A HUNDRED SMALL STEPS

Report of the Committee on Financial Sector Reforms

Planning Commission
Government of India

A Hundred Small Steps

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सत्यमेव जयते

Government of India
Planning Commission
New Delhi

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GOVERNMENT OF INDIA
PLANNING COMMISSION

Yojana Bhawan, Sansad Marg
New Delhi, 17th August 2007

ORDER

Subject: Constitution of a High Level Committee on Financial Sector Reforms

With a view to outlining a comprehensive agenda for the evolution of the financial sector indicating especially the priorities and sequencing decisions which the Govt. must keep in mind, it has been decided to set up a High Level Committee on Financial Sector Reforms with the following composition:

(i) Shri Raghuram G. Rajan, Professor, Graduate School of Business, University of Chicago—Chairman.
(ii) Suman Bery, Director General, NCAER.
(iii) Uday Kotak, CEO, Kotak Mahindra Bank.
(iv) Rajiv Lall, CEO, IDFC.
(v) Vijay Mahajan, Chairman, Basix.
(vi) Zia Mody, Senior Partner, AZB Partners.
(vii) O.P. Bhatt, Chairman, State Bank of India.
(viii) K.V. Kamath, MD & CEO, ICICI Bank.
(ix) Chitra Ramakrishna, Deputy MD, NSE.
(x) R. Ravimohan, MD & CEO, CRISIL.
(xi) J.R. Varma, Professor, Indian Institute of Management, Ahmedabad.
(xii) R. Sridharan, Adviser (FR), Planning Commission—Convenor.

02. The Terms of Reference of the Committee will be as follows:

(i) To identify the emerging challenges in meeting the financing needs of the Indian economy in the coming decade and to identify real sector reforms that would allow those needs to be more easily met by the financial sector.
(ii) To examine the performance of various segments of the financial sector and identify changes that will allow it to meet the needs of the real sector.
(iii) To identify changes in the regulatory and the supervisory infrastructure that can better allow the financial sector to play its role, while ensuring that risks are contained; and
(iv) To identify changes in other areas of the economy—including in the conduct of monetary and fiscal policy, and the operation of the legal system and the educational system—that could help the financial sector function more effectively.

03. The High Level Committee may invite such person(s) as it deems appropriate to participate in any of its meetings as special invitee(s).

Acknowledgements

When the Deputy Chairman of the Planning Commission, Shri Montek Singh Ahluwalia, asked me to put together a Committee to write a report on the next generation of financial sector reforms, I was intrigued but also puzzled. Why another report when so many reports had been commissioned in the recent past? He convinced me that there was merit in taking an overall view, highlighting the links between various needed reforms, and offering a generally consistent underlying approach. The purpose of the report would be to catalyze debate as well as action, some immediate and some over time as political will emerged.

With this in mind, I set about putting together a Committee of some of the finest financial and legal minds in the country. My first pleasant surprise was that no one I asked said no, despite their undoubtedly hectic schedules, and the fact that many of them were already on other Committees. Since then, I have been treated to a truly awesome display of true public–private partnership as people from the public sector, government, regulators, the private sector, academia, politicians, unions, NGOs, and the press have given freely of their valuable time to make this report possible. All constituencies had input into this process. We have also benefited from a large number of comments since a preliminary draft of the report was placed in the public domain for commentary.

I start my acknowledgements by thanking Mr. K.V. Kamath of ICICI Bank for kindly hosting many of the Committee's meetings, and creating a secretariat to take care of the logistical arrangements. It is clear that without the efficiency of the ICICI staff helping us, this report would certainly not have been completed on time. Dr. Nachiket Mor and Ms. Chanda Kochhar were free with their time, as well as their resources, including their very able assistants, Persis Bharucha and Nita Colaco. I particularly thank ICICI for making available the services of Dr. Sona Varma and Mr. Vinay D'Costa. Dr. Varma was a great help throughout, and directed the Committee's work on financial inclusion. Vinay embodies for me the spirit of young India. He has been tireless throughout this Committee's tenure, working at all hours of the day and night, going well beyond the call of any reasonable concept of duty, to make this report come together. Thank you Vinay!

I also am very grateful to Mr. Om Bhatt of the State Bank of India, who hosted a number of the Committee's meetings and events. He also was instrumental in helping us reach a number of constituencies that we would otherwise not have been able to access. Ms. Brinda Jagirdar from SBI was of tremendous help, both at Committee meetings and in reaching out to various parts of SBI.

The Planning Commission has also been invaluable to the working of the Committee. Shri Ahluwalia, of course, has been very supportive throughout. The convenor, Mr. Sridharan, and his assistant, Mr. A.K. Chakrabarti, have been extremely helpful. Mr. Sridharan's knowledge of how government works have been especially important in clarifying my views, and the views of the Committee.

All the members of the Committee took on the additional burden of attending its Saturday meetings cheerfully. Committee discussions, while sometimes heated (and never short), were always focused on attempting to understand what in our opinion would be right for the nation. Many Committee members have written pieces of the report, and have drawn others from their organizations to help in the work. This has been truly a collective effort, and I would like to express my sincere gratitude to Mr. Suman Bery, Mr. Uday Kotak, Mr. Rajiv Lall, Mr. Vijay Mahajan, Ms. Zia Mody, Ms. Chitra Ramakrishna, Mr. Ravimohan, and Prof. Jayanth Varma, in addition to the three members who have been acknowledged earlier.

The Committee is especially grateful to our ‘virtual’ members, Prof. Rajesh Chakrabarti, Prof. Eswar Prasad, Mr. Joydeep Sengupta, Dr. Ajay Shah, and Mr. Bahram Vakil, as well as Prof. Sankar De, Prof. Ashok Jhunjhunwala, Mr. Nirmal Mohanty, Mr. Ramesh Ramanathan, and Mr. Vidhu Shekhar. Each of them wrote, or helped in the writing of, significant portions of the report, and greatly enhanced the intellectual quality and practical content of the Committee’s discussions. It also thanks Ms. Naga Annamalai, Mr. Anindya Bannerjee, Mr. Abhinav Chandrachud, Mr. Ashwin Ramanathan, Mr. Pramod Rao, and Mr. Mahesh Uttamchandani, who while not explicitly part of the Committee, helped guide important aspects of the Committee’s work. Ritu Anand, Sugandha Garg, Leena Kinger Hans, Leena Pillai, Swati Ramanathan, Subrata Sarkar, and Priyanka Vasishtha were also very useful contributors to the work of the Committee. IIMS Dataworks and FINO helped us with data and in assessing practices.

We held nine formal Committee meetings and 11 informal ones. In addition, members of the Committee met with a number of relevant players in the financial sector arena. We obtained tremendous help from employees from a variety of public, private, domestic, and foreign organizations, as well as some self-employed individuals. In each case, the individual shared their expertise with the Committee in their personal capacity. Among those that we would like to thank especially are: Anup Banerji, Priya Basu, Gautam Bhardwaj, Sanjay Bhargava, Tarun Bhatia, Saugata Bhattacharya, Christopher Butel, Nick Collier, M. Damodaran, Amaresh Dubey, Ajay Dwivedi, Tilman Ehrbeck, Joshua Felman, Neeraj Gambhir, Jim Hanson, Dharmakriti Joshi, Sachin Khandelwal, S. Khasnobis, Kalpana Kochhar, Charles Kramer, K.P. Krishnan, Roopa Kudva, P.J. Nayak, M. Mahapatra, Varsha Marathe, Mihir Nanavati, Sanjay Nayar, Robert Palacios, Aurobind Patel, V. Ramkumar, C.S. Rao, Renuka Sane, Naveen Tahilyani, Vijay Tata, Yashwant Thorat, Arun Thukral, Essaji Vahanvati, S. Venkataraman.

A number of reviewers (because some of them asked not to be named, we have decided to keep the entire list anonymous) read a first draft of this report and offered very useful comments. They have our gratitude.

After a preliminary draft was placed in the public domain for comment, we received a large number of comments, both directly, and in the press. While we have not accepted all suggestions, each one has been weighed for its consistency with our overall framework and alterations, where justified, have been made to the report.

Raghuram G. Rajan
12 September 2008

List of Abbreviations

AAIFR	Appellate Authority for Industrial and Financial Reconstruction
ABS	Asset-backed Securities
ACC	Appointments Committee of the Cabinet
AD	Authorized Dealer
ADB	Asian Development Bank
ADR	American Depository Receipts
AMC	Asset Management Company
AML	Anti-Money Laundering
AP	Andhra Pradesh
ARC	Asset Reconstruction Company
ATM	Automated Teller Machines
BANSEFI, Mexico	Banco de Ahorro Nacional y Servicios Financieros, Mexico
BC	Business Correspondents
BCD	Bond-Currency-Derivatives
BF	Business Facilitators
BIFR	Board for Industrial and Financial Reconstruction
BIS	Bank for International Settlements
BoE	Bill of Exchange
BOT	Bank of Thailand
BPL	Below Poverty Line
BRIC	Brazil, Russia, India, China
BSE	Bombay Stock Exchange
BSNL	Bharat Sanchar Nigam Limited
CAGR	Compounded Annual Growth Rate
CAL	Capital Account Liberalization
CBLO	Collateralized Borrowing and Lending Obligations
CBRC	China Banking Regulatory Commission
CCIL	Clearing Corporation of India Limited
CD Ratio	Credit-Deposit Ratio
CDFI	Community Development Financial Institutions
CDO	Collateralised Debt Obligations
CDR	Corporate Debt Restructuring
CDS	Credit Default Swaps
CDSL	Central Depository Services India Limited
CFT	Combating the Financing of Terrorism
CGAP	Consultative Group to Assist the Poorest
CIBIL	Credit Information Bureau (India) Limited
CICA	Credit Information Companies (Regulation) Act
CMIE	Centre for Monitoring Indian Economy
COSPI	CMIE Overall Share Price Index
CPC	Code of Civil Procedure
CPI	Consumer Price Index
CRA	Community Reinvestment Act

CRA ID	Central Record Keeping Agency identification
CRISIL	Credit Rating and Information Services of India
CRR	Cash Reserve Ratio
CVC	Central Vigilance Commission
DA	Direct Assignments
DCCBs	District Central Cooperative Banks
DICGC	Deposit Insurance and Credit Guarantee Corporation
DIP	Debtor-in-Possession
DRT	Debt Recovery Tribunal
ECB	External Commercial Borrowings
EPFO ID	Employees Provident Fund Organisation identification
EPIC	Elector's Photo Identity Card
FDI	Foreign Direct Investment
FI	Financial Institution
FII	Foreign Institutional Investor
FINO	Financial Information Network and Operations
FIPB	Foreign Investment Promotion Board
FIRA, Mexico	Fideicomisos Instituidos en Relación con la Agricultura
FMC	Forward Markets Commission
FRBM	Fiscal Responsibility and Budget Management
FSA	Financial Services Authority
FSC	Financial Supervisory Commission, Korea
FSDC	Financial Sector Development Council
FSM Act	Financial Services and Markets Act, 2000, UK
FSOA	Financial Sector Oversight Agency
GDP	Gross Domestic Product
GDR	Global Depository Receipts
GIC	General Insurance Corporation of India
HLCC	High Level Co-ordination Committee on Capital Markets
HPEC	High Powered Expert Committee
IBA	Indian Bankers Association
IBPC	Inter-bank Participation Certificates
ICA	Inter-Creditor Agreements
ICAI	Institute for Chartered Accountants of India
ICR	Insolvency and Creditor Rights
ICRA	Information and Credit Rating Agency
ID	Identification
IDBI	Industrial Development Bank of India
IDRBT	Institute for Development and Research in Banking Technology
IFCI	Industrial Finance Corporation of India
IIMS	Invest India Market Solutions
IISS	Invest India Incomes and Savings Survey
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPDI	Innovative Perpetual Debt Instruments
IRDA	Insurance Regulatory and Development Authority
ISO	International Organization for Standardization
IT	Information Technology

KYC	Know Your Customer
LAB	Local Area Bank
LIBOR	London Inter-Bank Offered Rate
LIC	Life Insurance Corporation of India
LLP	Limited Liability Partnership
LSO	Loan Sell-Off
M&A	Mergers and Acquisitions
MBA	Master of Business Administration
MCA	Ministry of Corporate Affairs
MFI	Microfinance Institution
MGBBY	Mahatma Gandhi Bunkar Bhima Yojana
MNIC ID	Multi Purpose National Identity Card
MOF	Ministry of Finance
MOFE	Ministry of Finance and Economy, Korea
MPFI	Mobile Payment Forum of India
MTNL	Mahanagar Telecom Nigam Limited
NABARD	National Bank for Agriculture and Rural Development
NAFIN	Nacional Financiera, Mexico
NAIS	National Agricultural Insurance Scheme
NBFC	Non-Banking Financial Company
NCAER	National Council for Applied Economic Research
NCDEX	National Commodity & Derivatives Exchange Limited
NCLT	National Company Law Tribunal
NDS	Negotiated Dealing System
NEFIS	Nationwide Electronic Financial Inclusion System
NGO	Non-Governmental Organization
NHB	National Housing Bank
NPA	Non-Performing Assets
NPF	National Pension Fund, Korea
NPL	Non-Performing Loans
NPS	New Pension System
NREGS	National Rural Employment Guarantee Scheme
NRI	Non-Resident Indian
NSCC	National Securities Clearing Corporation
NSDL	National Securities Depository Limited
NSE	National Stock Exchange
NSEL	NCDEX Spot Exchange Ltd
NYMEX	New York Mercantile Exchange
OFO	Office of the Financial Ombudsman
OTC	Over the Counter
PAN	Permanent Account Number
PCAOB	Public Company Accounting Oversight Board
PCARDBs	Primary Cooperative Agriculture and Rural Development Bank
PIN	Personal Identification Number
PLR	Prime Lending Rate
POS	Point of Sale
PSB	Public Sector Bank
PSLC	Priority Sector Lending Certificates
PSU	Public Sector Undertaking

PTC	Pass-Through Certificates
QFII	Qualified Foreign Institutional Investor
RBI	Reserve Bank of India
REER	Real Effective Exchange Rate
RMBS	Residential Mortgage Backed Securities
RNBFC	Residuary Non-Banking Finance Company
ROE	Return on Equity
RRBs	Regional Rural Banks
RSBY	Rashtriya Swasthya Bima Yojana
RTGS	Real Time Gross Settlement
SAFE	State Administration of Foreign Exchange, China
SAT	Securities Appellate Tribunal
SBI	State Bank of India
SC(R)A	Securities Contract Regulation Act
SCARDBs	State Cooperative Agriculture and Rural Development Bank
SCBs	Scheduled Commercial Banks
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
SENSEX	Sensitive Index
SEWA	Self Employed Women's Association
SGL	Subsidiary General Ledger
SGSY	Sampoorna Gramin Rozgar Yojana
SHG	Self-Help Group
SIB	Securities and Investment Board, UK
SICA	Sick Industrial Companies Act
SIDBI	Small Industries Development Bank of India
SIP	Systematic Investment Plan
SLR	Statutory Liquidity Ratio
SME	Small to Medium Enterprises
SMS	Short Message Service
SNX	SAFAL National Exchange
SPV	Special Purpose Vehicles
SR	Security Receipts
SRFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act
SRO	Self-Regulatory Organisation
SSI	Small Scale Industries
STCBs	State Cooperative Bank
TRAI	Telecom Regulatory Authority of India
UCBs	Urban Cooperative Banks
ULIP	Unit Linked Insurance Plan
UNCITRAL	United Nations Commission on International Trade Law
UP	Uttar Pradesh
US 64	Unit Scheme 64 of Unit Trust of India
UTI	Unit Trust of India
VAT	Value-added Tax
VSNL	Videsh Sanchar Nigam Limited
WPI	Wholesale Price Index
WTO	World Trade Organization

Introduction, Executive Summary, and List of Main Proposals

chapter 1

The Committee on Financial Sector Reforms (henceforth 'the Committee') was tasked with proposing the next generation of reforms for the Indian financial sector. The immediate question, of course, is whether we need a new generation of reforms at all. There are two ways of answering this.

First, so much is yet to be done. On the retail side, financial services are still not reaching the majority of Indians. The single most frequently used source of loans for the median Indian household is still the moneylender. On the wholesale side, the financial sector is not able to meet the scale or sophistication of the needs of large corporate India, as well as of public infrastructure, and does not penetrate deeply enough to meet the needs of small and medium-sized enterprises in much of the country. Large parts of our financial system are still hampered by political intervention and bureaucratic constraints, limiting their potential contribution. And with external forces such as commodity prices and external demand volatility buffeting us, it is not clear we have the macroeconomic frameworks, the risk management structures, or the microeconomic flexibility to cope.

Second, there is so much to be gained from doing it. The financial sector has built capabilities such that, with appropriate policy changes, it can grow tremendously, both domestically and internationally. It can generate millions of well-paying jobs, and more important, have an enormous multiplier effect on inclusion and economic growth. Given the right environment, financial sector reforms can add between a percentage point and two to the economic growth rate. Financial sector reform is both a moral and an economic imperative!

There are thus at least three reasons for financial sector reform: to include more Indians in the growth process; to foster growth itself; to improve financial stability, flexibility, and resilience and thus protect the economy against the kind of turbulence that has affected emerging markets in the past, and is affecting industrial countries today.

Why do we need a new report? After all there have been numerous well-written reports over the past few years, many of whose recommendations remain unimplemented. One reason why this report is different is that other reports have been tasked with looking at specific segments of the financial sector (the corporate bond market, infrastructure financing, the inclusion agenda, the cooperative sector, etc.). By the very nature of their terms of reference, though, the analysis and proposed reforms have had to be partial. This Committee has had both the benefit of studying those earlier reports and the luxury of painting on a broader canvas, that is, the entire financial sector. The Committee has attempted to see links that others have not because of their narrower mandate. Hopefully, its proposals then take these linkages into account and attempt to create mutually reinforcing influences in the financial sector. Indeed, while the report is divided into separate self-contained chapters, the underlying theme behind all our proposals is the need to enhance inclusion, growth, and stability by allowing players more freedom, even while strengthening the financial and regulatory infrastructure.

An example may be useful. Reports on why India does not have a sizeable corporate bond market point out that many natural investors, such as banks and insurance companies, have restrictions placed on them, forcing them to invest large amounts in government securities. Foreigners are strictly limited in how much government debt they can buy. A straightforward recommendation seems to be to remove these restrictions. But why do regulators impose them in the first place?

In part, it is because regulators know the government deficit needs funding, in part they are overly conservative because their reward structure penalizes any failures on their watch far more than it penalizes lost growth, and in part corporate bonds are indeed risky given weak creditor protection. So a solution needs to address issues ranging from how the government deficit will be financed, to regulator incentive structures, to fixing the credit infrastructure. Similarly, if we wonder why foreign participation is so restricted, we have to address issues ranging from how open the capital account should be to whether the monetary framework should target the exchange rate at all. The point is that both analysis and recommendations have to ensure consistency across a number of policy areas, which this report attempts to achieve.

An equally important reason for a new report is that we need a new paradigm in the financial sector. Such a paradigm should recognize that efficiency, innovation, and value for money are as important for the poor as it is for our new Indian multinationals, and these will come from deregulation, new entry, and competition. The role of the government is not to take on the tasks that should legitimately be delegated to the private sector, but to create an enabling environment by building sound financial infrastructure. In other words, the kind of liberalization, as well as the more effective regulation, that has had such beneficial results in sectors like telecom, should now be extended to the financial sector, where the rewards could be so much more substantial. In this dynamic environment, we will need skilled regulators who encourage growth and innovation even while working harder to contain risks. The shift in paradigm, if implemented, could usher in a revolution in the financial sector almost as dramatic as the revolution that hit the real economy in the early 1990s, whose fruits we are now reaping.

There has been an enormous amount of attention paid to issues like capital account convertibility, bank privatization, and priority sector norms. While important, there are many other areas where reforms are less controversial, but perhaps as important. An example of the kind of reforms we would support is the trading of warehouse receipts. With the promulgation expected soon of the Warehousing (Development and Regulation) Act, 2008, warehouse receipts will become a negotiable instrument. They will become a new, reliable form of collateral in the agricultural sector, where till now there was no other security except land, which has its own infirmities. Warehouse receipts can be in physical or electronic form and must be issued by registered warehouses, which will be accredited by the Warehousing Development and Regulatory Authority.

The advent of the warehouse receipt system will result in a lower cost of financing and an increase in liquidity for agriculture, and is a break from the focus of the last few decades on targeted lending as a way to energize agricultural credit. In addition, the Act encourages scientific warehousing of goods, improved supply chains, enhances rewards for grading and quality and encourages better price risk management. This is an example of how forward looking regulation can help build the credit infrastructure (in this case, for agriculture) and enhance the availability of finance.

In anticipation of the legislation being passed (the Bill was introduced in 2005), and assisted by some well-targeted government schemes to build rural godowns, a large number of technologically advanced warehouses are already in various stages of construction. In addition, the traditionally unreliable warehouse keepers are being upstaged by newer actors such as collateral management agencies, assayers for checking the quality/grades of commodities stored, and authorized warehouse agents, who under the new Act will become legally liable for any shortfall in quantity and any variation in quality, from what is stated in the warehouse receipt issued by them. Assuming that at any time, about 15–20 per cent of the annual agricultural produce is stored in warehouses, the Act has the potential to inject over US$ 30 billion of agricultural credit.

This is the kind of reform the country can easily achieve. Instead of focusing primarily on a few large, and usually politically controversial steps, we also need to take a hundred small steps in the same direction that will collectively take us very far. As another example, credit to small and medium enterprises could be boosted enormously if the trade receivable claims they have on large firms could be converted to electronic format, accepted by the large firms, and sold as commercial paper. Mexico has a central agency facilitating this process, there is no reason why we could not create an environment where some institution like the National Securities Depository Ltd could do this. All this is not to say that we should not tackle the controversial large issues, and the report does offer comprehensive proposals on them, but it is to say progress can be made even otherwise.

This is, however, a difficult time to propose financial sector reforms in India. The near meltdown of the US financial sector seems to be proof to some that markets and competition do not work. This is clearly the wrong lesson to take from the debacle. The right lesson is that markets and institutions do succumb occasionally to excesses, which is why regulators have to be vigilant, constantly finding the right balance between attenuating risk-taking and inhibiting growth. In the United States, they clearly failed this time. But this is not to say they cannot find the right balance elsewhere. At the same time, well-functioning competitive markets can reduce vulnerabilities—the US equity, government debt, and corporate debt markets, despite being close to the epicenter of the crisis, have remained far more resilient than markets in far away countries.

It is important to recognize that vulnerabilities may be building up in India. Underdeveloped markets and strict regulations on participation are no guarantee that risks are contained, in fact they may create additional sources of risk, a forewarning of which may come from recent reports of substantial losses incurred by corporations on currency bets. For instance, a significant quantity of lending is undertaken by non-bank financial companies (NBFCs), some of which are growing at extremely rapid rates, free of burdens that hamper other sectors and relatively free of regulatory oversight. These entities have a very light regulatory burden because they do not take deposits. Yet their funding could, in some cases, be short-term money from mutual funds or from deposit taking institutions like banks, even though their assets are long term. This structure is risky because of the mismatch between the duration of assets and the duration of funding. The banking system, which is part of this structure through its loans, is thus not insulated from risk because of its direct loan exposure to NBFCs.

The typical regulatory response is to tighten bank exposure norms. But if the NBFCs are to maintain lending and sustain economic growth, they have to find funding somewhere. NBFCs would be far more stable if they funded themselves with long-term debt from the corporate debt market. Moreover, the market and passive investors would absorb any risk associated with the NBFCs' lending, instead of that risk being passed on to financial institutions like banks. A corporate bond market could thus serve as a useful buffer between financial institutions, and be an important source of stability in the current environment. But as indicated earlier, this will require a number of ancillary reforms, some of which taken by themselves may seem to increase the potential for instability (such as opening the corporate bond market further to foreign investors). This is yet another reason why a holistic picture is necessary.

Put differently, the Asian financial crisis is etched in the minds of Indian commentators. Yet the primary lesson of the Asian financial crisis is not that foreign capital or financial markets are destabilizing, but that poor governance, poor risk management, asset liability mismatches, inadequate disclosure, excessive related party transactions, and murky bankruptcy laws, make an economic system prone to crisis. Financial sector reform can reduce these vulnerabilities substantially. As much as the Committee's report focuses on the need to deregulate certain areas of the financial sector, we also focus on creating necessary institutions, and closing important gaps in regulation. Clearly, there is little urgency for reforms because India is not in a crisis. This is where political leadership is of essence. Reforming in a crisis is similar to driving with a gun to your head—you pay more attention, but there is much greater risk of accidents. Better to do it in normal times!

This Committee believes that it is critically important to introduce new ideas (or reintroduce old ones) into the debate. India mulls over many issues far longer than some would like, but eventually takes the right step. With apologies to Keynes, practical pieces of legislation, that seem to be exempt of any intellectual influence, are usually drawn from some long-forgotten report. Despite the current political climate, this is indeed the reason we have no doubt that this report will not be a wasted effort.

In what follows, we list the Committee's major proposals, as well as a brief rationale for them. As far as possible, in this report the Committee has tried to focus on a few key areas, and even there, on broad principles and directions, without entering too much into details of implementation—the Committee's broad mandate necessitates such an approach. We do propose some intermediate, or bridging, steps wherever possible. We do not go into nuances in this chapter. We end the chapter with a discussion of possible sequencing.

The chapters that follow offer a much more detailed and nuanced analysis, as well as more specific, and ancillary, proposals. Anyone who wants to take issue with specific proposals should read the background chapter for that proposal before coming to a definite conclusion.

THE MACROECONOMIC FRAMEWORK

Chapter 2 is on the macroeconomic framework. The Committee believes that while monetary management has been very creditable thus far, the framework will need to adjust more to a world of rapid capital flows. While inflows have been the problem in recent years, outflows could well be a problem in the future. The Committee believes that given how open India has become, it will be impossible to control capital flows in either direction for anything more than the very short term, and even that will create substantial uncertainty and volatility in markets.

Moreover, given capital flows, the real exchange rate, which is the key factor determining India's competitiveness, is influenced by factors such as productivity growth and demand supply imbalances that are not changed by central bank intervention against the dollar. So given that the real appreciation has to take place, the country has the Hobson's choice of taking it as inflation or as a nominal exchange rate appreciation.

