept of principal regulator has been addressed. The new framework provides for: (i) identification of financial conglomerate that would be subjected to focussed regulatory oversight, (ii) capturing intra-group transactions and exposures, (iii) identifying designated entity within each group for collating data for all other group entities and furnishing the same to principal regulator and (iv) formalised mechanism for exchange of information.
35.	Risk control guidelines including appropriate controls in up-stream and down-stream units, material risk concentrations, Intra-group Transactions and Exposures (ITEs).	RBI has issued comprehensive guidelines on risk management systems. Accounting Standard 18 takes into account disclosures related to ITEs. As a proactive stance to address the issue of monitoring of conglomerates, RBI had constituted a Working Group on Financial Conglomerates. The Group has set criteria and identified 24 financial conglomerates. It has also evolved a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-regulatory exchange of information in respect of conglomerates. The first report based on the format recommended by the Group is under preparation (see also Section on Advisory Group on Securities Market Regulation).
Cross-border Banking		
36.	A country-wise analysis should be undertaken to identify constraints in countries where local laws do not permit home supervisor to conduct on-site inspection.	There is no system of regular on-site inspection of foreign branches of Indian banks by RBI. In case of specific situations, matter is taken up with the respective host country supervisor.
37.	Separate approvals of home country supervisors of foreign banks should be insisted for their new branches.	Approval is sought from the home country supervisors of foreign banks for opening of their maiden branch. RBI could consider further action in this regard.

38.	Periodic review of supervisory systems and standards of host countries where Indian banks have presence.	RBI accepts standards as evolved by the Basel Committee. Periodical reviews of performance of overseas offices including regulatory environment in those countries are done.
39.	Information sharing on parent bank's difficulties.	Information on parent bank's difficulties is not being obtained. However, the functioning of the branches of foreign bank is monitored independently. RBI could consider necessary follow-up on this.

2.17 Substantial progress has been made in implementing standards relating to banking supervision since the recommendations of the Advisory Group were put forth. India has been complying with standards set by the Basel Committee in almost all its aspects. It has actively participated in evolving these standards with formal comments on the Consultative Papers of the BIS and by participation in the quantitative impact studies (QIS). Recently, risk-based supervision on a pilot basis was adopted. There is need to continue this momentum and strengthen supervision aspects of other related areas, specially in financial conglomerates and cross-border banking.

Advisory Group on Securities Market Regulation

2.18 IOSCO has been promoting international standards that cover standards for effective surveillance and mutual assistance for enforcement against offences so that market integrity could be maintained. The Advisory Group on Securities Market Regulation evaluated the regulatory framework in the country in relation to the IOSCO principles and identified issues that could be addressed in future as part of its Report submitted in April 2001. On the regulatory side, the Group suggested enhanced regulatory and enforcement power to SEBI and favoured a mechanism to strengthen co-operation amongst regulators. It also advocated a cautious approach to self-regulation. Regarding legal aspects, the Group noted that the amended Securities Contract (Regulation) Act (SCRA) gave regulatory powers to RBI in respect of government securities and money market, but necessary enforcement powers were still not provided. The Group advocated

consolidating SCRA and SEBI Act in line with the recommendations of the Dhanuka Committee. On market issues, the Group suggested a more rapid phase-in of rolling settlements and implementation of international standards in respect of SSS. It also made specific recommendations in respect of clearing systems in equity and debt segments.

2.19 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 6: Present Status of the Implementation of the Recommendations of the Advisory Group on Securities Market Regulation

Sr. No.	Recommendation	Present Status
1.	Allow SEBI enhanced authority and powers to impose penalty commensurate with the gravity of the violation (i.e., disgorgement powers).	Appropriate action has been taken. The SEBI Act, 1992 was amended in October 2002, and SEBI was vested with search and seizure powers in cases relating to insider trading and market manipulations. The amount of penalty has been raised substantially in respect of various offences under the SEBI Act.
2.	Streamline the procedures to detect frauds. Further, procedures relating to due process have also to be streamlined.	Significant steps have been taken in this direction. The Insider Trading (Amendment) Regulations were notified in February 2002 to enhance market transparency and strengthen insider-trading regulations. These regulations were amended to stipulate a code of conduct for intermediaries and listed companies. The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations 2003 are now being enforced. These new regulations strengthened the provisions relating to action against market misconduct. The Weekly Joint Market Review Mechanism comprising Surveillance Chief, SEBI and the Chiefs of BSE and NSE are meeting regularly to review the markets in order to ascertain the safety and integrity of the markets and maintain constant vigil. SEBI is in the process of setting up a state-of-the-art online surveillance mechanism. SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations 2002 have been notified for expeditious

		completion of enquiry proceedings and to bring uniformity in conducting enquiries in respect of all intermediaries. As the process of streamlining procedures to detect fraud is an ongoing one, GOI, RBI and SEBI can co-ordinate on further implementation.
3.	(i) The existing HLCCFCM should be given legal status and its functioning should be made more transparent, (ii) 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.	HLCCFCM is functioning as an effective forum for consultations and co-ordination in action amongst various regulators. As such its present form is considered suitable. As regards recommendation (ii), three sub-committees have been formed, viz., Technical Committee on SEBI Regulated Entities, Technical Committee on RBI Regulated Entities and Technical Committee on IRDA Regulated Entities, consisting of representatives at senior level from each of the regulators. These committees meet regularly to discuss and share information on the issues concerning the entities coming under regulatory jurisdiction of each regulator. Further, to effect a monitoring system on financial conglomerates, a Working Group on Financial Conglomerates was constituted as an inter-agency group with a member each from RBI, SEBI and IRDA. The group, in its report submitted in May 2004, suggested criteria for identifying financial conglomerates, a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-regulatory exchange of information in respect of conglomerates. Regulators may consider further necessary action so that the envisaged system is put in place and new arrangements work smoothly.
4.	SEBI's power to enter into agreements with foreign regulatory authorities does not have statutory backing. Necessary legislative changes need to be made to enhance SEBI's scope in this regard.	SEBI has entered into several MOUs with foreign regulatory authorities. The existing provisions of SEBI Act enable SEBI to enter into such agreements.
5.	Demutualise the stock exchanges to prevent conflict of interest.	The suggestion is being implemented. An Ordinance called the Securities Laws (Amendment) Ordinance, 2004 has been

		promulgated recently. The terms 'corporatisation' and 'demutualisation' of stock exchanges have been defined. The ordinance also empowers SEBI to restrict the voting rights of the shareholders who are also stockbrokers of recognised stock exchanges. Earlier, SEBI had approved the recommendations of the 'Group on Corporatisation and Demutualisation of Stock Exchanges' (Chairman: Shri. M.H. Kania) in January 2003, which recommended, *inter alia*, a uniform model of corporatisation and demutualisation to be adopted for all stock exchanges. SEBI in its circular of January 2003 had advised the stock exchanges to furnish their schemes on demutualisation based on the recommendations of the above Group. The schemes submitted by the exchanges are being examined by SEBI. Also, the Union Budget for 2003-04 granted one-time tax exemption for capital gains to stock exchanges which would be demutualised.
6.	The lacunae relating to the absence of margin requirement for institutional trades needs to be addressed.	This issue is being examined by SEBI as part of its regulatory guidelines on risk management.
7.	Same legislation to include both regulatory responsibilities and the authority to carry them. Further, the regulation should be made institution-specific rather than market-specific.	The SEBI Act contains both regulatory responsibility and the authority to carry it. Also, there is now substantial clarity on market-specific regulation. GOI has, by issue of a notification under SCRA, delegated authority to RBI to regulate contracts in Government securities, money market securities, gold-related securities, securities derived from these securities and repos. Thus, RBI effectively regulates money market, government securities market, repo market as also OTC derivatives market. RBI also regulates foreign exchange market under FEMA. Equity market and all exchange-traded contracts are regulated by SEBI. Commodity futures market is regulated by the Forward Markets Commission (FMC). However, as regards enforcement/ supervision, since regulations operate on institution-specific basis, there are

		some gaps/overlaps. The regulators could mutually consult and decide on how best regulatory overlap could be reduced and regulatory gaps bridged.
8.	Consolidate the SCRA and the SEBI Act in line with the Dhanuka Committee Recommendations.	Amendments have been made in the SEBI Act. The provisions of SCRA are also being amended.
9.	Phase-in rolling settlement more rapidly.	Appropriate action has been taken. The rolling settlement on T+5 basis was implemented for all scrips and all categories of investors with effect from December 31, 2001. The settlement cycle has since been shortened to T+3 from April 1, 2002 and T+2 from April 1, 2003.
10.	RBI and SEBI may expedite their scrutiny of the recent recommendations made by the joint task force of IOSCO and BIS on securities settlement systems for early implementation. (i) Adoption of rolling settlement in all securities markets. Final settlement should occur no later than T+3. ii) Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method of expediting the settlement of securities transactions. Barriers that inhibit the	Most of the recommendations of the IOSCO-BIS joint task force on Securities Settlement Systems (SSS) have already been implemented by RBI. The recommendations which have not been implemented fully include: (i) The benefits and costs of a settlement cycle shorter than T+3 should be evaluated. In India, rolling settlement has been adopted in equity market (T+2) and in government securities traded on exchanges (T+3). In the case of government securities transactions on OTC basis, while rolling settlement exists, there are two settlement modes - T+0 and T+1. It has been decided in principle for standardising a T+1 rolling settlement in outright transactions in government securities. (ii) There is securities lending and borrowing in equity market. Securities lending in government securities is not allowed on account of the existing prohibition on short sale. However, a limited purpose securities lending scheme for lending by approved institutions to Clearing Corporation of India Ltd. (CCIL) is being implemented for facilitating the meeting of securities shortfall in settlement.

	practice of lending securities for this purpose should be removed.	Re-purchase agreements (repos) in government securities are permitted and encouraged. Rollover of repo transactions in government securities was facilitated with the enabling of DvP III mode of settlement in government securities in April 2004 which involves settlement of securities and funds on a net basis.
	iii) Central Securities Depositories (CSD) that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.	(iii) For government securities, the Public Debt Office of RBI is the CSD. The government securities market is only domestic. Public debt office does not have links to settle cross-border trades. In view of this, the recommendation is not applicable. SEBI is also by and large compliant with the recommendations of the IOSCO CPSS Task Force on Clearing and Settlement. The Task Force is working towards finalisation of its recommendations on the settlement system and central counterparties.
11.	The current Indian system of each stock exchange having its own clearing corporation or clearing bank should be replaced by only two clearing corporations for the entire country, which would support many stock exchanges.	The law at present does not require settlement of trades by clearing corporation. Hence, some trades are settled by clearing houses and some others by clearing corporations. The recently promulgated Securities Laws (Amendment) Ordinance, 2004 has, however, provided for the transfer of the duties and functions of a clearing house by a recognised stock exchange (with the prior approval of SEBI) to a clearing corporation for the purpose of periodical settlement of contracts and differences under it and the delivery of, and payment for, securities. While the pros and cons of restricting the number of clearing corporations to two may be discussed, SEBI could consider how best an efficient system could be brought out in this respect.
12.	Establish a mechanism to seamlessly link the depositories with the payment system through the clearing corporation/clearing agency to ensure DvP.	Currently, the two depositories, viz., NSDL and CDSL are connected to each other through a leased line connection. Linking of the depositories with the payment system would be facilitated by the phased operationalisation of the RTGS, which commenced live operations earlier this year. The number of

		direct participants in the RTGS system is expected to go up to about 125 from 92 participants at present. Banks, PDs and clearing houses would be the targeted members. The linking of depositories with the payment system would depend on the interface of the Clearing Corporations/ Clearing Houses in the RTGS network. Upon the Clearing Corporation/ Clearing Houses becoming a part of the RTGS network, the implementation of a secured scheme of networking the Clearing Corporation/ Clearing House with the depositories to facilitate a payment gateway in the overall scheme of implementing DvP could be taken up. RBI has agreed to take Clearing Corporations of the Exchanges as member in RTGS. Depositories are already connected to clearing corporations and are executing securities settlement as per their instructions. Since Clearing Corporation provides 'novation', it is also responsible for settlement of funds. It is, therefore, necessary to have a seamless link between Clearing Corporation and RTGS rather than with depositories. In addition, SEBI is in the process of setting up a central Hub for STP which would provide inter-connection among various Closed User Groups (CUGs) (like Exchanges, Depositories, INFINET of RBI). Fund settlement is envisaged to be completed through establishing a link between the Hub and INFINET. RBI may continue to take envisaged action in this regard, in co-ordination with other concerned agencies.
13.	Recent initiatives to tighten regulation of the private placement market need to be complemented by simultaneous efforts to ease some of the regulations governing public issues.	SEBI has, in September 2003, prescribed disclosure guidelines for the private placement market. Regarding public issue of debt, SEBI's Disclosure and Investment Protection (DIP) guidelines provide for an IPO of debt. Prior to August 14, 2003, the guidelines required promoters to bring 20 per cent of the project cost. This requirement was slightly modified without sacrificing the basic intent and the promoters have been given flexibility to bring 20 per cent of the issue size in order to ensure

		their commitment to the project. However, they are required to arrange for funds from other sources to the extent of 20 per cent of the project cost in order to ensure financial closure of the project.
14.	The disclosure of material information, which could have a bearing on the performance of the company, has to be made available to the public immediately. In terms of contents of corporate disclosure, the following initiatives are necessary: (i) group company disclosures may be limited to top five companies by market capitalisation or turnover, to avoid cumbersome exercise of gathering information from all companies falling under the definition of promoter group; and (ii) risk factors have to be given in greater detail as per international practices, although management perceptions of risks need not be given.	SEBI stipulated in December 2001 that the announcement with regard to disclosure of material information should be made within 15 minutes of the conclusion of the Board meeting in which the decision was taken. Regarding disclosure requirement in offer document, the Committee on Disclosure Requirement in Offer Document (Chairman: Shri Y.H.Malegam), recommended that in case the issuer company has more than five listed group companies, the financial information of five largest listed companies based on market capitalisation one month before the date of filing draft prospectus with the Board, shall be required to be disclosed. SEBI may continue to monitor progress in this regard.
15.	UTI and its schemes should be brought under the regulatory powers of SEBI.	Appropriate action has been taken. On October 2002, the Government issued an ordinance to restructure the UTI by splitting it into two parts: UTI-I comprising US-64 and assured return schemes and UTI-II comprising NAV-based schemes. The scheme was effected in January 2003. UTI-II, renamed as UTI Mutual Fund, has been brought under SEBI Regulation in January 2003.
16.	Introduction and implementation of international accounting principles across the mutual fund industry will help promote fairness and stability of the sector.	Appropriate action has been taken. SEBI has made some modifications in accounting norms pertaining to the mutual funds industry, such as norms for valuation for listed and unlisted securities, uniform method of calculation of sale/repurchase price and other disclosure norms. SEBI continues to track further

		developments in national and international markets with a view to improving regulatory oversight. This has led to development of a legal and regulatory framework for mutual funds that is comparable to many advanced markets. In particular areas, the level of sophistication is considered to be much more than even in UK (Source: Draft Interim Report (2003): Reform of Mutual Funds in India – prepared by Cadogan Financial, UK). It is noted that all the IOSCO Guiding Principles for Collective Investment Schemes (Annexure II of the report referred) are fully implemented for mutual funds in India. Further, reforms in a large number of areas of mutual funds have been implemented in the last few years, some of which (like comprehensive risk management system, introducing benchmarks for performance measurement, strengthening the accountability of Chief Executives, Fund Managers and Compliance Officers of Mutual Funds, certification and code of conduct for agents/distributors, introducing fund of funds, allowing use of derivative instruments and permitting investments in overseas markets) are based on an extensive review of international practices.
17.	RBI has to facilitate the emergence of Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) as self-regulatory organisations (SROs). FIMMDA and PDAI should establish a code of conduct and best practices in security transactions and also have a mechanism to enforce such codes. SEBI to assist Association of Mutual Funds of India (AMFI) to develop it into a full-fledged SRO.	The proposal to accord legal status as an SRO to FIMMDA has been examined in detail by RBI and was not found feasible at present. However, FIMMDA has established a code of conduct and undertaken related responsibilities appropriate to an industrial body. According self-regulatory status to PDAI is a non-issue since all PDAI members are also members of FIMMDA. Regarding AMFI, SEBI is assisting AMFI to develop into a full-fledged SRO. AMFI has been designated to issue certificates to agents and distributors under the certification programme. AMFI could be given specific statutory recognition and be vested with legal character under the SCRA also. SEBI has since advised AMFI to take up the role of SRO for mutual funds in India. SEBI has

		impressed upon AMFI the importance of an SRO for Mutual Funds industry and has advised AMFI to expedite its recommendations on various aspects related to formation and operation of an SRO and also to fix a time-frame. SEBI also obtains policy inputs from AMFI and it has been included as a member of the Advisory Committee for Mutual Funds. The SEBI (Self-Regulatory Organisations) Regulations, 2004 were notified in February 2004 for development of SROs. According to this notification, 'Self-Regulatory Organisation' means an organisation of intermediaries which is representing a particular segment of the securities market and which is duly recognised by the (SEBI) Board under these regulations, but excludes a stock exchange.

2.20 With the empowering of SEBI through an amendment of SEBI Act in October 2002, the enabling framework has by and large been created to facilitate strengthening of securities market regulation in general. This would also help expedite progress in respect of implementation of international financial standards and codes in this area. However, contemplated legal changes need to be carried forward, specially in respect of providing an integral framework for regulatory and enforcement responsibilities and demutualisation of stock exchanges. Regarding strengthening of co-operation amongst regulators, a Working Group on Financial Conglomerates was set up with a member each from RBI, SEBI and IRDA with a view to setting up a monitoring system to capture intra-group transactions and exposures for such conglomerates. Though focussed on institutions, rather than markets, the Group provided an additional mechanism for co-operation amongst regulators in addition to the already existing HLCCFCM. The Group submitted its Report which has been placed on the RBI website. A nodal cell has also been established at RBI for smooth implementation of the framework and a Technical Committee with representatives from all three regulators has been interacting and addressing issues arising out of the reporting requirements (see also item 35 of Table-5

above). Steps taken by the regulators over the last few years have helped in meeting almost all the IOSCO-CPSS standards except in the area of cross-border transactions. Further progress in the area of securities market regulation would need to focus on cross-border transactions, SROs and on operational areas of trading in securities markets.

Advisory Group on Insurance Regulation

2.21 International Association of Insurance Supervisors (IAIS), that was established in 1994 for co-operation amongst insurance regulators and supervisors from over 100 jurisdictions, has provided IAIS Core principles, Insurance Concordat and several others standards, which have brought the insurance sector under the ambit of international financial standards and codes. The Advisory Group that was set up to look into these submitted a detailed report in two parts. The first part was submitted in September 2000, while the second part was submitted in February 2001. The first part focussed on licensing aspects, while the second dealt with solvency and actuarial issues.

2.22 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 7: Present Status of the Implementation of the Recommendations of the Advisory Group on Insurance Regulation

Sr. No.	Recommendation	Present Status
1.	The taxation of shareholders' share of surplus could be at the corporate rate and the balance below the current rate.	Since life insurance business is long-term and shareholders do not envisage immediate returns, a view can be taken that taxation of shareholders' share of surplus can be at a rate marginally lower than the corporate rate. GOI could consider this through amendment to First Schedule of Income Tax Act, 1961.
2.	Role of co-operatives in spreading insurance business in rural areas to be considered in future.	The Insurance Act has been amended permitting co-operatives, as defined in Section 2C of the Insurance Act, 1938 to register as Indian insurance companies and underwrite insurance business. Necessary safeguards like Rs. 100 crore capital requirement, solvency requirements, deposits, investments, annual accounts, file and use procedures have been put in place. As such, no further action appears to be necessary.
3.	The superannuation business needs to be brought under regulatory arrangements.	The definition of life insurance business provided in the Insurance Act, 1938 does cover pension and superannuation business. Accordingly, the registration regulations notified by the Authority under Section 114A of the Insurance Act, 1938 and Section 26 of the IRDA Act, 1999 has specified the definition to mean "business of effecting contracts to manage investments of pension funds or superannuation schemes or contracts to pay annuities that may be approved by the Authority in this behalf". By virtue of this legislative mandate, life insurers are carrying on this business. However, with the notification of the interim Pension Fund Regulatory Development Authority of India (PFRDA), a clearer distinction in legislation and regulations needs to evolve in the overlapping areas.

4.	Amending Insurance Act, 1938 to enable insurance companies to provide allied services to their customers.	The insurance legislation has not specifically defined business of insurance, contracts of insurance and insurance *per se*. The Act defines insurance businesses such as life insurance, general insurance, fire insurance, marine insurance and miscellaneous insurance. Though the activity of insurance is on a stand-alone basis, it has to take into account the matters connected therewith or incidental thereto which may not be completely pertaining to insurance. To carry out the development mandate and to protect the interest of the policyholders and the in-built jurisdiction where the insurance contracts and insurance business is not defined, the allied services pertaining to rendering advice to insurers, insurance education, risk management and such other allied and actuarial services as detailed in WTO agreements could be permitted on the lines of Section 6(2)(h) of the LIC Act, 1956 on specific permission granted by the Authority. A view could be taken by GOI on the same.
5.	Elaborate classification of life and non-life business.	No change in the provision may be considered as the current classification takes into account the needs of the insurance companies.
6.	Minimum capital levels may be fixed for each of business on a scientific and transparent basis. Section 6 of the Insurance Act could be suitably amended.	No change in the provision is necessary as IRDA would like to move towards Risk Based Capital Approach over a period of 3-4 years.
7.	Co-ordination among the regulators for an efficient unit-linked insurance business. If regulation of unit-linked insurance is vested with SEBI, both SEBI Act and IRDA Act could require a provision to ensure the co-ordination of regulators. Co-ordination	A High Level Committee, in which RBI, SEBI and IRDA are represented, provides for co-ordination on such issues. The unit-linked business is transacted by the life insurers in terms of the defined parameters of the "linked business" which means "life insurance contracts or health insurance contracts under which benefits are wholly or partly to be determined by reference to the

	should also provide for level playing field between insurance companies and mutual funds.	value of underlying assets or any approved index" and the products marketed by such insurers are filed with the Authority before its clearance for sale in the market. Investment parameters of such units linked in the life insurance business are provided in the investment regulations to ensure that 75 per cent of the funds arising out of linked business are invested in approved investments with the discretion of the insurer to invest in other investments.
8.	Supervisory authority should protect the interest of both policy holders and shareholders. Review Section 27 of Insurance Act and IRDA (Investment) Regulations to ease out the restriction on investment relating to shareholders' funds.	Uniform set of rules for shareholder funds and investments of assets would protect the interests of both, the policyholder and the shareholder. Section 27 and other sections relating to investments of insurers do not distinguish between shareholders' funds and policyholders' funds for the purposes of investments to protect the interest of the policyholders which is the mandate given to the regulator in the IRDA Act, 1999. All the controlled funds and the assets of the insurer, whether generated by the policyholders' funds or the shareholders' funds, are required to be invested in terms of the investment regulations already notified by the Authority.
9.	Transfers to the Unexpired Risk Reserve and Catastrophe Reserve in case of general insurance companies.	The suggestion to grant exemption to the Catastrophe Fund has not found favour with GOI for the time being. It could be reconsidered at an appropriate time.
10.	Explicit restriction on the formation of composite companies doing both life and non-life business.	The nature of life business and non-life business is completely different. The liabilities of life business are long-term while that of non-life short-term. Therefore, the two businesses cannot be combined and explicit restrictions are already in place on the formation of composites.
11.	Regulator, as a general rule, should ascertain	IRDA's (Registration of Indian Insurance Companies) Regulations, 2000, provides

	names of natural and legal persons holding direct or indirect qualifying participation in the applicant company and, more importantly, make this knowledge public while granting the license. IRDA could issue the relevant regulations in line with Section 3 of Insurance Act.	for the same and IRDA is ascertaining this at the time of consideration of application in a rigorous manner. As such this could be treated as complied with.
12.	System of detailed information about the Directors/ Senior Managers for registration of new insurance companies. Acceptable guidelines of IAIS could be brought into the IRDA regulations.	Under the present regulations, the company is required to take formal approval of the Authority at the time of appointment of new director/ chief executive officer or their change. It is also obtained at the time of renewal of certificate of registration. As such, no further action appears necessary.
13.	Consider outsourcing of various functions of an insurance company. Amend IRDA (Registration of Indian Insurance Companies) Regulations 2000, in consonance with Section 40 (1) of the Insurance Act, which places restrictions only in respect of the marketing function.	IRDA regulations cover not only marketing but certain core activities of the insurance companies like underwriting, claims servicing, investment, reinsurance and IT, which cannot be out-sourced. This policy is to prevent shell companies and is considered necessary to protect the policyholders. The area of claims settlement also cannot be outsourced since it is a core activity of an insurance company.
14.	For new products, the certificate of product design could be treated as published information. IRDA could issue suitable guidelines.	IRDA regulations require file and use procedure that requires all such information to be given to it. Adequate care for protection is, therefore, taken. The procedure covers all new products and any modifications to existing products.
15.	IRDA can issue suitable standard formats of Articles of Incorporation.	IRDA has not advised any standard formats so far, as the companies coming into the insurance business are big and possess the necessary expertise.