The central bank can keep the market guessing about which option it will choose, sometimes intervening in currency markets to keep the exchange rate fixed and accepting more inflation, and at other times letting the exchange rate appreciate while focusing on controlling inflation. This freedom of action however confuses markets, even while the real exchange rate goes where fundamentals say it must. This is not a theoretical assessment, it is consistent with the experience of a number of countries including ours. But the confusion does have adverse effects. To the extent that the public is not sure about the central bank's commitment to controlling inflation, it will expect higher inflation, and charge a high interest rate premium for inflation risk, both of which will increase long-term interest rates, hurting growth.

We therefore believe the Reserve Bank of India (RBI) can best serve the cause of growth by focusing on controlling inflation, and intervening in currency markets only to limit excessive volatility. This focus can also best serve the cause of inclusion because the poorer sections are least hedged against inflation. There are other benefits in choosing this option. By reducing the accumulation of foreign reserves beyond what is necessary for precautionary purposes, the burden on the budget will be limited. And an exchange rate that reflects fundamentals tends not to move sharply, and serves the cause of stability. Lastly exporters weaned away from expecting an undervalued exchange rate will focus on increasing productivity, thereby contributing to growth.

Proposal 1: The RBI should formally have a single objective, to stay close to a low inflation number, or within a range, in the medium term, and move steadily to a single instrument, the short-term interest rate (repo and reverse repo) to achieve it.

The RBI should be as willing to cut rates when inflation is expected to fall below the objective, so that the policy revives growth, as it is to raise rates when inflation is expected to exceed the objective because growth exceeds the economy's potential. It is in this way that the RBI can best support the objectives of growth and stability.

The Committee is well aware of the problems posed by substantial capital inflows. The real exchange rate is likely to appreciate when foreign capital flows in, and this can hurt the country's competitiveness. But what is the alternative? Is shutting off inflows, that is, imposing capital controls, likely to work in helping India retain competitiveness? We think not, simply because capital controls are ineffective beyond the short run. In an economy as open to trade as India is today, capital will always find a way to come in on the back of trade, for example as under-invoicing and over-invoicing, or as trade credit. Moreover, even though India looks attractive right now, it may not in the future. We should not stamp on foreign capital now for we may need to retain its confidence in the future. Similarly, sterilized currency intervention by the central bank can re-export inflows, but it is rarely effective beyond the short term, and creates a number of other costs for the economy.

While the Committee recognizes there are no easy solutions here, and a wide divergence of beliefs amongst respectable economists, the Committee believes we should use the current period when foreign investors are rediscovering India to strengthen India's markets so that foreign investors feel comfortable entering, and use them to help improve the experience for domestic investors too. For instance, given India's infrastructure needs, it has too few long-term domestic investors. Similarly, India relies too much on force-feeding government debt to its financial institutions. By allowing foreign investors in greater numbers into the corporate rupee-denominated bond market, we can build liquidity in that market through investors who are willing to take risks domestic investors are not. In turn, that liquidity will attract domestic investors and create a virtuous cycle. By allowing foreign investors into the government bond market, we fund our government debt more easily, freeing the balance sheets of domestic financial institutions to finance other entities and expand access.

Proposal 2: Steadily open up investment in the rupee corporate and government bond markets to foreign investors after a clear monetary policy framework is in place.

Of course, there is a worry about whether we will encourage more foreign inflows by opening debt markets further, exacerbating our real exchange rate appreciation. It may well be that some of those who now can only get India exposure through equity might switch to debt. But given our concern about appreciation, we should liberalize the bond markets opportunistically, expanding foreign investor limits more when other forms of capital inflows are at low ebb. Of course, it would not be prudent to wait till foreign investors shun India to liberalize, for there would be no interest precisely when the country needs them. Instead, we should accept the possible costs of appreciation as a legitimate down payment on the more robust markets and financing we will enjoy in the future.

We should also relieve pressure from inflows by becoming more liberal on outflows, especially in forms that can be controlled if foreign currency becomes scarce. For instance, we should encourage greater outward investment by provident funds and insurance companies when inflows are high. Such diversification will make these funds more stable (give them less exposure to high volatility Indian markets). The relevant constituencies need to be persuaded that by restricting their investment options to domestic government securities, they are greatly limiting future returns and possibly increasing risk. At the very least, a first step would be to diversify across foreign government securities, so that we offset foreign inflows into our government debt markets with outflows into foreign government debt markets, without these flows being driven by the RBI.

The Government of India must also recognize that fiscal discipline is an essential adjunct to the process of financial reforms. A high level of public deficit financing soaks up capital and has serious consequences for macroeconomic development and for the financial system. With a more flexible exchange rate and a more open capital account, fiscal policy also has an important role to play as a short-term demand management tool. Moreover, disciplined fiscal policy—lower levels of government deficits and a declining ratio of public debt to GDP—is necessary to free up monetary policy to focus on its key objective of price stability. Indeed, the effectiveness, independence and credibility of monetary policy can be severely compromised by high budget deficits. The principal elements of the framework laid out in this chapter—strengthening fiscal, financial and monetary institutions—would thus reinforce each other.

Finally, one cannot overemphasize the need for real sector reforms. Finance ultimately provides the lubrication that allows the engine of the economy to run smoothly. But it is not the engine itself—that needs real sector reforms such as building out infrastructure, reforming the labour laws, improving the social safety net, etc. The effects of the proposals made by this Committee will be magnified if they can piggy-back on real sector reforms.

BROADENING ACCESS TO FINANCE

In Chapter 3, the Committee turns to the most important issue of financial inclusion. The Committee proposes a paradigm shift in the way we see inclusion. Instead of seeing the issue primarily as expanding credit, which puts the cart before the horse, we urge a refocus to seeing it as expanding access to financial services, such as payments services, savings products, insurance products, and inflation-protected pensions. If, for example, the enormous transfers to the poor through various government programmes can be channelled into savings accounts that the poor open, not only will leakage be reduced, but the poor will be able to build savings histories with their bank which can then open the door to credit. Moreover, the financial experience dealing with the account and the bank will help households build a greater business capacity, a critical need in making better use of credit. This is why the Committee advocates a national goal of ensuring in three years that 90 per cent of households, if they so desire, have access to a deposit account and to the payments system, and that government transfers under various schemes be implemented through this system. While the proposed nationwide electronic financial inclusion system (NEFIS) could utilize much of the existing infrastructure, some elements, especially the last mile, will have to be built out, and should be encouraged on an expedited basis.

Ultimately, though, it is opportunities in the real sector, created by broader growth, which will give the poor the ability to use credit effectively. Instead of forcing credit to household that could thereby become heavily indebted, the focus should be on making them creditworthy so that when opportunities arise, they have access.

In addition, this Committee would suggest moving away from a sole focus on rural areas, where undoubtedly many of our poor live, to also include the urban areas where more of them are migrating. But perhaps the most important shift in paradigm is to alter the emphasis somewhat from the large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focused strategy for inclusion. The poor need efficiency, innovation, and value for money, which can come from motivated financiers who have a low cost structure and thus see the poor as profitable, but who also have the capacity of making decisions quickly and with minimum paperwork. The Committee proposes two organizational structures to foster such delivery:

Proposal 3: Allow more entry to private well-governed deposit-taking small finance banks offsetting their higher risk from being geographically focused by requiring higher capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms (loans as a share of capital that can be made to one party). Make significant efforts to create the supervisory capacity to deliver the greater monitoring these banks will need initially, and put in place a tough prompt corrective action regime that ensures these banks do not become public charges.

The small finance bank proposed above emulates the Local Area Bank initiative by the RBI that was prematurely terminated, though the details of the Committee's proposal differs somewhat. The intent is to bring local knowledge to bear on the products that are needed locally, and to have the locus of decision making close to the banker who is in touch with the client, so that decisions can be taken immediately. It would also offer an entry point into the banking system, which some entities can use to eventually grow into large banks.

A large number of commentators believe, based on historical evidence, that small banks will be unviable in India. They question the honesty of small promoters, as well as the profitability of these banks given high fixed costs. This Committee recognizes that small banks have not distinguished themselves in India in the past, often because of poor governance structures, excessive government and political support as well as interference, and an unwillingness/inability of the regulator to undertake prompt corrective action. These are not the banks the Committee wants, and the Committee would call for substantial care in who is licensed, as well as greater regulatory oversight.

There is, however, no necessary link between size and honesty, as the recent experience with large banks suggests. Indeed, the larger number of potential applicants for small banks suggests the regulator can be far more selective in applying 'fit and proper' criteria. Moreover, technological solutions can bring down the costs of small banks substantially, even while increasing their transparency. Finally, the failure of even a few small banks will not have systemic consequences, unlike the failure of a single large bank. In sum, the Committee believes there has been sufficient change in the environment to warrant experimentation with licensing small banks.

The second organizational structure the Committee proposes makes it easier for large financial institutions to 'bridge the last mile'. Large institutions have the ability to offer commodity products like savings accounts at low cost, provided the cost of delivery and customer acquisition is reduced. They should be able to use existing networks like cellphone kiosks or kirana shops as business correspondents to deliver products. The RBI's proposals on business correspondents, with some relaxations, are an important step in this direction.

Proposal 4: Liberalize the banking correspondent regulation so that a wide range of local agents can serve to extend financial services. Use technology both to reduce costs and to limit fraud and misrepresentation.

Cooperative banks, both urban and rural, are the face of banking that most Indians encounter. Unfortunately, primarily because of excessive political interference, poor governance and a willingness of governments to recapitalize and refinance even poor performers, this sector has underperformed seriously. This Committee supports the thrust of the Vaidhyanathan Committee recommendations on governance reforms and recommends they not be diluted in implementation. Indeed, it would suggest rethinking the entire cooperative bank structure, and moving more to the model practiced elsewhere in the world, where members have their funds at stake and exercise control, debtors do not have disproportionate power, and government refinance gives way to refinancing by the market. The Committee would suggest implementation of a strong prompt corrective action regime so that unviable cooperatives are closed, and would recommend that well-run cooperatives with a good track record explore conversion to a small bank license, with members becoming shareholders.

The Committee believes that priority sector mandates have a role in promoting inclusion, but they should be revised down to focus solely on the sectors that truly need access (including the urban poor). The process by which the mandates are implemented should be reformed to emphasize efficiency and ease of compliance, and once the new process is in place, the mandate should be strictly enforced. The focus should be on actually increasing access to services for the poor regardless of the channel or institution that does this—large banks may or may not be the best way to reach the poor, and while the mandate may initially force them to pay for expanding access, others may be able to offer the service more efficiently.

The Committee proposes the following scheme to allow a more efficient implementation of the priority sector lending mandate (with similar schemes extending to possible financial service mandates also—see later). Any registered lender (including microfinance institutions, cooperative banks, banking correspondents, etc.) who has made loans to eligible categories would get 'Priority Sector Lending Certificates' (PSLC) for the amount of these loans. A market would then be opened up for these certificates, where deficient banks can buy certificates to compensate for their shortfall in lending. Importantly, the loans would still be on the books of the original lender, and the deficient bank would only be buying a right to undershoot its priority sector-lending requirement by the amount of the certificate. If the loans default, for example, no loss would be borne by the certificate buyer. The merit of this scheme is that it would allow the most efficient lender to provide access to the poor, while finding a way for banks to fulfil their norms at lower cost. Essentially the PSLC will be a market-driven interest subsidy to those who make priority sector loans.

Proposal 5: Offer priority sector loan certificates (PSLC) to all entities that lend to eligible categories in the priority sector. Allow banks that undershoot their priority sector obligations to buy the PSLC and submit it towards fulfilment of their target.

One big factor impeding the flow of credit from formal institutions to the poor is that interest rate ceilings (either imposed by the centre or the state) make priority sector lending unprofitable, and ensure that the banker attempts to recover his money through hidden charges in the loans that are made, or that he does not lend so the poor are driven to the moneylender. The Committee believes a better way to proceed is to liberalize interest rates while increasing safeguards that prevent exploitation.

Proposal 6: Liberalize the interest rate that institutions can charge, ensuring credit reaches the poor, but require (*i*) full transparency on the actual effective annualized interest cost of a loan to the borrower, (*ii*) periodic public disclosure of maximum and average interest rates charged by the lender to the priority sector, (*iii*) only loans that stay within a margin of local estimated costs of lending to the poor be eligible for PSLCs.

Liberalizing interest rates would allow the formal sector to lend to the poor and keep them from the moneylender, though liberalization would require the political will to accept the widespread evidence that low interest rate ceilings simply do not help the poor. Formal institutions will have reputational reasons to not charge exorbitant rates, even after liberalization. The Committee believes that through a combination of transparency, incentives, and eventually competition, liberalized interest rates to the poor can be kept within reasonable limits, and liberalization would enhance, and improve the sources of, credit to the poor.

The Committee believes that we also have to improve methods of risk mitigation for the poor. Finally, technology may be the way of reducing costs so that services can be provided cheaply, and the Committee examines potential actions the government can take to facilitate roll-out.

LEVELLING THE PLAYING FIELD

There are a number of ways the playing field is not level in India. Some institutional forms, such as banks, are favoured in certain ways relative to others, while disfavoured in other ways. The public sector is constrained in some ways but enjoys some privileges in other ways. The domestic private sector enjoys some privileges relative to foreign players, but not everywhere. In an efficient financial system, the playing field is level so that different institutions compete to provide a function, no institution dominates others because of the privileges it enjoys, competition results in resources being allocated efficiently, and society gets the maximum out of its productive resources. This is also equitable for only thus will the interests of the consuming masses be emphasized, instead of the more usual trend of privileged producers being protected.

The Committee makes a number of recommendations on ways to level the playing field, with a focus on the banking sector. In particular, it believes it is time to unwind the grand bargain underlying the treatment of banks in India whereby banks get access to low-cost deposits in return for fulfilling certain social obligations such as lending to the priority sector, as well as meeting prudential norms such as statutory liquidity ratios (that also have a quasi-fiscal objective of funding the government). The reason, quite simply, is that the bargain will become increasingly unbalanced as competition erodes bank privileges. This is why the Committee suggests that the government pay more directly for the social obligations it wants banks to undertake (for example, by reducing priority sector obligations and, over time, paying directly for PSLCs), while it steadily allows more competition in banking activities.

Perhaps the greatest source of uneven privileges in the banking system stems from ownership. The public sector banks, accounting for 70 per cent of the system, enjoy benefits but also suffer constraints, with the latter increasingly dominating. There is little evidence that the ownership of banks makes any difference to whether they undertake social obligations, once these are mandated or paid for. So on net, what matters is how an ownership structure will affect the efficiency with which financial services are delivered. And it is here that government ownership is likely to have serious adverse effects going forward. Much of the public sector is falling behind in its ability to attract skilled people, especially at senior levels, in its ability to take advantage of new technologies, in its ability to motivate employees at lower levels, and in its ability to innovate. Since all these capabilities are needed in the emerging areas of opportunity, public sector banks risk falling seriously behind, and because risk management is one of the needed new areas, also risk becoming destabilizing.

The majority of this Committee does not see a compelling reason for continuing government ownership. There are other activities where government attention and resources are more important. However, the Committee does recognize that public opinion in the country is divided on the issue of privatization. A parallel approach is to undertake reforms that would remove constraints on the public sector banks, even while retaining government ownership. Intermediate steps such as reducing the government's ownership below 50 per cent while retaining its control (as suggested by the Narasimham Committee) are also possible.

Unfortunately, ideology has overtaken reasoned debate in this issue. The pragmatic approach, which should appeal to practical people of all hues, is to experiment, as China does so successfully, and to use the resulting experience to guide policy. One aspect of the pragmatic approach would be to sell a few small underperforming public sector banks, possibly through a strategic sale (with some protections in place for employees), so as to gain experience with the selling process, and to see whether the outcomes are good enough to pursue the process more widely.

Proposal 7: Sell small underperforming public sector banks, possibly to another bank or to a strategic investor, to gain experience with the process and gauge outcomes.

For the largest PSBs, the options are more limited. The selling of large PSBs to large private sector banks would raise issues of concentration. The selling of banks to industrial houses has been problematic across the world from the perspective of financial stability because of the propensity of the houses to milk banks for 'self-loans'. Without a substantial improvement in the ability of the Indian system to curb related-party transactions, and to close down failing banks, this could be a recipe for financial disaster. While large international banks could swallow our largest banks, it is unlikely that this would be politically acceptable, at least in the foreseeable future. That leaves a sale through a public offering. But such a sale would require confidence in the corporate governance of these enterprises so that a high price can be realized.

This Committee therefore believes that the second aspect of the pragmatic approach, especially for large and better performing public sector banks, should be to focus on reforming the governance structure, while perhaps also acquiring strategic partners, with the eventual disposition determined based on experience with privatization, the public mood, and the political environment.

Proposal 8: Create stronger boards for large public sector banks, with more power to outside shareholders (including possibly a private sector strategic investor), devolving the power to appoint and compensate top executives to the board.

Proposal 9: After starting the process of strengthening boards, delink the banks from additional government oversight, including by the Central Vigilance Commission and Parliament, with the justification that with government-controlled boards governing the banks, a second layer of oversight is not needed. Further ways to justify reduced government oversight is to create bank holding companies where the government only has a direct stake in the holding company. Another is to bring the direct government stake below 50 per cent, perhaps through divestment to other public sector entities or provident funds, so that the government (broadly defined) has control, but the government (narrowly defined) cannot be considered the owner.

Turning from the public sector to the banking sector as a whole, the Committee believes that fewer constraints should be imposed on banks, and more growth, competition, and entry should be encouraged. One method to foster bank growth is to allow bank mergers.

To the extent that takeovers of Indian banks (or domestically incorporated subsidiaries of foreign banks) do not raise issues of excessive concentration or stability, they should be permitted. It may be sensible to start by being more liberal towards the takeover of small banks with a view to allowing bidders, targets, regulators, and market participants gain experience in how to manage takeovers. Domestically incorporated foreign banks should be treated on par with private and public sector Indian banks in this regard from April 2009, as announced by the RBI in its roadmap.

Proposal 10: Be more liberal in allowing takeovers and mergers, including by domestically incorporated subsidiaries of foreign banks.

The commitment to allow foreign banks subsidiaries to participate in takeovers will substantially increase the pressure on domestic banks. This can be salutary, but domestic banks need to prepare themselves to meet the challenge. A second way to foster growth and competition, but also to strengthen banks, is to de-license the process of branching immediately. The RBI can retain the right to impose restrictions on the growth of certain banks for prudential reasons, but this should be the exception rather than the norm.

Proposal 11: Free banks to set up branches and ATMs anywhere.

Domestic banks have not had the freedom to set up branches anywhere thus far, and will not have anticipated such liberalization (which was not an element of the RBI roadmap). Given that foreign banks have deeper pockets, experience, and skills relative to domestic banks in rolling out a branching strategy in the newly liberalized environment, the Committee believes it necessary to allow a period of say two years from the announcement of the policy till the liberal licensing policy applies to domestically incorporated subsidiaries of foreign banks. Till such time, the existing policy of branch licensing will apply to domestically incorporated subsidiaries of foreign banks. They will, however, be able to acquire branches through takeovers of existing Indian banks.

One objective of branch licensing is to force banks into under-banked areas in exchange for permission to enter lucrative urban areas. This is again an obligation that will have to be revisited as competition increases in urban areas, but it can be explicitly achieved today by instituting a service norm—for every x savings accounts that are opened in high income neighbourhoods, y low-frill accounts have to be opened in low income neighbourhoods. The service provision obligation could become traded (much as the priority sector norms earlier), with small banks or cooperatives acquiring certificates for the excess number of accounts they provide and selling them to deficient banks. The government may provide added incentives by buying certificates, and should take over this obligation from banks over time.

Turning finally to the need for structures that allow a variety of financial functions under one roof, the Committee endorses much of the RBI proposal for holding companies.

Proposal 12: Allow holding company structures, with a parent holding company owning regulated subsidiaries. The holding company should be supervised by the Financial Sector Oversight Agency (see later), with each regulated subsidiary supervised by the appropriate regulator. The holding company should be well diversified if it owns a bank.

Universal banking should thus be possible in India through holding company structures. Some legislative and tax change is required to make these structures viable, and these are outlined in the report.

CREATING MORE EFFICIENT AND LIQUID MARKETS

Financial markets and institutions need to evolve considerably in order to keep up with the requirements of Indian firms and Indian investors in coming years. The corporate bond market is moribund and will have to be revived and a number of missing markets will have to be created, including exchange traded interest rate and foreign exchange derivatives contracts. But even in markets that exist, apart from the equity market for large capitalization stock, the ability to trade consistently at low cost (that is, liquidity) and the tendency of market prices to reflect fundamentals (that is, market efficiency) are typically low for most markets. This needs to change for markets to play a bigger role in inclusion, growth and stability.

In the equity markets, the environment needs to be made more conducive to private equity, venture capital, and hedge funds. Mutual funds and pension funds (when they emerge) should play a more active role in governance. In other markets, participation needs to increase substantially to enhance liquidity, and foreign players could play a key role, as could domestic financial institutions such as insurance companies and provident funds. Access to markets for the poor need to be increased, as does access to international financial services for Indian firms and investors. The production of international financial services by Indian financial firms needs to be enhanced.

Turning to specific suggestions, the Committee believes that there are substantial efficiencies to be had by consolidating the regulation of trading under one roof—this will allow scope economies to be realized, improve liquidity, and increase competition. Moreover, all markets are interconnected, so fragmenting regulation weakens our ability to regulate.

Therefore,

Proposal 13: Bring all regulation of trading under the Securities and Exchange Board of India (SEBI).

In areas where multiple regulators share concerns about a market (for example, RBI has a legitimate interest in the government bond market), regulators will have to cooperate even after the supervision of trading moves to SEBI. The rest of the Committee's main market-related proposals are self-explanatory.

Proposal 14: Encourage the introduction of markets that are currently missing such as exchange traded interest rate and exchange rate derivatives.

Proposal 15: Stop creating investor uncertainty by banning markets. If market manipulation is the worry, take direct action against those suspected of manipulation.

Proposal 16: Create the concept of one consolidated membership of an exchange for qualified investors (instead of the current need to obtain memberships for each product traded). Consolidated membership should confer the right to trade all the exchange's products on a unified trading screen with consolidated margining.

Proposal 17: Encourage the setting up of 'professional' markets and exchanges with a higher order size, that are restricted to sophisticated investors (based on net worth and financial knowledge), where more sophisticated products can be traded.

Proposal 18: Create a more innovation-friendly environment, speeding up the process by which products are approved by focusing primarily on concerns of systemic risk, fraud, contract enforcement, transparency and inappropriate sales practices. The threshold for allowing products on professional exchanges (see Proposal 16) or Over the Counter markets should be lower, so that experimentation can take place.

Proposal 19: Allow greater participation of foreign investors in domestic markets as in Proposal 2. Increase participation of domestic investors by reducing the extent to which regulators restrict an institutional investor's choice of investments. Move gradually instead to a 'prudent man' principle where the institutional investor is allowed to exercise judgement based on what a prudent man might deem to be appropriate investments. Emphasize providing access to suitable equity-linked products to the broader population as part of the inclusion agenda.

CREATING A GROWTH-FRIENDLY REGULATORY ENVIRONMENT

Sixteen years of reforms have created a fairly sound regulatory framework. Though the task is by no means complete, the groundwork that has been laid will allow us to move rapidly towards the regulatory architecture that is appropriate for a country of India's size and aspirations. While building on past successes, it is also important to remember there are deficiencies in the current regulatory system.

A number of problems exemplify the substantial road that still has to be travelled in achieving an adequate financial regulatory and supervisory structure in India. First, the pace of innovation is very slow. Products that are proposed to be introduced in India (though well established elsewhere in the world) take several years to get regulatory approval.

Second, excessive regulatory micro-management leads to a counter-productive interaction between the regulator and the regulated. The regulated respond to the needs and opportunities in the marketplace while attempting to comply only with the letter of the law. The regulator then attempts to stamp out violations of the spirit through new rules and the regulated find new ways to get around them.

Third, some areas of the financial sector have multiple regulators, while others that could pose systemic risks have none. Both situations, of unclear responsibility, and of no responsibility, are dangerous.

Fourth, regulators tend to focus on their narrow area to the exclusion of other sectors, leading to balkanization even between areas of the financial sector that naturally belong together. Financial institutions are not able to realize economies of scope in these areas, leading to inefficiency and slower growth. Moreover, by ignoring the links between areas, regulators miss sources of systemic risk. Macro-prudential risk assessments will become increasingly important as the economy modernizes and becomes integrated with the world economy.

Finally, regulatory incentive structures lead to excessive caution, which can be augmented by the paucity of skills among the regulator's operational staff relative those of the regulated. Such caution could actually exacerbate risks.

Of course, any discussion of regulation has to take cognizance of the recent turmoil in financial markets in industrial countries. While it is too early to draw strong lessons, a number of issues seem apparent:

1. It is not sufficient for regulators to only look at the part of the system under their immediate purview. Because markets are integrated, any unregulated participant can infect markets and thus contaminate regulated sectors also. For instance, there is some evidence that unregulated mortgage brokers originated worse loans than regulated ones, contaminating the securitization process. While the immediate conclusion is not to regulate everyone to the same degree, it does suggest regulators have to be alert to entities that could have systemic consequences, including on markets.
2. Capital regulation is no substitute for ensuring the incentives of financial institution management are adequate—that the spirit of the regulation is being obeyed rather than just the rule. For example, the off-balance sheet entities of the major banks, including the structured investment vehicles (SIVs), met the rules of being off-balance sheet (and hence did not require a charge on capital), but in practice turned out to be effectively on-balance sheet. Indeed, there is increasing debate about whether the Basel II capital norms are adequate, both in good times in preventing excessive risk taking, and in bad times when strict capital norms can hold back bank lending and result in a downward spiral.
3. In a market-based system, banks are not the only source of illiquidity risk. Any entity that has mismatched assets and liabilities (mismatched in terms of duration or liquidity) is subject to the risk of becoming illiquid. To the extent that entity is of systemic importance—either too big, too interlinked, or too many investors to fail—it will have a call on public funds. To the extent that regulators are likely to provide either liquidity or solvency support (and the line between these is very thin), they owe it to the public to monitor these entities and ensure the charge on the taxpayer is limited. Moreover, systems will have to be evolved to assess and maintain the overall liquidity position of the financial system, over and above its capital adequacy.
4. Deep markets with varied participants can absorb overall risk better. While indeed

the risk that has infected world markets started in the US sub-prime sector, in part because of excessive financial exuberance, despite its proximity and exposure the United States financial system has weathered the losses thus far surprisingly well. Indeed, US equity markets have held up better than the Indian stock markets! Part of the reason has to be its openness and variety. US banks could recapitalize quickly by tapping into sovereign wealth funds elsewhere. Even while banks are hamstrung by overloaded balance sheets, hedge funds and private equity players are entering the markets for illiquid assets.