16.	IRDA (Appointed Actuary) Regulation 2000 could be modified to provide for the firm of consulting actuaries.	Appointed actuary system is considered better for life insurance companies and has already been applied as such for these companies. In these cases, the person acts as eyes and ears of the Authority by reporting irregular practices to it. For general insurance business, the firms can have consulting actuaries, and hence, meet with the requirements of having a firm of consulting actuaries.
17.	The marginal gaps between the Indian and international standards for the calculation of unearned premium reserves may be addressed in due course.	IRDA's Accounting Regulations permit calculation of unexpired risk reserves on 1/365 method. Additional safeguards have been built into the system wherein under Section 64 v(ii)(b) if by 1/365 method the unexpired risk reserves are lower than the statutory minimum, then the company will have to keep the higher of the two. As such, no further action appears necessary.
18.	Amend IRDA (Assets, Liabilities and Solvency Margin) Insurance Regulation 2000 and position appropriate data base systems so that deficiencies with regard to collection of claims statistics relating to the estimation of the 'loss reserves' could be filled.	New private players already have sophisticated MIS system capable of generating statistics. Old players are also putting in place such MIS systems. IRDA could consider implementing this.
19.	Suitable standards for setting up catastrophe reserves should be evolved over next 2-3 years. IRDA regulations should be amended.	This would require tax incentives and has not found favour with GOI for the time being. GOI and IRDA could review this at an appropriate time.

2.23 The insurance sector in India is witnessing significant changes in recent years, with emergence of new players, new practices and new instruments. The regulatory issues as well as adoption and implementation of international standards require a close watch in these circumstances. One of the significant developments which has a bearing in this area in recent period has been the

setting up of an interim PFRDA and the operationalisation of a new defined contribution pension scheme for fresh entrants to government services from January 1, 2004. With this, the broad regulatory ambit has been defined. However, considering the possibility of some overlap in pension and insurance business, a clearer understanding is necessary for the implementation of standards and codes affecting these areas. If felt necessary, appropriate changes in legal and institutional framework could be considered. Additional mechanisms for greater interaction among various regulators, especially IRDA and PFRDA could evolve in due course.

Advisory Group on Bankruptcy Law

2.24 Bankruptcy laws in various countries have attracted attention in the context of corporate bankruptcies seen during recent financial crises that had generated some debate on issues such as creditors' and debtors' rights, seniority in debt and debtor-in-possession (DIP) financing. Insolvency laws were observed to differ widely from country-to-country and Chapter 11 type provisions of the US Law were not found to be in place in several countries. Also, creditor protection was weak in many countries and, in many cases, there were no clear guidelines on settlement of debt claims in case of bankruptcies. The World Bank is presently co-ordinating a multi-nation effort to develop a set of principles and guidelines on insolvency regimes. Against this backdrop, the United Nations Commission on International Trade Law (UNCITRAL) has adopted the Model Law on Cross-Border Insolvency in 1997, which can be considered as international code. To study the existing status of legislation in relation to international standards on bankruptcy laws, specially in the context of cross-border insolvency issues and to make suitable recommendations in this regard, the Advisory Group on Bankruptcy Laws was constituted. The Group has submitted its Report in two parts in May 2001.

2.25 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 8: Present Status of the Implementation of the Recommendations of the Advisory Group on Bankruptcy Law

Sr. No.	Recommendation	Present Status
1.	Code to contain provisions for company formation, capitalisation and finance, management, corporate governance, account and accountability issues, investors protection, reorganisations and winding up.	Companies Act, 1956 as on date contains provisions for company formation and capitalisation and finance and management in parts II, III, IV, V and VI (Sections 11 to 424). Regarding corporate governance, Section 292A provides for setting up of Audit Committee for the purpose of going into the internal financial affairs of public companies. This provision has been brought into effect by the Companies (Amendment) Act, 2000 following the recommendation of Naresh Chandra Committee. Regarding investors' protection, the Companies (Second Amendment) Act, 2002 has made provisions to check dissipation of debtor company's assets in liquidation.
2.	Code to contain provisions for corporate bankruptcy, restructuring, renegotiations and liquidation proceedings.	Chapter V of part VI of Companies Act dealing with Arbitration, Compromises, Arrangements and Reconstructions already provides for restructuring and renegotiations. Section 392 introduced by Companies (Second Amendment) Act 2002 empowers the National Company Law Tribunal (NCLT) to enforce compromise and arrangement. Bankruptcy provisions are provided in parts VII to X of the Companies Act and the provisions thereof have been elaborately amended by the Companies (Second Amendment) Act, 2002 to bring into effect the recommendations of Mitra Committee Report on Bankruptcy and Eradi Committee Report on the Law relating to Insolvency of Companies.
3.	The Advisory Group recommended repeal of SICA 1985, dissolution of BIFR, introduction of professional bankruptcy institutions known	The SICA (Repeal) Act, 2003 (Act 1 of 2004) received the assent of the President in January 2004 and is pending notification of the Central Government to come into effect. As per the provisions of

	as trustees to be appointed by the bankruptcy court to carry out restructuring and fast track liquidation. It is also recommended that the said trustee should play the role of administrator or regulator of the entity and keep custody of the corporate properties.	SICA (Repeal) Act, any appeal preferred to AAIFR or any reference made to BIFR or any enquiry pending before BIFR shall stand abated and such companies shall make reference under Part VIA of the Companies Act, 1956 within 180 days from the commencement of the SICA (Repeal) Act to National Company Law Tribunal (NCLT)/National Company Law (Appellate) Tribunal (NCLAT). Further, the Companies (Second Amendment) Act, 2002 provides for appointment of an Official Liquidator (substituted section 448) to be appointed from a panel of professional firms of Chartered Accountants, Advocates, Company Secretaries, C and WAs or firms having a combination of these professionals which is constituted by the Central Government for the tribunal, or a body corporate of such professionals approved by Central Government or a whole-time or a part-time officer appointed by the Central Government. Section 449 provides that the said Official Liquidator shall act as liquidator of the company. In Section 457 dealing with powers of liquidator, new sub-clause (ca) to clause (1) provides that the liquidator can sell whole of the undertaking of the company as a going concern. Elaborate powers have been vested with the liquidator with a view to protecting the assets in his custody by virtue of sub-clauses (2A) to (2G) by the Companies (Second Amendment) Act, 2002. Further, the proviso added to Section 513 states that a body corporate consisting of such professionals as approved by the Central Government shall be qualified for appointment as official liquidator under Section 448.
4.	Remuneration of Trustee to be proportionate to the principle of maximisation of realisable assets.	Section 448 clause (2) as amended by Companies (Second Amendment) Act, 2002 provides that the remuneration of the official liquidator shall be approved by NCLT subject to a maximum of 5 per

		cent of the value of debt recovered and realisation of sale of assets.
5.	Common judicial institution to deal with all bankruptcy matters.	The Companies (Second Amendment) Act, 2002 has been enacted to provide for the establishment of the NCLT and NCLAT, to which the powers of the High Court and the Company Law Board relating to winding up are being transferred. However, in view of the decision of Madras High Court in R.Gandhi vs. Union, the constitution of NCLT and NCLAT has been deferred at present.[6] The Companies Act, 1956 as amended by the Companies (Second Amendment) Act, 2002 seeks to bring within its coverage all companies registered under the Act (including NBFCs which are companies), Industrial Undertakings and Government Companies. Sections 2 and 6 of the Companies (Second Amendment) Act, 2002 came into effect from April 1, 2003. By a Press Note dated April 4, 2003, Department of Company Affairs (DCA) of GOI clarified that all preliminary steps required for establishment of NCLT would be set in motion and that a separate notification regarding constitution of NCLT will be issued. It was stated therein that till such time jurisdiction of Company Law Board would continue.
6.	Trigger point – minimum default limit be raised to Rs. 1 lakh from the present level of Rs.500/-	Companies (Second Amendment) Act, 2002 has provided for such change in Section 434 of Companies Act, 1956.
7.	Management responsible for bringing to the notice of the	As of now, no legal provisions have been made for this.

[6] The establishment of NCLT has been stayed by the Madras High Court vide its judgment of March 30, 2004 which felt that the constitution of the NCLT and NCLAT could result in executive powers in place of judicial power that was traditionally exercised by the Courts under safeguards. This judgment would prevent the establishment of NCLT bench within the jurisdiction of Madras High Court. However, the Central Government may proceed to establish the NCLT and the NCLAT for other States.

	Board that the company is unable to pay its debts, failing which they shall be personally liable for payment of the liabilities.	
8.	Likewise, the Board shall make independent examination whether the company is competent to pay its debts or not and if in this examination it concludes that it is unable to pay, it shall apply for bankruptcy proceedings. If any delay/non-observance is there, the Board Members shall be personally liable for company's liabilities. Further, such failure will disqualify the Board Member from holding similar position in any company.	Section 427 fixes liability on Director or Manager, whose liability is unlimited as per the provisions of the Companies Act, making them liable to contribute towards liquidation. However, for other aspects further legal provisions could be considered.
9.	Approval of reorganisation proposal – reorganisation on voluntary basis or based on proportionate right in relation to the claim based on the realisable claim arising from absolute priority rule - a meeting of 50 per cent of members holding 75 per cent of total realisable claim should agree to the reorganisation proposal – minority claim holders to be paid up.	Section 391 of the Companies Act provides for compromise or arrangements with creditors and members and states that in the case of reorganisation by members holding 75 per cent of the realisable claim, such compromise or arrangement shall, if sanctioned by NCLT, be binding on all the creditors/members and the company being wound up. The said provision does not provide for paying off minority shareholders.
10.	Time-bound bankruptcy proceedings – appointment of trustee within a week of application – day to day hearing to be given to parties in creditors' bankruptcy application to examine whether there is any substance in the petition (six weeks' time) – trustee to report on chances of restructuring (four weeks' time) – objections to restructuring to	Companies Act, 1956 even after the Companies (Second Amendment) Act, 2002 does not contain effective provisions for completion of liquidation procedure in a time-bound manner as recommended by the Group. However, Section 643 substituted by the Companies (Second Amendment) Act, 2002 provides that the Central Government may make rules to provide for fixing a time within which debts and claims shall be proved.

	be heard by Court (four weeks' time) – trustee to proceed with efforts of restructuring (eight weeks' time) – court may grant extension up to 12 weeks and in extraordinary cases for a further period of six weeks – trustee to place the scheme before court and court to hear objections (six weeks' time) – trustee to implement the scheme and report progress	
	(once in every quarter). If reconstruction not possible within this time, court to direct the trustee to go for winding up/liquidation. Trustee in winding up to realise maximum asset value and to submit reasons to court if winding up goes beyond one year.	
11.	Retransfer of the company to the management after the scheme is implemented by the trustee by an order of the court. The creditors may file objections before the court.	Provisions along these lines are not contained in the Companies Act.
12.	Special Institutions – Insurance, Telecommunication, non-banking financial institution, etc. regulated under different regulatory bodies – trustees in respect of winding up of these entities shall be appointed on the advice of respective authority – the authority may have some supervisory power at the stage of restructuring and winding up – special procedure to be provided for appointment of trustee in consultation with the relevant authority - the bankruptcy court to consult regulating authority for efficient	New sections 647A and 651A have been introduced in the Companies Act which provide for transfer of winding up proceedings, (including proceedings relating to arbitration, compromise, arrangements and reconstruction and winding up of a company) under the Insurance Act or any other law in force other than Banking Regulation Act, to NCLT.

	conduct of bankruptcy operations.	
13.	Different procedure for winding up of public sector undertakings and government companies not required.	Companies Act, 1956 may have to be amended to provide for winding up of PSUs and government companies as if they were public limited companies without any separate procedure for winding up. Chapter IXA of the Companies Act dealing with the Producer Company fix covers a large number of companies as stated thereunder including inter-state co-operative societies.
14.	The Group recommended that workers' claims must have equal treatment with that of secured creditor. Workers' claims, in this context, include Provident Fund (PF) and other benefits like workmen's compensation and gratuity.	Section 529A of the Companies Act provides that the workmen's dues and dues of secured creditors are overriding preferential payments and that they shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportion. In view of the said provision, no further amendment would be necessary for the same.
15.	The Group recommended that the preferential claim status for government debts shall continue. However, the government shall have the power to release the institution from such debt in appropriate cases.	There is no provision in the Companies Act.
16.	Separate provisions for banks and financial institutions and special protection of depositors' interest through deposit interest protection taken by banks and financial institutions or by insurance taken by individual depositors.	Based on the report by the Contact Group on the Legal and Institutional Underpinnings of the International Financial System on "Insolvency Arrangements and Contract Enforceability", RBI constituted a Working Group on Insolvency Regime for Banks and Financial Institutions in India (Chairman: Shri S.R. Kolarkar) in 2003 to examine issues such as (i) the need for considering special financial and banking insolvency law in India, (ii) the feasibility and desirability to have broad harmonisation of Indian insolvency framework with others, (iii) the possibility

		of implanting speedy and market based insolvency mechanisms, (iv) identifying current impediments to widespread use of financial arrangement like securitisation, (v) the need for a review of the role of RBI as the regulator of the financial system and as the initiator of insolvency proceedings for the entities in the financial system, (vi) the adequacy of existing exposure norms to minimise the extent of insolvency, (vii) the impact of financial integration on insolvency and (viii) the reforms required with reference to cross-border insolvency and other relevant issues. The Working Group recommended that there is need to evolve a distinct and special financial insolvency law to be applicable to the financial institutions and banks in India which is efficient, expeditious and equitable.[7] As follow-up of the Working Group Report, a Committee at the Government level to draw up a separate legal framework for insolvency of banks and financial institutions could be considered.
17.	Implementation of UNCITRAL Model – as a measure to improve cross-border bankruptcy principles.	The Eradi Committee Report and Mitra Committee Report had recommended the implementation of UNCITRAL Model in respect of cross-border transactions of corporates/ companies in India. As the Companies (Second Amendment) Act,

[7] The Working Group also recommended developing sophisticated early warning system (EWS) for all categories of banks to minimise chances of distressed banks. It recommended prompt corrective action (PCA) with a view to maximising depositors' and creditors' welfare in failing banks. For UCBs and banks, it was suggested that the work relating to insolvency may be entrusted to a separate institutional mechanism like the proposed Bank Deposit Insurance Corporation. Regarding payment systems, the Working Group recommended that multilateral net settlement obligation should prevail. The Group also recommended adoption of UNCITRAL Model Law on cross-border insolvency. The Group also recommended implementation of comprehensive consolidated supervision and putting in place a formal or informal protocol of supervisory exchange with other supervisors, both domestic and foreign, based on mutual co-operation. It also suggested incorporation of provisions to enable the liquidator to enter into "securitisation arrangements" and for NBFCs to be brought under the Securitisation Act. In its view, liquidatorship of insolvent banks could be entrusted to DICGC.

		2002 has not covered these issues, the recommendations could be considered separately. The UNCITRAL Model has been recommended by the RBI Working Group in the case of cross-border transactions of banks and financial institutions as well. Before adoption of the model, a Committee could be constituted to study as to how the model can be actually adopted in India and what necessary recommendations could be made to GOI.

2.26 Considerable progress has been made in improving bankruptcy laws in the country from the time the Advisory Group submitted its Report. Considering the Report of the Advisory Group, the Report of the Standing Committee (May 2002) had observed that bankruptcy law is one area where the Indian situation is far from satisfactory, when evaluated against the best practice norms. India did not have a comprehensive or satisfactory legal framework in this regard. The situation has markedly changed since then. Several legal changes have materialised as highlighted in Table 8. Though the comprehensive Act suggested by the Mitra Committee was not enacted, the objectives of the same have been achieved through the changes to Companies Act. However, progress in relation to the cross-border solvency suggested by UNCITRAL Model Law has been slow and there is a need to provide for appropriate legal provisions for the same. In general, there has been an improvement in bankruptcy regime.

2.27 Provisions have been made for timely restructuring to prevent bankruptcies. A Corporate Debt Restructuring (CDR) Mechanism was started in August 2001 and the mechanism was strengthened in February 2003. It seeks to provide a timely and transparent mechanism for restructuring corporate debts of viable corporate entities affected by internal or external factors, outside the purview of BIFR, DRT and other legal proceedings. The CDR mechanism provides separately for restructuring of standard and sub-standard assets (category 1) and doubtful assets (category 2). However, the mechanism is

voluntary in both cases based on the Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA), with the latter being legally binding amongst creditors. A legally binding limited period standstill agreement is also provided for under DCA.

2.28 Legal regime for recourse to assets has been strengthened through the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act which has contributed towards improving the insolvency regime, specially in case of NPAs. Till the enactment of SARFAESI, there was no legislation in India that provided for restructuring of standard assets and NPAs. Enforcement of rights of secured creditors now depend on DRTs, CDR or civil courts. Special provisions in Companies Act provide for secured creditors of insolvent companies to remain outside the liquidation process and to realise the securities subject to the *pari passu* charge of workmen's due on the assets of the company. The SARFAESI Act provides for securitisation or reconstruction of NPAs as well as standard assets by transfer of rights of a bank or FI in relation to financial asset to the securitisation company or reconstruction company. The constitutional validity of this Act was upheld by the Supreme Court in its judgement of April 8, 2004 in the case of Mardia Chemicals Ltd. vs. Union of India and others. The implementation of the Act is being strengthened in the backdrop of the Mardia Chemicals judgement. Changes through ordinance to the SARFAESI Act to provide for clear procedure for taking possession of secured assets, conferring power to Debt Recovery Appellate Tribunal (DRAT) to transfer pending DRT applications to one DRT, empowering RBI to call for periodic returns and information from securitisation companies and ARCs and to provide for taking over of management of the debtor is expected to remove difficulties in the smooth implementation of SARFAESI Act from now onwards.

Advisory Group on Corporate Governance

2.29 Corporate governance refers to the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as the Board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. OECD had, in 1999, spelled out corporate governance in this manner and this was consistent with the one presented by Cadbury Commission in the UK. From an economic point of view, as pointed by Shleifer and Vishny (1997), corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Corporate governance has several dimensions, but by and large the OECD principles have set the international standards in this regard. Corporate governance in banks is even more important as it affects not only the sources of funds, but also its uses. The uses of funds by banks and financial institutions are, in effect, the sources of funds for other deficit sectors, specially the corporates. The Advisory Group on Corporate Governance that submitted its Report in March 2001 examined the issues relating to corporate governance in banks in India, including public sector banks and development finance institutions and gave its recommendations on changes/reforms needed in various areas so that corporate governance in India could be brought on par with best international standards.

2.30 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 9: Present Status of the Implementation of the Recommendations of the Advisory Group on Corporate Governance

Sr. No.	Recommendation	Present Status
Corporate Governance in Private Corporate Sector		
1.	Clearly define the responsibility of boards in line with the OECD Principles. Corporate balance sheets are prepared to meet statutory requirements and are not informative for average shareholder. About 6-8 pages should be added to enlighten shareholders about the performance of the company in relation to last 4-5 years, with reference to other companies in the same/similar industry as also with reference to the industry as a whole. Consolidated accounts with subsidiaries as also performance of various	Progress has been made in respect of corporate governance, including establishing responsibilities of the Board and in disseminating more information in annual reports. SEBI norms for Corporate Governance are embodied in Clause 49 of the Listing Agreement.[8] The clause covers detailed norms pertaining to the composition of the Board of Directors, constitution of the Audit Committee and remuneration of the Directors. Further disclosures like dissemination of information to the shareholders in the Annual Report and information to be placed before Board of Directors have also been mandated. Kumar Mangalam Birla Committee had recommended that shareholders should

[8] These norms apply to the Listed Companies only. However, in the case of those listed entities which are not companies but body corporates incorporated under other statutes, this clause has been made applicable to the extent that it does not violate their respective statutes, guidelines or directives issued by the relevant regulatory authorities.

	divisions should be provided.	have information on quarterly results and presentations made by companies to analysts. Quarterly reporting of the segment-wise revenue, results and capital employed is being disclosed under Clause 41 of the listing agreement which came into vogue since the quarter ended September 2001. The companies have also been mandated to disseminate the presentation made by the analysts in their web-sites and also in the Corporate Governance Report section in the Annual Report. While the progress has been substantial, the information content for an average shareholder could still be improved further as envisaged by the Advisory Group and various other Committees. For example, companies' disclosures in their annual accounts relate to the year under review and the preceding year alone. Action on lines of the Advisory Group recommendation for 4-5 years performance being reported in annual accounts could be considered.
2.	On improving accountability of Boards to shareholders/ stakeholders, the Group recommended that they should be responsible to the shareholders, but not necessarily to the stakeholders (e.g., employers, creditors, suppliers, customers and environmental impact).	The issue needs further consideration. While corporates' primary responsibility needs to be to the shareholders, SEBI and DCA could examine how best societal responsibilities and interest of stakeholders could be considered to further good governance within the ambit of accountability to shareholders. Clause 49 of the Listing Agreement applicable to the Listed Companies has laid down the powers of the Audit Committee. The Audit Committee which is constituted of representatives of non-executive directors has been mandated to look into the reasons for substantial defaults in the payments to various stakeholders like depositors, debenture-holders and creditors.

3.	Access to information for Board members should be improved. They should be free to acquire professional advice at company's expense. Agenda of Board meetings should be clearly laid down well in advance and supported by substantive information.	SEBI has specified elaborate disclosure requirements to be placed before the Board of Directors by the Management during the Board meetings. Further, the Audit Committee which is constituted of representatives of non-executive directors is authorised to obtain legal or other professional advice. SEBI and DCA could consider if complete freedom to Board members on acquiring professional advice at company's expense is necessary.
4.	Independent and executive directors should be appointed on the recommendations of a nomination committee comprising the independent directors of the Board. The nomination committee should adopt clear and transparent criteria for selection of independent Board members. The criteria for choosing non-executive Directors should also be disclosed in the Annual Report.	Clause 49 of the Listing Agreement lays down the criteria for independence of directors, composition of independent directors and their appointment. Based on the experience of the Clause 49 of the Listing Agreement, the issue of independence of the Board of Directors has been further reviewed by Narayana Murthy Committee. The recommendations of the Narayana Murthy Committee in this regard would be implemented by SEBI shortly.
Corporate Governance in Public Sector Units		
5.	Most of the provisions in the Companies Act regarding role/responsibility of the Board also applies to PSUs. The Group advocated that balance sheet information should be on par with that in private sector companies, as suggested above.	The Narayana Murthy Committee has suggested that the nominee of the government on PSUs should be elected just as in case of private sector companies. However, a view needs to be taken by regulators and ultimately the GOI on this recommendation. Regarding balance sheet information, greater disclosure for both private sector companies and PSUs could be considered. This would be in line with the recommendation of the Advisory Group.

6.	The Board should be accountable to the ultimate owner of the government company, which is essentially the public and conduct affairs of the company in such a way that overall social interests receive the highest priority. The interests of the stakeholders should receive due attention.	The recommendation needs to be considered by SEBI and GOI. If the basic premise is acceptable, they need to consider how best the principle could be operationalised. The principal-agent problem is complex in such a case, as the Board acts as an agent of the government and in a sense a democratically-elected government is an agent of the public. Implementation of the suggestion would, therefore, require some understanding of how the possible conflicts of interest could be resolved in practice.
7.	Access to information to Board members should be improved. They should be free to acquire professional advice at company's expense. Agenda of Board meetings should be clearly laid down well in advance and supported by substantive information.	SEBI has specified the information that has to be placed before the Board of Directors during the Board meetings. Further, the Audit Committee which is constituted of representatives of non-executive directors is authorised to obtain legal or other professional advice. SEBI and DCA could consider if complete freedom to board members on acquiring professional advice at company's expense is necessary along with similar consideration for private sector companies.
8.	The selection of all Board-level posts in PSUs is done through a process involving Public Enterprise Selection Board (PESB). PESB advises Government and the process involves different levels of recommendations, interviewing and decision-making. An independent high-powered Selection Board on lines of the Union Public Service Commission (UPSC) to select full-time Directors of PSUs should be set up. Its decision should be final and not subject	Under the arrangement in place, PESB exists as an autonomous body within the Government. The Chairman and Managing Directors, who act as CEOs of PSUs, as also functional directors on the board, are recruited, selected, or promoted on the recommendation of the PESB. The recommendation for appointments to the board is considered by the Appointments Committee of Cabinet comprising of ministers, which may or may not accept the recommendation. All appointments are subject to due diligence process that includes clearance by the Central Vigilance Commission (CVC). The GOI

	to approval of the administrative ministry. The Selection Board should also prepare a panel of experts for nomination as independent professional directors on Boards of PSUs. The inclusion of non-executive directors should be done by a nomination committee. The criteria for choosing independent non-executive directors should be determined by a nomination committee.	has not yet taken a view whether the Chairman has to be an executive or non-executive member of the Board. However, existing guidelines recommend that full time functional directors should not exceed 50 per cent of the Board and government nominee directors should not exceed one-sixth of actual strength and in no case exceed two. Part-time non-official Directors should form at least one-third of the Board. These areas of corporate governance in PSUs could be considered further by GOI and SEBI.
Corporate Governance in Banks and DFIs		
9.	Clearly define the responsibility of bank Boards in line with international best practices. Boards should play an active role in risk assessment and oversight. Limits for individual voting rights are 1 per cent in PSBs, but 10 per cent for private sector banks.	Recommendations of the Consultative Group of Directors of Banks and FIs (Ganguly Group) have been forwarded to the banks for implementation, based on the decisions of their Boards. Further, in terms of circular of June 2004 to banks, the Boards are required to ensure in public interest that the directors execute the deed of covenants to discharge their responsibilities to the best of their abilities, individually and collectively, as recommended by the Ganguly Group.
10.	On improving accountability of Boards to shareholders/ stakeholders, the Group suggested that bank boards should be accountable to the owners of the bank, but should also keep in view the interests of the main shareholders such as depositors, creditors, employees and customers.	RBI has issued circular in June 2002 advising banks that the Chairman of the Audit Committee should be present at AGMs to answer shareholder queries. Banks have also been advised to form committees under the chairmanship of a non-executive director to look into the redressal of shareholders' complaints. RBI may continue monitoring progress in this regard.

11.	Access to information for Board members should be improved. They should be free to acquire professional advice at company's expense. Agenda of Board meetings should be clearly laid down well in advance and supported by substantive information.	RBI has issued circular in June 2002 following the Ganguly Group recommendation that summary of key observations made by directors should be submitted at next Board's meeting. A more detailed recording of the proceedings including dissent could be forwarded for confirmation later. Banks have also been advised that draft minutes should be made available to Board meetings electronically within 48 hours for ratification. However, further consideration on agenda and supporting information, as also on professional advice at company expenses, could be given.
12.	Presently, bank boards consist largely of nominated members as against elected members. They should be independent and elected and have different tenures to ensure continuity. Criteria for nominating executive directors and for non-executive directors should be clearly laid. Boards of companies, banks and PSUs should set up nomination committees with at least three independent Board members.	Ganguly Group felt that formal nomination committees should be set up. RBI has written to GOI in June 2002 requesting DCA to consider legislative changes. Efforts in this direction may be continued. RBI has also issued circular in June 2004 recommending that private sector banks should follow a 'fit and proper' criteria for appointments/ renewal of appointments to Board. They should undertake a process of due diligence in regard to the suitability for the appointment of directors by way of qualification, expertise, track-record, integrity and other aspects. The Boards of banks should form nomination committees to scrutinise declarations of candidates. The Boards also must ensure that directors execute deeds of covenants as recommended by Ganguly Group and implemented vide RBI circular of June 2002.
13.	Increasing number of professionals on Boards by specifying proportion of non-executive members on Boards as in case of other companies.	Ganguly Group recommendations cover this aspect. RBI has apprised GOI on this issue and the matter is being followed up by the concerned agencies. RBI directions on 'fit and proper' criteria for board appointments have been issued and would be helpful in this regard.

14.	Implementing the definition recommended by the Blue Ribbon Committee for defining independence of Board members.	RBI has issued circular in June 2002 annexing the mandatory recommendations of the SEBI Committee on Corporate Governance. It implies that in case a company has a non-executive Chairman, at least half of the Board should be independent.
15.	Training on Board practices.	RBI has conducted/ participated in seminars and workshops on Board practices in which members of the Boards have also participated. RBI also offers some training programmes/ seminars at its own training establishments, but large banks may conduct their own programmes.
16.	Director should not serve on more than 10 Boards or be member of more than 5-6 committees.	RBI has issued circular in June 2002 directing that a Director should not be in more than 10 committees or act as a Chairman on more than 5 committees.
17.	Separation of office of CEO and MD.	RBI has written to GOI in June 2002 requesting legislative changes as the Ganguly Group favoured this. RBI could consider drawing draft legislation for consideration of the Government. GOI may consider implementing the legislative changes.
18.	Audit Committees should be formed as per recommendations of the Blue Ribbon Committee.	RBI has written to GOI in June 2002 stating that it is in in-principle agreement with the Ganguly Group recommendation that Audit Committee should have independent non-executive Directors and Executive Director should only be a permanent invitee. The agencies could follow-up on this.
19.	Boards should set up Remuneration Committees made up exclusively of non-executive Board members.	RBI has written to GOI in June 2002 for DCA to consider the matter of legislative changes. RBI and GOI may follow-up on this.

20.	Boards of large companies and banks should meet at least six times a year.	RBI has issued circular in June 2002 making it mandatory that Board meetings be held at least 4 times a year with a maximum gap of 4 months.
21.	Tenure for independent Directors may preferably be up to ten years at a stretch. The age limit should be a maximum of 65 years for whole-time Directors and 75 years for part-time Directors. The liability of non-executive directors should be limited.	RBI has written to GOI in June 2002 to consider Ganguly Group's suggestion that whole-time Directors should have sufficiently long tenure. As per B.R. Act, maximum tenure of non-executive Directors is eight years. RBI has issued circular in June 2002 advising an age limit of 35-65 years for non-executive Directors. The upper age limit has since been revised to 70 years. In terms of Section 13 of the Banking Companies Act, 1970/1980, the Directors shall not divulge any information relating to constituents of the bank, except under the compulsion of a law. RBI and GOI may consider further implementation.
22.	Necessary biographical details of Directors should be provided in Annual Report. Banks should also make disclosures on senior management structures.	RBI has issued circular in June 2002 on appropriate procedures for nomination. A circular has also been issued in March 2003 on key management personnel in accordance with Accounting Standards 18.
23.	All large companies should make an evaluation of the quality of disclosures by independent agency.	RBI has issued circular in June 2002 as a follow-up to SEBI Committee on Corporate Governance asking banks to include separate section on corporate governance in their Annual Reports. Further consideration to the specific recommendation on independent evaluation on quality of disclosures could be given in due course.
24.	Financial reporting, disclosure and transparency of banks in India need further improvement.	RBI has taken several steps that include follow-up of SEBI Committee. The broad objective appears to have been met.

25.	Disclosures as per accounting standards should cover subsidiaries, specially where 26 per cent or more shareholding exists. Disaggregated segmental information should also be provided.	RBI has issued circular in February 2003 on consolidated accounting for compliance with period commencing from the year ending March 2003. It would be mandatory for banks to adopt all accounting standards that are required to be followed, though certain flexibility required by banks has been provided for.

2.31 Considerable attention has been given to corporate governance in recent years. In addition to the Advisory Group chaired by Dr. R.H. Patil (RBI, 2001), several official Committees have already gone into the issues relating to corporate governance and have given their Reports. These include the Committee chaired by Shri Kumar Mangalam Birla (SEBI, 1999), the Task Force on Corporate Excellence through Governance (GOI, 2000), Consultative Group of Directors of Banks/ Financial Institutions (RBI, 2002), Naresh Chandra Committee on Corporate Audit and Governance (SEBI, 2002), Naresh Chandra Committee-II on Regulation of Private Companies and Partnership (GOI, 2003) and Narayana Murthy Committee on Corporate Governance (SEBI, 2003). Recently, Malegam Committee has gone into disclosure norms for offer documents (SEBI, 2004) that would also contribute towards improving corporate governance in the country. Preceding these official committees, the industry association, CII, had itself provided a Code in 1998. However, over the years, a number of issues required attention for improving governance in the corporate sector.

2.32 Notable progress has been made in regard to corporate governance in private corporate sector following the SEBI guidelines and in banks following the RBI issuing operational circulars in June 2002. RBI has also issued circular on consolidated accounting in February 2003. These circulars have created an enabling framework for improving corporate governance in financial institutions. However, there is a need for consultative process to harmonise the approaches suggested by the Ganguly Committee and the Narayana Murthy Committee with

regards to banks. As proposed in the Mid-Term Review of Monetary and Credit Policy for the year 2003-04, SEBI and RBI are working jointly towards harmonisation of the approach adopted by SEBI towards corporate governance with the corporate governance practices in banks. While on an overall basis there has been a marked progress in this area, governance in PSUs requires focussed attention. Further progress in regard to corporate governance in all the three types of companies – private, public and banks (both private and public) could be facilitated by the Government and regulatory agencies by continuing the attention the subject has received in recent years.

Advisory Group on Accounting and Auditing

2.33 The Advisory Group on Accounting and Auditing that submitted its Report in January 2001 had examined the gap between international accounting standards and those prevalent in India. It also looked into the convergence of tax laws to accounting standards. It noted that the standards issued by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) were generally at par with international standards, but identified specific areas where gaps existed.

2.34 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 10: Present Status of the Implementation of the Recommendations of the Advisory Group on Accounting and Auditing

Sr. No.	Recommendation	Present Status
1.	The gap between International Accounting Standards (IAS) and those of the ICAI remains large. ICAI may take up on an emergency basis the issuance of standards on a comparable basis to 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 Measurement).[9]	Since the Report of the Advisory Group, many Indian Accounting Standards (AS) have been issued corresponding to the IAS. At present there are 29 Indian Accounting Standards. The International Accounting Standards Board (IASB) has recently issued revised Accounting Standards pertaining to financial instruments, viz., IAS 32 and IAS 39. ICAI is working towards formulation of corresponding Indian AS. Drafts of Indian AS corresponding to IAS 30, IAS 32 and IAS 39 are under preparation.
2.	Where Indian standards diverge from international standards, Accounting Standards Board (ASB) should issue a note explaining reasons.	ICAI has already started the practice of including an annexure, in all new/ revised accounting standards, which brings out major deviations, if any, from the corresponding IAS and reasons thereof.
3.	ASB should be an autonomous body within ICAI with own staff and independent funding. Full-time Chairman with members having technical expertise.	Matter relating to giving autonomy to the ASB is being sent to the Council of the ICAI. As regards representation of the regulators on the ASB, there is already adequate representation of regulators on the ASB with RBI, DCA, Central Board of Direct Taxes (CBDT), CAG, SEBI, etc. having representation.
4.	With reconstitution of ASB, no need for NAC or Central Government or RBI to issue directions in accounting matters. Only in case where matters are not covered by standards or there	ICAI and RBI could continue to co-ordinate. Issue of single standard-setting authority rests with ICAI. RBI has put in place appropriate arrangements to monitor compliance with accounting standards. A Working Group under the Chairmanship of

[9] In terms of international financial reporting standards, IAS 30 was issued in August 1990 (effective January 1, 1991), IAS 32 in June 1995 (effective January 1, 1996) and IAS 39 in December 1998 (effective January 1, 2001). IAS 30 was re-drafted and re-exposed as E34 and later reformatted in 1994. IAS 32 was re-drafted and re-exposed as E48 and again as E62. IAS 39 in terms of E62 followed by E66, supersedes those portions of IAS 25 (Accounting for Investments) that relate to investments in financial instruments. Effective January 1, 2001 IAS 30 and IAS 32 stand revised and amended by IAS 39. For details, IASB (2004) may be cited.

	are matters of interpreting standards, RBI may issue directives consistent with the standards issued by ICAI. RBI may also monitor standards issued by ICAI.	Shri N.D. Gupta, former ICAI President, was set up by RBI to identify compliance by banks, as also gaps in compliance with the Accounting Standards issued by ICAI. Based on the recommendations made by the Working Group, RBI issued detailed guidelines in March 2003 and April 2004, on the Accounting Standards where banks were not found to be fully compliant due to operational and other constraints or where they needed guidance from RBI to ensure uniformity among banks. Whenever ICAI introduces a new accounting standard, it circulates the exposure draft of the accounting standard to 12 notified bodies, including RBI, for comments. The exposure draft is examined and RBI offers its comments on the issues which would be of relevance to financial institutions / banks stating difficulties, if any, banks would face in complying with the proposed accounting standard. Besides, if ICAI considers amendment to any existing accounting standard, it seeks the comments of RBI on the proposed amendment. Hence, accounting standards issued by ICAI on accounting for financial institutions / banks are monitored by RBI.
5.	Differences in standards issued by ICAI and IAS arise due to differences in corporate and tax laws.	ICAI could consider and make recommendation to the GOI.
6.	A Task Force could be set up to look into emerging issues where standards are not issued.	The Research Committee of the ICAI considers emerging issues and makes pronouncements on such issues on a timely basis. For example, Research Committee has issued Guidance Notes to deal with accounting of dot-com companies, securitisation, equity index and equity stock futures and options. The Research Committee is generally assisted by specifically constituted Task Forces comprising members having experience in relevant areas. Therefore, it is felt that the

		creation of another Committee may not serve much purpose.
7.	A mechanism needs to be in place to ensure compliance with standards like SEC in the US. A panel within ICAI or outside could be set up for the purpose. Auditors could be obligated to report violations to this panel directly.	GOI may consider its various aspects in consultation with ICAI.

2.35 The gap between the international and Indian standards in respect of accounting and auditing needs to be constantly monitored as significant developments and improvements are taking place, both in US and Europe. The accounting irregularities by some firms in these parts have reinforced commitment to strengthen accounting, auditing and corporate governance. With opening up of the Indian economy, Indian firms are sourcing finance from abroad in the form of equity as well as debt, as also acquiring stakes abroad. The issue of adopting best practices in accounting and auditing standards, subject to country-specific needs, has acquired added importance and priority in this context. Therefore, the task relating to setting up of Indian standards in respect of IAS 30, IAS 32 and IAS 39 needs to be completed at the earliest. Regarding Indian standards, amended standards up to AS 29 have already been made available and effort is being made to retain only unavoidable differences. In general, there has been a noticeable improvement in enforcement mechanism for accounting and auditing standards in India over the last few years and the process needs to be taken forward.

Advisory Group on Payments and Settlement Systems

2.36 The Committee on Payment and Settlement Systems (CPSS) set up by the G-10, in January 2001, formalised the 'Core Principles of Systemically Important Payment Systems' and, along with IOSCO, released a report

containing recommendations on Securities Settlement Systems (SSS) for comments. These developments set the broad framework for adoption of international financial standards and codes in the area of payment and settlement systems. The Core Principles were initially released in December 1999 and a revised version was circulated in July 2000. The Advisory Group considered this version and submitted its Report in three parts covering clearing house operations, settlement in equity and debt market and settlement of foreign exchange (FX) transactions, respectively. In respect of Systemically Important Payment Systems, the focus was on introduction of Lamfalussy standards as a minimum benchmark and to develop appropriate mechanisms for a Real Time Gross Settlement (RTGS) system. Compliance with G-30 recommendations on SSS was the focus for equity and debt segments, while for forex segment, the Group made recommendations entailing actions that could facilitate Clearing Corporation of India Limited (CCIL) in conforming to international practices and principles.

2.37 The present status of the implementation of the main recommendations of the Group is summarised below:

Table 11: Present Status of the Implementation of the Recommendations of the Advisory Group on Payment and Settlement Systems

Sr. No.	Recommendation	Present Status
1.	Well-founded legal framework and clearing house rules.	Draft Payment and Settlement Systems Bill has been finalised and forwarded to GOI. After the Bill is passed, the Uniform Regulations and Rules for Bankers' Clearing Houses could be reviewed. RBI and GOI could consider further implementation in this regard with enabling legislative changes.
2.	Amendments suggested to Section 17(6) of RBI Act, N.I. Act (1881). Proposal for EFT Act.	No further action appears necessary on RBI Act and EFT Act as the Payment and Settlement Systems Act would take care of the requirements in conjunction with the Information Technology Act 2000 already in place; N.I. Act has been amended in the last quarter of 2002.
3.	Introduction of Lamfalussy standards would address risks but should be kept under review.	RBI is already following this. The Government securities settlement and forex settlement systems operated by the CCIL and the RTGS operated by the RBI are Lamfalussy-compliant and are under constant review.
4.	Place rules and regulations on clearing on website.	Appropriate action has been taken. RBI has placed the Uniform Regulations and Rules for Bankers' Clearing Houses, the NDS rules and the RTGS Business rules on the RBI website. The Procedural Guidelines for ECS and EFT are also on the website.
5.	Proper framework for counterparty risk.	Such a framework has been provided for Core Principles-compliant systemically important payment systems. No further action now appears necessary.

6.	If existing arrangements are not satisfactory, a common fund contributed by users of the system should be put in place.	The CCIL systems have adequate arrangements. However, cheque clearing systems, which are retail payment systems are not fully compliant with Core Principles. This issue is being deliberated by RBI and IBA with the member banks. A Working Group for Risk Mitigation Mechanism for Deferred Net Settlement Systems has been constituted to examine whether (a) a Contributory Guarantee Fund needs to be created to neutralise a settlement default by one or more participants in the clearing system; and (b) whether the minimum balances maintained by participants in the various clearing houses with the settlement banks should be significantly increased. Based on the recommendations of this Group, the systems for risk reduction in retail systems would also be implemented.
7.	Need to introduce limits for all participants in a fully centralised accounting structure.	The CCIL systems have such limits. RBI has undertaken several steps in the direction of centralised accounting. No further steps appear necessary.
8.	System should provide for same day or intra-day settlement.	RTGS, Government securities clearing and forex clearing provide for same day settlement. As far as cheque clearing is concerned, MICR-based clearing is already covered under same day settlement at clearing houses. ECS has same day settlement while EFT has multiple settlements during a day. In addition, RBI has implemented CFMS and introduced central counterparty arrangements and secure netting in some market segments to eliminate credit and liquidity risks. RTGS eliminates credit risk in large party transactions. Collateralised repo-based intra-day liquidity support has been provided to RTGS members. Necessary action has largely been completed.

9.	RBI should undertake periodic costing of various payment instruments to facilitate effective pricing.	The issue relating to pricing of various payment services has been left to banks to decide on the basis of their commercial strategies. RBI could, however, perform periodic research to assess the requirements in a dynamic scenario. There is a proposal to set up a research wing in the Department of RBI responsible for payment and settlement system. The charges for RTGS could be reviewed from time to time, *inter alia*, taking into account the research inputs. The proposed Board for Payment and Settlement Systems (BPSS) could supervise the arrangements. As such, RBI could continue monitoring effective pricing mechanisms and related aspects.
10.	Popularise EFT through a scheme of incentives and disincentives.	There has been significant growth in electronic modes of funds transfer from a throughput of Rs.6000 crore in 2001-02 to about Rs. 30,000 crore in 2003-04. Efforts are being continuously made in this direction. It has now been decided to completely waive service charges on banks for both ECS and EFT transactions up to March 31, 2006. Instructions have been issued to banks that this benefit should be passed on to customers. A Special EFT scheme has been introduced for same day settlement covering 127 centres. A variant of EFT – the National EFT – to cover a large number of branches of banks is being introduced. As announced in the mid-term Review of the annual policy Statement for 2004-05, in order to facilitate large scale usage of the ECS and EFT schemes for large value money transfers and to meet the requirements of various segments of the financial sector including securities market, the existing per transaction limits for ECS and EFT are being dispensed with from

		November 2004. CBDT has also agreed to grant refunds up to Rs. 25,000 through ECS facility at select centres in respect of individual tax payers.
11.	Cross-country survey on payment system objectives, their management and legal aspects should be undertaken.	This would require periodic research. The proposed Department of Payment and Settlement Systems includes a provision for a research wing for undertaking such studies. RBI could follow this up.
12.	Hiving off the management of DNS and RTGS systems from RBI, with only settlement of funds to remain with RBI.	As far as DNS is concerned, at all the new MICR-based cheque processing centres, RBI is performing the settlement function only. The Cheque Processing Centre (CPC) is being managed by other commercial banks. 35 such centres have been made operational in this manner till now. As for RTGS, as of now, hiving it off is not feasible given the stage of development. However, it may be possible to hive off certain components of payment and settlement systems. RBI may consider follow-up action in this regard.
13.	Constitution of an institutional problem resolution mechanism comprising multiple regulatory bodies and to ensure level playing field across participants.	The HLCCFCM includes representation from RBI, SEBI and IRDA. As such, no further action appears necessary. The mid-term review of the annual policy Statement for 2004-05 has announced the constitution of a Working Group on avoidance of conflict of interest. The Group to be set up in consultation with SEBI and IRDA will, *inter alia*, identify the sources and nature of potential conflict of interest and make recommendations for avoidance of such conflict of interest.

14.	Revision to the publication entitled, “Approach to an Integrated Payment System in India” (1998).	Appropriate action has been taken. The publication was revised and a new publication “Payment System Vision Document” has been published by RBI in 2001; this is currently being reviewed and the vision document for the period ending 2008 is being readied.
15.	In case of government securities, new system should be expedited to reduce pre-settlement risk by executing trade preferably on T+0 basis.	Appropriate action has been taken. The Negotiated Dealing System (NDS) has been put in place by RBI. The current move is to migrate towards a T+1 settlement for all securities settlements in the country.
16.	When government securities are settled through Clearing Corporation, it should be possible to introduce affirmation by indirect market participants.	The issue has been examined by RBI and a view has been taken that matching and confirmation will be insisted on only in SSSs. No further action appears to be necessary.
17.	Straight Through Processing (STP) should be the objective of SSSs. If National Clearing Corporation of India Ltd. is given the limited purpose bank status, STP can be achieved in equity segment. Same can apply to CCIL for government securities.	DBOD has examined the issue and has recommended against granting limited purpose bank status to these clearing corporations. In view of the above, no further action may be contemplated in this regard. Further, with RTGS / Special EFT in place, DvP need not be done by the same institution; the funds leg of the transactions could be settled through RTGS when they are accorded RTGS membership.
18.	Rolling settlements should be adopted for SSSs. Final settlement should occur on T+3 basis. The market could move from T+5 to T+3 with improvements in infrastructure and payment systems.	Appropriate action has been taken. The market has already moved from T+5 to T+2 rolling settlement. Payment system has also developed, especially with Special EFT Scheme already in place and National EFT to be introduced in a few months’ time.