5. Consumer protection is important. Not every household is fully cognizant of the transactions they enter into. While the line between excessive paternalism and appropriate individual responsibility is always hard to draw, in a developing country like ours, it may well veer to a little more paternalism in interactions between financial firms and less-sophisticated households. It is important to improve consumer literacy, the transparency of products that are sold, and in some cases, limit sales of certain products in certain jurisdictions, especially if they have prudential consequences.
6. There is no perfect regulatory system. The problems with Northern Rock in the United Kingdom are being attributed to the fact that the United Kingdom had moved to a single supervisor, the Financial Services Authority (FSA), with the monetary authority having no supervisory powers. At the same time, the Bear Stearns debacle in the United States is being attributed to the absence of a single supervisor. What is essential is effective cooperation between all the concerned authorities, which transcends the specifics of organizational architecture.

In sum then, the Committee believes that there is no room for complacency. The imperatives of the need to grow the economy and improve inclusion will necessarily create more risk. The regulators cannot stand in the way, they have to monitor and manage the greater risk, and the public has to be more tolerant of regulators in that more losses are part and parcel of the greater risk. At the same time, we have to become more clever about managing the risks, focusing efforts better at warding off the really big ones, and making participants cooperate more in the process rather than making them adversaries. Furthermore, financial sector development can help the risk management process, both by reducing risks, and by shifting them to where they can be borne better, a theme through much of this report. The Committee's proposals therefore seek to create:

1. A better risk management process for regulators and the regulated, addressing both the environment in which they operate, as well as the way they tackle risks, while allowing the innovation needed to spur growth.
2. A more streamlined regulatory architecture that reduces regulatory costs, overlaps, silos, and gaps.
3. Better coordination between regulators so that systemic risks are recognized early and tackled in a coordinated way.
4. A coordinated process to protect consumer interests as well as raise literacy levels.
5. Better frameworks for reducing the level of financial risk—for example, through prompt corrective action.

Changes to legislation

The primary source of the micro-management starts with the legislation governing regulation. For instance, the requirement that banks obtain regulatory approval for a range of routine business matters, including opening branches, remuneration to board members and even payment of fees to investment bankers managing equity capital offerings, is enshrined in the Banking Regulation Act. The Committee supports the recommendation of the High Powered Expert Committee on Making Mumbai an International Financial Centre that legislation governing financial sector regulation has to be fundamentally rewritten, focusing on broad principles rather than specific rules.

Proposal 20: Rewrite financial sector regulation, with only clear objectives and regulatory principles outlined.

However, such legislation would have to be drafted carefully, as Indian courts are not likely to look upon excessive delegation favourably (the Supreme Court of India has held that the 'essential legislative function' cannot be delegated and a statutory delegate cannot be given an unguided or un-canalized power). What should be left to the regulator is the ancillary function of providing the details.

Changes to the process of evaluation and compensation

It should also be recognized that excessive micro-management or rule-based regulation is not merely reflective of the statute books of the nation, but is also reflective of the approach adopted by the regulator. A regulator that adopts a 'rule-based' approach will seek to prosecute every minor breach of a rule, irrespective of its import in the larger scheme of things. It may well be that the regulator's fear that an acquittal may result in a possible vigilance commission inquiry leads to this emphasis. By contrast, when adopting a 'principle-based' approach, a regulator may ignore a minor violation of positive law, so long as the spirit of the laws is retained.

This is why the Committee believes that regulators should be given a clearer sense of their mandate and the specific outcomes they will be evaluated on, with any evaluation focused on whether those outcomes were achieved, and if not, whether the actions the regulator took had a high expectation of achieving the outcomes at the time they were taken. In other words, regulators at the highest level should not run the risk of having to face roving enquiries that second guess specific decisions with the benefit of hindsight. Regular interaction with parliament, where they explain how they are adhering to their mandate, should give them safe harbour against such enquiries.

Proposal 21: Parliament, through the Finance Ministry, and based on expert opinion as well as the principles enshrined in legislation, should set a specific remit for each regulator every five years. Every year, each regulator should report to a standing committee (possibly the Standing Committee on Finance), explaining in its annual report the progress it has made on meeting the remit. The interactions should be made public.

In addition, to ensure there are more direct checks on the regulator in a system that is less rule-bound, the Committee recommends Proposal 22.

Proposal 22: Regulatory actions should be subject to appeal to the Financial Sector Appellate Tribunal, which will be set up along the lines of, and subsume, the Securities Appellate Tribunal.

To enhance the quality of regulatory staff, the Committee suggests that regulators continue their ongoing attempts to give recruits higher remuneration as well as responsibilities, but also that every effort should be made to allow mobility to and from the private sector. Each individual organization will, however, have to take reasonable precautions against conflicts of interest arising out of prior or subsequent employment.

Changes to the regulatory architecture

The Committee felt it premature to move fully towards a *single* regulator at the moment, given other pressing regulatory changes that are needed. However, regulatory structures can be streamlined to avoid regulatory inconsistencies, gaps, overlap, and arbitrage. Steps in this direction should include a reduction in the number of regulators, defining their jurisdiction wherever possible in terms of functions rather than the forms of the players, and ensuring a level playing field by making all players performing a function report to the same regulator regardless of their size or ownership. In addition, the Committee felt it is prudent to start the process of unifying regulation and supervision at certain levels, and recommends a strengthening and consolidation of regulatory structures to deal with large complex, systemically important, financial conglomerates on the one hand, and with the consumer on the other.

One aspect of regulatory architecture has already been presented—to bring all regulation of trading under SEBI. The Committee also suggests a proposal (23).

Proposal 23: Supervision of all deposit taking institutions must come under the RBI. Situations where responsibility is shared, such as with the State Registrar of Cooperative Societies, should gradually cease. The RBI will have to increase supervisory capacity to take on this task. The Committee recognizes this involves constitutional issues but nevertheless recommends a thorough overhaul of the system of shared responsibility.

Drawing a lesson from the current crisis in industrial countries, the Committee recommends that joint responsibility for monetary policy and banking supervision continue to be with the RBI, and that the RBI play an important role in the joint supervision of conglomerates and systemically important NBFCs (see the proposal for the Financial Sector Oversight Agency below).

In India, annual accounts are filed with the Registrar of Companies under the Department of Company Affairs in the Government of India. However there is no system of reviewing accounting reports even on a selective or sample basis. The Committee believes that such a process of review is absolutely essential so that the public can have more confidence in company reports. This process can be outsourced initially. Furthermore, it should be monitored carefully so that it does not become a source of harassment but indeed adds genuinely to public confidence in accounts.

Proposal 24: The Ministry of Corporate Affairs (MCA) should review accounts of unlisted companies, while SEBI should review accounts of listed companies.

As financial conglomerates or holding companies begin to dominate the system, a consolidated system of supervision becomes more important. Moreover, spillovers between various aspects of the financial system necessitate constant communication between regulators at the highest levels. Regulators also need to have an overall view of the financial sector to initiate prompt and coordinated corrective action, and to remove inconsistencies in approach. Even though our Committee recommends separate prudential regulators, it strongly recommends strengthening the ties between them and improving coordination.

Proposal 25: A Financial Sector Oversight Agency (FSOA) should be set up by statute. The FSOA's focus will be both macro-prudential as well as supervisory; the FSOA will develop periodic assessments of macroeconomic risks, risk concentrations, as well as risk exposures in the economy; it will monitor the functioning of large, systemically important, financial conglomerates; anticipating potential risks, it will initiate balanced supervisory action by the concerned regulators to address those risks; it will address and defuse inter-regulatory conflicts.

The FSOA should be comprised of chiefs of the regulatory bodies (with a chair, typically the senior-most regulator, appointed from amongst them by the government), and should also include the Finance Secretary as a permanent invitee. The FSOA should have a permanent secretariat comprised of staff including those on deputation from the various regulators. There should be a prescribed minimum frequency of meetings of the FSOA. All issues of regulatory coordination, and supervision of systemically important financial conglomerates and financial institutions will be taken up by the FSOA.

The discussions of the FSOA with the management of systemically important institutions will be 'principles-based', and this will initiate the process of gradually implementing more 'principles-based' regulation throughout the system. It will be important that the FSOA add value by substituting for some existing processes instead of adding another layer, while bringing collective regulatory views to bear. It is not our intent that the FSOA be a 'super-regulator' displacing existing regulators. Instead it provides needed coordination and fills gaps that current structures have proved inadequate for.

In addition, there is merit in setting up a Working Group on Financial Sector Reforms with the Finance Minister as the Chairman. The main focus of this working group would be to monitor progress on financial sector reforms (such as the proposals of the Patil, Parekh, Mistry, and this Committee), and to initiate needed action. The working group's membership would include the regulators, as well as ministries on as-needed basis. The working group would be supported by a secretariat inside the Finance Ministry.

Proposal 26: The Committee recommends setting up a Working Group on Financial Sector Reforms with the Finance Minister as the Chairman. The main focus of this working group would be to shepherd financial sector reforms.

The Committee also notes the consumer faces an integrated portfolio of services. It is increasingly important for the consumer to have a 'one stop' source of redress for complaints, a financial ombudsman. Also, an integrated ombudsman is needed to enhance financial literacy and financial counseling, issues that span regulators. The ombudsman can also monitor the selling of different products, the degree of transparency about their pricing, and their suitability for targeted customers. Finally, given that household debt loads are increasing, the ombudsman can provide a neutral forum (and possibly act as an arbitrator) for out-of-court negotiated settlement of debt.

Proposal 27: Set up an Office of the Financial Ombudsman (OFO), incorporating all such offices in existing regulators, to serve as an interface between the household and industry.

Finally, the Committee noted that a large number of undercapitalized deposit taking entities continued to survive in the system. Regulatory forbearance should be the exception, especially when there is more rapid entry into the system.

Proposal 28: The Committee recommends strengthening the capacity of the Deposit Insurance and Credit Guarantee Corporation (DICGC) to both monitor risk and resolve a failing bank, instilling a more explicit system of prompt corrective action (see Proposal 3), and making deposit insurance premia more risk-based.

The combination of the proposed changes to legislation, regulatory incentive structures, and regulatory architecture, should help create a far more enabling regulatory framework, which will provide for greater stability, higher growth and innovation, and more inclusion.

CREATING A ROBUST INFRASTRUCTURE FOR CREDIT

In order for credit to flow freely, lenders should have sufficient knowledge about borrowers, be able to take the borrower's assets as collateral, be able to enforce penalties in case the borrower defaults (such as shutting the borrower's access to credit, at least for a while, or seizing the borrower's pledged assets), and be able to renegotiate their claims in an orderly fashion in case the borrower is simply not able to pay. A strong credit infrastructure allows widespread credit information sharing, low-cost pledging and enforcement of collateral interests, and an efficient bankruptcy system, which renegotiates un-payable financial claims while preserving the assets in their best use.

Even though a strong credit infrastructure seems to enhance creditor rights only, research shows it also significantly enhances the capacity of individuals to borrow, since creditors are now confident they will be repaid. Conversely, weakening the infrastructure, which seems politically appealing, while seemingly letting borrowers off the hook, also hurts their future access to credit. Despite progress on a number of fronts, India still has weak credit infrastructure, a major factor in limiting financial inclusion. Some of the Committee's key proposals are stated below.

Proposal 29: Expedite the process of creating a unique national ID number with biometric identification.

Any system of tracking individual information requires a unique identifier, and our credit information system is hampered by the lack of one. Furthermore, in a country where so many of our people are excluded from the formal financial system, credit information alone may not help inclusion much because so many have never had credit. More sources of information, such as payments of rent or of utilities/cell-phone bills, need to be tapped to build individual records of payment, which can then open doors to credit and expand access.

Proposal 30: The Committee recommends movement from a system where information is shared primarily amongst institutional credit providers on the basis of reciprocity to a system of subscription, where information is collected from more sources and a subscriber gets access to data subject to verification of 'need to know and authorization to use' of the subscriber by the credit bureau. This will also require rethinking the incentives of providers to share information, and a judicious mix of payments as well as mandatory requirements for information sharing will have to be developed.

Turning to collateral, it can be pledged if the potential borrower has clear title to assets. Land is probably the single most valuable physical asset in the country today. Unfortunately, the murky state of property rights to land make it less effective as collateral than it could be. The current state of land rights has many other adverse effects, including preventing agricultural land from migrating to its best use, slowing land acquisition for industrial and infrastructure projects, clogging courts with disputed cases, and elevating the level of political conflict. While making land rights clear and transparent is expensive, it is probably one of the most pressing needs of the country today.

Proposal 31: Ongoing efforts to improve land registration and titling—including full cadastral mapping of land, reconciling various registries, forcing compulsory registration of all land transactions, computerizing land records, and providing easy remote access to land records—should be expedited, with the Centre playing a role in facilitating pilots and sharing experience of best practices. The Committee also suggests the possibility of special law courts to clear the backlog of land disputes be examined.

Widespread prohibition of land leasing is not consistent with efficient resource allocation. It raises the cost to rural-urban migration as villagers are unable to lease their land, and often have to leave a family member (typically the wife) behind to work the land. Lifting these restrictions can help the landless (or more efficient large land owners) get land from those who migrate, and allow those who currently lease land informally to formalize their transactions and thus obtain institutional credit and other benefits. To the extent that liberalization of land leasing enhances owners' security and may allow adoption of long-term contracts, it is also likely to increase investment incentives for all parties.

Proposal 32: Restrictions on tenancy should be re-examined so that tenancy can be formalized in contracts, which can then serve as the basis for borrowing.

Given clear title to an asset, let us now turn to the process of registering a creditor's interest in the asset. In order for creditors to establish they have a secured claim to an asset, and in order that prospective lenders or purchasers be made aware of prior claims, a well organized system to register and publicize security interests is essential. The current system of registration in India is fragmented and neither fully computerized nor easily accessible. The Committee offers some suggestions in the report on how this can be remedied.

Once registered, secured debt claims are valuable only if they are enforced. Two important recent initiatives towards this purpose are the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SRFAESI), and asset reconstruction companies (ARCs).

The SRFAESI Act helps secured creditors by promoting the setting up of asset reconstruction companies to take over the Non-Performing Assets (NPAs) accumulated with the banks and public financial institutions. Furthermore, it provides special powers to lenders and asset reconstruction companies to enable them to take over the assets of borrowers without first resorting to courts. There is no reason though that only a special group should enjoy the powers of SRFAESI.

Proposal 33: The powers of SRFAESI that are currently conferred only on banks, public financial institutions, and housing finance companies should be extended to all institutional lenders.

ARCs have additional powers such as step-in rights and the ability to change management, and the right to sell or lease the business. Given these additional powers, it is important that a number of ARCs flourish so that no single ARC has excessive power. There is really no sensible case to keep foreign direct investment out of ARCs. The kind of risk capital as well as the kind of expertise foreign investors bring is useful in the economy, and can help provide a valuable buffer. From an economic perspective, capital that comes into the country when the banking sector is distressed and a flood of assets are sold to ARCs, is particularly valuable, and foreign investors, not domestic financial institutions, are most likely to be flush with capital at those times.

Proposal 34: Encourage the entry of more well-capitalized ARCs, including ones with foreign backing.

Finally, while secured creditors have been empowered, unsecured creditors still have little protection. If India is to have a flourishing corporate debt market, corporate public debt, which is largely unsecured, needs to have value when a company becomes distressed. This means a well functioning bankruptcy code, that neither protects the debtor at the expense of everyone else including employees, as our current system does, nor one that allows secured creditors to drive a well-functioning firm into the ground by seizing assets. A good bankruptcy code is especially needed for large complex infrastructure projects, which typically have many claimholders.

Proposal 35: The Committee outlines a number of desirable attributes of a bankruptcy code in the Indian context, many of which are aligned with the recommendations of the Irani Committee. It suggests an expedited move to legislate the needed amendments to company law.

In the final chapter, the Committee offers views on three important topics, the financing of infrastructure, the financing of old age pensions, and the generation of information in the economy.

PRIORITIES AND SEQUENCING

Low hanging fruit

Many of the proposals of this Committee are not controversial, do not conflict with any political party's views, and require little legislative effort. They should be implemented on an expedited basis. These proposals include almost all the proposals on financial inclusion, on improving markets, and on improving the credit infrastructure.

In particular, it ought to be a national priority to roll out a unique national ID number tied to biometric identification, to offer access to a linked 'no-frills' savings account for every household that wants one, and to channel all government transfer payments to poor households through such accounts. The credit information sharing system should be reformed to allow more information, such as rental and utility payments, to be used in assessing credit histories. Credit information should also be made available to a wider group of users, with appropriate safeguards.

With financial services reaching a wider fraction of the population, the Office of the Financial Ombudsman (OFO) should be set up so as to expand customer literacy, prevent exploitation, arbitrate grievances, and facilitate debt settlements. Technological innovations to reduce transactions costs (such as mobile payments) and new institutional and contractual structures (such as warehouse receipts and trade credit acceptances) should be encouraged.

Many of the market reforms we have suggested in Chapter 5 are also not technically difficult or politically controversial. They typically require steady liberalization and institution building, and will likely occur if the regulatory authorities exercise leadership, and are given support.

Technically simple but difficulties exist

A variety of reforms are technically quite simple (they do not require new thinking, new institutions, or substantial new legislation) but either do not command widespread consensus among technocrats, or are opposed by regulators or interest groups.

Among the reforms that do not command widespread consensus include those on monetary policy and on liberalizing the few remaining capital controls opportunistically. This report has encouraged more debate on these issues, and it is our hope that technocrats will realize the merit of our proposals. Unfortunately, this is an area where experimentation is not possible, and policy will have to be reformed in the face of substantial uncertainty. All the policy choices involve some benefits and some costs. A pragmatic assessment needs to be made about the path that is best suited for India's trajectory as a fast growing and rapidly internationalizing economy. Ultimately, though, it is our belief that if we do not undertake the needed reforms willingly, circumstances will force our hand.

Some reforms, such as allowing more small banks, are controversial amongst technocrats, burnt by the past experience with small cooperative banks. But unlike with macroeconomic policy, experiments can, and have, been conducted (see, for example, the licensing of Local Area Banks). We need a more pragmatic approach here amongst policymakers, and need to begin experimenting more widely. Successful experiments should be rolled out quickly on a nationwide scale. Amongst the other policies where experiments or evidence could prove useful are the Priority Sector Loan Certificate scheme, and the proposal to liberalize interest rates.

Improving land titling and registration is a reform, the need for which is not controversial but for which the right approach is a matter of substantial debate. Experiments have been under way in different states, and it is now important to distill lessons, develop a national consensus on a possible approach (or approaches), and find a way to allocate the expenses. Administrative, rather than political, leadership is required here.

Many of the reforms relating to banking—freeing bank branching, allowing public sector bank boards more freedom and improving bank governance—are blocked because of a natural belief (or desire) amongst some in (or for) command and control. The need here is for a reformist government that is willing to limit its powers (and the powers of future governments) in the national interest.

Finally, the costs of dealing with economic fluctuations will be reduced if we have a rapid and transparent process of dealing with the financial distress of households, firms, and financial institutions. While the OFO could help create a structure for households, much of the elements of a viable corporate bankruptcy code are in place and should be enacted rapidly, and the systems in place for dealing with the distress of large financial institutions should be stress-tested, and deficiencies remedied. It will be much harder putting codes and systems in place in the midst of financial turmoil, when vested interests will come to the fore, so it is best to undertake these reforms now. At the same time, one should not minimize the strength of the interests already in existence, who favour a distress resolution system based on government preferences and patronage, rather than on an arm's length process.

Technically and politically difficult

The toughest reforms are clearly those that are technically difficult (in that there is no agreement on the details on how it would be carried out) and politically controversial (in that support will have to be built for the substantial amount of legislation involved, and to overcome vested interests). These include substantially reducing government control in the financial sector and regulatory reform (such as rewriting archaic legislation to make it more principles based and streamlining the regulatory architecture). While they are extremely important for the health of the financial sector, they will take time. The Committee would suggest that a first step be to build more acceptance of the technical details through a mix of debate and experimentation (where possible).

Overall, the Committee would urge reducing bottlenecks where possible, in particular on legislation. It would urge a high quality technical effort on drafting new laws and putting them through a process of public scrutiny, as well as utilizing various government and non-governmental organizations in educating legislators on their import. It would urge greater speed of action in Standing Committees, and a prioritization of bills to make best use of scarce parliamentary time.

CONCLUSION

India's financial sector is at a turning point. There are many successes—the rapidity and reliability of settlement at the NSE or the mobile phone banking being implemented around the country indicate that much of our system is at the Internet age and beyond. There is justifiable reason to take pride in this.

Yet much needs to be done. Some parts of our system have not yet reached the electronic age, and unfortunately, this is the part that our poor typically face. There is an opportunity here. In the process of gaining the productivity and innovativeness to serve the masses, the financial sector will get the unique edge and scale to be competitive internationally—indeed, the road to making Mumbai an international financial centre runs through every village and slum in India.

But as we argue in this report, there is no easy path for the government. The old system of attempting to mandate outcomes from the centre does not work any more, even if it might have when our private sector institutions were less well developed and the Indian economy was more closed. The proper role of the government today is to improve the financial sector's infrastructure and its regulation even while removing the plethora of constraints and distortions that have built up over the years. It also requires the government to withdraw from financing and direct control of institutions so that the financial sector can get on with the job. The populism and the direct intervention, that unfortunately seems to be making a comeback, should be relegated firmly to the past.

This report places inclusion, growth, and stability as the three objectives of any reform process, and fortunately, these objectives are not in contradiction. With the right reforms, the financial sector can be an enormous source of job creation both directly, and indirectly through the enterprise and consumption it can support with financing. Without reforms, however, the financial sector could become an increasing source of risk, as the mismatches between the capacity and needs of the real economy and the capabilities of the financial sector widen. Not only would the lost opportunities be large, but, the consequences for the economy could be devastating. The country's leaders have a choice to make, and this Committee hopes they will make the right one.

The Macroeconomic Framework and Financial Sector Development

chapter 2

CONTEXT

India's economy has posted a stellar economic performance in recent years, with high growth, moderate inflation and the absence of major turbulence. This suggests that the overall macroeconomic policy framework has delivered good outcomes despite concerns about its durability and effectiveness. Indeed, this success has fostered an ambitious average growth target of 9 per cent per annum for the five-year period from 2007 until 2012. This rapid sustained growth is expected to be supported by a rising investment rate and greater integration with the world economy.[1]

But past success does not necessarily mean that the existing framework is well suited for achieving this ambitious growth target. The economy now faces major challenges in maintaining high growth and moderate inflation. Volatile capital inflows, while providing capital for investment, are causing complications for domestic macro policies. There are still major infrastructural bottlenecks that could prevent the economy from attaining its full potential. Moreover, the political sustainability of this growth process depends on its being inclusive and remaining non-inflationary.

Given the changes in the structure of the economy and its increasing outward orientation in terms of both trade and financial flows, India has reached a stage in its economic development where the macro policy framework has to be significantly adapted to changing circumstances, both domestic and external. The apparent success of the framework so far, however, suggests that the required changes are evolutionary rather than revolutionary. India's monetary policy framework, for instance, has continuously evolved in response to changing economic, institutional and political imperatives.[2] The economy's recent strong performance provides a good background for intensifying this process and undertaking the substantive macro policy reforms that are needed to respond to the rapid evolution in the domestic economy and in the global financial system.

The recent painful surge in inflation does raise some more basic questions about whether the present monetary policy framework is the right one for effectively stabilizing inflation expectations over a 2–3 year horizon in the face of sharp short-run shocks to prices. Moreover, the policy framework has to be adapted to cope with the practical realities on the ground. For instance, the capital account has already become quite open, both in terms of fewer formal restrictions on these flows and in terms of the sheer volume of flows. It is neither feasible nor desirable to turn back the clock on capital account opening by re-introducing controls or tightening the ones that still exist. The same is true of the rising sophistication and complexity of financial markets, which cannot and should not be unwound. Rather, the Committee's view is that the right approach is to manage the pace and sequencing of further reforms in a way that takes advantage of favourable circumstances and helps manage the inevitable risks during the transition process.

How do macroeconomic policies fit in to the game plan for financial sector reforms? There are deep, two-way links between macroeconomic management and financial sector development. Disciplined and predictable monetary, fiscal and debt management policies constitute the crucial foundation for further progress in financial sector reforms and the effective functioning of financial markets. At the same time, a well-functioning financial system is essential for macroeconomic stability, and can be particularly helpful in reducing the secondary effects of various shocks that inevitably hit any economy. A well-functioning financial system is also relevant for the implementation of macro policy. In its absence, monetary policy, for instance, has to use considerably less effective instruments to stabilize economic activity and inflation.

This chapter begins by reviewing the current institutional and policy framework for macroeconomic management. The chapter then discusses some short-run challenges posed by the recent volatility of capital inflows for monetary policy and for macro management. It explores how macroeconomic policy choices can influence the medium-term evolution of the financial sector and how that, in turn, can affect macroeconomic outcomes. It also describes a set of desirable outcomes in key dimensions of macro policies, and discusses strategies to make progress towards those outcomes. Specific policy recommendations are listed in the final section of the chapter.

CHALLENGES FROM CAPITAL FLOWS

Cross border capital flows pose profound challenges for macroeconomic management. In the past, the concern of the authorities was to limit capital flight, and India maintained tight capital controls in support of this goal. In recent years, the problem has been the reverse: foreign investors have been flocking in droves to India's doorstep, eager to be a part of India's growth story. In common with other parts of fast-growing Asia, India has experienced unusually large capital movements over the past four years. Over this period, capital inflows have more than quadrupled, although from a relatively low base. In 2006–07, net capital inflows amounted to 45 billion US dollars, a figure equivalent to nearly 5 per cent of India's GDP. These inflows far exceed the current account deficit, which was 10 billion dollars (or 1 per cent of GDP) in 2006–07. Capital inflows continued at a rapid pace during the financial year 2007–08, but have eased off in recent months, partly as a result of increasing turmoil in international financial markets. While the increase in net flows in recent years is itself impressive, the challenges of monetary and exchange rate management are arguably equally related to the increased scale of both gross inflows and outflows.

The challenges these large flows pose to macroeconomic policy have been commented on extensively by academics (both within India and outside), by official bodies (including the government and the RBI), and by distinguished expert Committees, most notably in the Report of the Committee on Fuller Capital Account Convertibility and the HPEC Report on Making Mumbai an International Financial Centre. Despite this large body of detailed and well-informed work, it is useful, for several reasons, to revisit these issues.

First, belief in the Indian growth story has been strong, and so the scale of capital flows to be managed has been larger than previously anticipated. Such flows represent only a minor adjustment in global portfolios in favour of India. This implies that if confidence in India remains strong, the absolute scale of these flows may well pick up again.[3] Indeed, the depth of India's equity markets, improvements in corporate governance, and the internationalization of many Indian firms in terms of trade in goods and services and in financial flows means that cross-border flows are likely to increase in any event. It would therefore be prudent to adapt the financial system to larger inflows than in the past. At the same time, it would also be wise to be prepared for a larger outflow of funds if either domestic or global circumstances were to deteriorate. The fact that India continues to run a current account deficit, albeit a modest one, makes it vulnerable to a sudden stop of inflows, although the level of foreign currency reserves does provide a cushion if this were to happen. The economy's managers therefore need to develop a policy framework that would help deal with both eventualities.

Second, the exigencies of dealing with this large volume of flows have slowed financial sector reforms in the Indian economy. They have also led to an increase in the fiscal burden through the cost of sterilization. There is therefore a need to think through the institutions and markets needed to facilitate a more effective response to what is likely to be a recurrent phenomenon.

Third, the debate surrounding the authorities' response to the 'capital flows problem' has indicated some uncertainty and occasional misunderstanding of what the monetary authorities can and cannot control. Frequent (and often misleading) references to the rather different macro policy choices exercised by China have also permeated the debate. Hence, this chapter engages in a discussion of the Chinese situation to see what lessons should (and should not) be drawn that are relevant for the Indian context.

There are no 'correct' or 'ideal' solutions for managing the integration of a large domestic financial system into the global economy. While the gains are considerable, the penalties for mistakes can be both large and harsh. What is clear is there is a premium on consistency, clarity, credibility and continuity of policies. It is also clear that a whole range of institutional (and even political) factors go to shape each nation's response. These include the nature of the financial system, the independence of the central bank (and its relationship with the Ministry of Finance), the quality of market regulation and even the functioning of the labour market. Thus, developments in the capital market and the possible policy responses must be seen in a much broader context.

Much of the discussion within India about exchange rate policy in the last 3–4 years has been about the desirability of limiting exchange rate appreciation in the face of large capital inflows. More recently, the fickleness of foreign capital has been in evidence, with inflows easing off and the rupee depreciating relative to the US dollar. This episode points to the need for a more flexible framework to cope with volatile capital flows (both inflows and outflows). Nevertheless, with India likely to continue posting higher productivity growth than some of its major trading partners, the underlying pressures for exchange rate appreciation may well return in the near future. The discussion in the next two sections focuses on the scenario associated with an appreciating exchange rate, which was the relevant scenario until very recently, although many of the arguments about exchange rate management are general and symmetric.

Capital inflows and the real exchange rate

A completely open capital account creates familiar and well-known issues for monetary management, usually referred to as the 'impossible trinity'.[4] This refers to the difficulty that an open capital account presents to a monetary authority in reconciling exchange rate stability with interest rate autonomy. As the experience of the oil-exporting countries (or of China) shows, imbalances between the supply and demand for foreign exchange can arise from trade flows just as much as from the capital account, and generate pressures for the nominal exchange rate to appreciate. Thus, exchange rate appreciation, and measures to counter it (such as central bank purchases of foreign exchange), are not phenomena that arise exclusively from an open capital account. What progressive opening of the capital account does is to enhance the scale (and potential volatility) of foreign exchange flows, and to link these flows to domestic monetary conditions, particularly efforts to set domestic interest rates and/growth of domestic credit.

In common with most large emerging markets, India has a long tradition of managing its nominal exchange rate to maintain 'external competitiveness', with generally positive results for growth in exports of goods and services. Stability and predictability of the exchange rate of the rupee, nominally against a basket of currencies but primarily against the US dollar, has been an established feature of the policy landscape for many years. The link to the dollar over the years can also be seen as representing an informal 'nominal anchor' for the Indian monetary system, necessary in the absence of either fiscal restraint or a formal inflation target.

While in the present decade there has been a boom in exports of business services, the magnitude of the ensuing surpluses did not present major problems for either exchange rate or monetary management. Thus, in the mind of the Indian public and Indian policy-makers, pressure on the nominal exchange rate to appreciate, and the perceived resulting threat to competitiveness, have come to be associated with the surge in capital inflows described above. The management problems have been complicated and aggravated by the decline of the dollar against other major currencies, and the tight link to the dollar of the currencies of major Asian competitors for India in third markets, particularly China.

Capital inflows have indeed created difficult challenges for monetary policy. In particular, they have generated pressures for nominal exchange rate appreciation of the rupee against the dollar. In order to counteract this pressure, the central bank has intervened by buying foreign exchange. But too much intervention could lead to excess domestic liquidity, and consequent inflationary pressures. Balancing these two considerations—external competitiveness versus domestic inflation—has become an increasingly complex problem. However, framing the issue in this manner, which has become the norm in the public debate, may in fact be misleading and has generated unrealistic expectations about what policy, and monetary policy in particular, can and should try to achieve. Let us examine both dimensions of the debate about the external value of the rupee.

What matters for external competitiveness is of course the real effective exchange rate (REER) rather than the nominal dollar-rupee exchange rate per se.[5] And the factors that drive the REER go beyond just capital flows. The primary factor tends to be differentials in productivity growth between a country and its main trading partners, and between the traded goods sector in a country (e.g., manufacturing, IT services) and the non-traded goods sector (haircuts). This is because more productive manufacturing workers in a country will earn more, and push up the price of housing or haircuts, thus causing the real exchange rate to appreciate. In the short to medium term, the exchange rate can also be influenced by conditions of domestic aggregate demand and supply, and, of course, the net capital inflows into a country.

In India, a confluence of forces has in recent years put enormous pressure on the real effective exchange rate to appreciate. Relative productivity growth of the traded goods sector has been higher than in most industrial countries that constitute final markets for India's exports, as well as relative to the domestic non-traded goods sector.[6] Aggregate demand has been higher than supply, in part due to the large government budget deficit (centre and states together). And foreign investors have been pouring money into India.

Even if it were granted that the real exchange rate is appreciating too quickly, it does not necessarily follow that the most efficient response is to attempt to restrain the nominal exchange rate through sterilized intervention. Indeed, as noted below, if the real appreciation is an equilibrium phenomenon, attempting to resist it through sterilized intervention can lead to an outcome of higher inflation, higher debt and a more repressed financial system than the alternative of allowing the nominal exchange rate to take on some of the burden of adjustment.

Countering real appreciation pressures

How can the economy possibly counter these pressures for real appreciation? The answer to this question follows directly from the causes listed above. Three strategies could be employed to prevent real appreciation. One is a non-starter for obvious reasons—to slow productivity growth. The second, tackling the fiscal deficit more aggressively or restraining private consumption will help rectify the demand-supply imbalance. And the third, limiting net inflows could help slow appreciation pressures.

Let us examine the last two more carefully. There is evidence that increased fiscal discipline may help offset some of the expansionary effects of capital inflows by reducing aggregate demand.[7] At a minimum, it is important to avoid fiscal deficits that add to demand when the economy is already booming, in part due to surges in inflows.[8]

Turning to net inflows, one way to limit them is through capital controls. Capital controls always appear attractive in theory, but there is little evidence that they work over sustained periods of time in an economy as open as India's—we will have more to say on this shortly. Indeed, trying to manage inflows using controls could simply spark more speculative inflows in search of quick returns associated with eventual currency appreciation. The same is true of the circumstance when controls on outflows are used as a tool to try and limit exchange rate depreciation. Over time, as de facto financial openness of the economy increases with greater integration into international capital markets, controls on capital flows may end up becoming not just ineffectual but counterproductive.

When inflows surge again, as they inevitably will at some stage, perhaps more useful than preventing foreign capital from coming in is to encourage domestic capital to flow out. One method is to encourage Indian corporations to take over foreign firms. It is dangerous, however, to force the pace of this process since takeovers have a checkered history, with losses for the acquirer more likely on average than gains. A second is to encourage domestic individuals to invest abroad. Indian investors have the opportunity to maintain assets abroad, but have not taken advantage of it to diversify their savings thus far, perhaps because of the strength of the performance of the Indian market, and perhaps because of their unfamiliarity with the channels of investing abroad. We need to make it much easier for the individual to invest in foreign assets. But perhaps the greatest opportunity lies in Indian institutions like pension funds and provident funds, as well as insurance companies. They could benefit tremendously from foreign diversification, and should be encouraged to place a fraction of their assets in well-diversified foreign equity and bond portfolios.

Notwithstanding any such steps, given India's stage of growth and productivity performance, as well as its robust domestic demand, it is likely that there will continue to be strong underlying pressures for appreciation, and they will be difficult to resist for anything more than a short period. In the short run also, appreciation pressures will be exacerbated by the need for industrial countries like the United States to increase exports to reduce their current account deficits and boost growth, which implies their currencies will have to depreciate.

Real exchange appreciation is not all bad. It makes foreign goods cheaper and thereby raises the standard of living of the average citizen—indeed, a significant portion of the rise in Russia's per capita GDP over the last few years has been through real exchange rate appreciation. It reduces the real value of the foreign currency debt of companies that have raised money in international markets.

The implications for employment growth in the tradables sector are also not as clear-cut as might seem to be at first glance. For firms that specialize in processing of imports and re-exports of finished products, the fall in import costs would offset much of the decline in export revenues (if these firms cannot change their prices in foreign markets). For a growing country, the lower cost of investment stemming from cheaper capital goods imports can also help. Similarly, if real exchange rate appreciation is a consequence of productivity growth, then the loss in external competitiveness through the price channel may be offset by the increase in productivity. Indeed, a steadily appreciating real exchange rate puts pressure on the export sector to improve productivity even while allowing the country to become richer in real terms.

It is also not a good idea to hold down the real exchange rate to make the country's export sector artificially competitive. An undervalued exchange rate is a subsidy to the export sector and the rest of the world that comes from taxing the rest of the domestic economy, something a poor country can ill afford. Moreover, it can lead to inefficient patterns of investment that are not based on comparative advantage, that reduce the country's overall productivity growth, and that can create serious problems when the real exchange rate returns to equilibrium. For an economy that has a low stock of physical capital and where the investment to GDP ratio is nearly 35 per cent, the cost of such distortions is likely to be very large in terms of long-term growth and economic welfare.

To summarize, it is hard to counteract pressures for a rising real exchange rate, especially if the pressures are driven by long-term fundamentals. It is also probably not necessary to counteract such appreciation, for it is a natural consequence of growing richer. At the same time, our intent is not to minimize the danger of a real exchange rate appreciating excessively, beyond what is warranted by fundamentals. An overvalued exchange rate can be very detrimental to export competitiveness and can affect job growth in exporting and export-competing industries. It is an important factor in slowing the growth of countries. We should guard against it happening, but it is not representative of India's situation today.

Should nominal exchange rate appreciation be resisted?

The question is what to do if there is a renewed tendency for excessive real appreciation, fuelled by strong capital inflows? Appreciation of the real effective exchange rate has two components—an increase in domestic inflation relative to inflation in trading partner countries and an appreciation of the nominal exchange rate. Can monetary policy play a role by attempting to peg the nominal exchange rate?

The answer typically is no. History has shown that strong pressures for real appreciation cannot be bottled up for long by pegging the nominal exchange rate. If the nominal exchange rate is prevented from rising, the real exchange rate will rise through greater inflation, and the economy will both have high inflation and be uncompetitive. Put differently, a strategy for boosting competitiveness by holding down the nominal exchange rate can be successful only if there is no underlying pressure for the real exchange rate to rise.

Also, the channel through which real exchange appreciation takes place has important effects—especially in terms of income distribution. A nominal exchange rate appreciation can help hold down inflation and reduce the prices of imported (or tradable) goods, including food and oil. By contrast, an increase in domestic inflation has far greater adverse consequences for the poor since the prices of tradable goods such as food and energy tend to rise fast and these constitute a substantial fraction of the consumption baskets of the poor.

Some argue that inflation is not a natural consequence of the central bank purchasing foreign exchange to keep the rupee from rising. It can issue market stabilization bonds to soak up the liquidity from capital inflows and prevent inflation from taking off. However, this 'sterilization' strategy has its limitations. The interest rate that has to be paid on these sterilization instruments increases as the market absorbs more and more of these instruments, and ultimately adds to the budget deficit. Sterilized intervention also frustrates the two natural forces for slowing inflows that would normally function, namely nominal exchange rate appreciation and a decline in domestic interest rates. Instead, it acts as a stimulus to further flows by widening the differential between foreign and local interest rates while creating expectations of additional returns once the postponed nominal appreciation finally occurs.

Sterilization also hampers financial reforms if the government relies on public sector banks to hold large stocks of sterilization bonds. In India, market stabilization bonds constitute the primary sterilization tool. A substantial expansion of this stock, which would be required to avoid nominal exchange rate appreciation if strong capital inflows were to resume, would have fiscal costs as well as broader costs by affecting financial reforms.

A more basic question is whether sterilized intervention is effective, at least in the short run, in limiting the nominal exchange rate appreciation that could otherwise result from a surge in capital inflows. There is no evidence that other East Asian economies that have been experiencing large and persistent capital inflows have been able to significantly influence the level or changes in the exchange rate, especially beyond very short horizons.[9] But there is some evidence that sterilized intervention modestly reduces exchange rate volatility, which suggests that the role of intervention should be limited, if at all, to marginal smoothing out of trend changes in the exchange rate.

In summary, this Committee believes that it is neither possible, nor advisable to manage the external value of the rupee through persistent nominal exchange rate intervention. Clearly, steps to curb domestic demand or expand supply can help slow the rise of the rupee, as can steps to encourage domestic savings to be invested abroad. These should be implemented. But perhaps the best antidote to pressures for the exchange rate to rise is to increase the flexibility of the economy to adapt to it and for firms to hedge the risk (see next section). This is cold comfort for those who believe the government can always do something, and is anathema to those who believe India can still adhere to the old ways it followed when the economy was closed and India unattractive, but it may be the right answer today.

Sometimes, adaptation is best achieved when firms realize they have no alternative. For instance, exporting firms will have an incentive to achieve productivity gains by boosting their efficiency. These adjustments are much more likely to take place in an environment where manufacturers anticipate exchange rate appreciation and prepare for it. If manufacturers believe that the central bank (or fiscal authorities) will protect them from appreciation or that the government will offer sops to deal with the effects of appreciation, they will have no incentive to prepare for it in advance. When the inevitable—exchange rate appreciation—then happens, they will be caught off guard and not be able to respond effectively.

Of course, not all exporters can adapt easily, especially the small- and medium-sized ones. The medium-term answer is to help them do so, by providing them more flexible labour laws, better finance, and managerial support services. In the short run, however, there should be a two-pronged approach. Employees of ailing firms could be supported directly by whatever safety nets the government deems appropriate (though in a poor country like India, it is not clear that the support can be substantial), while viable firms can be helped to adapt. Though the consequences are not pleasant, the economic pain would be worse, though possibly more widely spread, if the macroeconomic framework was held hostage by a small segment of the export sector.

Let us summarize our analysis. The Committee does not suggest a real exchange rate appreciation is always a good thing. But to the extent it is an equilibrium phenomenon (and the rebalancing of world investment portfolios towards India can be part of the fundamentals driving the equilibrium), currency intervention can, at best, smooth short-term movement. Indeed, if the appreciation pressure is strong, intervention may just bottle up the volatility, only to unleash it when intervention stops. The Committee does not believe that tried and tested methods of exchange intervention can help preserve India's competitiveness in today's more open economy. While the implications for competitiveness and inflation are obviously very different in an environment with a depreciating exchange rate, the

Lessons from China[10]

Many analysts have argued that China is a counter-example to the proposition that productivity growth will unavoidably lead to real exchange rate appreciation. They note that China has kept the real exchange rate undervalued for a prolonged period by tightly managing the nominal exchange rate relative to the US dollar and has done so without major inflationary consequences. With CPI inflation now surging past 6 per cent and reserve money growth in excess of 30 per cent, the latter proposition is less tenable now. Moreover, the mix of policies that has maintained this configuration includes extensive financial repression along with a relatively closed capital account. Financial repression has kept the costs of sterilized intervention low by inducing state-owned banks to absorb large quantities of sterilization bonds at low interest rates.

This set of policies has led to substantially unbalanced growth, driven largely by investment. Not only has financial repression kept the price of capital cheap in the form of low interest rates, but energy and land have also been subsidized to encourage more investment. As a consequence, more than half of nominal GDP growth in recent years (almost two-thirds of growth in some years) has been accounted for by investment growth, with consumption growth accounting for a significantly smaller fraction. This has had serious environmental consequences and greatly limited employment growth. It has also reduced the welfare consequences of growth; moreover, excessive investment has created huge risks for the future.

A different facet of financial repression, which has been necessary to keep the price of capital cheap for firms, has been the ceiling on deposit rates. This has led to negative real rates of return for Chinese households, which save nearly one-quarter of their disposable income and put most of it into bank deposits. Over the last year, the negative real interest rates have led to some money flowing out of bank deposits and into the stock market, creating a huge bubble that is likely to end very messily.

Another complication is that the leakiness of capital controls has increased over time, thereby constraining the independence of monetary policy, which has become increasingly beholden to the exchange rate objective. Indeed, the massive accumulation of foreign exchange reserves since the beginning of this decade is an indication of the amount of capital that has managed to find its way into China despite the efforts of the authorities to control inflows (capital inflows through official and unofficial channels account for about two-fifths of the reserve accumulation since 2000).

In an economy with real GDP growth of over 10 per cent and rising inflation, negative real interest rates clearly do not constitute an appropriate monetary policy stance. But the increasingly open capital account has constrained the central bank's ability to aggressively raise policy interest rates to control credit expansion and investment growth. If it tried to do so, even more capital would flow into the economy to take advantage of the higher interest rates, especially since interest rates in the US have been falling due to recent actions by the Federal Reserve. This would flood the economy with more money and complicate domestic macroeconomic management even more.

These constraints on using interest rates to meet domestic objectives have also meant that banking reforms, which the government has declared to be a major priority, have been held back. After all, it is difficult to get the banks to function as efficient financial intermediaries if they do not have price signals (policy interest rate changes) to respond to but simply continue to take their marching orders from the government.

Finally, commentators in India have not adequately recognized the unnaturally low level of Chinese consumption (unnatural for a country of its per capita GDP) which has helped keep demand-supply imbalances in check and thus prevented some of the pressures on the real exchange rate that are seen in India. If India is to emulate China in exchange rate management, as some suggest, one should ask whether India is also ready for policies such as the constraints on financial development, reductions in social expenditures on health and education, and the one-child policy that are prime factors driving high savings and low consumption.

There are many useful lessons to be learnt from the Chinese growth experience—the emphasis on fiscal discipline, the reduction in trade barriers as part of the WTO accession commitments, the focus on building physical infrastructure etc. It is equally important that India's policymakers see the risks and welfare costs that China's growth model has generated, and not just the positive outcomes to date. Besides, India is simply too far along in the process of financial sector development and capital account liberalization, relative to China, to return to a regime of financial repression and/or capital controls, or to severely constrain consumption.

basic points about the futility of orienting macroeconomic policy towards exchange rate management over long horizons are essentially the same.

IMPLICATIONS FOR MANAGEMENT OF MONETARY POLICY

Options for the monetary policy framework

Despite the challenges laid out in the previous section, monetary policy has in the past managed to strike a balance between managing inflation and stabilizing the nominal exchange rate. This balance has become increasingly difficult to maintain, resulting in a series of spurts of exchange rate volatility as the RBI tries to hold the line on the nominal exchange rate until a particular level becomes difficult to sustain, either because inflationary pressures mount or sterilization operations become costly and harder to manage. Moreover, the recent surge in inflation has highlighted the difficulties the current monetary policy framework faces in serving as a credible anchor for stabilizing inflation expectations over the medium term in response to sharp short-run price shocks. Such demands on monetary policy in India are going to grow over time and it is important that the framework be upgraded to make monetary policy more effective and independent.

What are the options? One is to try and manage the exchange rate more aggressively.

Indeed, the Committee on Fuller Capital Account Convertibility had recommended that the real exchange rate should be maintained within a band. Many observers in fact argue that this should be a central objective of monetary policy so that loss of competitiveness through real exchange rate appreciation can be avoided. As the discussion in the previous section makes clear, this Committee feels that this is not a viable option—even if desirable, it is simply not possible to use monetary tools (other than through demand management) to control the real exchange rate.

Another option would be to continue with the mixed approach, hitherto used with a reasonable degree of effectiveness by the RBI. This approach is based on a medium-term objective for inflation but involves active management of the exchange rate at certain times. It has a certain degree of appeal since it gives policymakers some flexibility in their responses to pressures on the exchange rate or on inflation at different times.

This approach also has its drawbacks. The mix of inflation and exchange rate objectives generates uncertainty of its own and, in contrast to a framework with a single well-defined objective, does not serve as a firm and predictable anchor for inflation expectations. Thus, it can in fact be counterproductive by generating unpredictability of policies and, consequently, unpredictability in market participants' responses to policy actions.[11] It could therefore constrain rather than increase the room for aggressive policy responses to shocks. By contrast, a more predictable and transparent policy framework can in fact generate more room for policymakers to respond to large shocks because the market would better understand the objectives of monetary policy. Besides, as the preceding discussion suggests, exchange rate management (other than to reduce day-to-day volatility) is unlikely to be effective and will be increasingly costly.[12]

What is the way forward? This Committee feels that monetary policy should be reoriented towards focusing on a single objective, and there are good reasons why this objective should be price stability (defined as low and stable inflation). An exchange rate objective would limit policy options for domestic macroeconomic management and is not compatible with an increasingly open capital account.

Is a low inflation objective too limiting?

The Committee's recommendation of a single objective for monetary policy may at first glance seem divorced from the reality of the public pressures that a central bank faces. After all, it seems reasonable for a central bank to be concerned not just about inflation, but also about overall macroeconomic stability, high employment and output growth, and financial sector development. Especially in a developing economy like India, surely the central bank needs to worry as much about growth as it does about inflation. The Committee fully agrees with this proposition—but the issue is how best monetary policy can contribute to non-inflationary and stable growth.

The argument against the emphasis on an inflation objective is based on a deep fallacy that there is a systematic trade-off between growth and inflation. There is a great deal of evidence, both from individual country experiences and cross-country studies, and not just in industrial countries, that a central bank that is focused on price stability can be most effective at delivering good monetary and macro outcomes.[13] Low and stable inflation has large macroeconomic benefits—it would stabilize GDP growth, help households and firms make long-term plans with confidence, increase investment, and thereby allow monetary policy to make its best possible contribution to long-term employment and output growth. It would also have financial market benefits—for instance, by enabling the development of a long-maturity bond market, which would assist in infrastructure financing and public debt management.

Another fallacy is that the process of switching to an objective of price stability entails a loss in output growth. This is true in countries where an inflation target has been used as a device to bring down inflation from a high level and to build credibility for a central bank that has lacked inflation-fighting credentials. One of the earliest inflation targeters—New Zealand—suffered this problem. Inflation targeting was introduced in early 1988 in an attempt to bring inflation down from around 15 per cent in the mid-1980s. Inflation was brought down to 2 per cent by 1991, although with an adverse impact on growth and employment during that period.[14] Output losses were also experienced at the time of introduction of inflation targeting in some Latin American economies. But in every one of these cases, inflation targeting was seen as a solution to high inflation and lack of central bank credibility. However, there is no reason why, if inflation is low and the central bank has a reasonable degree of credibility, switching to a focus on price stability rather than multiple objectives should have output costs.

A third fallacy is that making low and stable inflation the objective of monetary policy creates an anti-growth bias, wherein inflationary pressures would be dealt with swiftly and decisively, but disinflationary growth slowdowns would not be resisted as aggressively. In fact, there is no reason why there should be an asymmetric approach to inflation versus disinflation. If the inflation objective is specified as a range, the norm is to treat the floor of the target range as seriously as the ceiling.

Put differently, if growth falters, it is also likely to bring inflation down below the floor of the inflation objective, allowing the central bank to ease. Indeed, if the public's expectations of future inflation are firmly fixed, as would be the case if the central bank has a transparent policy objective, a cut in short-term interest rates will not be accompanied by a rise in inflationary expectations and, thus, long-term interest rates. The central bank then can bring all interest rates down by cutting the short-term interest rate, and can thus stimulate growth. In this case again, the ability of the central bank to move aggressively with its policy instrument to maintain price stability (and thus growth), rather than being hamstrung by an exchange rate objective, is crucial. Indeed, this is demonstrably the way that central banks with inflation objectives have responded to growth slowdowns.

Focusing on low and stable inflation does not mean that short-term fluctuations in output and employment growth will be ignored in monetary policy formulation. This objective provides a framework for thinking about how other macro developments affect inflation and, therefore, how monetary policy should react to those developments. This means that a slowdown in growth would, through its implications for inflation, cause the central bank to loosen monetary policy in order to prevent inflation from falling below the objective. Thus, an inflation objective is quite consistent with using monetary policy as a tool to stabilize the business cycle.

Moreover, an inflation objective can increase the independence and effectiveness of monetary policy by setting more realistic expectations about what monetary policy can and cannot achieve. When households, firms and financial market participants clearly understand the central bank's intentions about its medium-term objective, then the central bank in fact has more flexibility in responding to shocks in the short run without losing control of inflationary (or deflationary) expectations. Finally, transparency about the monetary policy process allows financial market participants to plan for the already high volatility they need to deal with without it being augmented by policy volatility.

In short, a predictable and transparent monetary policy that has a clearly-defined primary objective may be the best contribution that monetary policy can make to macroeconomic and financial stability and, therefore, to long-term growth. By contrast, trying to do too much with one instrument is a recipe for ineffectiveness, especially in difficult times. Stabilizing the domestic business cycle, which would be a corollary of an inflation objective, would be a better use of monetary policy than attempts to manage the exchange rate. Moreover, the notion that monetary policy can itself raise long-term growth through activist policies has been shown to be demonstrably false—in fact, faith in that belief led to stagflationary episodes (economic stagnation coupled with high inflation) in the US in the 1970s and 1980s.

Let us now turn to the importance of monetary policy for financial markets. Transparency and predictability of monetary policy are essential ingredients for achieving liquid financial markets, reducing fragility of financial firms and stabilizing capital flows. A stable macroeconomic environment not only helps make cross-border capital flows more stable by giving domestic and foreign investors more confidence in a country's fundamentals, but it also helps in dealing with the vagaries of those flows.