19.	Multilateral netting systems should be capable of timely completion of daily settlements. Setting up of CCIL may be expedited and settlements should be made possible even if three or more of largest members default.	CCIL has been set up and it provides secure netting system within a central counterparty arrangement. No further action is necessary in this regard.
20.	Need for cross-margining to deal with multiple exposures.	As only one SSS exists, the issue of cross-margining does not arise. Therefore, as of now, no further action is necessary in this regard.
21.	Security Lending System should be put in place both in equity and debt segments.	Such a system exists for the equity segment and RBI has decided against securities lending and borrowing. For limited purposes such a system has been put in place in CCIL. Therefore, no further action appears to be necessary.
22.	Measures may be put in place to facilitate DvP by giving limited purpose bank status to CCIL.	DBOD has examined the issue and has recommended against granting limited purpose bank status to these clearing corporations. In view of the above, no further action may be contemplated. Further, with RTGS / Special EFT in place, the funds leg of the transactions could be settled through RTGS when they are accorded RTGS membership.
23.	Providing access to fund settlement facility.	CCIL, NSE/BSE would be given membership to the RTGS system and thereby will get funds settlement facility.

2.38 The progress with regard to implementation of standards in the area of payment and settlement systems has been impressive. Action in respect of a large number of recommendations made by the Advisory Group has been completed. Enactment of the legislation covering payment and settlement systems could help strengthen the legal framework covering the payment and settlement systems and help make further advances towards meeting the best practices advocated as part of the international financial standards and codes.

Operationalisation of RTGS since March 26, 2004 marks a significant progress in respect of some important recommendations made by the Advisory Group on Payment and Settlement Systems. Significantly, same day and intra-day settlement has been provided, meeting important standards in this regard.

Technical Group on Market Integrity

2.39 With increased threat of using financial channels for funding illegal and terrorist activities, the world community has been increasingly focussing on Anti Money Laundering (ALM) and Combating Financing of Terrorism (CFT). International standards have been evolved in this area since last decade and a half. After the G-7 Summit in Paris in 1989, the Financial Action Task Force on Money Laundering (FATF), in the following year, made 40 recommendations which provided a blueprint of the action required to prevent the use of financial system for money laundering. These recommendations were first revised in 1996 considering evolving money laundering methods and patterns. The recommendations were expanded in 2001 to deal with the issue of financing of terrorism and included a new set of eight special recommendations on terrorist financing. These eight recommendations complemented the original 40 recommendations and together became the international standards for combating money laundering and the financing of terrorism. The Technical Group on Market Integrity, that submitted its Report in May 2002, had reviewed the feasibility of implementation of these 48 recommendations in India, making appropriate suggestions to this effect.

2.40 Subsequent to the issuing of the eight special recommendations and the Report of the Technical Group, the FATF immediately started the task of reviewing and revising the 40 recommendations issued earlier. In May 2002 it issued a Consultation Paper on the same. The process of revision was completed in about a year thereafter after extensive consultation and study of the experience gained from earlier implementations. The revisions took into account changing money laundering methods and techniques in response to counter-

measures taken by many countries. In particular, the focus was on the increasing use of legal persons in money laundering by disguising true ownership, as also the help of professionals, such as lawyers, for laundering criminal funds. The revised 40 recommendations that were issued by the FATF in June 2003 now apply not only to money laundering but also to terrorist financing[10]. They along with the eight special recommendations on terrorist financing provide the new international standards for combating money laundering and terrorist financing. Implementation of the standards on AML and CFT enforce market integrity. Market integrity is adjudged as taking steps to improve international cooperation between law enforcement authorities and financial regulators on cases involving serious financial crimes, regulatory violations and regulatory arbitrage. As the present FATF framework has undergone revision since the Report of the Technical Group on Market Integrity, the present status of the implementation is summarised in Table 12 by benchmarking against the revised, enhanced and comprehensive FATF framework. In summarising, the focus is on the recommendations that have a direct bearing on the banking sector.

[10] The revised 40 recommendations include interpretative notes explaining concepts and a glossary clearly defining important terms.

Table 12: Present Status of the Implementation of the Recommendations of the FATF on Market Integrity

Sr. No.	Recommendation	Present Status
1.	Revised FATF recommendations 1-3: Legal systems that provide for scope of the criminal offence of money laundering and measures for confiscation should be on the basis provided by the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, 1988 (the Vienna Convention) and the United Nations Convention against Transnational Organised Crime, 2000 (the Palermo Convention).	GOI has promulgated the Prevention of Money Laundering Act(PMLA), 2002 to prevent money laundering and to provide for confiscation of property derived from, or involved in, money-laundering and for matters connected therewith or incidental thereto. All serious offences have been included in the list of predicate offences listed in the schedule of the PMLA.
2.	Revised FATF recommendation 4: Countries should ensure that financial institutions secrecy laws do not inhibit FATF recommendations.	The PML Act, 2002 requires banks to report specified transactions and bank officials have been provided indemnity from any civil proceedings against such disclosures.

3.	Revised FATF recommendation 5: Financial institutions should not keep anonymous accounts or accounts in fictitious names. Financial institutions should undertake customer due diligence (CDD) measures including identifying and verifying the identity of their customers. Identifying the beneficial owner and verifying the identity of the beneficial owners for legal persons to understand the control structure and ownership pattern of the customer. Conduct ongoing due diligence to ensure that the transactions being conducted are consistent with the institution's knowledge of the customer, their business and risk profile, etc. Where financial institution is unable to comply with the CDD measures, it should not open the account etc. or to close the account, if already opened.	Banks advised not to open anonymous accounts or accounts in fictitious names. KYC guidelines require banks to identify the customer and to verify the identity of the customer through documentary evidence. Banks have been advised to understand the ownership and control structure of the customer and determine who are the natural persons who ultimately control the legal person. Banks advised to do ongoing monitoring of transactions in the accounts of the customers and periodically review the risk categorisation of accounts and the need for applying due diligence measures. Banks have been advised not to open an account or close an existing account, where the bank is unable to apply appropriate CDD measures.
4.	Revised FATF recommendation 6: Financial institutions should, in relation to politically exposed persons (PEPs), have a system of obtaining approval from senior management before establishing business relationship with such a person, conduct enhanced due diligence and establish sources of funds/ wealth etc.	PEPs of foreign origin have been categorised as high risk and banks are required to conduct enhanced due diligence which includes ascertaining sources of funds. Approval of senior management is required before opening account of PEPs. Banks have also been advised to undertake enhanced monitoring of such accounts. The norms in this regard are also applicable to the accounts of the family members or close relatives.

5.	Revised FATF recommendation 7: Financial Institutions while establishing cross-border banking relationship should gather sufficient information about the respondent institution to fully understand its reputation, the quality of supervision and anti money laundering policy followed by it. Such relationships should be established with the approval of senior management.	Banks have been advised to establish such relationships with the approval of their boards or a committee constituted by their Boards. Banks have also been advised to look into the level of KYC/AML compliance by the respondent/correspondent bank and the regulatory/ supervisory framework in that country.
6.	Revised FATF recommendation 8: Financial Institutions should pay special attention to any money laundering threats that may arise from new developing technologies that might favour anonymity. There should be policies and procedures in place to address any specific risks associated with non-face to face business relationships or transactions.	Banks are advised to pay special attention to any money laundering threats that may arise form new or developing technologies that might favour anonymity. Further, apart from applying all KYC norms in respect of non-face to face business relationships, banks are advised to implement specific and adequate procedures to mitigate the higher risks involved.
7.	Revised FATF recommendation 9: Countries may permit financial institutions to rely on intermediaries or other third parties to obtain necessary information on CDD process provided the third party is regulated and supervised for compliance with CDD requirements and financial institutions ensure that necessary CDD information is provided to it upon request without delay.	Where the banks rely on CDD done by an intermediary or on a third party certification in case of cross border account, banks should satisfy themselves that the intermediary or third party is a regulated and supervised entity and has adequate KYC systems in place.
8.	Revised FATF recommendation 10: Financial Institutions should maintain, for at least five years, all necessary records on transactions and identification data and transaction records should be made available to domestic competent authorities.	Banks are required to maintain records for more than five years under different laws. The PML Act 2002 further requires data to be preserved for ten years and to be made available to the designated authority on demand.

9.	Revised FATF recommendation 11& 13: Financial Institutions should pay special attention to all complex, unusual large transactions, and all unusual pattern of transactions which have no apparent economic or visible lawful purpose. If the financial institution suspects that the funds are the proceeds of a criminal activity or related to a terrorist financing, it should be required to report its suspicion promptly to FIU.	At present, bank branches are required to report to their controlling/head office all cash transactions of Indian rupees of one million and above, as also the transactions of suspicious nature for further scrutiny. Banks will also be required to report certain types of transactions, the nature and value of which may be prescribed to the designated authority under PML Act 2002. GOI has decided to set up an FIU as the designated authority to which all banks will be required to report.
10.	Revised FATF recommendation 14: FIs, their directors, officers and employees should have legal protection for disclosure of information to the FIU and they should be prohibited by law from disclosing STR or related information reporting to FIU.	In terms of the provisions of the PMLA, the financial institutions, intermediaries and their officers shall not be liable to any civil proceedings against them for disclosures made under the provisions of the Act.
11.	Revised FATF recommendation 15: Financial Institutions should develop programmes against money laundering which should include development of internal policies, procedures and controls, ongoing employee training programmes and an audit function to test the system.	Banks have been advised to put in place an effective KYC programme which should cover proper management oversight, systems and controls, segregation of duties, ongoing training of employees, etc. Banks are further advised that internal/ concurrent audit should provide independent evaluation of its policies and procedures in this regard and also verify its compliance by branches.
12.	Revised FATF recommendation 18: Financial Institutions should refuse to enter into correspondent banking relationship with shell banks.	Banks are not permitted to enter into any relationship with shell banks. Shell banks are not permitted in India under extant regulations.

13.	Revised FATF recommendation 19: Implementing feasible measures to detect or monitor the physical cross-border transportation of currency and bearer negotiable instruments. Also reporting of all domestic and international currency transactions above a fixed amount to a national central agency with a computerised database.	The law requires persons, carrying currency in excess of the prescribed ceiling for domestic and international currencies, to declare the same to customs authorities at the time of entry/exit.
14.	Revised FATF recommendation 21: Financial Institutions should give special attention to business relationships or transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply the FATF Recommendations.	Banks have been advised to be extremely cautious while continuing relationships with respondent banks located in countries with poor KYC standards or those identified as Non-cooperative Countries and Territories (NCCT).
15.	Revised FATF recommendation 22: The principles applicable to financial institutions should also be applied to the branches and wholly owned subsidiaries located abroad.	Banks have been advised to ensure compliance with KYC norms and anti money laundering guidelines by their branches and wholly owned subsidiaries abroad. They have also been advised to being to the notice of RBI cases where local laws or regulations prohibit implementation of KYC guidelines.
16.	Revised FATF recommendation 23: Countries should ensure that financial institutions are subject to adequate regulation and supervision and are effectively implementing the FATF Recommendations.	Reserve Bank has issued comprehensive guidelines on KYC/AML measures and compliance thereto is ensured through effective supervision and follow-up. Violations in this regard invite penalties.
17.	Revised FATF recommendation 25: The competent authority should establish guidelines in terms of which the financial institutions would be able to detect and report suspicious transactions.	A working group set up by Indian Banks Association came out with illustrative list of suspicious transactions which is available to banks. IBA has been advised to constitute a group to redefine the list based on the latest revised KYC guidelines issued by RBI.

18.	Revised FATF recommendation 29: Supervisors should have adequate powers to monitor and ensure compliance by financial institutions with requirements to combat money laundering and terrorist financing including the authority to conduct inspections.	Reserve Bank of India has adequate powers to regulate and supervise the banking sector and ensure compliance of the directions issued on KYC norms and anti-money laundering standards. It can conduct inspections of and issue directions to banks.
19.	Revised FATF recommendations 12, 16, 17, 20 and 24: These apply to designated non-financial business, other business and professions, natural or legal persons in respect of AML and CFT. They cover aspects of CDD, record keeping, sanctions and other aspects of market integrity.	Banks have been advised to apply CDD measure to beneficial owners /clients if it has knowledge or reason to believe that a professional intermediary e.g. lawyers/ chartered accountants or stock brokers, have opened accounts on their behalf. The Money Changers require licence from RBI before setting up an office and report high value transactions above $10,000.
20.	Revised FATF recommendations 26-28 and 30-32: Countries should set up FIU with adequate powers as national centres for receiving, analysis and dissemination of STR and other information. Competent authorities conducting investigations should have powers to call for records of financial institutions, search premises and seize property. It should have adequate human and technical resources and effective systems	Competent authorities conducting investigation of money laundering offences have been given adequate powers to have access to records of financial institutions, search premises and seize the property subject to compliance with the provisions of PML Act. An FIU as a national centre for receiving, analysis and dissemination of information is under process of being set up. FIU will have experts of various fields in its staff.
21.	Revised FATF recommendations 33 & 34: Countries should ensure that legal persons are not used by money launderers. It should be ensured that there is accurate information on beneficial ownership and control of legal persons, especially, express trusts, including settlor, trustee and beneficiaries.	Banks have been advised that while opening of accounts of trusts reasonable precaution should be taken to verify the identities of the trustees and settlors, grantors, protectors, beneficiaries and signatories.

22.	Revised FATF recommendations 35-40: Countries should ratify and implement relevant international conventions on anti-money laundering and financing of terrorism. They should also provide for international co-operation in form of mutual legal assistance and extradition, as also other forms of cooperation.	India is a party to the Vienna Convention and various UN Security Council Resolutions on anti money laundering measures including UN convention against illicit traffic in narcotic drugs and psychotropic substances. The PML Act provides for mutual agreement with any country outside for enforcing the provisions of the Act and exchange of information relating to money laundering. Requests received from "contracting states" in this regard is to be referred to appropriate law enforcement authority for execution.
23.	FATF's eight special recommendations on CFT: Ratification and implementation of UN conventions and resolutions, criminalizing the financing of terrorism and associated money laundering, freezing and confiscating terrorist assets, reporting suspicious transactions related to terrorism, providing for international cooperation and measures in relation to alternative remittance, wire transfers and non-profit organisations as envisaged in eight special recommendations on terrorist financing.	The PML Act, 2002 empowers the designated authority to search, seize and confiscate the property of any person suspected to have committed offence of money laundering which includes waging war or abetting waging of war against theGovernment of India. It also provides for international cooperation, reporting of suspicious transactions etc. A list of terrorist organisations banned under UNSC resolutions is circulated among banks. Besides, the Foreign Contribution and Regulation Act, 1976 requires of non-profit organisations to obtain registration from the Government before receiving donations from abroad. Donations received by them are reported to Home Ministry.

2.41 Legal and regulatory provisions in India to combat money laundering have been considerably strengthened since the Report of Technical Group. RBI had in August 2002 issued KYC guidelines under which banks were advised to follow certain customer identification procedure for opening of accounts and monitoring of transactions of a suspicious nature. The Guidelines have since been revised in the context of the revised Recommendations of FATF. The revised guidelines

substantively address the major concerns of the international community in its fight against money laundering. These guidelines now cover all four key elements of the KYC policy – customer acceptance policy, customer identification procedures, monitoring of transactions and risk management.

2.42 Other regulators like SEBI and IRDA have also been putting in place systems which are consistent with AML and CFT guidelines. SEBI has put in place KYC guidelines for certain market intermediaries like stock-brokers, sub-brokers and depository participants. SEBI has also introduced Unique Identification Number (UIN) under the SEBI (Central Database of Market Participants) Regulations, 2003 (MAPIN database). Market participants in the form of SEBI registered intermediaries, corporate investors, FIIs, their sub-accounts, foreign venture capital investors and resident individual investors who enter into any securities market transaction of value of one lakh rupees or more are covered under this centralised database. Regarding the insurance sector, KYC principles indirectly apply to insurance policy holders where banks acting as agents of the insurance companies sell the policies to depositors. Further, insurance policy forms contain all the details of the individuals and are verified by agents before submission of the same to the insurance companies. Agents who sell the policies on behalf of the insurance companies are also required by the IRDA Licensing Regulations, 2000 to bring to the notice of the insurer any adverse habits or income inconsistency of the prospect in the form of 'Insurance Agents Confidential Report. In respect of cross-border relationships, IRDA (General Insurance – Reinsurance) Regulations, 2000 specifies the norms under which an Indian insurer can place their reinsurance business outside India. As per these norms the Indian insurer can enter into reinsurance only with Lloyd's syndicates or with those reinsurers who have over a period of past five years enjoyed a rating of at least BBB with Standard & Poor or equivalent rating of any other international rating agency. In general, record maintenance systems have laid down practices for preservation of transactions records for a long period of time. Payments transactions are mostly through cheques and any large value payment gets into the notice of bank branches. Regulators have the power to

call for information, undertake inspection, conduct enquiries and audits and these powers can and are being used with the requirements in respect of AML and CFT guidelines that are now in place.

Chapter III

Some Recent Developments in International Financial Standards and Codes

3.1 Most of the work on international financial standards and codes were taken up in the aftermath of the Asian financial crisis. However, new standards are being advised by standard-setters from time to time with recognition for newer concerns and innovations in financial market practices. The emphasis, however, has shifted towards consolidating the gains in strengthening financial stability from progress in implementation of the standards already prescribed. The implementation reports being generated in the form of Report on Observance of Standards and Codes (ROSCs) by the IMF and those being generated as part of Financial Sector Assessment Programme (FSAP) by the IMF and World Bank have provided several areas of evaluation where efforts can be made to suitably modify standards or their implementation. The IMF in March 2003 reviewed the FSAP and suggested further prioritisation to keep costs in check. The BIS has also been making steady progress towards implementing the standards in the areas of banking and payment and settlement systems. It has focussed more closely on market infrastructure in the recent period. Several other standard-setting bodies also continue to undertake work in the area of international standards and codes. Recent developments in this area are enumerated below in brief.

Guidelines for Public Debt Management

3.2 The IMF and the World Bank issued amended Guidelines for Public Debt Management in December 2003. It defines public debt management as a process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding and to meet any sovereign debt management goals the government may have set, such as developing and maintaining efficient market for government securities. The guidelines seek to avert poorly structured debt in terms of maturity, currency, or interest rate

composition and large unfunded contingent liabilities. The guidelines are designed to assist policymakers in improving quality of the public debt management and to reduce macroeconomic vulnerabilities relating to international shocks. The guidelines cover both domestic and external public debt and encompass a broad range of financial claims on the government.

3.3 The guidelines provide 33 principles that lay down the objective and scope of public debt management along with co-ordination of monetary and fiscal policies, transparency, accountability and assurance of integrity of financial agencies responsible for public debt management, an open process for policy formulation and public availability of information on debt management policies. They also provide for institutional framework of governance and management of internal operations and legal documentation. The debt management strategy should cover monitoring and evaluation of risks, scope for active management to contain risks, as also a consideration for contingent liabilities. It suggests portfolio diversification and transparent functioning of primary markets with a view to evolving efficient markets in government securities. It also suggests that central banks should promote development of resilient secondary markets.

3.4 It would be useful to evaluate internal debt management in India against the 33 guiding principles. The revised guidelines are important in many new respects, such as providing for risk mitigation through Collective Action Clauses (CACs). Inclusion of CACs in international bond documentation can take several forms, such as the majority restructuring provision or the majority enforcement provision. The monitoring of this area is also important from the viewpoint of making further progress on fiscal transparency. It may, however, be noted that the discussions on CACs in the IMF were related to the sovereign external bond issuances. India, till date, has not issued sovereign bonds externally.

New Basel Capital Accord

3.5 In June 2004, the BIS released a Report titled, 'International Convergence of Capital Measurement and Capital Standards: a Revised Framework'. This Report presents the outcome of the work of BCBS over the recent years to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks. BCBS mooted the first round of proposals for revising the capital adequacy framework in June 1999 (BCBS, 1999). An extensive consultative process was conducted with all member countries and the proposals were also circulated to supervisory authorities worldwide. The BCBS subsequently released additional proposals for consultation in January 2001 and April 2003 and furthermore conducted three quantitative impact studies (QIS) related to its proposals.

3.6 Following the third quantitative impact study (QIS3), the Basel Committee in May 2003 released two notes outlining its findings. The results show that overall level of capital requirements will not increase but in case of credit risk and operational risk, the requirements need to be slightly modified. A large number of other issues relating to Basel II need to be closely watched, as the progress is made towards its implementation. These include recognising risk mitigation techniques, review of counterparty credit risk and trading issues, advanced measurement approaches to operational risk requirements, treatment of securitisation exposures and capital treatment for expected and unexpected losses.

3.7 The June 2004 Report on Basel II contains improvements considered following the consultative approach and the QIS approach. The framework and the standards contained therein have been endorsed by the G-10 central bank Governors and the heads of supervision. The Committee expects the framework to be available for implementation by the end of 2006 and, in case of most advanced approaches, by the end of 2007. In the revised framework, the BCBS has retained key elements of the 1988 capital adequacy framework, including the

general requirement for banks to hold total capital equivalent to at least 8 per cent of their risk-weighted assets; the basic structure of the 1996 Market Risk Amendment regarding the treatment of market risk and the definition of eligible capital.

3.8 The revised framework is divided into four parts. The first part provides scope of application and details on how the capital requirements are to be applied within a banking group. Calculation of the minimum capital requirements for credit risk and operational risk, as well as certain trading book issues are provided in part two. The third and fourth parts outline expectations concerning supervisory review and market discipline, respectively.

3.9 The revised framework for Basel II provides for a greater use of assessments of risk by banks' internal systems as inputs to capital calculations. It also details a set of minimum requirements designed to ensure the integrity of these internal risk assessments. It provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors to select approaches that are most appropriate for their operations and their financial market infrastructure. The framework also suggests establishment of minimum levels of capital for internationally active banks. The revised framework is more risk-sensitive than the 1988 Accord, but provides for countries to consider if banks should be required to hold additional capital over and above the Basel minimum. This is particularly the case with the more broad-based standardised approach, but even in the case of the internal ratings-based (IRB) approach, the risk of major loss events may be higher than allowed for in this framework.

3.10 In its report, the BCBS, has highlighted the need for banks and supervisors to give appropriate attention to the second (supervisory review) and third (market discipline) pillars. The revisions in the framework reflect several significant changes relative to the BCBS's most recent consultative proposal of April 2003. These include the changes in the approach to the treatment of expected losses (EL) and unexpected losses (UL) and to the treatment of

securitisation exposures. Changes in the treatment of credit risk mitigation and qualifying revolving retail exposures have also been made. The BCBS has clarified its expectations regarding the need for banks using the advanced IRB approach to incorporate the effects arising from economic downturns into their loss-given-default (LGD) parameters.

Consolidated KYC Risk Management

3.11 The Basel Committee on Banking Supervision (BCBS) has in August 2003 issued a consultative paper that provides banks with practical guidelines on managing their 'know-your-customer' risks on a consolidated basis. It suggests principles on customer acceptance, customer identification, ongoing monitoring of higher risk accounts and risk management, which could be adopted at head offices, branches and subsidiaries.

Risk Integration and Risk Transfer

3.12 In August 2003, the joint forum of BCBS, IAIS and IOSCO issued two survey-based reports. The first report covers operational issues relating to protection buyer and protection seller when transferring operational risk. The second report covers risk management across sectors (risk integration) and related efforts to capture them by use of economic capital methodology and other quantitative methods (risk aggregation).