In the absence of a clearly-defined monetary framework, the effectiveness of the monetary transmission mechanism may also be reduced. Since long-term interest rates are more important than short-term rates for aggregate demand management, there is a temptation to manage different points of the yield curve for government debt (the return on debt instruments at different maturities) rather than just setting the short-term policy rate, as is typical in most mature economies. This has three deleterious effects. It hampers the development of the government bond market. It stymies the development of a corporate bond market since a market-determined yield curve is needed to serve as a benchmark for pricing corporate bonds. It also limits the information and market feedback from the yield curve about inflation expectations and the market's assessment of monetary policy actions.

Changes needed to the current framework

What modifications to the present monetary policy framework are needed to enhance its effectiveness? In answering this important question, it is necessary for the Committee to establish some general principles, rather than delve deeply into specific aspects of the monetary framework. This is not to say that the details are unimportant or easy to grapple with, but they can best be examined in detail separately once the principles are established. For instance, in India there are intense debates even about the right index of inflation (WPI or CPI) that the RBI should focus on. These are important practical issues. But to let debates about such details shift the focus away from the broader questions about the right framework that are this Committee's mandate would be to allow the tail to wag the dog.

The RBI already has a medium-term inflation objective, and its actions and statements are consistent with that being a key objective of monetary policy. But making that *the* primary objective of the RBI and indicating this clearly to markets, both through communications and actions, may provide important additional benefits in terms of anchoring inflation expectations and the macroeconomic stability that would follow from that. Indeed, what is needed is not so much a drastic change in operational approach but rather a change in strategic focus.

Some changes in the operational approach would also be useful to make the transmission of monetary policy more effective. The use of multiple tools other than the interest rate in attempting to meet multiple objectives can generate distortions in the financial and corporate sectors. Varying the CRR affects only banks while their competitors like non-banking finance companies (NBFCs) and money market funds are left unhindered. Lack of predictability of regulations and ceilings on external commercial borrowings (ECB) makes it hard for corporations to plan borrowing, and even service old loans that need to be refinanced, creating added uncertainty and risk, which adds to their costs. These costs need to be factored into the broader assessment of monetary management. The Committee recognizes that it may not be practical to do away with multiple monetary policy tools immediately. Given the adverse implications of the use of tools such as the CRR for financial sector reforms, there should be a definite and short time line for modifying the strategy for monetary policy implementation, in tandem with other reforms to the framework. Moreover, developments in the economy, including the declining importance of agriculture and the rising importance of interest-sensitive sectors such as consumer durables and housing, should make it easier to use interest rates as the tool for managing aggregate demand.

There are undoubtedly difficult constraints on the effective operation of monetary policy in India. These include a variety of real rigidities, such as a labour market that is not fully flexible on account of restrictive regulations, a higher education system that is not meeting demand, a moribund system of corporate restructuring, and an economy that is still based to a considerable extent on primary industries, including agriculture. These structural factors put an even greater burden on monetary policy to deliver macroeconomic stability based on a clear objective.

Waiting for rigidities in the economy to disappear fully before improving the monetary framework could in fact be counterproductive. The interaction of these rigidities with a monetary policy framework that does not firmly and credibly anchor inflation expectations could exacerbate the adverse effects of shocks to the economy. Similarly, while large budget deficits undoubtedly constrain the room for monetary policy actions as well as its effectiveness, the right implication is that a well-focused and predictable monetary policy is all the more important for macroeconomic stability.

A related argument has been made that, given the weaknesses in the monetary transmission mechanism, focusing on an inflation objective would be a strategy doomed to failure. The corollary is that the nominal exchange rate could serve as a more stable nominal anchor. As already discussed earlier in this chapter, there are good reasons why an exchange rate target is neither desirable nor feasible without adding distortions to the economy. Many of the financial sector reforms discussed in this chapter will make the monetary policy transmission mechanism work much better. But these reforms, in turn, can work better if monetary policy is based on a stable domestic anchor. Thus, a move towards an inflation objective and financial sector reforms need to be pushed forward in tandem and can, together, deliver good macroeconomic outcomes in terms of both growth and stability.

Some have argued that available indicators of inflation are subject to huge measurement error and are therefore unreliable. There is no doubt that ongoing attempts to improve the quality and timeliness of data are a high priority for effective macro management. Pending improvements in the quality of inflation data more, rather than less, transparency on the part of the RBI in laying out its inflation objectives, and how it views the incoming data is called for.

The RBI is already transparent in the sense that it puts out regular monetary policy reports and its senior officials frequently make speeches about their macroeconomic assessments and policy intentions. But a clearly-specified monetary policy framework would greatly enhance the benefits of such open communications. In short, improving both the clarity of objectives and the clarity of communications about these objectives would help to make monetary policy more effective.[15]

Some observers argue that there is a strong political consensus in favour of low inflation in India, and therefore it is not necessary to enshrine it in an objective. The Committee agrees that inflation is politically very sensitive, but would argue this is all the more reason to make it the overriding focus of the RBI. The problem is political attention focuses on inflation only when it is high—when, given the lags in monetary policy transmission, it is already too late to do anything about it. The time to focus policy on curbing inflation is when inflation is anticipated to rise. But if at that time the central bank is being held to other objectives, it will not act in time. The consequence then is that politicians lose faith in the ability of the RBI to exercise control, and attempt to implement short-sighted, distortionary actions to control inflation. This is to the detriment of overall macroeconomic management.

Instead, the Committee believes the government should invoke the political consensus against inflation in giving the RBI its mandate, in setting the medium-term inflation objective, and in providing support in the form of more disciplined fiscal policies that keep budget deficits in check. Finally, the Committee wishes to emphasize that it is key that the RBI should have operational independence—i.e., the freedom to take monetary policy actions to attain its medium-term objective. The government should not, through its control of certain interest-setting entities, work at cross-purposes. While typically the RBI and the Finance Ministry have reached a reasonable accommodation on their respective roles, this should not be left to the personalities heading these organizations. Clearly, tradition plays a large role in determining, and strengthening, the accommodation, and we would urge that this tradition be reinforced over time through clarifying statements by all concerned.

How Transparent is the RBI?

In an extensive cross-country study, Dincer and Eichengreen (2007) construct a composite measure of central bank transparency that incorporates indices of transparency on five dimensions—political (openness about policy objectives); economic (economic information, including data and models, used in monetary policy formulation); procedural (clarity about operational rules and procedures); policy (prompt disclosures of policy decisions and explanations thereof); and operational (concerns the implementation and evaluation of policy actions). Their index is based on 15 elements and the scale goes from zero to 15 (Saudi Arabia gets a score of zero and, at the other end, New Zealand, Sweden and the UK get scores of 12 or higher). They report that their composite measure of central bank transparency is positively associated with lower output and inflation volatility, and reduced inflation persistence.

How does the RBI stack up? India gets a rather measly score of 2. More importantly, India's score remains unchanged from 1998 to 2005. The average for Asian central banks goes from 3.0 to 5.1 over this period (from 4.6 to 6.6 for selected East Asian countries including Japan). The Dincer-Eichengreen index involves a judgemental (but careful) assessment of the various elements that go into the construction of the index, so it should not be taken too literally. But it does point to some concerns about monetary policy transparency in India.

In response to such concerns, a number of improvements were introduced in 2004–05 and the volumes of material (both spoken and written) emanating from the RBI since then are evidence of a concerted effort to increase transparency. Indeed, a recent IMF (2007) study notes that the RBI's communications strategy has improved in a number of areas.

There are still residual concerns about the RBI's transparency, however, especially when compared to international best practices in some dimensions. The Dincer-Eichengreen index provides a useful benchmark for evaluating the current level of transparency and how it can be enhanced to improve communications with the markets and the overall effectiveness of monetary policy.

What are the specific dimensions in which monetary policy transparency could be improved? One is related to operational procedures and the other relates to the communications strategy. The use of multiple tools have generated market uncertainty about the RBI's intentions. The RBI should refrain from using the CRR or SLR as a standard tool of monetary policy. More regular policy meetings on a pre-announced schedule would also be helpful in giving markets more direction at predictable intervals.

As for communications, a key step would be to make the main policy documents and statements put out by the RBI (especially the Quarterly Review) much shorter and more focused. In addition, the RBI could provide more information to the public about its fore-casting and simulation models, which could in fact be useful for the central bank in getting feedback from the academic and market communities that could help improve the models.

CAPITAL ACCOUNT LIBERALIZATION

Capital account liberalization (CAL) can play a useful role in financial reforms. Opening up to foreign banks and other financial firms and to foreign direct investment in the financial sector has many potential benefits. These benefits include the introduction of financial innovations and sophisticated financial instruments by foreign financial firms, added depth in domestic financial markets due to foreign inflows, and more efficiency in the domestic banking sector through increased competition. The HPEC Committee on Making Mumbai an International Financial Centre lays out the reasons why an open capital account is necessary for Mumbai to compete with other aspiring international financial centres and also to minimize incentives to import financial intermediation services from abroad.

The academic literature indicates, however, that precipitous opening of the capital account before the domestic financial sector has reached a certain level of maturity and the appropriate regulatory expertise is in place could spell trouble. How can the process of CAL in India be fine-tuned to balance these benefits and risks?

In the case of India, this debate may already be irrelevant to a large extent. The official channels for bringing capital into or taking capital out of the country have been opened up quite significantly over the last decade. Recent steps taken by the RBI to liberalize outflows of capital are welcome as they will give domestic investors more opportunities for international portfolio diversification and increase competition for the domestic pool of funds. Moreover, as noted earlier, channels for unofficial capital flows have expanded in tandem with rising trade flows and the rising sophistication of investors.

This inevitable de facto opening of the capital account, which is a common phenomenon in virtually every emerging market (including China) as financial globalization continues apace, makes capital controls an increasingly ineffective tool in managing capital flows and exchange rate volatility. The notion of waiting for all of the preconditions to be put in place before allowing further CAL is also a distraction as it ignores the practical realities on the ground and could give policymakers false comfort that they can control capital flows in order to give themselves more room to manage domestic policies.

How should policymakers approach further CAL? The alternatives are clear. One is to manage the process of further capital account opening in a manner that maximizes its direct and indirect benefits. The second is to try and resist de facto openness using capital controls. Evidence from other countries that have imposed capital controls shows that they tend not to be effective beyond short horizons, if at all, and can create multiple distortions in an economy. For instance, limiting external borrowing tends to disproportionately hurt smaller firms that may find it difficult to raise capital from abroad through other means.[16] Moreover, capital tends to find ways around controls, which inevitably results in a cat-and-mouse game as country authorities and investors try to stay a step ahead of each other. This game is detrimental to the efficiency and the stability of the financial system.

Ostensibly temporary and targeted controls are tempting but are typically not very effective; they even have the potential to backfire by creating uncertainty in market participants' minds about the authorities' policy intentions and possible future actions. When the Thai government imposed a modest unremunerated reserve requirement

The State of the Academic Debate on Capital Account Liberalization

There has been a long, contentious and still-unresolved debate about the costs and benefits of capital account liberalization (CAL). Kose et al. (2006) survey the vast literature on CAL and conclude that it is difficult to find per-suasive evidence that financial integration boosts growth, once other factors that affect growth—financial development, good macroeconomic policies, quality of corporate governance—are controlled for. Prasad, Rajan and Subramanian (2007) report an even more surprising finding—developing/emerging market economies that are less reliant on foreign capital have on average grown faster over the last three decades. This is consistent with work by other authors that a higher share of domestic financing in total investment is positively related to growth outcomes (Aizenman, Pinto and Radziwill, 2007).

Why does CAL not have strong positive effects on growth? PRS note some channels through which CAL could hurt growth. Surges in inflows could lead to exchange rate overvaluation that hurt the external competitiveness of the manufacturing sector. Authors such as Bhalla (2007) and Rodrik (2008) go even further in suggesting that a policy of undervaluing the currency could be good for growth. Rodrik (2007) argues that the constraint on growth may not be related to domestic savings but to investment. That is, domestic financial systems may simply not be up to intermediating finance from savings into productive investment. Indeed, Prasad, Rajan and Subramanian find that countries with weak financial sectors are the ones where foreign capital has its most harmful effects on growth. Moreover, Henry (2007) argues that CAL should, even in theory, have only temporary effects on output growth. Of course, these 'temporary' effects could last for many years. Gourinchas and Jeanne (2006) contend that the welfare gains from additional financing provided by foreign capital are likely to be small since, ultimately, even a relatively poor economy can eventually attain the optimal level of capital through domestic savings.

The other presumed benefit of financial integration is that it should allow for more efficient sharing of risk among countries. The basic logic is that open capital accounts allow individuals to acquire financial assets in other countries, enabling them to achieve better diversification of their portfolios. In this manner, they can make national consumption much less volatile than national income.

Industrial countries have in fact achieved substantial risk sharing through international financial markets. Unfortunately, Kose, Prasad and Terrones (2007) find that emerging markets experienced a deterioration in risk sharing during the period 1985–2004. Interestingly, FDI and portfolio equity flows facilitate more efficient risk sharing by emerging markets, while debt flows work against it. Thus, the predominance of debt in total inflows of emerging markets during the 1980s and 1990s drives these results.

So why should a developing/emerging market country expose itself to the risks of CAL if the benefits are ephemeral? Kose et al. argue that the real benefits of financial integration are not related to financing, but the 'collateral benefits' that come with openness to foreign capital. These collateral benefits, which should increase total factor productivity growth, include financial development, efficiency gains through increased competition, incentives for better corporate governance, discipline on macro policies, etc. Mishkin (2006), for instance, provides a detailed account of how financial integration can boost domestic financial development. The evidence for such collateral benefits of financial openness is mounting but is not yet conclusive. Indeed, Eichengreen (2007) and Rodrik and Subramanian (2008) express scepticism about the size and even about the very existence of these benefits.

What about the risks? The composition of gross private inflows into emerging markets has been shifting over time, to the point where FDI and portfolio equity flows now exceed debt flows. FDI and portfolio equity flows are likely to bring with them more of the indirect benefits of financial integration and also enable more efficient risk sharing. Moreover, even inflows in the form of debt are now increasingly denominated in domestic currencies, which is far less risky for recipient countries.

Given these developments, Prasad and Rajan (2008) conclude that it makes more sense for emerging markets to actively manage the process of CAL rather than attempt to resist financial integration. With expanding trade flows, the rising sophistication of international investors, and the sheer volume of financial flows, capital controls are growing increasingly impotent since they can easily be evaded. Hence, trying to use capital controls as a policy tool to fend off financial integration is likely to prove futile, deprive the economy of many of the indirect benefits of financial integration, and impose costs on the economy through various distortions created by capital controls and the measures taken by individuals and corporates to evade them. A well-articulated programme of CAL can provide a context for a broader set of macroeconomic reforms. But hurtling towards CAL without undertaking other necessary reforms in tandem is also not a good idea.

on portfolio inflows in December 2007, domestic stock markets fell precipitously and the government was forced to retract the measure. The rollback of CAL is rarely a viable option, either economically or politically.

There is another cost of ad hoc capital controls such as the actions on limiting external commercial borrowings. It creates uncertainties about the overall macroeconomic policy environment, making it harder for corporations to plan, which can serve as a deterrent for domestic investment.

In short, the option of trying to use capital controls to restrict inflows and/or outflows may leave policymakers in the worst of all worlds—the complications of domestic macroeconomic management related to de facto capital account openness, distortionary costs of capital controls, and few of the indirect benefits of financial globalization.

Before going further, it makes sense to see where India stands in the comparative picture on openness. The picture on how open India's capital account is relative to other major East Asian economies is mixed (see Appendix 2.1). In terms of Foreign Institutional Investors' (FIIs) investment in equity, India is largely in line with other countries, both in terms of caps on individual investors and in terms of an aggregate cap. The restrictions on FII participation in the corporate and government debt markets, and domestic financial institutions investing in securities in overseas markets, are generally more restrictive in India than in other countries. India also has more restrictions on FDI than most other countries including China. India has liberalized to a considerable extent outflows by corporates for mergers and acquisitions overseas, and has also liberalized outflows by individuals.

The right approach to further capital account opening at this stage may be to see how best it can serve as an adjunct to other reforms, especially those related to the financial sector. One concrete measure would be to eliminate restrictions on foreign institutional investors' participation in corporate and government bond markets. This could help improve market liquidity and pricing, and introduce more market discipline on government borrowing. It would provide more funding for government-aided infrastructure projects. It could also more directly assist financial sector reforms by offsetting some of the loss of debt financing that would occur if the statutory liquidity ratio was no longer used as a regular instrument for government deficit financing. As discussed further in Chapter 4, banks should be required to own government securities only as a prudential measure, and not to fund the government deficit.

There is a legitimate concern that opening these channels could induce more inflows. But, given that foreign investors who want to bring money in can easily find ways to do so, it is more likely that this will lead to a shift in the markets that inflows go to. That is, some foreign investors may see government or corporate bonds as providing a less risky instrument than equity holdings to participate in the India growth story. This may even help take some of the froth off equity markets as debt markets get built up.

There is also little justification for maintaining restrictions on foreign direct investment. These flows tend to bring with them the greatest indirect benefits of financial integration, including spillovers of technological and managerial expertise. Concerns about national security and about the lack of transparency of certain investors such as sovereign wealth funds are legitimate. But these concerns should not be used as a cloak to block FDI in sectors where the real concern may be those of incumbents who are wary of increased competition due to foreign investment.

One could also debate the necessity for restrictions on external commercial borrowings. On the one hand, there is an element of risk in a regime where the exchange rate is not freely floating in allowing corporations to take on exchange rate mismatches between earnings and obligations. Foreign lenders are also not subject to the same impediments that domestic banks are subject to, which may partly explain the lower cost of foreign funds and their higher attractiveness. At the same time, lower cost foreign funds can help bear some of the funding risk our banks are unwilling to undertake, as well as create needed competitive pressure on our banks. Moreover, leaving the equity channel open for foreign equity/mutual fund inflows while closing the debt channel simply creates all kinds of arbitrage as entities bring in equity capital and on-lend it to domestic firms. Ultimately the domestic firms get debt, but with an added costly layer of intermediation. It is debatable whether the risks are any lower.

This Committee would advocate a steady liberalization of constraints on external commercial borrowing (with a time path laid out in terms of permissible quantities), with hard-to-monitor stipulations about end-use being done away with. It would advocate more freedom for small firms to use this channel, especially in export-oriented sectors. Since small firms are by necessity riskier, they are more likely to find interest rate ceilings (or ceilings on spreads) on foreign borrowings a constraint. Over time, interest rate spreads should also be liberalized.

As the capital account becomes more open, other elements of financial regulation need attention. For instance, a priority is to foster the development of currency derivatives markets. Currency derivatives are important for firms and households to deal with exchange rate volatility, which may increase temporarily as monetary policy focuses on stabilizing prices. Manufacturers in traded goods industries, in particular, need to be able to hedge against short-run fluctuations in exchange rates in order to maintain their competitiveness and margins. Access to these hedging instruments would alleviate some of the pressures on monetary policy to manage the exchange rate. It is encouraging that currency futures trading in India was sanctioned and began in August 2008. The Committee notes that foreign investors can play a useful role in developing products to be traded on these markets and adding depth to these markets. In this context, the Committee would encourage the RBI to rapidly eliminate the remaining restrictions (which include prohibitions against foreign institutional investors, against non-resident Indians, against products other than futures, against underlying trades other than on the rupee–US dollar rate, and against positions greater than US$5 million).

We also need to make it easier for our individuals and institutions to invest abroad. For individuals, the primary task may be to simplify procedures, and liberalize the kinds of assets and managers that can be invested in. For our institutions like pension funds, we have to convince various constituencies that a portfolio diversified across the world is safer than a portfolio concentrated only in India, and has better risk properties (for one, it retains value when the Indian economy suffers a downturn). Regulatory authorities then have to allow institutional portfolios to become broadly and internationally diversified.

At the end of this chapter, we summarize these and a list of other concrete steps towards further CAL that could be implemented in relatively short order and that would serve as a useful complement to a broader set of macro and financial sector reforms. The recommendations on CAL are in fact similar to those of the Committee on Fuller Capital Account Convertibility although this Committee recognizes that changes in international capital markets as well as changes in India's macroeconomic environment have led to much greater de facto financial openness. Hence, the timetable laid out in that earlier report and its emphasis on certain preconditions being met before removing certain capital controls may now be less relevant. Another key difference is that this Committee would like to emphasize the inconsistency between CAL and tight management of the exchange rate.

FISCAL POLICY

Fiscal policy is a key component of the reform process. It ties together all of the elements of macroeconomic policy discussed so far. With a more flexible exchange rate and a more open capital account, fiscal policy has a crucial role to play as a short-term demand management tool. Fiscal discipline is essential to manage pressures generated by capital inflows and also to reduce financial repression. Well-managed fiscal policy is also necessary to free up monetary policy to focus on its key objective of price stability. Indeed, the effectiveness, independence, and credibility of monetary policy can be severely compromised by high budget deficits.

A high fiscal deficit also creates pressures to hide it by burying it in public sector firms (for example, the enormous oil subsidy) or in disguised and less efficient forms (when a government guarantees returns in an infrastructure project, it is essentially bearing all the risk associated with borrowing even if the project is ostensibly private sector financed). Indeed, rather than disguising more of the deficit, the government should achieve more of its public objectives by explicitly paying for them rather than by imposing an implicit tax. For instance, it should attempt to achieve priority sector objectives and universal service objectives through explicit and targeted fiscal transfers rather than routing these objectives implicitly through the banking system and hindering its efficiency.

Although India has a history of chronically large fiscal deficits, the situation had been improving until recently. The Fiscal Responsibility and Budget Management Act of 2003 was beginning to show results, with a declining central government deficit and prospects for further reductions in the deficit over the medium term. However, there are a number of concerns about the medium-term outlook for the fiscal position. First, it remains to be seen to what extent the decline in the central government deficit is merely cyclical and mainly a result of strong economic growth in recent years, or the result of a structural and longer-term trend decline in deficits. Second, there are a number of disguised or off-budget obligations of the government that could swell the deficit and public debt if properly recognized as fiscal obligations of the government. Indeed, by some counts there has been little improvement in the central government deficit when these obligations are added back. Third, the burgeoning impact of the recent waiver of farm loans and the full cost of implementing the 6th Pay Commission report could derail any recent progress that has been made on reducing the deficit. These factors have been compounded by the surge in oil prices that has resulted in a massive increase in fuel subsidies.

These issues are of serious concern to the Committee since any halting or reversal of progress on reducing the public sector borrowing requirement would hamper financial reforms and the effectiveness of monetary policy. The Committee would like to emphasize that it will be difficult to make significant headway on financial sector and monetary policy reforms if India's fiscal house is not in order.

In particular, the burden of high levels of public deficit financing has serious consequences for macroeconomic development and for the financial system. Issuance of public debt crowds out financing for private investment. If banks are seen as a continued source of cheap debt financing through the statutory liquidity ratio, it can also have long-term economic costs by holding back efficient financial intermediation. A roadmap for eliminating such elements of financial repression thus needs to go hand in hand with the restoration of fiscal health.

This is also a good time to carefully think about changing the structure of public debt management, particularly in a way that minimizes financial repression and generates a vibrant government bond market. The Ministry of Finance has announced that an independent Debt Management Office (DMO) will be set up. This provides an opportunity to think about and incorporate best practices in this field. The structure of public debt management should also be designed while keeping in mind the broader implications for financial market development.

CONNECTIONS AND TIMING

One of the key themes of this chapter is that there are inextricable linkages among various macroeconomic reforms and reforms to the financial sector. Fortunately, a combination of favourable circumstances makes this a propitious time to move forward aggressively on multiple fronts.

On monetary policy, the heightened focus on inflation management makes this an opportune time for a transition to a new framework that shifts from multiple objectives to a sharper focus on the objective of price stability (low and stable inflation). As discussed earlier in the report, no big discontinuity in the RBI's operational procedures is required. What is essential, however, is a change in strategic focus and some modifications to operational procedures. Indeed, focusing on an inflation objective, moving away from exchange rate management and clarifying the roles of different tools in the monetary policy toolkit could have the beneficial effects of reducing incentives for speculative capital inflows and improving the effectiveness of the transmission mechanism.

The fiscal deficit had been shrinking, in part because of improvements in fiscal management, and in part because the surging economy had resulted in a cyclical reduction in the deficit. Some of this progress has been reversed recently, but there is still room for optimism that progress towards the FRBM targets will be restored. But this will require some political will and tough choices will have to be made. An improving fiscal position would provide an opportunity to reduce the pre-emption associated with financing of the deficit and to rethink the structure of public debt management. Reducing the financing needs of the government would create more space for monetary policy and reduce the risks of CAL. It would also create more room for private debt issuance. As noted above, however, it may be premature to declare victory on the fiscal front.

Well-managed CAL can serve as a useful component of the overall financial sector reform process. For instance, given latent demand among foreign institutional investors for government debt, this may be a good time to consider liberalization on this front. This would add depth to this market and improve incentives for fiscal discipline. A resumption of large inflows would also make it possible to opportunistically liberalize capital outflows, but this should be done as part of a broader CAL programme rather than just as a short-term attempt to manage exchange rate pressures. To make liberalization of outflows serve its purposes, however, it will be necessary to reduce regulatory restrictions on vehicles that allow households to efficiently diversify their portfolios internationally.

The principal elements of this framework—strengthening fiscal, financial, and monetary institutions—would reinforce each other. In sum, a programme of reform on all three fronts, while seemingly more ambitious, may in fact be easier than a programme of reform in just any one dimension.

POLICY RECOMMENDATIONS

Based on the analysis in the chapter, the Committee proposes the steps below as a means to upgrade the policy framework to meet the challenges that lie ahead. The Committee emphasizes that these recommended reforms should be seen as a package. Implementing them partially would make the individual reforms far less effective; indeed, the Committee cautions that implementing the recommendations selectively could in some cases be counterproductive. For instance, liberalizing external commercial borrowings by corporates without allowing for greater exchange rate flexibility would increase incentives for borrowing via foreign currency-denominated debt, which could be risky.

The Committee views proper sequencing of the recommended reforms as important but, rather than lay out a specific and rigid timeline, prefers to take a more practical approach of indicating which reforms could be undertaken in the short run (the next

1–2 years) and which ones should be seen as longer-term objectives (over a 3–5 year horizon).

Monetary policy

1. Move towards establishing RBI's primary objective as the maintenance of low and stable inflation. Implicit in this objective will be to maintain growth consistent with the economy's potential and to ensure financial sector stability. The objective could be translated quantitatively into a number, a number that can be brought down over time, or a range that will be achieved over a medium-term horizon (say, two years). This will have to be done with the full support of the government, which would simultaneously commit to maintain fiscal discipline (i.e., stick to the FRBM deficit reduction path) and not hold the central bank accountable for either the level or volatility of the nominal exchange rate.

   The inflation objective would initially have to be set on the basis of a widely-recognized indicator such as the WPI or CPI, notwithstanding the conceptual and practical problems with targeting these measures of inflation. Measurement issues will need to be tackled as a priority and, over the initial medium-term horizon, the RBI will have to be transparent about what its headline objective implies for inflation based on other price indexes.
2. The government would make the RBI accountable for the medium-term inflation objective, with the terms of this accountability initially being laid out in an exchange of letters between the Government of India and the RBI.
3. The RBI should be given full operational independence to achieve the inflation objective. It would be useful to enshrine this operational independence and the inflation objective in legislation, but also strengthen it through clarifying public statements on the respective roles of the RBI and the government.
4. The RBI would progressively reduce its intervention in the foreign exchange market.
5. The RBI should make its operational framework clear, and supplement this with more frequent and concise statements about its assessments of macroeconomic developments, the balance of risks in the economy, and projections for output growth and inflation.
6. The RBI's Monetary Policy Committee should take a more active role in guiding monetary policy actions. This Committee should meet more regularly; its recommendations and policy judgements should be made public with minimal delays.
7. The RBI should develop a model for forecasting inflation and make the details of the model public. The model will require refinement as techniques and data improve; feedback from analysts and academics will facilitate this process. It will have to be made clear (and the public and market participants will quickly learn) that the model is intended to guide monetary policy decisions but not in a slavish manner or in a manner that precludes a healthy dose of judgement.

Timing: Steps 1, 2 and 4 could be implemented in the short term. Legislation (step 3) could take longer to formulate and pass, but it is important that the other steps be implemented and tied to a clear public understanding between the government and the RBI. Steps 5–7 should be implemented soon, especially since they are refinements (although fairly substantive ones) to current practices.

Capital account

1. Remove restrictions on outflows by corporates and individuals. There are already few restrictions on these outflows, but formal removal of controls, easing of procedures and elimination of the need for permissions, as well as a strong push to encourage outward flows would send a strong signal that the government is committing to increased financial integration and the policies that are needed to support it. Easing of restrictions on vehicles such as mutual funds and domestic fund managers (see Chapter 5), that individuals could use for international portfolio diversification, would be an important ancillary reform.
2. The registration requirements on foreign investors should be simplified. One

transparent approach would be to end the foreign institutional investor (FII) framework for investment in equities and, instead, allow foreign investors (including NRIs) to have direct depository accounts. The distinctions between FIIs, NRIs and other investors could also be eliminated, with the intent being to eliminate any privileges or costs they may experience with respect to domestic investors.

3. Remove the ceilings on foreign portfolio investment in all companies, with a narrow exception for national security considerations—treat foreign investors just like local shareholders.
4. Remove restrictions on capital inflows based on end-uses of funds. These do not serve much purpose anyway, since they are difficult to monitor.
5. Remove restrictions on inward FDI, with a narrow exception for national security considerations.
6. Liberalize, then eliminate, restrictions on foreign investors' participation in rupee-denominated debt, including corporate and government debt.
7. Remove regulations that hinder international diversification by domestic institutional investors. Insurance companies, as well as government pension and provident funds should especially be encouraged to diversify their holdings by investing abroad.
8. Reduce restrictions on borrowing by domestic firms and banks, whether this borrowing occurs offshore or onshore, in Indian rupees or foreign currencies. For instance, the ceiling on corporate external commercial borrowing could be steadily raised for the next few years until eliminated. If there is excess demand during the transitional phase to removal of restrictions, borrowing rights could be auctioned.[17] Stability concerns raised by exchange mismatches between bank assets and liabilities should be addressed by supervisory and prudential measures.

Timing: The first four steps would essentially formalize existing de facto arrangements and remove impediments that serve no substantive purpose in terms of economic efficiency or macro management. These changes could be implemented relatively quickly. Steps 5–6 could be implemented over the short term, in tandem with other reforms including improvements in the structure of public debt management. Step 7 could be implemented over 2–3 years. This lag is to allow for adequate regulatory capacity to be built up, and to allow for public debt management to be improved and for foreign investors to be allowed to participate in domestic debt markets so that there are no major implications for financing of the public debt. As noted earlier, step 8 should be tied in with other reforms and not undertaken in isolation from reforms to the monetary policy framework described under Monetary Policy above.

Fiscal policy

1. Continue to reduce levels of consolidated government deficit and public debt (ratios to GDP); resume progress towards targets specified under the Fiscal Responsibility and Budget Management Bill. Amend the FRBM Act so as to bring the off-balance-sheet borrowing by the government integrally into calculations of the government budget deficit and public debt.
2. Reduce the Statutory Liquidity Ratio to a level consistent with prudential needs; switch to direct bond financing of new deficits. Similarly, regulators of pension funds and insurance companies should set regulations on fund portfolio holdings so as to maximize the welfare of beneficiaries, and not so as to mobilize the purchase of government bonds.
3. Transition away from providing sops for exporters in response to currency appreciation. While many of the recent sops are in the process of being removed, it is important to curtail expectations of similar sops being offered in the future in the event of currency appreciation.

Timing: The time horizon for some of these measures could be in the range of 1–2 years, but it is essential to start laying the foundation for some of these changes much sooner.

Other reforms

1. Remove the remaining restrictions on the currency futures market in the short

term (prohibitions against foreign institutional investors, against non-resident Indians, against products other than futures, against underlying trades other than the rupee–US dollar rate, and against positions greater than US$5 million). Permitting onshore currency derivatives markets with no restrictions on participation is an important measure that includes elements of financial market regulation as well as capital account liberalization. These markets could be developed fairly quickly as the technical infrastructure for trading of these derivatives could be built up soon on the backbone of the existing securities trading infrastructure.

2. Improve the structure of public debt management to increase depth and transparency of this market.

The Committee is pleased to note that the RBI is working on the first item and the Finance Ministry has announced that it is setting up a public debt management office. These measures are long overdue and should be implemented soon.

The set of reforms listed here has not touched upon broader issues, some of which were discussed in the main text of the chapter—easing of labour market regulations, increasing investment in physical infrastructure and education, reducing red tape, improving data collection, etc. Action on all of these fronts will ultimately determine India's growth trajectory. But the specific steps listed above will make a major contribution to achieving the desired trajectory and could generate momentum for broader reforms.

ANNEXURE 2.1: A COMPARISON OF CAPITAL CONTROLS IN SELECTED ASIAN ECONOMIES

INDIA	
Investment Restrictions	
FII in:	**Ratio of 70:30 for Equity and Debt respectively**
Stock Market	1. Each FII (investing on its own) or sub-account cannot hold more than 10 per cent of the paid-up capital of a company. A sub-account under the foreign corporate/individual category cannot hold more than 5 per cent of the paid-up capital of the company. 2. The maximum permissible investment in the shares of a company, jointly by all FIIs together is 24 per cent of the paid-up capital of that company. 3. This limit of 24 per cent can be raised to 30 per cent, 40 per cent, 49 per cent or up to the FDI limits specified for that particular sector, subject to approval from the shareholders and RBI.
Government Debt	Effective 31March 2007, the cumulative debt investment limits for the FIIs/sub-accounts in government securities and treasury bills is US$3.2 billion (previously US$2 billion).
Corporate Debt	The cumulative debt investment limits for the FII/sub-accounts in corporate debt is US$1.5 billion. Investments in IPDI and Upper Tier II instruments raised in Indian rupees, are subject to a separate ceiling of US$500 million.
FII/FDI in:	
Banking	The total foreign ownership in a private sector bank cannot exceed 74 per cent of the paid-up capital and shares held by FIIs under the portfolio investment schemes through stock exchanges cannot exceed 49 per cent of the paid-up capital. In case of public sector banks the foreign ownership limit is 20 per cent. Single investor cap is 10 per cent and RBI approval required for acquisition or transfer of shares to the equivalent of 5 per cent or more of its total paid up capital.
Insurance	Cap of 26 per cent
Domestic FI Investing in Foreign Securities:	
Insurance	Cannot invest in securities in offshore markets.
Pensions	N.A.
Mutual Funds/Investment Firms and Collective Investment Funds	Mutual Funds in India with at least 10 years of operation may invest in overseas securities such as global depository receipts by Indian companies, equity of overseas companies and foreign debt securities in countries with fully convertible currencies, within an overall limit of US$3 billion.
Outward Direct Investment by Domestic Corporations	Indian corporations can invest in joint ventures/subsidiaries or acquire foreign companies overseas up to 200 per cent of their net worth through the automatic route. They can invest 200 per cent of their GDR and ADR issues for these investments. ECB credits/borrowings can be used to fund these investments. Share swap transactions require prior approval of the Foreign Investment Promotion Board (FIPB). Any Indian company that has issued ADRs or GDRs may acquire shares of foreign companies engaged in the same area of core activity up to 10 times their annual exports. Resident employees of a foreign company's office, branch or subsidiary in India in which the foreign company holds not less than 51 per cent equity, either directly or indirectly, may invest under an employee stock option plan without limit, subject to certain conditions.
Borrowing Restrictions	
External Commercial Borrowings	The maximum amount of ECB credit that a corporation can engage in under the automatic route is the equivalent of US$500 million in a financial year. All corporations registered under the Companies Act (except banks, financial institutions, housing finance companies and non-bank financial companies) may borrow abroad up to the equivalent of US$20 million for loans of a minimum three years' average maturity and up to US$500 million for loans of more than five years' average maturity under the automatic route without RBI approval. Borrowing with an average maturity of three to five years is subject to a maximum spread of 200 basis points over the six-month LIBOR of the currency in which the loans are raised or the applicable benchmark(s), and borrowing with more than five years' average maturity is subject to a maximum spread of 350 basis points.

Borrowing Overseas by Banks/FIs	External Commercial Borrowing is subject to the policy framed by the RBI in consultation with the MOF. Authorized Dealers (ADs) may avail themselves of foreign currency borrowing not exceeding 25 per cent of their unimpaired Tier-I capital or the equivalent of US$10 million, whichever is higher. Banks are allowed to raise capital using two foreign exchange instruments. First, banks may augment their capital funds through the issue of IPDI in foreign currency up to 49 per cent of the eligible amount (i.e., 15 per cent of Tier-I capital) without seeking the prior approval of the RBI, subject to compliance with certain specified conditions. Second, banks may augment their capital funds through the issue of Upper Tier II instruments in foreign currency up to 25 per cent of their unimpaired Tier-I capital without seeking the prior approval of the RBI, subject to compliance with certain specified conditions. Capital funds raised through the issue of these two instruments in foreign currency are in addition to the existing limit for foreign currency borrowing by ADs.
Imports and Exports	
Commercial Credits	Trade credits up to one year for non-capital goods and less than three years for capital goods are available up to US$20 million for an import transaction; ADs are permitted to guarantee such trade credits. Trade credits (buyer credits, supplier credits) exceeding US$20 million for financing imports of goods and services for a period less than three years are considered by the RBI, subject to certain conditions.
Documentation Requirements for Release of Foreign Exchange for Imports	Documentary evidence is required for foreign exchange payments for imports exceeding the equivalent of US$100,000.
Export Proceeds—Surrender Requirements	Effective 30 November 2006, exporters are permitted to retain up to 100 per cent (previously 50 per cent) of foreign exchange receipts in foreign currency accounts with banks in India. Effective 28 February 2007, ADs may extend the period of realization of export proceeds beyond six months from the date of export, up to a period of six months at a time, irrespective of the invoice value of the export, subject to conditions.
CHINA	
Investment Restrictions	
FII in:	**Restrictions on Investment in 'A' Shares, but no Restrictions on Investment in 'B' Shares**
Stock Market	Qualified Foreign Institutional Investor (QFII) may invest in A shares, subject to the following limitations (in addition to the criteria of investee's net worth, track record, assets etc): 1. Ownership of any Chinese company listed on the Shanghai or Shenzhen stock exchange by a QFII may not exceed 10 per cent. 2. Total shares owned by QFIIs in a single Chinese company may not exceed 20 per cent. 3. QFIIs are restricted or prohibited from investing in some industries or businesses (e.g., medicine manufacturing, mining, telecommunication, etc.).
Government Debt	QFIIs may invest in treasury bonds listed on domestic securities exchange.
Corporate Debt	QFIIs may invest in convertible bonds and corporate bonds listed on domestic securities exchange.
FII/FDI in:	
Banking	CBRC approval is required. Aggregate cap of 25 per cent with ceiling of 20 per cent for single foreign investors.
Insurance	Cap of 50 per cent.
Domestic FI Investing in Foreign Securities:	
Insurance	Approved Insurance companies may invest in shares in offshore markets within the permitted limit, but may not exceed 10 per cent of the investment limit permitted by the SAFE.
Pensions	N.A.
Mutual Funds/Investment Firms and Collective Investment Funds	Effective 15 April 2006, on approval, qualified fund management firms and other securities management companies may, within a certain limit, combine foreign exchange funds owned by domestic institutions and individuals and use the funds overseas for portfolio investments, including for stocks.
Outward Direct Investment by Domestic Corporations	Effective 1 July 2006, the limit on the amount of foreign exchange used in Chinese enterprises' direct investments abroad has been abolished, allowing domestic investors to purchase foreign currency to participate in direct investments abroad.

Borrowing Restrictions	
External Commercial Borrowings	One-year or longer international commercial borrowing by Chinese institutions must be approved in advance. Financial Institutions with an approval to engage in foreign borrowing may conduct short-term foreign borrowing with maturities of one year or less within the balance approved by the SAFE. Specific transaction-based approval is not required. All foreign borrowing must be registered with the SAFE.
Borrowing Overseas by Banks/ FIs	The regulations governing ECB-corporates above apply. Domestic banks that are funded abroad may not convert proceeds from debt contracted abroad into renminbi and are not allowed to purchase foreign exchange to service these debts.
Imports and Exports	
Commercial Credits	The regulations governing ECB above apply.
Documentation Requirements for Release of Foreign Exchange for Imports	In order to purchase foreign exchange or make payments from a foreign exchange account, importers must provide the import contract, the exchange control declaration related to the import payment in foreign exchange, the customs declaration (required for payment-on-delivery settlement), the invoice and the import bill of lading. Collections and LCs do not require customs declaration, and cash-on-delivery payments do not require bills of lading.
Export Proceeds—Surrender Requirements	Domestic institutions may establish current account foreign exchange accounts with proof of a business licence (or organization registration) and an institution identification number and may retain foreign exchange revenue resulting from 80 per cent of the previous year's current account foreign exchange revenue minus 50 per cent of current account foreign expenditure. Domestic institutions that in the previous accounting year had no current account foreign exchange revenue may retain an initial limit of foreign exchange revenue of US$500,000 when establishing accounts.
THAILAND	
Investment Restrictions	
FII in:	
Stock Market	The combined shareholdings of an individual and related family members may not exceed 5 per cent of a bank's total amount of shares sold and 10 per cent of that of finance companies and credit companies.
	Foreign equity participation is limited to 25 per cent of the total amount of shares sold in locally incorporated banks, finance companies, credit finance companies and asset management companies.
	Foreign investors are allowed to hold more than 49 per cent of the total shares sold in local financial institutions for up to 10 years, after which the amount of shares will be grandfathered, and the non-residents will not be allowed to purchase new shares until the percentage of shares held by them is brought down to 49 per cent. Foreign equity participation is limited to 49 per cent for other Thai corporations. Holdings exceeding this limit are subject to the approval of the BOT.
Corporate Debt	Effective 4 December 2006 investments of more than B 50 million a consolidated entity in short-term debt and related products (not exceeding six months) issued by local financial institutions in the primary market without underlying transactions are not allowed. Effective 15 November 2006, local financial institutions may not issue or sell bills of exchange in baht for any maturity to non-residents.
FII/FDI in:	Foreign capital may be brought into the country without restriction, but proceeds must be surrendered to authorized financial institutions or deposited in foreign currency accounts with authorized financial institutions in Thailand within seven days of receipt.
Banking	Same as applied to FIIs above. Foreign investors may be allowed, on a case-by-case basis, to hold up to 100 per cent of shares sold in commercial banks for a period of 10 years, which will be grandfathered. However, after the 10-year period, they will not be allowed to purchase additional shares unless their holding is less than 49 per cent of the total amount of shares sold.
Domestic FI Investing in Foreign Securities:	
Insurance	Effective 15 January 2007 insurance companies are allowed to invest in securities issued abroad by Thai juridical persons without limit and in foreign securities issued by non-residents up to US$50 million but not exceeding the limit set by their regulator, without BOT approval.
Pensions	Same as above for insurance. The ceiling on investment in stocks is 25 per cent of the portfolio, and that on any single stock is 5 per cent of the portfolio.

Mutual Funds/Investment Firms and Collective Investment Funds	Same as above for Insurance.
Outward Direct Investment by Domestic Corporations	Investments exceeding US$10 million (or the equivalent) a year require BOT approval. Effective 15 January 2007, residents may invest up to US$20 million a person a year in their parent companies abroad (owning at least 10 per cent of the resident companies) and US$50 million a person a year in their affiliated companies abroad (owned at least 10 per cent by the resident) without approval from the BOT.
Borrowing Restrictions	
External Commercial Borrowings	A limit of B 50 million applies on the amount that non-residents may lend to domestic financial institutions. This limit applies to loans granted by non-residents without underlying transactions, with maturities not exceeding—effective 24 December 2006—six months (previously, three months). The non-resident's head office, branches, representative offices and affiliated companies are counted as one entity.
Borrowing Overseas by Banks/FIs	The limit that non-residents may lend to domestic financial institutions is B 50 million or its equivalent. Effective 24 December 2006, this limit applies to loans granted by non-residents without underlying transactions with maturities of less than or equal to six months (previously three months).
Imports and Exports	
Documentation requirements for release of foreign exchange for imports	No documentation requirements.
Export proceeds—Surrender requirements	Foreign exchange proceeds must be surrendered to authorized financial institutions within seven days of receipt. Effective 15 January 2007, foreign exchange earners are allowed to deposit foreign exchange proceeds in their foreign currency accounts up to US$50,000 for a natural person and US$2 million for a juridical person even if no future obligation on foreign exchange can be documented.
KOREA	
Investment Restrictions	
FII in:	
Stock Market	Foreign investors are allowed to freely purchase shares issued by Korean companies. However, purchase of shares of unlisted or non-registered corporations requires notification to a foreign exchange bank. Acquisitions of shares exceeding certain ratios of designated public sector utilities in the process of privatization are limited by the relevant laws.
FII/FDI in:	
Banking	Non-residents may acquire 10 per cent of stocks without restrictions; acquisition exceeding 10 per cent requires approval of the FSC.
Domestic FI Investing in Foreign Securities:	
Insurance	The sum of the assets of an insurance company denominated in foreign currency must not exceed 30 per cent of its total assets.
Pensions	There are no restrictions on the compositions of foreign currency assets imposed by the relevant laws. For example, according to the National Pension Fund (NPF) Act, there is no limitation on the composition of the NPF's foreign currency assets. Instead, this is ruled by internal asset management guidelines.
Mutual Funds/Investment Firms and Collective Investment Funds	According to the Indirect Investment Asset Management Business Act, there are no limitations on the compositions of investment firms and collective investment funds.
Outward Direct Investment by Domestic Corporations	Residents are free to invest abroad on notification to the designated foreign exchange bank. However, investments in financial institutions or insurance companies require notification to and acceptance by the MOFE. Investment by individuals is also limited to 30 per cent of annual sales revenue. Effective 2 March 2006, the limit on investment by individual was abolished.
Borrowing Restrictions	
External Commercial Borrowings	Financial credits up to the equivalent of US$30 million require notification to foreign exchange banks. Other credits exceeding US$30 million require notification to the MOFE.
Borrowing Overseas by Banks/FIs	Foreign exchange banks are required to notify the MOFE of funding with maturities exceeding one year and amounts exceeding US$50 million.

Imports and Exports	
Commercial Credits	Commercial credits other than trade credits (including deferred payments, installment payments, exports advances, and export down payments) up to US$30 million require notification to foreign exchange banks. Other credits exceeding US$30 million require notification to the MOFE.
Documentation Requirements for Release of Foreign Exchange for Imports	No documentation requirements.
Export Proceeds—Surrender Requirements	Effective 2 March 2006, export earnings exceeding US$500,000 (previously US$100,000) must be repatriated within one and a half years (effective 1 January 2006; previously, six months) of receipt. These funds, however, may be held abroad and used for overseas transactions in accordance with the regulations on foreign exchange transactions.

NOTES

1. Acharya (2006) and Virmani (2006) discuss the roles of different policies in driving India's growth.
2. See RBI (2004) and Bery and Singh (2007) for a comprehensive documentation of this evolutionary process. In reviewing monetary policy outcomes, Virmani (2007) notes that there has been a steady convergence between Indian and international (US) inflation levels, as measured by comparable consumption deflators, over the last 15 years. Such convergence greatly facilitates financial integration and needs to continue.
3. This point has been made by Virmani (2007).
4. See Mohan (2007) and Reddy (2007) for a clear articulation of some of these issues in India's context.
5. In plain language, even if the exchange rate of the rupee for the dollar remains fixed, India loses competitiveness if its inflation rate is higher than US inflation. This is because the rupee's real exchange rate—nominal appreciation, augmented by the inflation differential—has appreciated. There are several related concepts of the real exchange rate. One concept focuses on the change in the relative price of non-tradables (haircuts) to tradables (iPods), with an increase in the price of non-tradables representing a real appreciation of the rupee. An alternative concept focuses on external competitiveness and typically compares changes in price levels between the home country and its main competitors. We use the term 'real effective exchange rate' to refer to the latter concept.
6. Bosworth and Collins (2008) present calculations of total factor productivity growth for China and India, both at the aggregate level and separately for agriculture, manufacturing and services.
7. See the analysis in the IMF's October 2007 *World Economic Outlook*, and the references therein.
8. Kaminsky, Reinhart and Vegh (2004) discuss how procyclical fiscal policy has hurt the ability of Latin American economies to deal with capital flows.
9. See Chapter III in the IMF's October 2007 *World Economic Outlook*. Of course, it is difficult to establish a clear counterfactual in such an exercise (how much the exchange rate would have appreciated if there was no intervention), so one should be cautious in interpreting these results.
10. This box is based on material taken from Prasad (2008).
11. Patnaik and Shah (2007) discuss the related problem of moral hazard caused by implicit government guarantees such as those related to reducing exchange rate fluctuations through intervention. They provide firm-level evidence that a managed exchange rate induces firms to increase unhedged currency exposures.
12. See Shah (2007) for a more detailed discussion of these points.
13. In a recent contribution, Rose (2007) marshals empirical evidence that countries that have adopted inflation targeting regimes have lower exchange rate volatility and fewer sudden stops than similar countries that do not target inflation. He also notes that this monetary regime seems durable—no country has yet been forced to abandon an inflation targeting regime.
14. See Brash (2000).
15. Crowe and Meade (2008) discuss different aspects of central bank transparency and provide some evidence on the benefits of increased transparency.
16. See Forbes (2006, 2007).
17. This suggestion is taken from Virmani (2007).

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Broadening Access to Finance

chapter 3

Financial sector policies in India have long been driven by the objective of increasing financial inclusion, but the goal of universal inclusion is still a distant dream. The network of cooperative banks to provide credit to agriculture, the nationalization of banks in 1969, the creation of an elaborate framework of priority sector lending with mandated targets were all elements of a state-led approach to meet the credit needs of large sections of the Indian population who had no access to institutional finance. The strategy for expanding the reach of the financial system relied primarily on expanding branching, setting up special purpose government sponsored institutions (such as regional rural banks (RRBs) and cooperatives) and setting targets for credit to broad categories of the excluded. Its success has been mixed, and has been showing diminishing returns.

A new approach to financial inclusion is needed that builds on the lessons of the past. It will require a change in mindset on the part of policymakers, practitioners, and other stakeholders in India to figure out effective ways to provide financial services to the poor. It should lead to a set of financial sector reforms that explicitly prioritize inclusion. We note some important lessons from India's past experience:

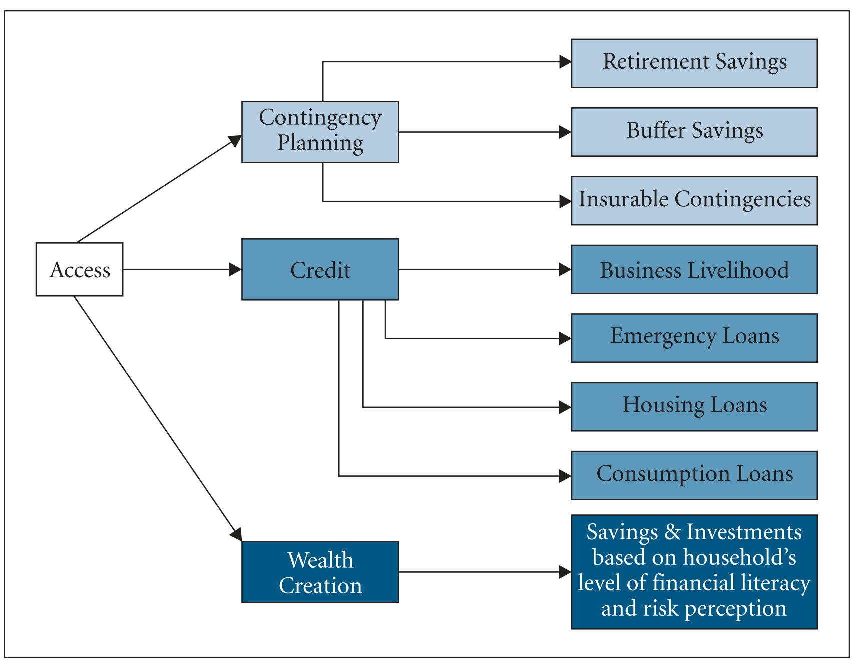
- Financial inclusion is not only about credit, but involves providing a wide range of financial services, including saving accounts, insurance, and remittance products. An exclusive focus on credit can lead to undesirable consequences such as over-indebtedness and inefficient allocation of scarce resources. Moreover, credit provision, without adequate measures to create livelihood opportunities and enhance credit absorption among the poor will not yield desired results.
- Perhaps the most important financial services for the poor are vulnerability reducing instruments.[1] Thus access to safe and remunerative methods of saving, remittances, insurance, and pensions needs to be expanded significantly. Within insurance, crop insurance for farmers and health insurance for the poor in general, are major vulnerability reducers. A significant expansion in coverage is needed, even while action is taken on the real side to reduce the factors creating vulnerability (such as broader access to irrigation, agricultural extension services, and preventive, as well as actual, health care).
- Efforts at financial inclusion need to move away from sectors to segments of people that are excluded. Past efforts have focused largely on agriculture. As the Indian economy diversifies and more people move away from farming, there is an urgent need to focus on other segments as well, for instance the poor in urban areas. Moreover, sector-specific approaches result in benefits that often accrue to non-poor recipients, as in the case of subsidized agriculture credit.
- Past strategies to expand inclusion are reaching seriously diminishing returns.
    - While mandated branching, especially by public sector banks in rural areas, has made banks easier to reach for significant portions of the population, these branches have not gone out of their way to attract the poor. Rural branches are seen as a burden rather than an opportunity by the increasingly profit-oriented public sector. At the same time, it appears that more branching itself cannot be the way to reach the poor, since the poor in richly branched urban areas have no more access than the poor in rural areas.
    - Priority sector norms do force a focus on particular sectors. But because they are now so broad in coverage, banks migrate towards the bankable within the priority sector rather than the excluded, with those lucky enough to get themselves classified as priority sector

enjoying access over and above what they would otherwise normally get.