Credit Risk Transfer

3.13 The IAIS issued a study paper in April 2003 that focuses on credit risk transfers through credit derivatives. In October 2004 the Joint Forum of Basel Committee on Banking Supervision, IOSCO and IAIS issued a Report on Credit Risk Transfers (CRT). It examined issues whether the instruments/ transactions accomplish a clean risk transfer, the degree to which CRT market participants understand the risks involved, and whether CRT activities lead to undue concentrations of credit risk inside or outside the regulated financial sector. The report makes 17 recommendations covering the role of senior management, credit risk assessment, external ratings, legal issues, documentation, disclosures

and information sharing. These could be seen as emerging standards in this area which have implications for financial stability. In this context, the regulators could examine the recommendations and the issue of ambiguity in assessing credit risk transfers and its implications for capital adequacy.

Rating Agencies

3.14 The Committee on Global Financial System (CGFS) Study Group examined products and structure of rating industry and submitted its report in May 2003 suggesting a working group to go into these aspects and raising a question whether some standards are necessary for rating agencies themselves. This could become a very important aspect of strengthening standards as several regulatory standards for banks and other financial institutions themselves depend on the integrity of the rating process.

Risk Management Principles for Electronic Banking

3.15 In July 2003, BCBS released two documents – 'Risk Management Principles for Electronic Banking' and 'Management and Supervision of Cross-Border Electronic Banking Activities'. These two documents lay down the principles for e-banking. The former, in its earlier version was issued by Electronic Banking Group (EBG) in May 2001, but has been revised in view of growing importance and changing practices. The area of e-banking has not received focussed attention in India yet, but technological innovation and competition amongst existing banks, new entrants and potential entrants is growing. As a result, banking products and services have already begun to be delivered to retail and wholesale customers through electronic distribution channels. Such e-banking brings many benefits but has risks attached with that can be additional and different from conventional banking. BCBS, in this report, has identified 14 risk management principles for e-banking to help banking institutions expand their existing risk oversight policies and processes to cover their e-banking activities. These principles are not mandatory, absolute requirements or best practices but have been identified more for supervisory

expectations and guidance. National supervisors are expected to use them as tools with adaptations.

3.16 The risk management principles for e-banking fall into three broad categories: (i) board and management oversight, (ii) security controls, and (iii) legal and reputational risk management. Principles for board and management oversight provide for specific accountabilities, policies and controls to address risks, including those arising in a cross-border context. Management oversight is also expected to cover review and approval of bank's security control process, with a view to safeguarding e-banking systems and data from both internal and external threats. Security control processes should include appropriate authorisation privileges and authentication measures, logical and physical access controls, adequate infrastructure security and clear audit trails. Protection against business, legal and reputation risk require e-banking services to be delivered on a consistent and timely basis in accordance with high customer expectations and effective incident response mechanisms.

Management and Supervision of Cross-Border Electronic Banking Activities

3.17 This cross-border e-banking paper from the BCBS released in July 2003 supplements the 'Risk Management Principles for Electronic Banking'. It provides principles for banks to integrate cross-border e-banking risks into the bank's overall risk management framework. It specifically provides for refinements to the risk management principles to stress on due diligence and to ensure appropriate disclosures. The principles suggest effective home country supervision. It also clearly defines the cross-border e-banking activity as provision of transactional on-line banking products or services by a bank in one country to residents of another country. This definition, however, does not address legal questions concerning the authority of a local jurisdiction.

3.18 In relation to cross-border e-banking, two additional principles are prescribed. The first states that prior to engaging in cross-border e-banking activities, a banking institution should conduct appropriate risk assessment and

due diligence, and establish an effective risk management programme for such activities. The second states that a banking institution intending to engage in cross-border e-banking activities should provide sufficient disclosure on its website to allow potential customers to determine the bank's identity, home country and regulatory license(s). The paper also details guidelines for supervision of cross-border e-banking activities and states that introduction of such activities does not change the fundamental responsibility of the home country banking supervisor for ensuring effective oversight of a bank's consolidated risk profile, risk management and capital adequacy. The home country supervisor should assess whether the bank understands the challenges and risks associated with its cross-border e-banking activities. It also details considerations for local banking supervisor who will need to decide that the activity does not present any local supervisory interest. The local supervisory authority should consider that these activities are subjected to effective home country supervision and that there exists adequate process for supervisory dialogue between the supervisor and the foreign bank. The foreign bank's plans and intentions should be discussed and the foreign bank should be made aware of relevant local banking laws, regulations or requirements, and should inform foreign bank's home supervisor as to how compliance with local banking laws would be ensured.

3.19 The principles, on the whole, are useful in establishing a workable regime for e-banking and their implementation in India should be considered keeping in mind local conditions. There is a need to examine the suggested principles on e-banking and cross-border e-banking to position national stance on the recommendations, even though they are not mandatory as of now. This appears necessary in view of the aspects which cast the burden of making local banking laws and their compliance known on the local supervisor, without commensurate obligations cast on home country supervisor of the foreign bank.

Principles on Interest Rate Risk

3.20 The BCBS has released a consultation paper on principles for management and supervision of interest rate risk in September 2003. The proposed principles cover business strategy, ALM, internal controls, interest rate risk arising from exposure in bank's trading books as well as other activities of the bank that are not reflected in bank's trading books.

Objectives and Principles of Securities Regulation

3.21 In May 2003, IOSCO issued the captioned document revising the earlier document issued in September 1998. The document sets out 30 principles of securities regulation, which are based on three objectives: (i) protection of investors, (ii) ensuring fair, efficient and transparent markets and (iii) reduction of systemic risk. The 30 principles cover principles for (i) regulators, (ii) self-regulation, (iii) enforcement of securities regulation, (iv) co-operation in regulation, (vi) issuers, (vii) collective investment scheme, (viii) market intermediaries and (ix) secondary market.

3.22 The IOSCO principles suggest that the regulator's responsibilities should be clearly and objectively stated and the regulator should be operationally independent and accountable in the exercise of its functions and power. It should have adequate power and resources, should adopt clear and consistent regulatory process and the staff of the regulator should observe highest professional standards, including standards of confidentiality. Regarding SROs, regulatory regime should make appropriate use of SROs that exercise some direct oversight responsibility for their respective areas of competence and, to the extent appropriate, to the size and complexity of the markets. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities. If, however, there is a possibility of a conflict of interest between the regulation of

the institution/market regulator and a SRO, associations of market participants may not be formally recognised as SROs to avert a possible conflict. In respect of co-operation in regulation, the principles suggest that the regulator should have authority to share both public and non-public information with domestic and foreign counterparts. Information-sharing mechanisms should be set out and allowance should be made for assistance to foreign regulators.

3.23 On enforcement, IOSCO principles recommend comprehensive inspection, investigation, surveillance and enforcement powers for regulators and effective and credible use of the same by regulators. On issuers, IOSCO principles suggest full, accurate and timely disclosure of financial results and other material information, fair and equitable treatment of holders of securities by the company, and high and internationally acceptable accounting and auditing standards. Principles for collective investment schemes are based on eligibility standards for marketing or operating such schemes, rules governing legal form and structure of such schemes, disclosure guidelines and proper and disclosed basis for asset valuation and pricing. Principles for market intermediaries cover minimum entry standards, capital and other prudential requirements, standards for organisational and operational conduct and procedure for dealing with failures. Principles for secondary markets include trading systems, regulatory supervision of exchanges and trading systems, transparency in trading, detection and deterrence of manipulation, proper management of large exposures and regulatory oversight of clearing and settlement.

3.24 While, understandably, with the establishment of SEBI and amendments to SCRA, India is compliant with most principles, it would be useful to clearly benchmark compliance with the best standards so that further action could be clearly charted. This could best be done by an independent committee which could be set up by SEBI.

Insider Trading

3.25 The Emerging Markets Committee of the IOSCO finalised a Report in May 2003 titled, 'Insider Trading – How Jurisdictions Regulate It'. The Report provides a useful survey on regulations prohibiting insider trading in the jurisdictions of IOSCO members and provides guidelines for creation or amendments of such regulations. The Report defines insider trading in terms of prohibited use of inside information. Inside information is seen as information that is non-public and material. Materiality is judged with reference to the importance, scope and source of information. Distinction is made between primary insider and secondary insider. The former includes members of management, supervisory or administrative bodies of the issuer, while the latter acquires inside information from someone else. The Report suggests recognition of primary insider, temporary insider, secondary insider, 'tippee' and accidental insider. Prohibited activities under insider trading relate not only to actual trading, but also of tipping, improper use of inside information for own or others' benefit and even the intent to do so. The Report also provides clear principles for legitimate disclosure of information and other exemptions from insider trading.

3.26 The Report lays down the role of supervisory institutions regarding insider trading. The role covers collection of information, identification of parties, analysis of previous activity of identified investors, identification of persons with access to inside information and analysis of relations between persons with access to inside information and parties who indulge in suspicious transactions. The ambit of the regulatory action is defined in terms of various actions that could include civil sanctions, penal sanctions, administrative sanctions, compensation to investors, etc. It also lays down duties of the SROs and of the companies in the context of insider trading. In order to limit the trading possibilities for insiders, the Report suggests internal rules to limit trading by members of the board, managing directors and other employees for their own or third party account. It also suggests preventing insider trading by intermediaries.

3.27 The Report is of great significance for the widening and deepening of securities market in India. The insider trading laws, regulations and their monitoring and implementation require greater attention than provided hitherto. The IOSCO Report, in effect, sets standards in this area which need to be implemented and monitored closely for further guidelines in this area. SEBI and RBI may consider implementing these guidelines.

Transparency in Short Selling

3.28 As a sequel to the IOSCO Report on Transparency and Market Fragmentation, published in November 2001, IOSCO has published its Technical Committee Report on 'Transparency in Short Selling' in June 2003 which summarises the current rules on short selling and makes suggestion for greater transparency in short selling. It notes that, in several countries, short sale is not specifically defined in primary legislation and has no formal legal status. Short sale commonly describes a transaction in which a person sells securities which he does not own and which, at the point of sale, he has not entered into agreement to purchase. From a prudential angle, therefore, short sellers should cover their delivery obligations before they fall due. They are expected to do so by making purchases at some point of time following the sale but before the delivery or by borrowing an equivalent amount of securities before sale or after sale, but before delivery. Short selling is helpful in maintaining efficient market, improving market liquidity and in risk management. However, if not appropriately regulated, short selling could increase market volatility, contribute to market manipulation, cause settlement disruptions and cause prices to move away from fundamental valuations. Naked short sales are particularly disruptive.

3.29 The IOSCO Report clearly enunciates both the benefits and potential drawbacks of transparency in short selling. It notes that such transparency provides timely information and early signals to market players and investors, removes uncertainty and rumours, creates awareness and deters market abuse. However, such information can expose open short positions that could be exploited by others through tactical behaviour. It could reduce incentive for

bearing private search costs and lower market liquidity. Noise traders could exploit ambiguous information and mislead markets through herding.

3.30 Considering all the above aspects, the IOSCO Report recommended that where regulators are contemplating a transparent short selling regime, they should explicitly identify (i) perceived inefficiencies in short selling process, (ii) potential benefits from greater transparency, (iii) data dissemination reconciliation with the aim of protection to short sellers, (iv) explicit and implicit costs of disclosure regime, and (v) ways for cost-effective supply of information to market users, where information gathering on short sales primarily addresses regulators' need. They should also publicly provide a definition of short sales which is precise and robust and yet clear and simple. Effort should be made for putting in place arrangements that are required for effective enforcement, *inter alia*, through measures that ensure reliable declaration and documentation of short sales and specific measures for short sales booked outside the jurisdiction for regulatory arbitrage. It also advocates continuous monitoring of new methods, market practices and trading strategies used for short selling and the impact of the transparency regime in this context. Though no firm mandatory principles are as yet advocated by IOSCO in respect of short selling, it is important to track developments in this regard. As the securities markets are at widely different stages of development in different countries, it is important to let country-specifics govern regulatory dispensation in regard to short selling.

Insurance Core Principles (ICPs) and ICPs on Corporate Governance

3.31 In October 2003, the IAIS issued revised Insurance Core Principles and Methodology. It recommended 28 core principles to be adopted by members. The 28 principles cover all aspects of a supervisory framework. It also issued an associated assessment methodology offering new guidance for effective operation and insurance supervisory systems around the world. In January 2004, IAIS Technical Committee issued a supplementary note on ICPs relating to corporate governance. This relates to the ICP 9 that provides the insurance core principle on corporate governance. It also deals with other ICPs that may directly

or indirectly relate to corporate governance, viz., ICP 7 (suitability of person), ICP 8 (changes in control and portfolio transfers), ICP 10 (internal control), ICP 13 (on-site inspection), ICP 18 (risk assessment and management) and ICP 26 (information, disclosure and transparency towards the market).

3.32 The ICP corporate governance framework recognises and protects rights of all interested parties and lays down supervisory authority requirement of compliance with all applicable corporate governance standards. It lays down as essential criteria that the supervisory authorities “require and verify” that all insurers comply with applicable corporate governance principles, while the Board of directors should set out its responsibilities in committing to specific corporate governance principles. The Board should also establish policies, strategies and means for attaining these principles and should satisfy itself that the insurer is organised in a way that promotes effective and prudent management. It also suggests advance criteria under which the board may establish committees with specific responsibilities, like a compensation committee, audit committee or risk management committee. A remuneration policy for directors and senior management is also suggested. Senior management is also subjected to corporate governance guidelines. However, the guidelines establish the Board as the focal point of the corporate governance system.

3.33 On changes in control and portfolio transfers, the ICP corporate governance framework recommends that the term ‘control’ be defined in legislation in terms of defined percentage of shareholding, voting rights and power to appoint or remove directors from the Board and other executive committees. The supervisory authorities should review internal controls and checks and their adequacy for the nature and scale of business. By law, they should have wide-ranging powers to conduct on-site inspections. They should also require and check that insurers have in place comprehensive risk management policies and systems capable of promptly identifying, assessing, reporting and controlling risks. Insurers should be required to disclose qualitative and quantitative information on their financial position and the risks to which they

are subject. Advance criteria suggest quantitative information on relevant risk exposures.

3.34 The IRDA is a member of IAIS since 1996 and is on its Technical Committees, Emerging Markets Committee and the Executive Committee. The IRDA has already constituted a working group of its core officers to monitor compliance of core principles and undertake the task of self-assessment. On corporate governance, IRDA is in the process of constituting a Corporate Governance Committee to lay down the guidelines for ensuring good corporate governance by the insurance companies as they act as custodians of public money which they hold in trust. The responsibility of the insurance company is, therefore, greater as they are accountable to both policy holders and shareholders. Though formation of compensation committee, audit committee and risk management committee is not mandated under the Act, the insurance companies have been encouraged to constitute such committees. The Insurance Act, 1938 requires every appointment, reappointment, termination and remuneration of whole time directors, managing director and the principal officer to be done only with the prior approval of the Authority. In addition, the Authority is in the process of evolving guidelines for remuneration to be paid to the managing directors of the companies. On the issue of corporate control, the provisions relating to percentage of shareholding, voting rights and power to remove directors on the Board and other committees have been laid down in the Insurance Act already. The Authority has powers vested with it to undertake on-site investigations and inspections of the insurance companies. The Act also gives powers to the Authority to appoint staff, issue directions, appoint of additional directors, and conduct search and seizure in exercise of its functions as laid down in the Insurance Act.

Supervisory Standards on Supervision of Reinsurers

3.35 The IAIS issued standards for reinsurers in October 2003, to supplement the ICPs. These supplementary standards and guidelines cover technical provisions relating to non-life reinsurers, general issues relating to both life and

non-life insurers, investments and liquidity, economic capital requirements, corporate governance and exchange of information.

3.36 The principles advocate a global approach to regulation of reinsurers. The home supervisor is responsible for effective supervision of business worldwide and is expected to communicate with supervisors in other jurisdictions where reinsurer writes business. Two principles are particularly important in this context. First, regulation and supervision of reinsurer's technical provisions, investments and liquidity, capital requirements, and policies and procedures to ensure effective corporate governance should reflect the characteristics of reinsurance business and be supplemented by systems for exchanging information amongst supervisors. Second, except as stated in the first principle, regulation and supervision of the legal forms, licensing and the possibility of withdrawing the license, fit and proper testing, changes in control, group relations, supervision of the entire business, on-site inspections, sanctions, internal controls and audit, and accounting rules applicable to reinsurers should be the same as that of primary insurers.

3.37 The IAIS has also issued two supervisory standards on supervision of reinsurers. While Supervisory Standard No. 7 deals with evaluation of the reinsurance cover of primary insurers and the security of their reinsurers, Supervisory Standard No. 8 relates to supervision of reinsurers. The IRDA has internally benchmarked its regulations against these standards and is evolving practices considering these standards, their objectives and practices in Indian insurance industry.

Guidance Paper on the Use of Actuaries as Part of a Supervisory Model

3.38 The IAIS issued in October 2003 its seventh guidance paper. It focussed on the use of actuaries as part of a supervisory model. It provides 17 cross-country survey based conclusions that are in the form of recommendations and could define standards in this area. The guidance paper also defines actuary as a professional trained in evaluating the financial implications of contingent

events, through understanding of stochastic nature of insurance, the risks inherent in assets and the use of statistical models.

3.39 The guidance paper suggests that the application of actuarial expertise is a key component in the operation of insurance markets and insurance supervisory authorities. It also recommends clear distinction in the roles of actuary and external auditors, while providing for effective arrangement for formal communication between the two. The decision on the use of a responsible actuary in an official capacity as part of supervisory model should give due regard to the need to ensure effective supervisory oversight and management accountability. Where this model is adopted, the actuary should have clearly-defined tasks and responsibilities as well as rights and obligations under law. In case this model is not preferred, then the supervisor should have access to sufficient actuarial resources to perform detailed and quantitative reviews. The decision to provide an official role for actuaries should take into account the availability of suitably qualified actuaries. Where the use of a responsible actuary model is adopted, the supervisor should not normally accept the work of an actuary without further scrutiny, but should have access to actuarial resources to review and interpret the advice of the responsible actuary. The appointment of a particular responsible actuary should be subject to review and supervisor should have the capacity to have an unsatisfactory appointee removed from the position. Where a responsible actuary model is in place, there should be some criteria regarding who may qualify for appointment as a responsible actuary. These criteria may be based on qualifications, experience and membership of professional association. Consideration should be given to potential conflict of interest situation in case of a responsible actuary model. There should be some avenue available for a responsible actuary to be removed. Supervisory model should also take into account qualifications and professional standards. The nature of the professional associations should influence the supervisors dependence on responsible actuary. The IRDA may consider the above recommendations with a view to providing suitable guidelines in the Indian context.

3.40 In respect of use of actuaries as part of the supervisory model, the IRDA is already using actuaries extensively as part of its overall supervision of insurance companies. The Authority has specified the qualifications, procedure of appointment, powers, duties and obligations of an appointed actuary under the Appointed Actuary Regulations. The Appointed Actuary is involved in the areas of actuarial reporting, life insurance products approval, investments, IBNR reserving, etc. The Appointed Actuary has been given a special place in the functioning of a life insurance company and is the eyes and ears of the Authority in the company. His appointment and removal is done only with the prior permission of the Authority. A distinction is provided in the roles of an actuary and an auditor so that the work undertaken by an actuary will not be audited by the auditor. The auditor's report in the Accounting regulations states that the auditor will rely on the actuarial valuations of liabilities duly certified by the appointed actuary including the assumptions for such valuations which will be issued by the Actuarial Society of India. In order to further strengthen the appointed actuary system, the Authority has introduced the concept of peer review wherein the work carried out by the Appointed Actuary is reviewed by the Committee of Actuaries.

Guidance Paper on Solvency Control Levels

3.41 The IAIS issued a guidance paper in October 2003 on solvency control levels. This supplements the January 2002 paper that lays down 'Principles on Capital Adequacy and Solvency'. Principle 6 (capital adequacy and solvency regimes have to be sensitive to risk), principle 7 (control levels) and principle 8 (minimum level of capital) have since provided the solvency guidelines. The guidance paper issued now suggests ways to set solvency control levels and to discuss possible supervisory actions when solvency levels are breached.

3.42 The guidance paper suggests that solvency levels should be set high enough to allow intervention at sufficiently early stage, so that realistic prospect of rectification is there. Early corrective action may be kept confidential to prevent worsening of the situation that may arise from damage to the reputation. As the

insurer may continue to take risks in a period of stress, it is necessary to set high control levels to consider potential portfolio growth amidst recovery problems that may arise from unusual or catastrophic events or otherwise. In setting solvency control levels, consideration may be given to quality of capital and sensitivity to risks, especially risks not covered by solvency rules. Supervisory and jurisdictional issues also need to be considered.

3.43 On supervisory action, the paper suggests that they should be directed towards strengthening the insurer's solvency position and maintaining or returning it to a level above solvency control. Measures could seek to directly address the problem by capital or asset injections or punitive measures or measures to protect policy holders. Disclosure of solvency control levels is also important.

3.44 With regard to the guidance paper, it may be stated that the IRDA Act and the regulations provide a framework for the calculation of solvency margin which the insurance company must maintain at all times. The solvency margin is kept at a minimum level of Rs. 50 crore. The solvency ratio has been kept at the level of 1.5 before any regulatory intervention is taken by the regulator. This allows sufficient time to the regulator to take early corrective action to prevent worsening of the situation that may arise. Powers to give directions to the insurance company to strengthen its solvency position exist. Measures can be taken to directly to address the problem by capital or asset injections or punitive measures to protect the policyholders as powers for the same are vested with the Authority under the Insurance Act, 1938. The insurers are required to file the solvency statement annually indicating the solvency ratio. This is monitored to ensure that the company is backed by sufficient assets to meet its liabilities. While the measures required for effective monitoring and supervision are already in place, the guidance paper and any subsequent developments in this regard can be noted by all stakeholders.

Guidance Paper on Stress Testing by Insurers

3.45 In pursuance of the Principle 10 of January 2002 'Principles on Capital Adequacy and Solvency', the IAIS issued a 'Guidance Paper on Stress Testing by Insurers' in October 2003. Stress tests are also relevant for Principles 1-7 and 11-13. Stress testing is required for insurance management as well as supervisory process. These tests cover sensitivity testing as well as scenario testing. They analyse the impact of unlikely, but not impossible, adverse scenarios.

3.46 The guidance paper recommends that each insurer should have access to the expertise and technology required to design and perform stress tests. This may involve specialised risk management unit, actuarial personnel or external consultants. Those involved in stress tests should have a mix of expertise in actuarial, accounting, economic, legal and financial expertise, a thorough understanding of the business of insurer, ability to identify risks and to analyse how they may impact, as also understanding of various models that can be used in stress testing. The stress test should be designed considering the insurer's solvency position, line of business, investment policy, position in the group and market, business plan and general economic conditions. Ability of the insurer to withstand catastrophic events, increases in unexpected exposures and latent claims or aggregation of claims is of particular importance. Apart from these insurance risks, market risks, credit risks, liquidity risks, operational risks, group risks and systemic risks have also to be kept under consideration.

3.47 The stress tests covered in the guiding principles and the recommendations made are very relevant for insurers. The IRDA recognises the importance of stress tests and has decided to fully comply with the principles in this regard in a phased manner. It intends to review, in due course, the existence of the risks and potentiality of its consequences affecting the insurer's solvency position, business growth, investment yield, exposure and aggregation of latent as well as the expressed claims.

Role of Central Bank Money in Payment Systems

3.48 The CPSS published a Report on the role of central bank money in payment systems in August 2003. The Report provides guidance over which institutions may have accounts at the central bank, the range of services that central banks may provide to their account-holders, the running of payment or securities settlement systems in central bank money with a view to containing liquidity and on risks and benefits attendant to concentration of payments with few banks. It also covers risks relating to settlement assets of the settlement institutions as well as direct participants and their customers. It notes the co-existence of central bank money with systems where settlement involves commercial bank monies – such as that cleared in CLS bank, Euroclear and Clearstream.

3.49 There could be various categories of institutions, including banks, non-bank financial institutions and non-resident banks, whose importance in the payment system may be increasing, but which may not have access to central bank money. For example, institutions like securities firms and mutual funds in the United States, insurance companies in Japan, or SSS participants in the United Kingdom do not participate in the inter-bank payment systems but are generating increasing values and volumes for payments. In such cases, it has been suggested that as part of a wider set of policy changes, policymakers should consider to broaden the range of institutions allowed direct access to settlement assets. The guiding principle in this regard should be to allow and encourage broader use of central bank money, if that can be done without adversely affecting market efficiency or transferring the risk to the central bank. Central bank money has the advantage of competitive neutrality, meaning that participants in central bank money settlement do not have to rely on competitors for settlement services.

3.50 The range of services available and their costs are important factors that influence the demand for settlement assets. Operating hours, hours in which an account can be accessed, payment instructions input and settlement achieved

are important aspects that need to be considered in payments system designing. Ensuring a default-free settlement institution can limit the risk of service interruption.

3.51 The choice of settlement assets is affected by safety and liquidity amongst other things. In a fiat money system, the central bank money is safe in its jurisdiction, though its complete safety depends upon the central bank maintaining price stability so that the value of central bank money can be protected. For commercial banks, it depends on its ability to convert, on demand, their sight liabilities into money of another commercial bank or into central bank money. Settlement assets should be liquid, but the degree of liquidity varies. Some form of credit facility is, therefore, necessary to ensure liquidity.

3.52 Systems designs for central bank settlement services have been covered in detail in this CPSS Report. Though no new standards are prescribed explicitly, important guidelines are given, specially on access policy. It has been suggested that central bank policies towards payment systems should not be independent of its policy towards institutions. Criteria for direct participation in the systems should be clearly laid down and inconsistencies in the criteria should be avoided. Implications of the Report for payment and settlement services being provided by RBI could be closely examined.

CPSS-IOSCO Task Force on Risk Management Standards for CCP

3.53 The CPSS and the IOSCO Technical Committee had in its November 2001 Report concluded that international standards for central counterparty (CCP) risk management are essential because of CCPs' large and growing role in securities settlement systems and the potential for risk management failures by CCPs to disrupt markets and payment and securities settlement systems. Accordingly, in February 2003 they directed their Task Force on Securities Settlement Systems to develop such standards.

3.54 In March 2004, the Task Force released a consultative report titled 'Recommendations for Central Counterparties' which includes 14 headline recommendations for CCPs covering legal risk, participation requirements,

collateral requirements, financial resources, default procedures, custody and investment risks, operational risks, money settlements, physical deliveries, risks in links between CCPs, efficiency, governance, transparency and regulation and oversight RBI and SEBI are represented on the task force. The Task Force would review the comments and develop the final recommendations based upon the information gained in the consultative process. This is the third report prepared by the Task Force on SSS. International standards for CCP risk management are considered critical in promoting financial stability. This is so, because a CCP interposes itself between counterparties to financial transactions, becoming a buyer to the seller and a seller to the buyer. Designing appropriate risk management arrangements, therefore become important for reducing risks faced by the SSS participants,

3.55 The recommendations in the consultative Report include a well-founded, transparent and enforceable legal framework for CCP activities, holding of collateral to cover credit exposures and clear and transparent default procedures. Participants as well as the CCP should have sufficient financial resources to meet obligations and withstand defaults. In order to lower custody and investment risk, assets should be held in a manner to minimise credit, liquidity and market risks. CCP should have money settlement arrangements that limit its settlement bank risks. Obligations with respect to physical deliveries should be clearly stated and risks arising from it should be identified and managed. Cross-border links of CCPs should be designed and operated in a manner consistent with other principles. CCPs should also be cost-effective and have effective, clear and transparent governance arrangements. Market participants should be provided sufficient information. CCP should be subjected to transparent and effective regulation and oversight. Central banks and securities regulators should co-operate in this regard.

3.56 The principles given above are important from the standpoint of Indian financial sector and the operations of CCIL as CCP could be benchmarked against these principles.

Market Integrity for Combating Money Laundering

3.57 In June 2003, the FATF issued 40 revised recommendations to combat money laundering, which combined with eight special Recommendations set the current international standards on combating money laundering and terrorist financing. These recommendations are recent developments, but substantial progress has already been made in its implementation in India as has been detailed in chapter 2.

3.58 The revised list of recommendations cover specified list of crimes relating to money laundering, enhanced measures for customer due diligence, enhanced measures for higher risk customers and transactions, extension of money laundering measures to designated non-financial business and professionals, that include casinos (including internet casinos), real estate agents, dealers in precious metals and stones, lawyers, notaries and accountants. In particular, it has been realised that there has been an increasing use of legal persons to disguise true ownership and control of illegal proceeds. Professionals are being increasingly used to advise and assist money laundering and terrorist financing activities. The revised recommendations also provide for greater international co-operation and prohibition of shell banks. The term 'financial institution' has also been broadly defined to include person or entity engaged in any one or more of the listed activities that cover acceptance of deposits, lending, financial leasing, transfer of money or value, issuing or managing means of payment (credit and debit cards, cheques, money orders, bank drafts, e-money, etc), financial guarantees and commitments, trading in financial instruments (including commodity futures), participation in securities issues, portfolio management, depositories or safekeeping on others' behalf, underwriting or placement of insurance or related products and money-changing.

3.59 In addition to the 48 recommendations, the FATF has in October 2004 issued a ninth special recommendation to deal with terrorist financing. The recommendation relates to the use of cash courier. It requires countries to have measures in place to detect the physical cross-border transportation of currency

and bearer negotiable instruments, including a declaration system or other disclosure obligation. Competent authorities should have legal authority in this respect to stop or restraint currency or bearer negotiable instrument that are suspected to be related to terrorist financing or money laundering. The scope of the 49 FATF recommendations is now quite broad. The FATF in its revised recommendations has listed out designated categories of offences that include participation in organised criminal group and racketeering, terrorism, terrorist financing, trafficking in human beings, migrant smuggling, sexual exploitation, including those of children, illicit trafficking in narcotic drugs and psychotropic substances, illicit arms trafficking, illicit trafficking in stolen and other goods, corruption and bribery, fraud, counterfeiting currency, counterfeiting and piracy of products, environmental crime, murder, grievous bodily injury, kidnapping, illegal restraint and hostage-taking, robbery or theft, smuggling, extortion, forgery, piracy, insider trading and market manipulation.

Some Other Upcoming Areas of Work

3.60 Apart from the above-mentioned developments where Indian stance and implementation would need to be calibrated to global developments, work is in progress in several other areas and governmental and regulatory attention is necessary in these areas as well. These include external vulnerability assessment, co-ordinated portfolio investments, cross-border e-banking, financial characteristics of FDI, bank insolvency, effective insolvency and creditor rights system, disclosure and transparency of the reinsurance industry, ratings in structured finance, policy guidance for banks' compliance functions, principles for regulation and supervision of private pension funds, offshore financial centres (OFCs) assessment and recommendations of Multi-disciplinary Working Group on Enhanced Disclosure (MWGED) on Highly Leveraged Institutions (HLIs). Monitoring upcoming areas is an ongoing task, but of utmost importance. All regulators, financial institutions and market participants are expected to be vigilant regarding such developments, so that response could be framed at a formative stage itself with an objective of strengthening financial stability and transparency, keeping in view the country-specific circumstances. Efforts should

be made to undertake feasible implementation in the shortest possible time, once the international financial standards and codes are in place.

Chapter IV

The Future Agenda

4.1 There is a need for drawing up a road-map that could provide the future agenda for implementation of standards and codes in India, specially with respect to the unfinished agenda from the time of the Report of the Standing Committee (May 2002) and the still-evolving global developments that have introduced new standards in several key areas. This chapter provides some views in this respect. Also, it would be useful to track recommendations that require legal changes, so that a clearer perception aids the follow-up measures. Impending legal changes could be debated among all stakeholders and such transparency could aid consensus building and facilitate the political support necessary to effect institutional and legal development. The agencies, which are monitoring implementation in the areas of their core competencies, could continuously track these aspects over the next year, before the next review is taken up.

Assessing Implementation

4.2 According to the eStandards Forum, a private initiative that makes an assessment of the implementation of standards and codes in countries across the globe, India ranked 46th as at end-October 2004. India is ranked ahead of several other major emerging markets such as Malaysia (47th), Brazil (48th), Thailand (57th), China (60th) and Taiwan (64th), while it is behind others such as Hong Kong SAR (12th), Republic of Korea (15th), Mexico (18th), South Africa (25th), Argentina (42nd). India ranks ahead of its SAARC neighbours such as Pakistan (51st), Sri Lanka (59th), Pakistan (62nd) and Bangladesh (74th). India also ranks ahead of some OECD members such as Belgium (51st), Austria (53rd) and Slovakia (54th).

4.3 The rankings by independent bodies reflect many aspects, such as areas where intent has been declared, but compliance is not in progress and required changes have not been legislated. There are areas where necessary enactment

has taken place, compliance is in progress, but full compliance is not achieved. While the view of independent assessments could be at variance with those in this Report, independent assessments are nevertheless useful for understanding perceptions. They also, in some cases, indicate the need for improving dissemination of information and communication policies so that measures being taken by regulators contextually in country-specific circumstances are more fully understood. Independent assessments may also help shape future action plan towards implementation of international financial standards and codes.

Transparency in Monetary and Financial Policies

4.4 Some of the recommendations in respect of transparency in monetary policies that have been enumerated earlier in Chapter II are contingent on legal changes. GOI may have to examine these in their totality and take a holistic view on the same, considering the evolution of economic and political institutions in the country. The Parliamentary Standing Committee on Finance has looked at some of these issues. Theoretical and empirical evidence suggests that central bank independence lowers inflationary bias in monetary policies in case of developed countries. Following Rogoff (1985), there are theoretical arguments in favour of central banks pursuing a single objective of lowering inflation, but these are contingent on the assumption that central banks seek to minimise inflation, while governments seek to maximise output. Real world situations, however, are more complex. Inflation tolerance threshold differs widely from country to country and the political economy objectives and constraints differ accordingly (Saggar, 2001)[11]. In practice, all central banks pursue multiple objectives, though countries adopting inflation targeting have generally defined a hierarchy where other objectives can be pursued only when they are not in conflict with the main

[11] He cites instance where central banks sought to expand output and government sought inflation control.

objective.[12] Governments also have multiple objectives. The empirical evidence in favour of central bank independence is less strong in case of developing countries than for developed countries. Security of tenure for the top management is helpful as a practical and feasible reflection of the Walshian contracts and can be considered even independently of single monetary policy objective. Furthermore, Mohan (2003) points out that independent central banks, increased transparency, greater accountability through contractual framework and greater co-ordination between monetary and fiscal authorities have improved public credibility of monetary authorities in delivering lower inflation. However, the delivery of lower inflation has been aided by several other factors as well. The case for inflation targeting is not so clear for developing countries. There is a growing sense that by the time the current phase of the global business cycle has run itself out, inflation targeting may not be seen to have stood the test of time.

4.5 Monetary policy frameworks differ widely amongst countries. Monetary policy objectives as well as operating tools provide many models to follow and it is not easy to define a hierarchy of choices in this respect. Fry, *et al* (1999) provide results from a Bank of England Survey on monetary policy objectives. Of the 77 countries surveyed, only 27 considered control of inflation as their main monetary policy objective, while 23 others stated it as another important objective. In contrast, 54 or 70 per cent of the countries stated management of exchange rate as an objective. More than a third of the countries had output growth as an objective and over 40 per cent stated financial stability as an objective. Nearly a third had balance of payments as an objective and 56 per cent had money control as an objective. So it is not clear whether a single objective is a feasible reality, even though under a set of assumptions, a theoretical case exists for central banks addressing inflation bias through this. It may be added that the IMF Code of Good Practices in Monetary and Financial

[12] In the Indian context, Tarapore (2001) has suggested that RBI as the central bank should focus on inflation as the central, if not the only, objective of monetary policy, as it will also serve as an anti-poverty measure.

Policies has imparted considerable flexibility in recommending its principles keeping in view the differing monetary policy objectives and policy frameworks. It stresses upon open process for formulating and reporting monetary policy decisions but does not necessarily advocate permanent monetary policy-making body of the MPC kinds. However, where such permanent bodies exist and hold regularly scheduled meetings, the meeting schedules along with composition, structure and functions of that body are expected to be publicly disclosed, as also the main considerations underlying its monetary policy decisions. The Code also recognises the rationale for limiting certain types of disclosures because it could adversely affect the decision-making process. These cover contingency plans, possible emergency lending, supervisory deliberations and enforcement actions related to individual financial institutions, markets and individuals. Within the flexibility afforded by the Code, as financial system matures, there is a case for further improving transparency in monetary and financial policies.

4.6 There could be two approaches to further progress on transparency in monetary policies – a big bang approach or a phased approach. Each has its own merits. If all the main recommendations of the Advisory Group are considered desirable, they could be delivered as a package at an appropriate time. The package would need to include institutional changes that are suitable for the country and as such can be modelled considering the experiences of other countries. There is far too much heterogeneity in monetary institutions across globe and no single model can be considered conclusively better than the others. Even in case of developed countries, substantial differences exist. For instance, the Federal Open Market Committee (FOMC) of the US Fed, in constitution and operations, differs substantially from the Monetary Policy Committee (MPC) of the Bank of England (BoE). Communication policies of the Governing Council of the European Central Bank (ECB) also considerably differ from those of the Fed, BoE or the Bank of Japan. In contemplating any legal changes, a clear view would first be necessary on the monetary policy framework that is most suitable for the country. This would depend on the transmission mechanism and the relative efficacy of monetary policy instruments that impact

the choice of operating instruments and operating procedures. The process needs to be preceded by political consensus and a political mandate.

4.7 Some changes, however, are possible even without an amendment to the RBI Act. For instance, to begin with, an Advisory Committee on Monetary Policy on the lines of the 'Technical Advisory Committee on Money, Forex and Government Securities Markets' or on the lines of the 'Standing Technical Advisory Committee on Financial Regulation' can be constituted by RBI itself within the extant provisions of law. This will further enhance the consultative process. Alternatively, as suggested by the Advisory Group, a Committee of the RBI Central Board of Directors could be constituted to serve as MPC. To enable a more formal institutional set-up on the lines of the Board for Financial Supervision or the proposed Board for Payments and Settlement Systems, the Government may have to issue the necessary notification. The Advisory Group had recommended a seven-member MPC comprising of Governor, three deputy Governors and three Board members. Concerned Executive Directors and Departmental Heads dealing with monetary policy, internal debt, exchange rate management and economic analysis could be permanent invitees. However, if MPC is to be constituted with statutory backing, one needs to consider whether the body should be cast on the lines of the MPC of the BoE or the FOMC of the US Fed or on some other lines. MPC of the BoE is constituted as a nine-member body with five internal and four external members. The five internal members are Governor, two Deputy Governors, Bank's Chief Economist and the Executive Director in charge of monetary policy operations. The four external members are directly appointed by the Chancellor of Exchequer. MPC sets the policy rate at its monthly meetings which is the 14-day repo rate. FOMC is constituted as a 12-member body that includes seven members of the Board of Governors of the Federal Reserve System, the President of the New York Fed and four of the remaining 11 Reserve Bank Presidents – one each from the four groups for the 11 Feds – who serve one year term on a rotating basis. FOMC is responsible for open market operations and sets the target federal funds rate, which is the overnight inter-bank rate. The Board of Governors of the Federal

Reserve System is responsible for the discount rate and the reserve requirements. It is felt that RBI and GOI may continue to consider these options and undertake necessary groundwork so that the objective of greater transparency in monetary policy can be achieved.

4.8 Constitution of institutional bodies by themselves is not, however, sufficient for greater monetary transparency. Necessary technical work to improve out-of-sample forecasting of key macroeconomic parameters and on transmission mechanism by the professional staff is necessary to give inputs to MPC or any other similar body. This may be taken up within a short span of time to impart confidence that changed institutional procedures would work. The efforts currently made for forecasting for the internal Monetary Policy Strategy Meetings need to be strengthened.

4.9 Within the existing legal framework, RBI has already made considerable efforts to improve its communication policy. This has contributed in no small way in improving monetary policy transparency, and RBI proposes to continue its efforts in this direction. RBI is providing its periodical assessment on the Indian economy, including its assessment of output, inflation and other important macro-economic parameters periodically, as part of the annual policy Statement (in April/May), Annual Report (in August), mid-term Review of the annual policy Statement (in October/November) and the Report on Currency and Finance (generally in January). These roughly correspond to quarterly assessments, but the option of more formal quarterly assessments, including conjectural projections on key macroeconomic parameters, in the form of an inflation report or otherwise, could also be considered in the course of institutional developments.

4.10 Regarding transparency in financial policies, the progress has been far more satisfactory. Enhanced disclosures in respect of accounting, bad loans, etc. have placed Indian practices at par with the best international practices. This includes disclosures in respect of forex transactions of the central bank, as the country now fully complies with the disclosures required by the new template on

international reserves and foreign currency liquidity under the SDDS. However, increased frequency of data disseminated on forex interventions could be considered by RBI over time, once forex markets acquire greater depth. Any move in this direction would need to take into account the impact it may have on the efficacy of such interventions.

4.11 Regarding transparency in case of regulatory forbearance, there could be a need for a cautious approach as financial markets are characterised by multiple equilibria. If placing information about solvency and liquidity in public domain could cause an avoidable run, there could be a ground for delayed disclosures. The possible impact of disclosures could differ between public and private sector banks, with the perception that restructuring packages could be more easily available for the former. However, even in case of the former, disclosure of forbearance may have to be considered for its possible moral hazard problems. Issues of timing, form and extent of disclosure need to be carefully considered by the regulator, within the overall ambit of improved transparency of its financial policies.

4.12 RBI has put in place an effective offsite surveillance system for both banks and non-bank financial intermediaries. It has also evolved a system of aggregate micro-prudential indicators. Disclosure from the OSMOS database is still limited, though recent issues of Report on Trend and Progress of Banking in India have provided some information from this source. It would be more useful to structure data-dissemination for offsite surveillance and aggregate macro-prudential indicators. This could be done through the Report on Trend and Progress of Banking in India or, if necessary, a separate publication of an article in Bulletin or a separate Report could also be considered with a view to giving more detailed information on financial stability aspects. The Reserve Bank has already added a chapter on financial stability in the Report on Trend and Progress of Banking in India. A formal report on Financial Stability could also be considered on lines of some other central banks. This could perhaps be published bi-annually. However, its coverage as part of Report on Trend and Progress has its advantages as it is a statutory document. Formal involvement of the Central

Board, the Board for Financial Supervision and the proposed Board for Payments and Settlement in the reporting and related assessment on the financial stability could also be examined.

Fiscal Transparency

4.13 On fiscal transparency, the implementation has gathered considerable pace with the legislation of FRBM Act. The Government has demonstrated its commitment to prudent fiscal and financial policies by notifying the FRBM Rules with effect from July 5, 2004. With the notification, the documents on Medium-term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Statement have now become statutory. The Union Budget 2004-05, was presented to the Parliament on July 8, 2004 along with the three above-mentioned documents, putting in place a system of greater fiscal transparency and meeting, by and large, the expectations of the Advisory Group in respect of some of the recommendations that originated from the IMF Code. For instance, the Advisory Group had stated that while it may not be possible to project key fiscal magnitudes for 5-10 years ahead as indicated in the IMF Manual, it would be useful to project major categories of expenditure and revenue two years ahead. The Medium-term Fiscal Policy Statement laid for the first time with the latest Union Budget has provided rolling targets for 2005-06 and 2006-07 in addition to the year 2004-05 for which budget estimates are presented. These rolling targets are provided as percentages to GDP for key fiscal indicators, viz., revenue deficit, fiscal deficit, gross tax revenue and total outstanding liabilities. Assumptions underlying these fiscal targets are explained in the document in some detail and cover expected developments in relation to GDP growth, inflation, receipts and expenditure. The Macroeconomic Framework Statement provides a clear idea of central government finances as also the major macro-economic parameters covering real activity, money, inflation and the external sector. The Fiscal Policy Strategy Statement provides an overview of the past policies and the broad policy for the ensuing year. Policies regarding taxes

and expenditure, government borrowing, lending and investment, contingent liabilities and pricing of administered goods are discussed along with targets and strategic priorities for the ensuing year. Rationale is also provided for policy changes. With these changes, the budget presentation process has been streamlined in accordance with the provisions of the FRBM. The rationale for budget policy has thus become open and available for scrutiny by legislature and public.

4.14 Greater action and time-bound movement towards fiscal transparency for sub-national governments appears necessary. While individual states are making efforts in this direction, some general principles could be agreed for time-bound implementation by all States. Transparent fiscal rules of some kind could also be considered both for State Governments and municipal corporations. Further progress on the lines of transparency by Centre on the part of state Governments could also be of help at the time of discussion in Parliament to review the consolidated fiscal position of Centre and States and for taking a more comprehensive view on fiscal policies in the country. The State Finance Secretaries forum and the CAG could play an important role in furthering transparency at the sub-national level. For instance, work could be undertaken to evolve minimum standards on transparency in respect of QFAs, specially on losses of State Electricity Boards so that progress could be made in compilation of the information and its disclosure at a future date.

4.15 Modernisation of tax system is an ongoing process, but it would be better to front-load the modernisation process so that the tax system could be simplified and compliance as well as enforcement improved. Recognising this aspect, the GOI has already taken several steps in this direction and the momentum in this regard needs to be sustained over the next few years. In addition, areas which require further attention include preparation of institutional table in Government Finance Statistics, uniform budgetary practices at State level and reporting revenue loss from tax concessions.

Data Dissemination

4.16 Standards of data dissemination in India match with the best practices in most of the areas of data dissemination. India has a well-developed, elaborate statistical system that respects integrity and transparency. This is not to say that scope of improvement does not exist. For instance, information on employment conditions and capacity utilisation is inadequate for policies on aggregate demand management. Several suggestions on macroeconomic and financial data are documented in the Report of the National Statistical Commission (Chairman: Dr. C. Rangarajan), which provides the blueprint for strengthening the statistical system further, bringing about improvements and refinements that are possible. While the Report of the Commission is comprehensive and covers all aspects of statistical system, the recommendations made by the Advisory Group on Data Dissemination were more focussed on the SDDS requirements so that compliance in respect of international standards on data dissemination can be ensured.

4.17 India has been complying with the SDDS requirements for sometime now, though a few finer aspects remain towards which implementation could be geared, so that the country can become fully compliant in all its minor details as well. Summary methodology for all data categories is required to be provided under SDDS. For India, the methodologies have been already provided for real sector and central government operations. However, the same are not yet provided for financial and external sectors, for population data and for fiscal categories of public sector operations and central government debt. The methodologies need to be posted on DSBB as quickly as possible and the same could be done in a short time span. Regarding forward-looking indicators, surveys of business expectations are already being conducted by independent agencies like NCAER and CII. RBI also conducts Industrial Outlook Survey for its internal use on quarterly basis. Further progress on forward-looking indicators can be considered on the lines suggested by the Working Group on Leading

Indicators. There is a need for a survey on inflation expectations. The GOI could initiate action on data dissemination on public sector (non-banking) operations. The same is the case with dissemination of Central Government debt data by original as well as residual maturity, where necessary action could be considered by Government of India and RBI by mutual consultation.