- Interest rate ceilings for small loans further reduce commercial banks' desire to service the truly excluded—the higher fixed costs and higher perceived credit risk associated with small loans imply lenders need higher, not lower, interest rates to meet demand.[2] When a low interest rate is mandated in the face of tremendous unfulfilled demand for credit, it has three effects. First, a market determined interest rate is often charged, but the difference between the ceiling and the true rate is made up through hidden fees or through bribes (and when bribes are paid to secure the loan, the incentive to repay is severely diminished). Second, the very poor, who have the least ability to pay these additional charges, are further excluded. Third, a plethora of bureaucratic norms and paperwork is imposed on loan officers to counter the possibility of corruption, which further reduces the flexibility or the attractiveness of the loans. The need to remove interest rate ceilings and replace them with transparent but market-based pricing has been echoed by past Committees that have seriously addressed the issue, but the political unwillingness to make changes has ensured that the poor are excluded from the formal sector and driven further into the hands of moneylenders.

- There is a clear need to increase the commercial viability of reaching the poor. Product innovation, organizational flexibility, and superior cost efficiency are essential in reaching the excluded (as cell phone companies have discovered) and offering them financial services that they will want to use. Competition, technology, as well as the use of low cost, local organizations for outreach will have to play a much greater role in any strategy. The role of the government should be to attempt to increase the returns and reduce the costs of servicing the financially excluded, even while expanding the desire and the ability of financial firms to compete for such business. By necessity, this will imply a greater tolerance for innovation and risk, which is not inappropriate so long as that risk does not become systemic.
- The Committee recognizes, however, that greater commercial viability cannot be truly achieved for all sections of the poor, and therefore some kind of mandated coverage will always be required. The key is to move the primary strategy towards innovation and commercial viability, with more carefully targeted mandates seen as filling the gaps, rather than having broad mandates as the central instrument as is current practice.

Figure 1: Household Access to Financial Services



Source: IISS, 2007.

DEFINING ACCESS IN A FINANCIALLY INCLUSIVE SYSTEM

Financial inclusion, broadly defined, refers to universal access to a wide range of financial services at a reasonable cost. These include not only banking products but also other financial services such as insurance and equity products (see Figure 1). Households need access to finance for several purposes, the most important being for contingency planning and risk mitigation. Households build buffer savings, allocate savings for retirement (for example via pension plans) and purchase insurance and hedging products for insurable contingencies. Once these needs are met, households typically need access to credit—for livelihood creation as well as consumption and emergencies (in the event that they do not have savings/insurance to fund them). Finally, wealth creation is another area where financial services are required. Households require a range of savings and investment products for the purpose of wealth creation depending on their level of financial literacy as well as their risk perception.

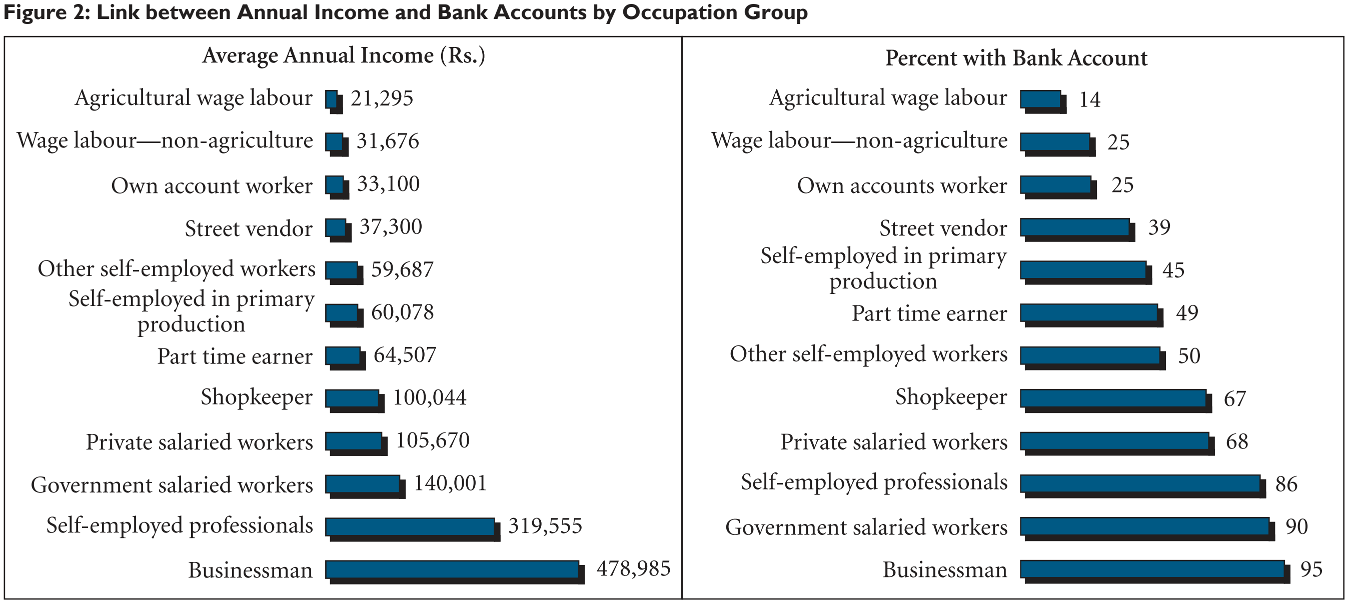
FINANCIAL INCLUSION IN INDIA—AN UPDATE OF THE EVIDENCE[3]

Broad assessment

India's poor, many of who work as agricultural and unskilled/semi-skilled wage labourers, micro-entrepreneurs and low-salaried worker, are largely excluded from the formal financial system (Figure 2). Over 40 per cent of India's working population earn but have no savings.[4] Even accounting for those with financial savings, too large a proportion of the poor lie outside the formal banking system. For example, only 34.3 per cent of the lowest income quartile has savings, and only 17.7 per cent have a bank account. By contrast, in the highest income quartile, 92.4 per cent have savings and 86.0 per cent have bank accounts. Similarly, 29.8 per cent of the lowest income quartile had taken a loan in the last two years, but only 2.9 per cent had loans from banks (about one tenth of all loans), while 16.3 per cent of the highest income quartile had loans and 7.5 per cent had loans from banks (about half of all loans).

The rich-poor divide has replaced the conventional rural-urban divide in access to financial services, as measured by the distribution of savings accounts. It is true that headline statistics on access to banks seem to convey that there is a rural-urban divide in access to banking services. The population served per bank branch in rural India is approximately 18,000 while in urban India is 5,000 (World Bank-NCAER *Rural Financial Access Survey*, 2003). But 80 per cent of those without savings reside in the rural areas. For those in higher income brackets, access to banks in rural areas is not vastly different from access in urban areas. Banks are approaching near 100 per cent coverage of individuals with incomes above Rs. 2 lakh, irrespective of geographical location. In urban India, 34 per cent of workers in the lowest income quartile have savings, and of

Figure 2: Link between Annual Income and Bank Accounts by Occupation Group

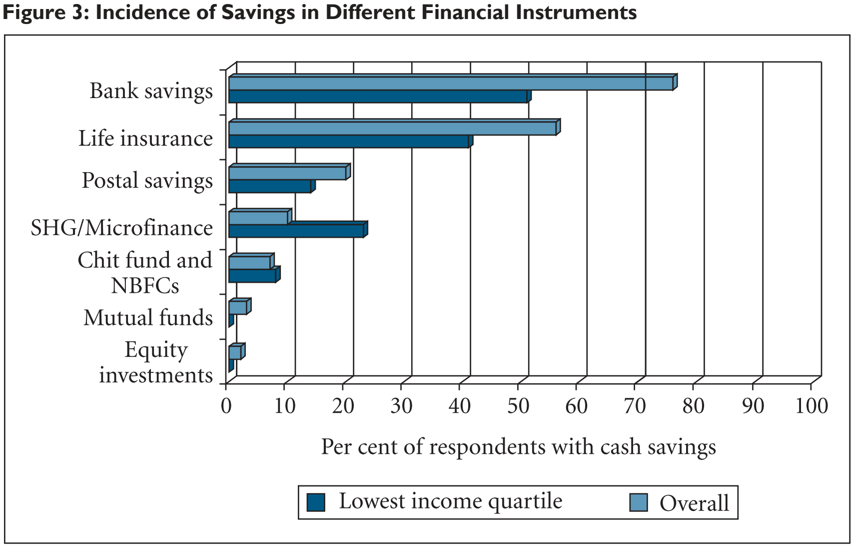


Source: IISS, 2007.

whom only 60 per cent have bank savings account, while in the highest income quartile, 92 per cent have financial savings and of whom 96 per cent have bank savings account. A similar trend is evident for rural India where 83 per cent of rural workers with annual incomes above the national average (Rs. 71,000 for the Survey) have bank accounts. Even inter-state differences in banking coverage can largely be explained by large differences in incomes and savings among states.[5] Though we cannot rule out the possibility of other sources of causality, income seems to be a big factor explaining access to financial services.

Public ownership of financial services also does not contribute significantly towards expanding access. The clientele of private or foreign banks located in rural areas is not very different from the clientele of public sector banks (see Chapter 4). Similarly, the poor's access in the public sector dominated rural areas is not significantly higher than in urban areas (though costs of access may indeed be higher in rural areas). Finally, branching as a strategy to improve inclusion itself seems to have reached diminishing returns. The poor have no more access in the richly branched urban areas than in the rural areas. Inclusion has to be more than opening up more branches.

Figure 3: Incidence of Savings in Different Financial Instruments



Source: IISS, 2007.

Specific needs of the poor and extent to which met by formal system

The use of financial services is not only a function of economic criteria but is also dependent on socio-cultural parameters and risk perception, an understanding of which is critical to increase usage—not just availability—of formal financial services. What is particularly of concern is the extent to which the poor use financial services, but sourced from the informal rather than the formal financial system.

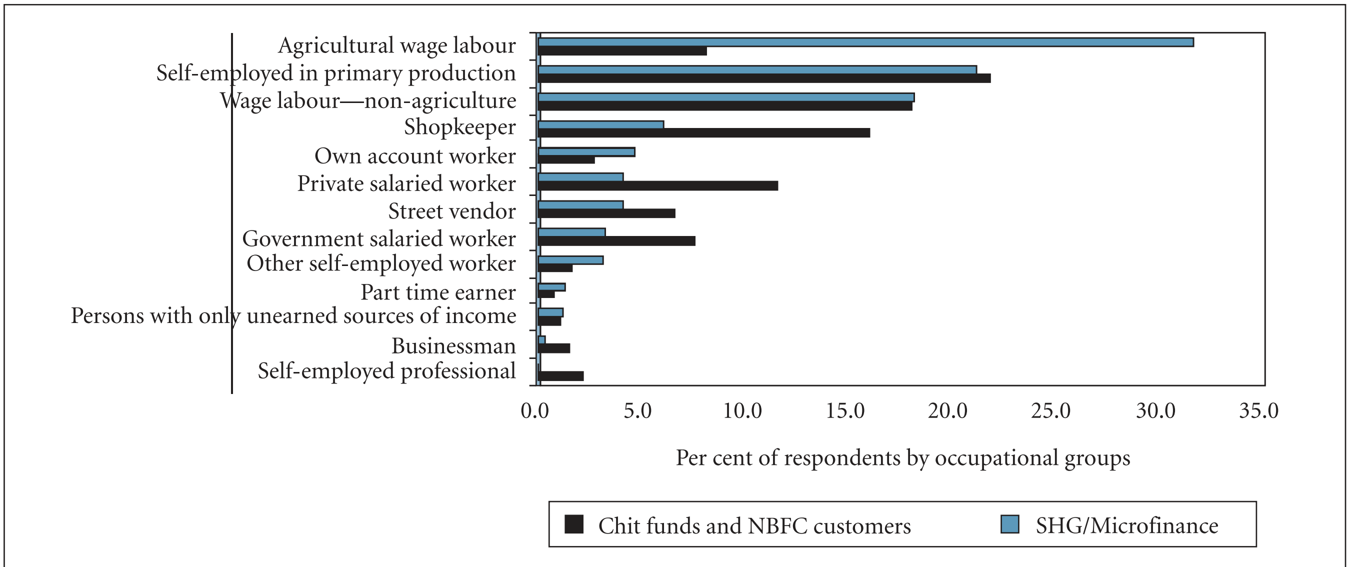
1. Savings

   Seventy-six per cent of respondents with savings reported keeping their money in bank savings accounts. Other popular savings instruments include life insurance and postal savings (Figure 3). In the lowest income quartile, the most preferred savings instruments were bank savings accounts though only 50 per cent of those with savings had bank accounts. Life insurance and informal savings schemes like self-help groups and microfinance institutions were the other preferred instruments. Over 20 per cent of respondents in the lowest income quartile held savings in chit funds and self-help groups/microfinance, though the absolute number of people saving in these informal savings schemes is still small—approximately 10 per cent of those with cash incomes or 33 million. Over 50 per cent of the clients saving with SHGs/microfinance institutions were agricultural wage labourers and self-employed farmers, while 30 per cent of chit fund members belonged to this category (Figure 4).

   Few people save for retirement, with less than 10 per cent of the paid workforce saving explicitly for retirement through employer-sponsored schemes, or voluntarily through public provident fund, life insurance and mutual fund products.[6] In the lowest income quartile, 3.7 per cent of respondents in the category saved for old age security.

   Higher income categories are more likely to diversify into other financial instruments. The RBI Annual Report, 2006–07, states that the share of household financial savings in shares and debentures increased from 1.1 per cent in 2004–05 to 6.3 per cent in 2006–07.[7] The Survey

Figure 4: Use of Informal Savings Schemes by Occupation Category



Source: IISS, 2007.

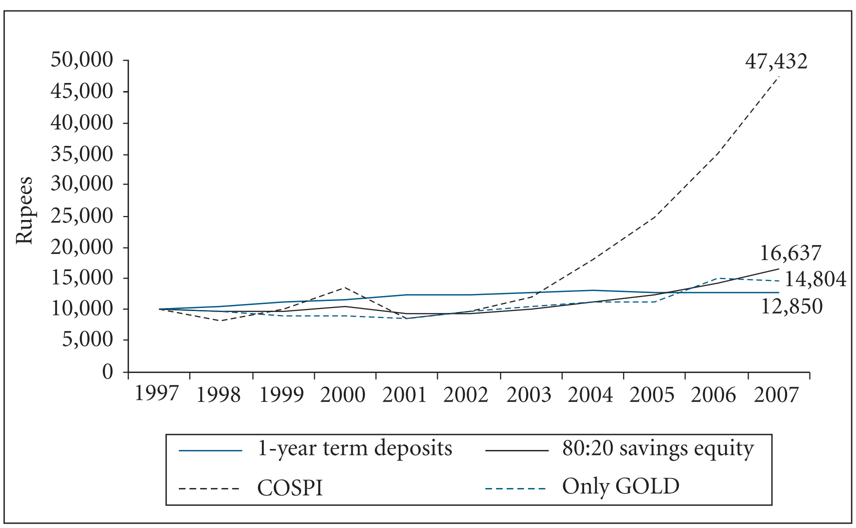
reveals that increased investor interest in equities and mutual funds figured prominently among respondents citing wealth creation and investment as their main motivation for savings.[8,9] Although 30.0 per cent of equity investors and 32.0 per cent of mutual fund investors report an annual income of below Rs. 2.5 lakh, they comprise less than 1 per cent of the population in this income category. In the income category above Rs. 2.5 lakh, over 29 per cent have invested in mutual funds and 20 per cent in equities. The one common quality among these investors appears to be education—over three-fourths of investors are graduates. Less than 4 per cent of the investors are women.

Bank savings are overwhelmingly the most popular savings medium even among those who appear to have choices in deployment of their savings. However, real returns on bank savings have paled in comparison with returns on equity especially in recent years (Figure 5). The poor have largely missed out on the boom in the equity markets for a number of reasons, including a high priority on security and liquidity, and perhaps a limited understanding of the economic effects of inflation on savings. Worse, the tax on bank deposits has increased the gap in returns between bank savings and equity.[10] This emphasis on bank deposits is beginning to change slowly at the margin as more low income households invest in mutual funds and equities.

2. Insurance

The participation of low-income groups in life insurance, the second most preferred savings instrument after bank savings deposits, is still very limited. Life insurance is the preferred choice to deal with insurable contingencies, particularly premature death. One-third of all paid workers have some life insurance protection. However, only 14 per cent of

Figure 5: Returns on Various Savings Instruments for an Investment of Rs. 10,000 in 1997



Source: ICICI Bank research.

Note: COSPI is an equities index developed by the Centre for Monitoring Indian Economy which is based on all listed Indian companies.

people in the lowest income quartile and 26 per cent in the second quartile have life insurance as against 69 per cent in the highest income quartile. While the elaborate sales and distribution model has contributed to the popularity of life insurance, this has come at considerable cost by way of high commissions and a large per cent of lapsed policies.[11] Policy lapses are low only in the highest income quartile, while in all other segments at least 20 per cent respondents have had a policy lapse. The penetration of non-life insurance products is negligible. For example, only 1 per cent of the population appears to have medical insurance.

3. Credit

The poor borrow predominantly from informal sources, especially moneylenders and relatives/friends. In the lowest income quartile, over 70 per cent of loans taken were from these sources. Only 10 per cent of respondents took a loan from a bank in the last two years. Correspondingly, in the highest income quartile, banks were the most preferred followed by relatives/friends (Figure 6). A large proportion of borrowers, irrespective of income, sourced their loans from friends and relatives (though the fact that nearly half these loans are made at interest rates above 36 per cent per annum suggest they may include informal commercial sources such as shop keepers that are well-known to the poor). Even among the urban poor, a large per cent of their housing finance needs are met by informal sources.

Medical and financial emergencies were the main reason for household borrowing accounting for 42 per cent of all loans made in the past two years. For the lowest income quartile population, the incidence of emergency loans was highest at almost 50 per cent, with the top three loan sources being moneylenders, friends and relatives and SHGs. Nearly 90 per cent of Survey respondents in this quartile relied on informal sources for credit. In the highest income quartile, the incidence of emergency loans was around 35 per cent, mostly for financial emergencies. The Survey results on incidence of financial and medical emergency loans among the various income quartiles revealed that medical emergencies were particularly high for the lowest income quartile. Loans for medical emergencies decline substantially as income levels increase. Loans taken for emergency purposes created an unsustainable amount of debt for the lowest income segment with outstanding debts out of emergency loans resulting in debt on average exceeding a full year's earnings.

The high dependence on informal sources in turn implies that bulk of the borrowing by the very poor is at very high interest rates. Almost half the loans taken by the lowest income quartile carry annual interest rates above 36 per cent (Figure 7). While the majority of small loans by banks are at low interest rates, only a small fraction of the loans the poor get are from banks. It appears that the low interest rate ceiling may be a factor leading to the higher-credit-risk poor being denied credit by the formal sector.

Given the extremely high demand for credit, interest rate ceilings could simply increase the extent to which costs are recovered through fees and other mechanisms. A 2003 World Bank survey revealed that despite lower nominal interest rates, rural borrowers paid substantial unofficial borrowing costs in the form of bribes and the time taken to process a loan.[12] While the per cent of bribes as a share of the loan were highest in government sponsored schemes (around 42 per cent of the loan) and lowest for banks (10 per cent of the loan), the time taken to process loans was the longest for commercial banks in rural areas. Households generally received significantly less than the total amount of loan they applied for, and the data suggest that speed of loan approval was positively correlated with the amount of bribe paid. The Survey covered just two Indian states (Uttar Pradesh and Andhra Pradesh),

Figure 6: Sources of Loan by Income Group

Loan sources	Percentage of persons in income quartile who have taken loan from sources in last two years			
	Lowest income quartile	Second income quartile	Third income quartile	Highest income quartile
Relatives/friends	39.2	34.4	33.2	32.0
Moneylenders	39.8	33.2	25.8	14.8
Banks	9.6	20.7	33.3	45.8
Self-help groups	9.7	8.4	3.3	3.4
Cooperative societies	5.4	4.9	6.5	7.4
Chit funds/NBFC	1.6	1.9	1.5	1.2
Microfinance Institutions	1.1	1.4	1.2	0.9
Others	1.0	0.9	0.8	1.4

Source: IISS, 2007.

however, anecdotal information supports the findings of this survey and strengthens the belief that the cost of access to credit often goes well beyond nominal interest rates charged on the loan.

Other sources support our conclusion that large segments of India's poor households continue to be shut out of mainstream finance. More worrying, according to some measures, access is actually declining. The All India Debt and Investment Survey, conducted every 10 years, documents how Indian cultivators' reliance on formal debt sources increased substantially from 18 per cent in 1961/62 to 63 per cent in 1981/82, but this progress was reversed in the next two decades as the share of cultivators' debt from moneylenders increased from 18 to 30 per cent between 1991 and 2002. The National Commission for Enterprises in the Unorganized Sector points out that microenterprises with investments below Rs. 0.5 million constitute over 90 per cent of small enterprises in the country and contribute 30 per cent to industrial production but receive just 2 per cent of net bank credit.

ASSESSING THE STRATEGY FOR INCLUSION

The broad strategy for expanding the reach of the financial system had mixed results. The strategy relied primarily on expanding branching into rural areas, setting up special purpose government sponsored institutions (such as regional rural banks and cooperatives) and setting targets for credit to broad categories of the excluded. Rural branches have not been profitable, and there is little interest among private and public sector banks in opening new branches there. It is fair to question whether the stationing of highly-paid urban-recruited staff in short-term postings in rural areas is conducive to the development of local knowledge and low cost efficient delivery of financial services, especially credit. Even if the staff make local contacts and understand local needs, the controls that central offices have to exercise over them allow them little leeway for taking initiative. Indeed, the predominant lender to the poor is still the moneylender, in part because he is flexible, does not need documentation, is prompt, and can respond to his client's emergency needs very well.

Figure 7: Annualized Interest Rates Paid by Income Groups

Income quartile	Percentage of persons in the income quartiles paying interest at the rate			
	<=12% pa	12%–24% pa	24%–36% pa	>36% pa
Lowest income quartile	16.0	16.9	18.7	48.4
Second income quartile	22.8	18.8	18.7	39.7
Third income quartile	29.1	26.1	18.7	26.2
Highest income quartile	40.4	24.5	11.7	23.4
Total	22.6	19.4	17.7	40.4

Source: IISS, 2007.

Note: Figures are indicative and do not take into account the fact that some sources provide only short-term loans.

Credit

Special purpose government sponsored local institutions such as rural cooperatives did increase access to credit, but they are experiencing serious financial problems, in part because they did not have the right governance and incentive structures. As indicated by the Vaidyanathan Committee, cooperatives unfortunately became agencies solely for credit dispensation.[13] Upper tiers were created to provide refinance for the lower. This resulted in a structure driven by borrowers at all levels, with each layer adding costs. Indeed, the whole concept of top-down financing inherent in the Indian cooperative sector is in sharp contrast to the cooperative movement in other countries, where member savings are channelled through careful member control into local loans. This bottom-up flow of financing, coupled with member monitoring, ensures that loans are carefully made and repayment rates are high. Loan assessment and monitoring in the cooperative movement in India has been much more lax, in part because of the easy availability of refinance from outside, and because of limited control exercised by those whose funds are being employed.

Cooperatives also suffer from a number of other disadvantages. Their inability to lend well has increased the interest cost of deposit financing. They have high transaction costs owing to over-staffing and salaries unrelated to the magnitude of business. Actual repayments are influenced by ad-hoc government decisions to suspend, delay or even waive recovery. All these impediments have ensured they have played a smaller role than they could have.[14]

Priority sector lending requirements played a useful role in facilitating the provision of bank credit to underserved sectors and sectors identified as national priorities.[15] It is probably fair to say that banks' loan portfolios in agriculture, microfinance, small-scale industry and other sectors (that were neglected with respect to credit provision) would have seen a more modest growth in the absence of priority sector lending norms. If an objective of priority sector lending, however, was to direct credit to those *segments* that are truly underserved, the outcomes are not encouraging. All banks, public and private, have consistently missed their targets for credit provision under the direct agriculture segment (though public sector banks have done relatively better), which is largely intended for farmers.[16] Similarly, they have missed priority sector lending targets for the 'weak and vulnerable' category.

Dilution in priority sector norms also contributed to a reduced focus on underserved segments. The bulk of increase in credit to agriculture was accounted for by increase in indirect finance to agriculture, which includes activities that can be considered commercially viable. Another example is the loans to housing. Housing loans were introduced into the priority sector framework in the 1990s to spur the development of this market. The ceiling on housing loans eligible for priority sector treatment was initially set at Rs. 5 lakh; this limit was rapidly increased to Rs. 20 lakh by 2006. To qualify for a housing loan of Rs. 20 lakh, an individual needs an annual income of at least Rs. 4 lakh per year. Surely this is not the category of borrowers that need to be targeted via mandated lending!

The dilution in priority sector norms over time was a reaction to the lack of profitable lending opportunities when norms were more tightly specified. The fundamental dilemma is obvious. Profit-seeking banks will look for all lending opportunities that are profitable. Priority sector norms will expand access only if they make banks do what they would otherwise not do, which almost by definition is unprofitable. There is therefore a delicate balance in setting priority sector norms and eligible categories. High priority requirements and narrow eligible categories targeted at those who truly do not have access could lead to greater access to credit, but could reduce bank profitability considerably. Essentially, banks would be making transfers to the needy, a role better played by the government.