4.18 Further progress in data collection and dissemination could cover increasing use of electronic media. With progress in the development of Tax Information Network (TIN), considerable information could be collected from this source. The use of this information for the purpose of compilation/cross-validation of national accounts and other statistical data could be examined. On the dissemination side, RBI has recently placed the publishable segment of central database management system (CDBMS) in the public domain for the convenience of researchers, analysts and other users, keeping in view RBI's overall framework of data dissemination policy for users. An Expert Group (Chairman: Prof. A. Vaidyanathan) was constituted for guiding the process in this regard. The Expert Group has made recommendations with regard to coverage, quality, timeliness, presentation, metadata and access by public, keeping in view the user requirement and the best international practices in this regard. The public domain component (CDBMSi) provides an example for dissemination that could facilitate increased reach for transparent dissemination of the data.

Banking Supervision

4.19 In Chapter II of the present Report, it has been observed that substantial progress has been made in implementing standards relating to banking supervision, since the recommendations of the Advisory Group. Such implementation has resulted in wide ranging financial sector reforms which has resulted in clear gains on financial stability and financial sector efficiency. However, banking supervision is central to ensuring the strength of the financial sector and in avoiding fragilities which could result in systemic problems. As such, continued efforts to implement international standards in spirit and all its details are necessary. As part of future agenda, which could further financial

sector reforms, concerted efforts are necessary to take the process of legal, institutional and regulatory reforms forward.

4.20 On the legal side, amendment to the Banking Regulation Act could facilitate progress in many areas. The Narasimham Committee on Banking Sector Reforms had earlier recommended a review of the provisions contained in this legislation. Taking into account the recommendations of the Narasimham Committee, the Advisory Group and the constraints experienced by RBI in the past in the enforcement of regulation and supervision of the banks in India appropriate amendments could be worked out. These amendments could focus on the following: (a) ownership of banks by individuals and entities which are 'fit and proper', (b) powers to dissolve a bank's Board in order to protect the interest of depositors and in public interest, (c) disclosure of information to shareholders, (d) levy of stringent penalties for violation and (e) supervision of banks on a conglomerate basis. In some cases, effecting amendments to the Act would help align legislative provisions with the instructions and guidelines issued by RBI. For instance, there is a need for special mention on the proposal to strengthen the existing system of regulating the acquisition of shares in private sector banks by replacing the *ex post* acquisition acknowledgement process with an *ex ante* approval system. New sections envisaging that no person shall acquire more than 5 per cent shares in a banking company without the prior approval of the Reserve Bank and higher levels of due diligence at acquisition thresholds above 5 per cent requires to be inserted.

4.21 On the regulatory and institutional side, focus on core principles may be continued with further consideration on a feasible time frame for its implementation. Several micro-level changes can be introduced within a year's time frame, so that improved compliance on core principles take place. For instance, while fixing the definition of 'substantial interest' at a higher level, it would be desirable to require banks to obtain the prior approval of the supervisor for any proposed changes in ownership or exercise of voting rights over the 'threshold'. Connected lending is already prohibited under the Banking Regulation Act. However, this aspect could be implemented with greater

stringency. ‘Closely related groups’ need to be explicitly defined and the supervisor should have the discretion, prescribed in law, in interpreting the definition on a case-by-case basis. Banks may be required to monitor the total amount of loans to connected and related parties and introduce an independent credit administration process. In terms of accounting standards banks are required to disclose details of the transactions with their related parties. To bring the audit profession accountable for their lapses in regard to auditing of financial institutions, the legal statues may be amended to allow the supervisors to initiate legal action against the auditors for negligence subject to varying degrees of covenants as in the case of US, Canada, Japan. The supervisor may consider introducing trilateral meetings with banks’ boards and external auditors in the interest of greater involvement of the board and the auditors with supervisory concerns and actions in order to enrich the scope of examination of banks. The meetings could cover areas relating to divergence in provisioning requirements noticed in the previous inspections, non-provisioning of pension dues, if any, etc. This could take care of the accountability issues arising out of information gaps for any of the parties involved in a transparent manner. As part of the Annual Financial Inspection, a formal arrangement could be considered for the inspection team to discuss/clarify necessary issues with the auditors as an additional input before finalising the report. The comments offered by the statutory auditors could be appended to the report and may be signed by both the Principal Inspecting Officer and any of the senior auditor of the bank. The audit process could additionally examine and furnish an assessment of the internal control structure and procedures for financial reporting in the bank to RBI. An amendment to Banking Regulation Act 1949 to formalise the system as also give powers to regulate statutory auditors of the commercial banks could be considered as an important component of future agenda in respect of banking supervision.

4.22 Another area of importance which needs to be addressed in future relate to the public disclosure of derivatives transactions. Such disclosure need to be improved so as to be in alignment with The Basel Committee’s recommendation

on ‘Public Disclosure of Trading and Derivative Activities of Banks and Securities Firm’. The recommendations enunciated two main themes for the rationale for the public disclosure, viz., disclosing meaningful summary information, both qualitative and quantitative, on the scope and nature of their trading and derivative activities and illustrating how these activities contribute to their earnings profile and disclose information produced by their internal risk measurement and management systems on their risk exposures and their actual performance in managing these exposures. Since quantitative disclosures provide information only at a particular point in time, it is important that qualitative information on business objectives, strategies and risk taking philosophy, including principal internal control procedures for managing risk is to be furnished. The disclosure requirement should also be extended in regard to securitised assets separately for such transactions occurring in the current financial reporting period and for remaining “retained interests” from transactions occurring in prior financial reporting periods, the nature and extent of such transactions, including a description of any collateral and quantitative information about the key assumptions used in calculating the fair values of new and retained interests; (ii) whether the financial assets have been derecognised or not. Apart from these disclosure requirements, there is a need to activate bodies such as IBA, FIMMDA, CIBIL etc for publication of various data relating to the volume of transactions in the market, the details of the participants, etc both in regard to securitised assets as also that of derivative transactions.

4.23 Material progress has already been made on moving towards consolidated accounting and supervision with the issuing of the circular in February 2003. Both accounting consolidation and consolidated supervision are key aspects of the supervision of banking groups. As of now, the supervisors do not have the legal authority to prohibit detrimental intra-group transactions and exposures. The earlier committee on Consolidated Supervision had commented in this regard that 'such authority needs to be specifically sought and obtained, as a part of the evolution of the consolidated supervisory policy'. This should be pursued vigorously. While formal MOUs do not exist, in case of internationally

active banks, information of supervisory interests is being exchanged on a need basis with host country supervisors. Perhaps, it may be useful to develop a position paper enunciating the principles on which information would be shared with other supervisors. Such a paper could be made available in public domain.

4.24 In case of corporate governance, certain actions could be charted for implementation in a year's time. The process of induction of directors into banks' boards and their initial orientation may be streamlined in line with recommendations of the Ganguly Committee. Banks could be encouraged to develop mechanisms which can help them ensure percolation of their strategic objectives and corporate values throughout the organisation. Their boards need to set and enforce clear lines of responsibility and accountability for themselves as well as the senior management and throughout the organisation. Disclosures in respect of committees of the board and qualifications of the directors, incentive structure and the nature and extent of transactions with affiliated and related parties also need to be encouraged. Professionalism of the board members of the bank should be encouraged. Since the public sector status of major banks is likely to stay in the medium term, there is a need to create a panel of professionals, who could be appointed to the board of banks. The panel could be prepared by Government of India, with active consultation with RBI, IBA etc., which would rule out the current criticism against the nominee directors of the banks that several of them are not professional.

4.25 Progress in the area of supervision relating to internal controls, credit risk and loan accounting has been satisfactory, but RBI could monitor these areas towards successful implementation. On supervision of financial conglomerates, certain recommendations could be implemented quickly. Fitness, propriety or other qualification tests need to be applied on a continuous basis so that the 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. However, at present, RBI does not have jurisdiction over unregulated entities. In case of fitness of shareholders, the same would require amendment to the Banking Regulation Act and the process of legal

and institutional change in this regard could be implemented quickly. The RBI-SEBI Technical Committee has placed coordination between various regulators on an institutional footing. Formalised arrangements for exchange of information between all regulators involved in regulation of different entities in a conglomerate are being considered. However, risk management has to be largely addressed by institutions themselves and regulators role is only complementary arising from the financial stability angle. In this context, RBI could consider issuing further appropriate guidelines requiring banks to ensure that they and their subsidiaries and joint ventures have adequate risk management processes covering group-wide risk concentrations as well. To ensure that financial conglomerates have controls in place to manage their risk concentrations, it may also issue instructions to banks so that their up-stream and down-stream units introduce appropriate controls to manage their risk concentrations. Where more than one supervisor is involved, co-ordinated supervisory action should be enabled, particularly in the area of risk management by different entities of a conglomerate. The range and scope of information exchange among sectoral supervisors should be made broader and multi-point. Risk management systems that are being put in place in banks need to take into account the special risks posed by ITEs. Supervisors should co-ordinate closely with one another to ascertain their respective concerns as deemed appropriate.

4.26 On banking supervision in relation to cross-border banking, some actions could be targeted for implementation in a year's time. For supervision of foreign banks which have branches in India as also for subsidiaries of Indian banks abroad, a more proactive and focused policy could be put in place. A system of periodic review of the supervisory systems and standards of host supervisors for Indian banks could be put in place. In regard to the quality of control exercised by the head office of foreign banks, whose branches are operating in India, RBI may convey to the home country supervisors its expectations about receiving from the home country supervisor, information about the extent and quality of control maintained by the head office over its branches operating in India.

4.27 All the above suggestions in the area of banking supervision fall under the purview of RBI as a regulator or supervisor and it can make efforts to implement them within a short span of time. However, in near future, the biggest challenge in banking supervision lies in adoption of the Basel II standards. It has been sometimes argued that Basel II may adversely affect the supply of capital to emerging market economies. However, whether this happens or not would also depend on the confidence with which a country approaches and effects transition[13]. Capital requirements under Basel I helped in strengthening capital structure of several financial institutions making them more safe, though pitfalls in this context have also been debated.[14] Udeshi (2004) has clearly enumerated the challenges that lie ahead in this context. In India, the level of rating penetration is not yet significant. For banks having interest rate risk or concentration in risks or risk exposures, enhanced capital requirements have to be prescribed and given that there are about 100 banks, this task to be completed by end of 2006, poses a challenge.[15] Cross-border issues are complex. Capital requirements under Basel II could be procyclical.[16] Supervisory issues relating to large and complex financial conglomerates also need to be addressed. The road to Basel II would involve tough steering and this can best be done by strengthening consultative process with banks even further. In this direction, RBI has set up a Steering Committee comprising of senior officials of select public sector, private sector

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[13] Hayes and Sapotra (2002) argue that regulatory capital charge for lending to several emerging markets may, in fact, fall. Since bank's loan pricing already reflects the borrower's credit worthiness, it seems unlikely that there will be a marked contraction in the supply of loans, even for the low credit quality emerging market borrowers.

[14] See Rojas-Suarez (2001) for a contrary view.

[15] Banks also have to choose between Standardised Approach and Internal Rating Based Approach towards measurement of capital requirements for credit risk. In standardised approach, banks have to measure credit risk as prescribed by the regulator and as supported by external assessments. Internal Rating Based Approach is based on bank's internal assessment of key risk parameters, but is much harder to implement and it requires considerable amount of data mining.

[16] This procyclicity of Basel II has also been stressed by Gordy and Howells (2004). However, the Basel Committee is of the view that procyclicity of the new accord could be addressed through some of the modifications that have been made regarding the computation of long run average PD estimates and LGD estimation on a more conservative basis.

and foreign banks, Indian Banks' Association and the Reserve Bank to guide the transition of the banking sector towards Basel II. The Steering Committee in turn has focussed sub-committees for various aspects pertaining to each of the three pillars of Basel II.

Securities Market Regulation

4.28 The action on enhanced authority and powers to SEBI has been completed with the October 2002 amendment to the SEBI Act. This constitutes a significant move towards meeting the international financial standards and codes in respect to securities market regulation. On streamlining procedures to detect frauds, the Expert Committee on Legal Aspects of Bank Frauds in its Report of August 2001 made various recommendations for the procedures to be followed in cases of bank/financial fraud. The Committee also outlined an illustrative draft legislation called the Financial Fraud (Investigation, Prosecution, Recovery and Restoration of Property) Bill, 2001. Apart from this new legislation, amendments to Indian Penal Code, Code of Criminal Procedure, etc. would be required. Legislative measures as proposed by the Committee are yet to be implemented and GOI could consider implementing the same as soon as possible. On according a legal status to HLCCFCM, it is not possible to suggest a time frame for effecting suitable legislation. Demutualisation of stock exchanges has been provided with a legal basis and operational steps can be taken. Recently, the provisions of the SCRA were amended through promulgation of an Ordinance called the Securities Laws (Amendment) Ordinance, 2004 that aims at segregation of ownership and management from the trading rights of the members of a recognised stock exchange in accordance with a scheme approved by the SEBI. Necessary amendments to the Indian Stamp Act and the Income Tax Act are also being considered by GOI in consultation with SEBI.

4.29 On the recommendation for only two clearing corporations for the entire country, the feasibility of implementation would depend upon the view on the desirable policy in this regard, as well as appropriate legal framework. The recently promulgated Securities Laws (Amendment) Ordinance, 2004 has

provided for the transfer of duties and functions of a clearing house from a recognised stock exchange (with the prior approval of SEBI), to a clearing corporation, for the purpose of the periodical settlement of contracts and differences thereunder and the delivery of, and payment for, securities. While SEBI can come out with regulations relating to clearing corporations, it appears that one cannot restrict the number of clearing corporations to any specific number, as it would depend on market requirements.

4.30 Over the next year or two, efforts could be made to bring about further improvements in settlement systems by phasing in rolling settlements more rapidly, including that in G-sec OTC trades. The legal framework for derivative trading, including OTC derivatives and banks' participation in commodity futures trading also need to be covered under the future agenda in this area.

Insurance Regulation

4.31 Insurance is a rapidly upcoming area in India's financial sector. With liberalisation, private insurance companies are rapidly making inroads into the insurance market. They have just commenced their operations after opening of the sector and are presently understood to account for about 10 per cent of the market share in terms of premium. *Per contra*, the Government insurers have about 90 per cent of the insurance market share. The rapidly changing structure of the insurance market makes it even more important that international standards and codes in insurance industry are adopted and observed. Over the last few years, IRDA has issued several regulations that have helped India's insurance sector to improve its compliance with IAIS guidelines. While there appears to be broad compliance with the advocated principles, there are several aspects where progress would be necessary so that all the core principles are implemented in letter and spirit. IRDA is currently making a self-assessment and a phased approach for implementing the core principles is contemplated. Drawing up a blueprint for improved corporate governance, covering both the state-owned insurance companies as well as the private insurers, could be the focus of immediate agenda. In this context, IRDA is also placing emphasis on the

regulator ensuring that the industry establishes a grievance redressal mechanism (Rao, 2004).

4.32 In respect of reinsurance business, implementation of Standards 7 and 8 is important. Currently, reinsurance regulations do not specifically require the reinsurance programme to be approved by the board of directors. The life reinsurance regulations require the reinsurance programme to be approved by the Appointed Actuary. There is no similar requirement in general reinsurance regulations because the Appointed Actuary has no role to play in the matter. The principles that should govern the outward reinsurance programme are set out in regulation-3 of general reinsurance regulations and regulation-3 of life reinsurance regulations. The insurers are also required to file their reinsurance programme with IRDA, which has reporting forms that enable it to review the reinsurance programme. A reinsurance programme normally deals with the net risk to be retained and the type and extent of reinsurance to be purchased on an automatic basis. Requirement of collateral has not been insisted because reinsurers are most reluctant to provide collaterals and even the practice of holding premium and loss reserves is disappearing. In this situation, if insistence on collaterals is made mandatory, the insurers will find themselves handicapped to find adequate reinsurance protection at best possible terms. However, IRDA tries to achieve this objective by allowing only reinsurers rated BBB or higher by recognised rating agencies. Nonetheless, regulations concerning the reinsurance business need to be constantly reviewed and adoption of modern practices could be encouraged gradually. For instance, currently, dynamic financial analysis techniques are not mandatory due to paucity of data for general insurance business. Over time, things could change in this respect. On the appointed actuary system, IRDA has put in place a system that can be considered to be in conformity with international standards and, therefore, it does not call for a review at this stage. However, propagation of stress testing for judging solvency position so that business plans are appropriately tailored, could be a major thrust area.

4.33 There is also a need to address the possibility of overlap in regulatory functions in this sector, especially in respect of pension activities. With the

notification of the interim Pension Fund Regulatory and Development Authority of India (PFRDA), a clear distinction would be helpful so that growth in services in these areas could be facilitated in an orderly manner. Also, concentrated efforts would be necessary to help move towards Risk Based Capital Approach in insurance sector over the medium-term.

Bankruptcy Law

4.34 India has not experienced a banking crisis of systemic proportions. The banking sector is more sound than many of its emerging market counterparts. Financial sector reforms since mid-1991 have gone a long way in strengthening financial sector further. However, one needs to guard against any complacency creeping in this area and keep a watch on financial fragilities. A continued vigil of the NPAs is central to this effort. A rising volume and value of NPAs could lead to isolated, group or systemic bankruptcies. SARFAESI Act, 2002 was enacted to ensure early recovery of bad debts, which are NPAs as per RBI guidelines, by securitisation, asset reconstruction and enforcement of security interest. The recent decision of the Supreme Court in Mardia Chemicals case upholding the constitutional validity of the Act has provided the legal framework for addressing issues relating to bankruptcies. Recent promulgation of the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Ordinance, 2004 to bring the provisions of the Act in conformity with the Supreme Court judgement that balances various considerations while dissuading borrower from indulging in dilatory tactics with a view to postpone the repayment of dues and to enable the secured creditors to make speedy recovery has reinforced the efficacy of the legislative provision. It would help financial sector in recoveries and in keeping incremental NPAs low. The framework also helps the country to adopt international best practices in this area. The Act has helped to improve the credibility of the solvency regime in this country. It has placed India's bankruptcy legislative framework closer to international standards.

4.35 The CDR mechanism covers the NPAs as well as standard assets. There is no requirement of the account/company being sick, NPA or being in default for a specified period. As implementing bankruptcy procedures is important for attaining international standards, CDR mechanism may be accorded statutory recognition. This would serve as a corporate governance measure to guard against insolvency of corporates and, in turn, of lending institutions as well. Giving statutory recognition to the existing CDR mechanism would also impart certainty to the legal position prevailing in the country and thereby improve cross-border transactions. Further, as far as the lenders in foreign currency outside the country are concerned, they are not part of the CDR system. However, the foreign lenders could join the CDR mechanism of a particular corporate by signing transaction-to-transaction inter-creditor agreements, wherever they have exposure to such corporate. This aspect would also assume significance in the context of cross-border insolvency. Necessary changes to bring the foreign lenders within the scope of the country's CDR mechanism could be considered along with statutory recognition for the scheme. This step coupled with the proposed implementation of UNCITRAL model law in India, would go a long way in improving cross-border insolvency procedures.

4.36 It would be possible to be compliant with the best practices in respect of cross-border bankruptcy with the adoption of UNCITRAL model of insolvency in India. Once the enabling legislative changes are made in respect of the Companies Act, 1956, provisions relating to insolvency in respect of non-financial companies could be implemented by GOI, while those in relation to banks and financial institutions could be implemented by RBI.

4.37 Considering the above, the future agenda in respect of bankruptcy law could cover the following five aspects: (i) adoption of the UNCITRAL model for companies/corporates, (ii) extension of the UNCITRAL model to banks/ FIs, (iii) provision for multilateral netting in treatment of financial contracts for cross-border transactions, (iv) expeditious establishment of NCLT and (v) notifying SICA (Repeal) Act, 2003.

4.38 Before adoption, the provisions in the UNCITRAL model needs to be examined in detail to give force to the law in the Indian conditions. It may be useful for GOI to set up a Committee involving RBI and other regulators such as the SEBI, IRDA and TRAI to prepare the preliminary draft in this regard. Extension of UNCITRAL model to banks and FIs could also be considered, if necessary, through a separate law to deal with their insolvency.

4.39 In the context of cross-border transactions of banks/ financial institutions, it is necessary to provide for netting of counter party obligations. At present, the proposed Payment and Settlement Bill, 2002 provides for netting relating to the payment leg of the transactions routed through banks and financial institutions, which are participants of a payment system. However, the Bill does not provide for final settlement of mutual obligations of counterparties as also the closing out method of settlement. A separate legislation for the purpose of enabling multilateral netting of securities and closing out netting may be recommended.

4.40 In view the Madras High Court decision dated March 30, 2004 in R. Gandhi vs. Union of India [CC (120) 2004, 510], the setting up of NCLT has been deferred at present. Speedy implementation of NCLT and NCLAT are important for effective insolvency regime. It would be useful for GOI to explore all possible avenues, through appeal or otherwise, to facilitate an enabling framework. GOI could notify the enforcement of SICA Repeal Act simultaneously with the establishment of NCLT and NCLAT.

4.41 Several new international developments are taking place in the area of bankruptcy laws. These include the World Bank initiative on Principles and Guidelines for Effective Insolvency and Creditors Rights Systems, the Fund-Bank initiative on bank insolvency, OECD forum on Asian insolvency reform, G-10 initiative on legal and institutional underpinnings of global financial markets, G-10 draft model contractual clauses and G-10 effort to establish Code of Good Conduct (COGC) covering operational principles to help sovereign debtors and contractors. These need to be closely followed, so that appropriate Indian response could be formulated.

Corporate Governance

4.42 India has opted for ROSC assessment in the area of corporate governance on two occasions. The first assessment was completed in July 2000 and the Report was publicly disseminated the following year. The second was completed in April 2004 and the Government of India agreed to its publication in June 2004. The recent ROSC has noted that a series of legal and regulatory reforms have transformed the Indian corporate governance framework and improved the level of responsibility/ accountability of insiders, fairness in the treatment of minority shareholders and stakeholders, board practices and transparency. It also states that the introduction of corporate governance clause in the listing agreements (Clause 49) by the securities regulator (SEBI) has clarified many issues in this area. Recent efforts to strengthen enforcement have enhanced investor's trust in the market.

4.43 The Report, however, identifies several areas where further reform is necessary. These relate to: (i) tightening of related party and insider trading norms so as to make sanction and enforcement process a credible deterrent, (ii) removing the regulatory arbitrage arising from multiple regulation of listed companies by DCA, SEBI and the Stock Exchanges, (iii) further strengthening of board practices, and (iv) formulation of comprehensive corporate governance policy by institutional investors, *inter alia*, covering voting and board representation.

4.44 There is a gap between corporate governance in law and words and the corporate governance as it is enforced. While there has been improvement in both the legal framework as well as the way corporate governance is practiced in the country, the gap still remains large. There are about 9,500 listed and 23 registered stock exchanges, but about 2,650 companies or about 28 per cent of total listed companies are suspended at present. This indicates that efforts on implementation of corporate governance need to be reinforced. Particular attention is required that the control structures are consistent with the interest of the shareholders who are the owners, especially as control is often exercised

through thin holdings and cross holdings through a complex pattern of subsidiaries, companies and investment companies, which now has an added dimension of investments by institutions incorporated abroad. Close monitoring of arms length transactions is also necessary. In this backdrop, notwithstanding the adoption of most good practices as enshrined in OECD principles and adapted domestic legislations/codes, the success of the corporate governance initiative would ultimately depend on legal and regulatory enforcement. The costs, time and uncertainty in legal process in dealing with corporate cases are large. Even satisfactory statistics on pending cases are not available. The Company Law Board (CLB) website currently gives statistics only till end-March 2001. Furthermore, orders of CLB are generally followed by appeals in courts.

4.45 Continued legal support for corporate governance is important. For example, Porta, *et al* (2002) demonstrate that legal protection of minority shareholders leads to higher valuation of the firm. Poor corporate governance laws encourage not only bad behaviour by management, but also activities that fall under the classification of 'looting' as defined by Akerlof and Romer (1993) or 'tunnelling' as defined by Johnson, *et al* (2003).[17]

4.46 Considering the above aspects, improved corporate governance is required in all three segments covered by the Advisory Group. PSUs in recent past accounted for about a third of BSE's market capitalisation, with public sector oil exploration and drilling company, ONGC accounting for 10.7 per cent. BANKEX group of stocks that covers banks accounts for relatively lower proportion of 4 per cent of market capitalisation, but at the NSE the financial services account for 12 per cent of the total market capitalisation. Corporate governance for banks is also important since, as prime lenders to the private companies and PSUs, they affect the functioning of the entire corporate sector. Furthermore, FI nominees are represented on the board of these companies. Considering the growing importance of PSU and bank stocks, the principle

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[17] Tunnelling is defined as transfer of assets and profits out of firms for the benefit of their controlling shareholders. Looting is defined as similar phenomenon for the benefit of the management of the firm.

sought to be established by the Advisory Group that corporate governance in these companies should be more or less at par with private companies should guide further implementation.

4.47 Regarding private sector companies, the Narayana Murthy Committee has clearly laid down the broad parameters of the future agenda. It has suggested that the mandatory recommendations of the Naresh Chandra Committee on Corporate Audit and Governance be implemented by SEBI through mandatory compliance by amendment to clause 49 of the listing agreement. SEBI has since amended Clause 49 of the listing agreement in line with the recommendations. A good account of the practical aspects of corporate governance in these companies in India and why it may matter are given in Bajpai (2003a and 2003b).

4.48 Regarding corporate governance in public enterprises, the Yaga Report (Reddy, 2001) provides a set of 16 useful guidelines. Together with the recommendations of the Advisory Group, it provides a broad agenda for reforms towards improved corporate governance that could be pursued.

4.49 RBI is implementing the recommendations of the Consultative Group of Directors of Banks and FIs (Ganguly Group) and those made by the Advisory Group that considered various aspects of corporate governance. Several circulars issued by RBI in 2002, 2003 and 2004 in this area have provided the right framework for improved corporate governance, but the task remains unfinished in this area and there is need for focussing more closely on implementation of these circulars in letter and spirit. With improvements in corporate governance, the regulator would have the comfort of lesser interventions in micro-management issues. All banks in the private sector were advised by Reserve Bank of India in June 2004 to set up Nomination Committees to undertake a process of due diligence to determine the suitability of the persons being considered for appointment/ continuing to hold appointment as a director on the Board, based upon qualification, expertise, track record, integrity and other 'fit and proper' criteria. For this purpose, the banks were advised to obtain necessary information and declaration from the proposed/ existing directors in a

prescribed format. This exercise will be an ongoing exercise and reported to RBI at annual intervals. The quality of corporate governance in private sector banks would have to be at least comparable to that of corporate governance in non-financial private sector companies. The quality of corporate governance in public sector banks also needs to be similarly improved, though the approach could be different in view of its different ownership structure and principal-agent relationship.[18]

4.50 While improvement in corporate governance needs to be furthered, the course has to be carefully negotiated. Enhanced stock disclosure rules are necessary, but they have to be carefully framed keeping in view the heterogeneity in the corporate sector. The experience with the Sarbanes-Oxley Act 2002 that has been put in place in the United States to enhance corporate governance, inter-alia, through enhanced disclosures has been a mixed one. A recent paper by Luez, et. Al. (2004) shows that a large number of public companies have ceased filing with the US SEC by deregistering their securities, but continuing to trade in the OTC market, which in effect means a substantial decrease in disclosure and investor protection. They document a large negative abnormal return at the announcement and filing of deregistration, which is more pronounced for the firms that deregistered after the passage of the Sarbanes-Oxley Act. Another recent paper by (Gomes, *et al*, 2004) shows that the US SEC's adoption of Regulation Fair Disclosure (RegFD) in October 2000 has raised costs of capital for small firms. RegFD stopped selective disclosure practice to analysts and institutional investors before public disclosure without adequately replacing it with alternative information channels that were cost-effective for small firms. There is a lot to be learnt from experiences of other countries, specially those which have progressed in this area.[19]

[18] Patil (2002) provides a good summary of the key issues relating to corporate governance in public sector banks.
[19] Fremond and Capaul (2002) provide cross-country experience in corporate governance. See also Jordan and Majnoni (2002) on regulatory harmonization in this context.

Accounting and Auditing

4.51 The issues relating to accounting and audit comes to the fore with every case of irregularity, bankruptcy, liquidation or regulatory action to avert liquidation. The need for accounting and auditing transparency has been amply felt and the conduct of internal accounting procedures and of auditing firms has come under scanner in the wake of recent corporate delinquencies such as Enron and World Com. Most recently, it has happened domestically, in case of Global Trust Bank where some variances were observed in assessment of the auditors and that of the regulators.

4.52 The gap between Indian and international standards in respect of accounting and auditing has been gradually narrowing. However, with increasing globalisation and market-based finance, issues of standards in accounting and auditing could be accorded priority. With increasing complexities in financial instruments, specially in case of derivatives, the accounting and auditing standards need to be strengthened further, keeping in view the issues of systemic financial stability, as well as to prevent irregularities specially where they constitute frauds and looting behaviour. Considering these aspects, a clear time-frame is desirable. However, in the case of all the recommendations mentioned in Chapter II, with the exception of cases where standards have been issued by ICAI and consistent directives are to be issued by RBI, monitoring and follow-up action lies in ICAI's domain. ICAI could take a comprehensive view on all IASB standards extant as at end-March 2004, which would be effective January 1, 2005.[20]

4.53 In case of the gap between standards set by IAS and those set by ICAI, the latter has been making progress in formulation of parallel standards. Where possible, ICAI could consider taking a specific view on time frame for putting in place parallel standards, including those relating to financial instrument accounting and disclosures. It may mentioned that even in developed countries

considerable reservations have been expressed on some standards, most notably IAS 39. Fair value accounting would need to be promoted in a careful manner which minimises ambiguity. This is important to ensure broad comparability of accounts. Special consideration would be necessary for accounting unrealised gains and losses. Also, in cases where free market based prices are not available, model-based techniques would need to be promoted in a manner which does not lead to undue distortions. Fair value accounting in case of high volatility in financial asset prices would also need to be considered. In cases where divergence in fair value accounting arises from corporate and tax laws, GOI can consider suitable changes in consultation with ICAI. ICAI could consider making its recommendations in this regard as soon as possible. Monitoring of compliance with accounting standards by RBI in respect of banks and financial institutions regulated by it would be useful and needs to be continued. Where there are interpretation issues in respect of any standards or in matters where there are no standards, RBI could take up such issues with ICAI on an ongoing basis. Suggestions for constituting a Task Force to look into the emerging issues where comparable standards are not issued and for setting up of a panel to which auditors could be obligated to report violations could be explored by ICAI so that implementation of international accounting standards could be strengthened further.

Payments and Settlement Systems

4.54 In Chapter II of this Report, it was noted that the compliance of international standards in respect of payment and settlement systems has been impressive. Payment and settlement system has been an area in which RBI has framed a clear path of transition, what could be considered as a short period of time in relation to similar developments in other countries. From a relatively inefficient and archaic, and largely manual payment and settlement system, India's financial sector is, thus, placed on the threshold of an efficient, modern and largely automated payment and settlement system, which could have a

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[20] A comprehensive listing is provided in IASB (2004).

significant impact on reducing transaction costs and time-delays in settling financial transactions. The RTGS has gone live this year. Currently there are 92 participating banks with average daily turnover of about Rs. 24,000 crore. As of now, banks offer RTGS payment services through 1,095 branches located in 141 cities and towns. This coverage is expected to increase to 3,000 branches in 275 centres by the year-end. The coverage will later be extended to about 500 centres comprising commercially important centres, capital market intensive centres and e-commerce centres. With stabilisation of the RTGS system, the country would become compliant with the Core Principle 4 of the 'Core Principles of Systemically Important Payment Systems'. A pilot project for cheque truncation will be implemented in two small centres near two metros in a year's time. The pilot project is proposed to be held at New Delhi. The National Electronic Funds Transfer (NEFT) System is at a testing stage and is expected to be commissioned shortly, thus leading to compliance in respect of Core Principle-8.

4.55 While the above recommendations could be implemented by RBI within a year's time frame, the following two sets of issues may take a longer time to implement. First, for the legal issues related to the payment and settlement systems in the country (Core Principle 1), compliance would depend on the adoption of the proposed Payment and Settlement System Bill. This area of further reforms could, therefore, be considered by executive at an early date so that due political process could follow for the creation of appropriate legal framework in this area. Second, hiving off of the management of DNS and RTGS systems from the RBI with only settlement of funds to be retained with the RBI (additional action points indicated by the Advisory Group) is a recommendation which needs careful policy decision. As of now, DNSs are, by and large, managed by entities other than the central bank. Except 15 important DNS for cheque clearing, all other DNSs are managed by commercial banks. Even in these 15 DNSs, the clearing function in 11 is undertaken by commercial banks only. Further, the DNS for government securities and forex clearings is the CCIL, which as a separate entity manages the system. As regards RTGS system,

international experience is that RTGS remains with the central bank, which is the ultimate repository of liquidity for intra-day support for member banks.

4.56 Further action in the area of payment and settlement systems could focus on consolidation of the giant steps taken over last few years, with a view to ensure safety, security, soundness and efficiency of the systems. The focus in this direction could be on creation of a sound legal base, improving the structure for retail payment systems, further reduction of risks in payment and settlement systems, improved efficiency and reduction in costs where possible, improving customer services and improving outreach of services in the rural sector. Legal framework has been amended over last few years with amendments in the Negotiable Instruments Act, 1881 and in the Information Technology Act, 2000 providing a legal basis for electronics-based payment systems in Indian banking. However, further legal changes through the Payment and Settlement Systems Bill could explicitly provide a basis for 'netting' and 'finality of settlement'. Multiplicity of operators and local practices in retail payment system could come in way of safety, efficiency and better customer service. Creation of a separate legal entity for retail clearing function could be considered in this context after studying cross-country experiences of the prevalent structures in this regard. Integrating all settlements in central bank money at one place is an option that could be explored. For further risk mitigation, inter-bank clearing at all places could be migrated to RTGS and guarantee funds could be considered so that secured netting systems could cover high value transactions. PKI based digital signatures system could be quickly introduced wherever necessary and possible. To further enhance efficiency, cheque truncation, rationalisation of clearing houses, mandatory MICRistaion could be considered. There is a need to improve customer awareness and enhanced help to customers could be provided to redress their problems in use of payment systems. It would be useful for the payment service providers to disclose publicly its standards, terms and conditions under which the payment will be effected. To improve the technology outreach in rural areas smart cards, ATMs, electronic fund transfers, etc could be increasingly provided in rural areas. Options could be explored to see if use of

Kissan cards in ATMs could be made possible over the medium-term. Apart from these areas cross-border initiatives for linking with regional payment systems and for linking forex settlement with CLS could also be considered.

Market Integrity

4.57 Substantial progress has been made on the implementation of most of the original 48 recommendations of the FATF that were examined from the standpoint of India by the Technical Group on Market Integrity in May, 2002. The PML Act, 2002 provides the basic framework for implementing major FATF recommendations as it lays down an institutional and legal framework for sharing/ reporting of information, investigation and prosecution including confiscation/ seizure of property derived from money laundering activities. The President of India has accorded his sanction for setting up of Financial Intelligence Unit, India (FIU-IND). The FIU-IND has been set up with a view to coordinate and strengthen collection and sharing of financial intelligence through an effective national, regional and global network to combat money laundering and related crimes. RBI has issued comprehensive Guidelines on KYC norms and Anti-Money Laundering Standards which require banks to develop comprehensive risk management systems, follow a risk based approach while establishing new business relationships, monitor and report suspicious transactions in conformity with regulatory and legal requirements etc. With the setting up of FIU-IND and the implementation of the RBI guidelines on ALM and CFT, Indian banking system would have in place effective systems and procedures to combat money laundering and financing of terrorism.

Our Future Approach to International Standards and Codes

4.58 While a fair ground has been covered, further action in this regard is substantially contingent on actions of various agencies. As regards to the unfinished agenda, the regulatory agencies would need to continue their efforts to support GOI in taking necessary action. Need for legislative changes is constraining implementation of some of the recommendations. Draft legislative changes could be quickly drawn for the purpose, where this has not been done

so far. Political process of enactment could follow. However, simultaneously concerned agencies should try to make incremental changes that are within their ambit and which can go towards strengthening implementation process of various standards and codes.

4.59 The future approach would be to cover new areas where work has been recently undertaken by international standard-setting bodies. Such work has been detailed in Chapter III of this Report and one could take a view whether setting up of any new Advisory Groups would be necessary in any of the areas where new developments have taken place. The Standing Committee could examine, in-depth, this aspect over a period. In general, however, the Advisory Groups have already provided the yeoman's service by raising consciousness of the regulatory and supervisory officials towards implementing international standards and codes in this country. Wherever it is considered possible, implementation of any new principles and guidelines could be undertaken internally by the regulators in their respective domains as this could help achieve more in les time. Appropriate dissemination in this respect would provide the right checks and balances to bring to the fore any lacunae that could be rectified later by concerned agencies themselves. However, whether pursued by concerned agencies on in-house or with outside expert advice, some new areas require urgent attention. Payment and settlement for central bank money, risk integration and risk transfers and interest rate risk could be four areas where new initiatives are required on a priority basis in India.

4.60 There are a few areas of international development that require further examination as these have not been sufficiently captured in the earlier reports. First, substantial developments have taken place in the recent past in the US in the area of accounting standards and corporate transparency. The need for greater transparency in corporates as well as banks could be looked at against this background. Second, the issue of transparency in regulator's view of the regulated could be examined further. Third, protection to whistleblowers through a Whistleblowing Act could be considered.

4.61 In general, the broad approach set by the Report of the Standing Committee on International Financial Standards and Codes (May 2000) has served the country well. It has helped the country to adopt a clear stance with multilateral agencies and standard-setting bodies. This stance has been constructive and has unequivocally recognised the importance of such standards in reinforcing domestic financial stability and in strengthening the international financial architecture. The Standing Committee Report has helped in improved understanding of various standards and codes amongst Indian standard-setting agencies, regulators and supervisors, banks and other financial intermediaries, as also general public and their representatives. The dissemination of codified material by regulators in the area of international financial standards and codes, including Reports in this area, need to be supplemented through seminars, conferences, research and further institutionalisation of inter-agency coordination in this area. While providing an objective assessment of the present status, this Progress Report has documented the significant advances made in implementing these standards and codes in India. It has also brought to the fore certain difficulties and suggested the course of action ahead to implement the past recommendations and new standards that have emerged. The general approach, set earlier by the Standing Committee has helped in moving ahead on the process of implementation of standards and codes in several areas, particularly taking note of the country-specific features. It is intended to continue with the approach so as to achieve further progress on the subject.

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Annex - I

The Standing Committee on International Financial Standards and Codes and its 11 Advisory/Technical Groups

Standing Committee on International Financial Standards and Codes	Dr. Y.V. Reddy (Chairman), Shri C.M. Vasudev (Alternate Chairman) (formerly Dr. E.A.S. Sarma and Shri Ajit Kumar), Dr. Adarsh Kishore (formerly Dr. A. Vasudevan, Dr. Arvind Virmani, Shri V. Govindarajan and Dr. Rakesh Mohan) (members)
Advisory/ Technical Groups	
Monetary and Financial Transparency	Shri M. Narasimham (Chairman), Shri S.S. Tarapore (member)
Fiscal Transparency	Dr. Montek Singh Ahluwalia (Chairman), Dr. Parthasarthy Shome, Shri C.S. Rao, Shri A.C. Tiwari and Shri J.L. Bajaj (members)
Data Dissemination	Dr. A. Vaidyanathan (Chairman) (vice late Dr. Pravin Viasaria), Dr. S.L. Shetty and Dr. Ajay Shah (members)
Banking Supervision	Shri M.S. Verma (Chairman), Shri Janki Ballabh, Shri K.R. Ramamoorthy and Shri H.N. Sinor (members)
Securities Market Regulation	Shri Deepak Parekh (Chairman), Shri Sitin Desai, Shri I.C. Jain Shri Nimesh Kampani, Shri Anand Rathi, Shri Uday S. Kotak and Shri Ravi Narain (members)
Insurance Regulation	Shri R. Ramakrishnan (Chairman), Shri L.P. Venkataramana, Shri T.G. Menon and Shri Naresh Chandra Gupta (members)
Bankruptcy Law	Dr. N.L. Mitra (Chairman), Shri Bimal Kumar Chatterjee, Shri Cyril Shroff, Dr. T.C. Anant, Shri S. Krishnaswamy and Dr. S. Gangopadhyaya (members)
Corporate Governance	Dr. R.H. Patil (Chairman), Shri Rajendra P. Chitale, Shri Deepak H. Satwalekar, Shri Nandan M. Nilekani, Shri M.G. Bhide and Dr. V.V. Desai (members)
Accounting and Auditing	Shri Y.H. Malegam (Chairman), Shri N.P. Sarda, Shri Mohindar M. Khanna and Shri T.V. Mohandas Pai (members)
Payment and Settlement System	Shri M.G. Bhide (Chairman), Dr. R.H. Patil, Dr. Ajay Shah, Shri Vishnu Deuskar, Shri Rajendra P. Chitale, Shri P.K. Bindlish and Shri D. Sanchety (members)
Market Integrity	Shri C.R. Muralidharan, Dr. Himanshu Joshi and Smt. Indrani Banerjee (members of the internal Group)

Annex - II

Reports of the 11 Advisory/Technical Groups of the Standing Committee on International Financial Standards and Codes#

Standing Committee on International Financial Standards and Codes	**Report of the Standing Committee on International Financial Standards and Codes, May 2002** (The Report incorporates the Synthesis Report, prepared by Prof. T.C.A. Anant, Delhi School of Economics at the request of the Standing Committee and covers the recommendations of all Advisory Groups)
Monetary and Financial Transparency	Report of the Advisory Group on Transparency in Monetary and Financial Policies, September 2000
Fiscal Transparency	Report of the Advisory Group on Fiscal Transparency, June 2001
Data Dissemination	Report of the Advisory Group on Data Dissemination, May 2001
Banking Supervision	Report of the Advisory Group on Banking Supervision, May 2001
Securities Market Regulation	Report of the Advisory Group on Securities Market Regulation, April 2001
Insurance Regulation	Report of the Advisory Group on Insurance Regulation (Part-I, September 2000) and (Part-II, February 2001)
Bankruptcy Law	Report of the Advisory Group on Bankruptcy Law (Volume-I and II, May 2001)
Corporate Governance	Report of the Advisory Group on Corporate Governance, March 2001
Accounting and Auditing	Report of the Advisory Group on Accounting and Auditing, January 2001
Payment and Settlement System	Report of the Advisory Group on Payment and Settlement System, (Part-I, June 2000; Part-II, December 2000 and Part-III, July 2001)
Market Integrity	Report of the Technical Group on Market Integrity, May 2002

All the above Reports were publicly disseminated by RBI in published form, in CD-ROM and on RBI website.

Annex - III

Advisory Panel on Review of the Progress on the International Financial Standards and Codes

Chairman	Dr. Rakesh Mohan, Deputy Governor, RBI.
Members #	
Monetary and Financial Transparency	Shri S.S. Tarapore, former Deputy Governor, RBI and Chairman, Standing Committee on Procedures and Performance Audit on Public Services.
Fiscal Transparency	Dr. N.J. Kurian, Principal Consultant, National Institute of Public Finance and Policy.
Data Dissemination	Dr. S.L. Shetty, Director, Economic and Political Weekly Research Foundation.
Banking Supervision	Shri H.N. Sinor, Chief Executive, Indian Banks' Association.
Securities Market Regulation	Dr. Urjit Patel, Chief Officer, IDFC.
Insurance Regulation	Shri L.P. Venkataramana, former Executive Director, Life Insurance Corporation.
Bankruptcy Law	Shri Cyril Shroff, Managing Partner, Amarchand & Mangaldas & Suresh A. Shroff & Co., Mumbai
Corporate Governance	Dr. R.H. Patil, Chairman, Clearing Corporation of India Limited.
Accounting and Auditing	Shri Y.H. Malegam, Chartered Accountant, S. B. Billimoria & Co.
Payment and Settlement Systems	Shri M.G. Bhide, Director, CRISIL.
Market Integrity	(Internal Group represented by DBOD)
SEBI representative	Shri Pratip Kar, Executive Director, SEBI.
IRDA representative	Shri Prabodh Chander, Executive Director, IRDA.

Members of the Advisory panel provided expert comments on all aspects of the International Financial Standards and Codes and not necessarily limited to the Advisory Group areas shown above, which is based on the area on which they were requested to comment upon at the Meeting of the Advisory Panel, in view of their past primary association with the Group as Chairman/ member/ special invitee.

Annex - IV

Nodal Officers for the Follow-up Work on Recommendations of the 11 Advisory/ Technical Groups of the Standing Committee on International Financial Standards and Codes at the Completion of this Review

Sr. No.	Name of the Advisory Group	Nodal Dept./ Agency	Nodal Officer	Associated Officer
1.	Transparency in Monetary and Financial Policies	MPD	Shri Deepak Mohanty, Adviser-in-Charge	Dr. Mridul Saggar, Director
2.	Accounting and Auditing	DBOD	Shri C.R. Muralidharan, CGM-in-Charge	Shri P. R. Ravimohan, General Manager
3.	Fiscal Transparency	DEAP	Dr. Narendra Jadhav, Principal Adviser and Chief Economist	Smt. Deepa S. Raj, Assistant Adviser
4.	Banking Supervision	DBS	Shri G. Gopalakrishna, CGM-in-Charge	Shri K. Gopalakrishnan, General Manager
5.	Data Dissemination	DESACS	Dr. K.S. Ramchandra Rao, Principal Adviser	Shri Ajit Joshi, Director
6.	Market Integrity	DBOD	Shri C.R. Muralidharan, CGM-in-Charge	Shri Lalit Srivastava, General Manger
7.	Corporate Governance	DBOD	Shri C.R. Muralidharan, CGM-in-Charge	Shri T.B. Satya-narayan, Deputy General Manager
8.	Bankruptcy Laws	Legal Dept.	Shri N.V. Deshpande, Principal Legal Adviser	Smt. G. Geetha, Legal Officer
9.	Securities Market Regulation	IDMD & SEBI	Shri B. Mahapatra, CGM-in-Charge, IDMD/ Shri Pratip Kar, ED, SEBI	Shri A.K. Mitra, Assistant Adviser, IDMD / Shri V.S. Sundaresan, DGM, SEBI
10.	Payment and Settlement Systems	DIT	Shri R. Gandhi, CGM-in-Charge	Shri Ganesh Kumar, General Manager
11.	Insurance Regulation	IRDA	Shri Prabodh Chander, ED, IRDA	Shri Randip Singh, Deputy Director, IRDA

The co-ordination and drafting work in relation to this Progress Report has been done in the Monetary Policy Department of RBI. The task was undertaken by Dr. Mridul Saggar, Director. Inputs of Shri H.R. Khan, Shri S. Arunachalaramanan, Shri K. Damodaran, Dr.(Smt.) Mohua Roy, Shri Sanjay Hansda and Shri Ajay Prakash for the Report at various points of time are acknowledged. The overall process of preparation of the Report was guided by Shri D. Anjaneyulu, Consultant and Shri Deepak Mohanty, Adviser-in-Charge. The Report reflects the inputs from various nodal departments/ agencies and the views expressed at the two meetings of the nodal officers and the meeting of the Advisory Panel. These meetings were chaired by Dr. Rakesh Mohan, Deputy Governor, RBI, whose valuable advice at various stages helped shape the present Report. Inputs from Ministry of Finance, SEBI and IRDA, specially those from Shri D. Swarup, Secretary (Expenditure and Budget), Ministry of Finance, Shri Pratip Kar, ED, SEBI and Shri Prabodh Chander, ED, IRDA are acknowledged.