Insurance

Government efforts at providing risk mitigation have also been less than adequate, and have unfortunately hindered the development of private efforts. Recognizing the need for risk mitigation, the government set up a mandatory National Agricultural Insurance Scheme (NAIS) for farmers, which requires that farmers borrowing for 16 specific crops purchase crop insurance through the NAIS. However, the payout from this scheme for the past six years has been in excess of the premia received. This is a direct consequence of the caps imposed on the premium rates of oilseeds and food crops—less than 1.5 per cent and 3.5 per cent or the actuarial assessed rates for food crops and oilseeds respectively. Though the broad structure of the NAIS is sound, a key problem is the significant delays in claims settlement (9–12 months on average). These delays could be significantly reduced by strengthening the yield data collection process, combining early trigger indices into NAIS to make part payments during the crop cycle with final settlements made on the area yield measured, and most importantly by moving towards an actuarial regime where the Agriculture Insurance Company of India (AICI) could receive upfront government support and would bear residual insurance risks.[17] For now, the highly subsidized nature of this insurance has distorted farmers' views on what the true price of insurance should be, and discouraged private initiatives to provide crop insurance. Subsidized livestock insurance schemes have had a similar effect. Insurance against agricultural price fluctuation has been hampered, as small farmers are unable to exercise hedging options that are available to larger farmers.

In summary, the past strategy for inclusion had mixed results**.** While the public sector did create a rural network, that network did not bring enough of the poor into the formal system, and the rural network weighs on public sector bank profitability (see Chapter 4). The cooperative system is in serious financial difficulty. Narrowly defined priority sector norms can force banks to lend, but again by impairing profitability. The focus on increasing credit in the absence of appropriate products for risk mitigation led to over-indebtedness among the poor. As the financial sector becomes more competitive, and as banking privileges get eroded, it will become more difficult and unwise to compromise bank profitability by mandating that banks take on the burden of financing inclusion. Instead, the approach has to be to make inclusion more profitable.

Microfinance

Microfinance is the fastest growing 'non-institutional' channel for financial inclusion in India. A key factor that influenced the success of microfinance was its ability to fill the void left by mainstream banks that found the poor largely uncreditworthy, and were unable (or unwilling) to design products that could meet the needs of this segment in a commercially viable manner. Using group-based lending and local employees, microfinance provides financial services (largely credit) using processes that work, and in close proximity to the client. These qualities facilitated the proliferation of microfinance from a virtually non-existent activity in 1990 to a small, but increasingly important, source of finance for India's poor.[18]

Two models of microfinance are practiced in India: (*i*) the Self-Help Group (SHG)-Bank linkage model where commercial banks lend directly to SHGs formed explicitly for this purpose and (*ii*) the Microfinance Institution (MFI) model where MFIs borrow funds from banks to on-lend to microfinance clients, many of whom form joint liability groups for this purpose. The first model is the predominant channel for microfinance in India and is a good example of a meaningful liaison between commercial banks and informal SHGs. As of end-March 2007, 29 lakh SHGs had been formed and total loans outstanding to these groups was about Rs. 11,000 crore.[19] Credit provided by MFIs to microfinance clients was about Rs. 3,500 crore in end-March 2007, 80 per cent of which was provided by less than 20 large MFIs which are registered as NBFCs/Section 25 companies. The bulk of microfinance activity was concentrated in South India, though this is beginning to change.[20]

There is evidence that an increase in microfinance lending is associated with a lower incidence of borrowing from moneylenders, especially for low income segments. The IISS 2007 survey reveals that in the lowest income category, respondents who are members of SHGs appear to borrow less from moneylenders and friends and family than those who are not members of SHGs. It also appears, however, that the demand for credit of SHG members is appreciably high, and this group still needs to source a large share of its credit from elsewhere (Figure 8).

Microfinance also appears to help its clients in their efforts to reduce poverty, though more careful randomized evaluations are needed to fully assess its impact.

Figure 8: Credit Sources for Loans Taken in Past Two Years by Income Groups

Income group (Rs. lakh)	Members of SHGs			
	<=0.3	0.3–0.6	0.6–0.9	>0.9
Relatives/friends	24.8	27.0	32.9	25.3
Banks	7.8	15.0	19.9	36.8
Self-help groups	40.5	36.7	32.6	19.2
Money lender	33.3	21.3	18.4	14.9
Others	5.0	6.8	5.8	13.8
	Non-members of SHGs			
Relatives/friends	41.4	35.2	34.7	30.6
Banks	11.3	22.8	38.7	51.0
Cooperative society	6.1	5.3	5.6	7.4
Money lender	40.1	34.5	21.8	13.6
Others	7.6	7.4	4.5	4.2

Source: IISS, 2007.

Note: Figures relate only to SHG members who have regular cash incomes. Numbers denote percentage of respondents in each category that had borrowed from a particular source. Cells add up to more than 100 due to borrowing from multiple sources by respondents.

A recent report by the Grameen Foundation took stock of the evidence on the impact of microfinance on poverty alleviation.[21] It highlighted several studies that indicated microfinance plays a significant role in poverty reduction. For example, one study by Khandkar suggested that microfinance was responsible for 40 per cent of the entire poverty reduction in Bangladesh.[22] Another study of SEWA Bank, Gujarat, found that SEWA Bank clients had higher levels of income than others in the area who were also self-employed, but did not participate in SEWA Bank's programmes.[23] The Report also found evidence that microfinance had a wider positive impact on socio-cultural issues, such as women's empowerment, nutrition and contraceptive use.

Despite its success, the future growth of microfinance is constrained by a number of factors. An important issue is the ability of MFIs to raise financing. Given the large estimated demand for microcredit, MFIs need multiple sources of financing, apart from the traditional loan financing from banks.[24] Other constraints include an unclear regulatory environment and the lack of well-developed management information systems and an adequate supply of trained management talent to facilitate sustainable scaling up.

A NEW STRATEGY FOR INCLUSION

Any comprehensive and sustainable response to addressing issues of financial inclusion must necessarily factor in the role of the market. This is because efficiency, innovation and cost-effectiveness are key to serving the financial needs of the poor. The financial sector does not ignore the poor because of biases, but because the transaction costs in serving them are high. Initiatives that reduce these costs will allow service providers to begin thinking of financial services for the poor as a business opportunity and not as an act of charity. Policy initiatives need to make financial services for the poor as attractive as those for the rich, and increase competition to serve them. To reduce transaction costs, public policy must facilitate the use of technology and the creation of low cost organizational structures to reach the poor.

A new strategy for increasing access to financial services will require the creation of a vibrant ecosystem that supports financial inclusion. This calls for changes on several fronts. Six areas are identified and are described in detail below:

An organizational structure that facilitates inclusion

The starting point for a vibrant ecosystem for financial inclusion is to ensure that the organizational architecture supports and creates institutions that can reach the poor. The Committee recommends a two-pronged approach—first, to facilitate the creation of small finance banks, and second, to strengthen the linkages between large and small financial institutions. Both measures should be pursued with equal vigour.

There is a growing consensus around the world that small business/farmer credit is best delivered by local small private or voluntary

Institutions, especially if standardized credit information is limited. Experiences in US, Europe, the Philippines, and other countries in the creation of small and local financial institutions are a case in point. These institutions should be 'local' because someone who is part of the locality has much better information on who is creditworthy than someone who is either posted temporarily from a city, or someone who takes the bus everyday from the nearest town. They are also better able to understand local farmer and business needs. 'Small' because the centre of decision making is close to the loan officer—he can get approval directly from the manager without the documentation, delays, and loss of information that would be incurred if he had to get approval from head office. 'Private' or 'voluntary' because the manager has the right incentives in handling flexible, low documentation, loans if he has a significant stake in the enterprise and its future.[25] And finally, local, small, private or voluntary institutions have the low cost structure and low staffing costs (because their local hires will be paid at local wage rates instead of at city rates) that allow small loans to be profitable. In fact, successful micro-lenders, the moneylender and the microfinance institutions have precisely these characteristics.

Many of the government initiatives in this regard suffer from one or more deficiencies with respect to local private or voluntary institutions. Large banks do not have the decentralized loan making authority, the local knowledge, the incentives (in the case of public sector banks), or the low cost structures to make local loans. More automated credit information with wide coverage would help (see Chapter 7). This is not to say that large banks have no role in financial inclusion—they do have an important direct role in offering 'commoditized' products such as checking accounts, where scale economies can be brought to bear, and an indirect role through local partners in offering customized products. Hence the recommendation of a two-track approach that involves the creation and promotion of small finance banks as well as the strengthening of linkages between large banks and small local entities to facilitate the retailing of large banks' financial products to small clients.

The Indian financial landscape is dotted with a number of small, local financial institutions. As mentioned in 'Assessing the strategy for inclusion', many of these, especially those in the public sector, ran into difficulties, and are now in various stages of transformation. Various categories of small banks were created, but with less than satisfactory success in banking the poor. The RRBs and the Urban Cooperative Banks (UCBs) are testament to this. A key problem faced by these institutions was that the quality of lending was compromised due to various reasons. In the case of RRBs, the wage structure for RRB staff was equalized with their higher wage national commercial bank counterparts, resulting in a cost structure that was unprofitable. High profile crises in two UCBs in 2001–02 led to a decline in public confidence in UCBs.[26] These institutions were largely denied the key factors that are crucial to small banks' success, namely the flexibility and independence to adopt low cost, innovative processes and structures to make small-scale banking viable.

A large number of commentators believe, based on historical evidence, that small banks will be unviable in India. They question the probity of small promoters, as well as the profitability of these banks given high fixed costs. This Committee recognizes that small banks have not distinguished themselves in India in the past, often because of poor governance structures, excessive government and political interference, and an unwillingness/inability of the regulator to undertake prompt corrective action. These are not the banks the Committee wants, and the Committee would call for substantial care in who is licensed, as well as greater regulatory oversight. There is, however, no necessary link between size and probity. Indeed, the larger number of potential applicants for small banks suggests the regulator can be far more selective in applying 'fit and proper' criteria. Moreover, technological solutions can bring down the costs of small banks substantially, even while increasing their transparency.

This Committee believes that notwithstanding the checkered history of small banks in India, a strong emphasis on good quality lending, low cost structures, effective governance and management, and tight prudential norms, could make small banks very useful to provide financial services to the poor. The Local Area Bank (LAB) scheme, that bears some resemblance to our proposal, was prematurely discontinued, and certainly has not resulted in the catastrophic failure that some associate with small banks.[27] Indeed, Box 1 documents the case of small banks that have achieved success by leveraging these strengths.

Box 1: A Case for Small Banks

Experience in Indonesia and the Philippines showed that the establishment of small banks has been a critical factor for increasing the provision of financial services to the poor (ADB, 2004). For example, several rural banks in the Philippines that cater to small savers and borrowers were offered incentives in the form of low minimum capital requirements, lower reserve requirement ratio and exemption from various taxes for the initial five years of operations. These incentives enabled these banks to offer higher interest rates on their deposits and lower interest rates on loans and also build-up their capital. By 2004, these banks had a share of over 40 per cent of the total microfinance market in the country. In Indonesia, a study of the banking sector post the East Asian Crisis showed that 77 largely private small banks that were an important source of small business lending were profitable and had a return on assets that was higher than that for the banking system as a whole.

In the US, there is evidence of a strong negative correlation between the ability to lend to smaller entities and bank size (see Berger et al. [2005]). A large number of small, community-focused, banks co-exist with large money centre banks, primarily be-cause they provide relationship loans within the community. The US data shows that small businesses with local banking relationships received loans at lower rates and fewer collateral requirements, had less dependence on trade credit, enjoyed greater credit availability, and protection against the interest rate cycle than other small businesses (see Petersen and Rajan [1994]).

In the UK, the Treasury Committee of the House of Commons noted that localized forms were better able to target financially excluded who tend to have geographic concentrations. New innovations in financial inclusion strategies have often come from credit unions, community banks and non-profit banking institutions (House of Commons, 2006).

A number of dynamic local financial institutions with a good track record of reaching the poor currently exist in India. Many of these are MFIs, with a client base that largely consists of the poor. These institutions are small, yet well performing, and are undertaking a fair amount of innovation in increasing financial services to the poor. They are constrained in that they cannot offer a full range of financial products to their clients, especially deposits which would also allow them to lower their cost of funds (and commensurately their lending rates). This results in a situation where MFIs cannot reach critical mass, in terms of asset size or profitability, to be able to finance investments in core banking solutions, HR etc. These MFIs are too small to apply for an SCB banking license, which would require a capital base of Rs. 300 crore. As of March 2007, the total equity base of all the 54 Indian MFIs put together was a shade below the Rs. 300 crore capital requirements. Even among the top 15 MFIs, it would take anywhere between 5 years to 15 years to grow their asset and equity base to meet the minimum criteria to be a bank. Given the current interest in microfinance, raising equity capital is a possibility for expansion, but this would require promoters to significantly dilute their stake in the MFI, with attendant loss of incentives and governance. Some of these well-performing MFIs would benefit from transforming into small finance banks.

The Committee recommends, therefore that the regulator allow more small finance banks to be established, with the ability to provide both asset and liability products to their clients. One rationale for these banks would be to increase financial inclusion by reaching out to poorer households and local small and medium enterprises. But these banks should not be constrained to only these clients. As we argue in Chapter 4, these banks could also be an important entry point into the banking system from which some banks could grow into large banks. We suggest the following features:

1. Having obtained the permission to start up based on an initial business plan, small banks should have some leeway to decide where they will grow and what they will focus on, much as we advocate for large banks (see Chapter 4), conditional on meeting regulatory requirements and obligations. Given, for example, that the poor will increasingly be concentrated in towns and cities, and given they are underserved there, we do not see any reason to limit small bank locations to only rural areas.
2. However, given that we are recommending unlimited branching for banks elsewhere, it would be appropriate to restrict the initial license to a certain maximum number of branches and asset size, with these restrictions removed after a review of performance.
3. These banks would provide a comprehensive suite of financial services (credit, savings, insurance, remittances, and investments). To facilitate appropriate diversification and smaller loan ticket sizes, their exposure limits would be set at a lower fraction of capital than for SCBs, allowing them to increase ticket sizes as they grow.[28] They would also be expected to provide mainstream-banking products, thus precluding, for example, the need for a large treasury operation or other activities that require very sophisticated human capital or management.[29]
4. Interest rates on loans would be deregulated, as is the case for Local Area Banks (LABs). Initial total required capital should be kept at a low level, consistent with the initial intent behind LABs. However, the focus should be on a number of performance measures, such as (*i*) the capital adequacy ratio, which could be

more conservative for small banks given that they typically operate in smaller geographies and lend to riskier businesses; (*ii*) the ownership structure (for private banks) ensuring appropriate incentives; (*iii*) governance norms, fit and proper criteria; (*iv*) the adoption of a core banking solution, which could be developed in-house for larger entities or purchased from a specialized provider for smaller entities; (*v*) the track record of the promoters and (*vi*) strict prohibitions on self-lending to promoters and directors.

5. These banks would require greater monitoring and would likely increase the supervisory burden on the regulator, especially in the beginning. In the initial years after the inception of a small bank, the banking supervisor should conduct more off-site and on-site inspections (perhaps quarterly as with the LAB proposal), bringing them down as confidence is established in the bank's procedures. Off-site supervision could be via standardized uniform back-office processes and computerization through a common platform. Strict prompt corrective action norms should be applied after the initial teething years (see Chapter 6) so that unviable banks, and there will be unviable banks, are not continued. The Committee understands that regulatory capacity will have to be increased (certainly, for example, the number of bank supervisors). But regulatory capacity should adapt to the needs of the banking system rather than vice versa.
6. The government should encourage the creation of low cost technological platforms that can be offered widely to small banks. Small banks may also be encouraged to pool back-office functions, and even a centralized skill base, along the lines of models that exist in other countries.[30]

With the creation of a small bank category, current institutions that operate at a local level—MFIs, community-based lending organizations, etc.—would have the choice of deciding their institutional structures. Those that would like to remain purely credit-based institutions can choose to remain as NBFCs—as most MFIs today are—or Section 25 companies. Others could choose to provide savings facilities as limited business correspondents of large banks (see below).

Still others that have established a good track record of banking and wish to raise their own deposits could choose to become small finance banks with a capital base which would, in effect be well below the current Rs. 300 crore for SCBs. These institutions' financial health would be monitored using risk ratios, governance and management standards that attest to their financial soundness. As these banks grow and achieve scale, they could be permitted to become full-fledged SCBs. The regulator would need to further think through the ownership issues related to the transition between small banks and SCBs. While at inception a small bank could be majority owned by a single promoter, as it scales up and approaches the size of an SCB (i.e., gets closer to a capital base of Rs. 300 crore) it would be governed by ownership norms currently applicable to SCBs, and it is expected that promoters would dilute their shareholding to that applicable to SCBs.

We see four important merits in the proposal for small finance banks. First, a full range of institutional options will become available to a spectrum of players who are important for an inclusive finance marketplace. Second, a point of entry will be established into the banking system, increasing competition, especially for small customers. Third, this flexibility would be enabled in a manner that preserves the stability of the overall financial system, an important consideration for the regulator. Fourth, the clarity that emerges from the small finance bank structure will remove the regulatory uncertainty that many MFIs currently operate under and release management time to focus on the clients of these organizations, and also increase risk appetite and innovation in these institutions.

A clear articulation of the regulatory and organizational options to service poor clients will help do away with many lingering issues plaguing institutions operating in the 'inclusive finance' space. For example, small finance banks would be required, by virtue of their 'bank' status, to disclose the effective interest rate charged including loan processing fees, bad debt provisions and other ancillary charges. The focus on transparency, reporting standards and codes of conduct should also be carried through to the rest of the financial institutions—NBFCs, MFIs, etc.

The second channel to create an inclusive financial architecture is to create strong linkages between large institutions and local entities to bring the existing large banks closer to the poor. This is certainly the trend to reach the poor, as evidenced by the increasing use of credit-scoring and technology by large banks to reach remote areas. To facilitate this, in India, the business correspondent legislation is particularly laudable given its good potential for combining the scale economies and diversification that large banks bring with the local knowledge and low cost outreach provided by business correspondents.[31] However, recently announced regulations, such as one stipulating the presence of a bank branch within 15 km of its business correspondent in rural areas, vitiates the objective of low cost outreach.

A central difficulty in using business correspondents is the extent of responsibility the bank should bear for the processes and actions of the correspondent. While it seems clear that the bank should be responsible for actions undertaken by the agent on its behalf, requiring the same standards and processes at the agent as the bank would negate the potential benefits of a correspondent model. The true test is whether the standards and processes are adequate for the business the correspondent is required to do. So long as the bank exercises due diligence and is responsible for outcomes, a fair amount of flexibility should be allowed in the relationship. The Committee recommends that the BC definition be broadened and endorses the recommendations of the Rangarajan Committtee on Financial Inclusion with regard to the BC model. It supports the proposal to allow microfinance NBFCs to act as limited BCs for banks for savings and remittances products and recommends that microfinance NBFCs also be allowed to provide credit as BCs of banks if they choose to do so.[32] Finally, in order to make this business viable, it is important that business correspondents be allowed to levy reasonable user charges to recover the cost of services. Competition, as well as mechanisms for consumer protection, rather than regulation, should be the means through which the regulator ensures business correspondent charges are not excessive.

Given the reality that moneylenders will always perform the much-needed function of providing residual credit to the poor, rather than prohibit them or levy unenforceable interest caps, it may be prudent to explore ways in which moneylenders and banks may work together. The Committee endorses the model legislation recommended by the RBI Technical Group to Review Legislations on Money Lending, 2007 as a good step towards providing a single regulatory framework for money lending.[33]

Finally, the Committee recommends that the regulator actively explore the channels by which non-traditional entities with extensive low cost networks (e.g., post offices), regular contact with the underserved (e.g., kirana shops, cell phone companies) or with some leverage over potential borrowers (e.g., buyers of produce, sellers of inputs such as fertilizers) could be used to provide financial services in a viable manner.[34] While the business correspondent model will be one way these entities can link up to the formal financial system, the larger question, however, will be whether some non-traditional entities can directly and independently provide regulated financial services. For instance, should cell phone companies be able to offer account-to-account transfers without going through bank deposit accounts? The answer to these questions should be based on what is the most efficient way to provide services while imposing tolerable levels of systemic risk. Some of the new non-traditional players may be large and well capitalized (e.g., cell phone companies), and may therefore add less risk to the system than the existing reliance on some financial entities. However, the more such players are allowed to take part in payments, the more extraneous obligations on the banking system will have to be brought down so that banks can compete on a level playing field (see Chapter 4).

More generally though, given the importance of expanding inclusion, a greater tolerance for risk is warranted, and more entities should carefully be allowed into regulated activities. Box 2 highlights some guiding principles that could help regulators identify the key features of a regulatory and supervisory framework that could underpin branchless banking.

A focus on risk mitigation

Perhaps the greatest challenge to financial inclusion is to design efficient risk management products for the poor. The poor are typically exposed to a level of risk that is too high for them to obtain insurance at affordable rates. Thus the levels of risk may have to be first brought down through physical methods—soil and water conservation for reducing drought risk in case of crop insurance; herd vaccination in case of livestock insurance; and preventative health care, safe drinking water and sanitation, in case of health insurance. A key policy implication therefore is to increase investments that lead to intrinsic risk reduction so that insurance can be offered at premia that minimize the need for subsidies. Once this is done, it will be useful to use public funds to build awareness about insurance as a critical financial service, since greater demand for insurance can bring down costs due to scale economies.

A number of specific policy initiatives can help develop microinsurance products that

Box 2: Regulating Branchless Banking: Key Considerations

Branchless banking has emerged as an important medium to increase financial inclusion in a cost-effective manner. The two models currently used include the bank-based model where customers transact with an agent of a prudentially licensed and supervised financial institution, and the non-bank based model where deposits are taken by and cash is exchanged with a retail agent not affiliated to a bank, such as mobile operator or an issuer of store value cards. The virtual account is stored on the server of this non-bank entity. Branchless banking has been especially useful in providing remittance and payments services.

The Philippines and Kenya have achieved some degree of success with the non-bank model. In the Philippines, both major telecom operators, Globe and Smart, offer mobile financial services to over 4 million users. In Kenya, Safaricom's M-PESA service also focuses on getting domestic and international remittances to remote parts of Kenya using a POS device that captures client details in a smart card. Brazil and South Africa have chosen bank-based models to mitigate risks associated with the non-bank model. In Brazil, Caixa Economica is a bank that uses a range of retail outlets (grocery stores, lottery shops, etc.) as business correspondents to provide banking services, the most popular being payment services. The two models can also be used in combination. For example, Philippines' Globe Telecoms has teamed up with member banks of the Rural Bankers' Association of the Philippines to offer its clients the ability to effect loans payments, deposits, withdrawals and transfers from savings bank accounts from these banks by sending a text message. Recently, Pakistan released draft guidelines for branchless banking and has endorsed the bank-led model either via the bank-agency arrangement or creating joint ventures with telecom/non-banks.

The experience so far with both models is limited and it is difficult to draw clear lessons about which model may be superior. The risk issues related to the non-bank model are far from trivial, though not insurmountable, as the Philippines and Kenyan examples show. Going forward, a number of guiding principles are useful for policymakers to consider as countries adopt the model most viable for them. These are highlighted below:

- First, it is imperative to enact regulation that takes care of issues related to compliance with anti-money laundering and combating the financing of terrorism (AML/CFT) guidelines. This is well understood globally, and explains why some countries have chosen bank-linked models for branchless banking. Compliance issues should not rule out the viability of non-bank models; however it is difficult today to point to a non-bank model that seems to achieve full compliance with AML/CFT issues.
- Second, regulators should set clear guidelines for technology use, security of customer data and standards for messaging (in the case of mobiles). This should be complemented by a robust mechanism for consumer protection that is well communicated to consumers.
- Third, implementation of branchless banking should be closely monitored in order to provide policymakers/regulators relevant, recent and reliable data about the progress of various initiatives.
- Fourth, the regulator should clarify the legal power of non-bank retail outlets and clearly specify restrictions (if any) on the range of permissible agents and types of relationship.
- Fifth, and perhaps most important, regulators should strive to achieve complete interoperability between banks, telecom companies, and other branchless banking entities in the medium term. This is crucial to ensure value added from branchless banking to the consumer. A good analogy is the text message market, which ballooned only after users could send text messages to persons even if the recipient subscribed to a different telecom provider. This would involve a number of steps, including uniform KYC requirements, the ability of RTGS to handle branchless banking transactions, and other issues that are just beginning to be understood as branchless banking gathers steam.

The success of branchless banking will depend greatly on the ability of different regulators and agencies responsible for banking, telecom, and anti-money laundering to ensure an outcome that is truly value added to the consumer and can radically transform the way financial transactions are conducted.

Sources: CGAP, Regulating Transformational Branchless Banking: Mobile Phones and other Technology to Increase Access to Finance.

are critical for the poor. Among the most important are actions that would increase awareness about the benefits of insurance and communicate the provision of government insurance more transparently to the insured population. A number of central and state government insurance programmes are currently offered through insurance companies, however, awareness about these schemes is minimal as indicated by the fact that claims ratios on them are far below actuarial expectations.[35] This leads to short run profits for insurance companies but no benefits to the poor. User fees are also critical to ensure ownership of insurance by the insured. A number of public insurance programmes have required no premia contribution on part of the insured. A 'symbolic' premium would go a long way to increase awareness about the insurance plan as well as increase usage. The government should also conduct negative auctions, where an insurance company asking for the least amount of subsidy for a specified level of coverage of a target group, should be given the mandate to do so and collect the premia.

A second set of issues relates to deregulation of premia. IRDA microinsurance guidelines should eliminate caps on premia and commissions, and allow for-profit entities to be microinsurance agents. The argument here is analogous to the interest rate deregulation argument. To cover a large number of the poor, pricing must be left free so that over a period of time many players will enter and reduce costs through competition. The counterpart of free pricing has to be greater transparency about all-in costs, as well as public disclosure of premia. Similarly, in addition to NGOs and SHGs, NBFCs and banks as well as non-traditional outlets should be allowed to distribute microinsurance.

Health insurance for the poor, and particularly for women, needs to be designed with a high priority. For this, the IRDA should facilitate the creation of health insurance mutuals, friendly local entities that function as the interface between the client and the insurance company.[36] These 'mutuals' would require adequate reinsurance cover against large covariant risks and 'long-tail' claims to ensure that they remain solvent in the event of large covariant adverse events such as an epidemic or a few expensive claims.

Customer service issues in terms of claim processing delays and deductions need to be monitored tightly and penalties enforced on erring companies. The Office of the Financial Services Ombudsman needs to be set up quickly (see Chapter 6), with close ties to the IRDA.

Finally, a number of policy actions are required to deal with the insurance needs of agriculture. The link between crop credit and crop insurance, though mandatory, should be made more effective and benefit more farmers. The National Agricultural Insurance Scheme should be reengineered to ensure timely claim settlement by improving the crop cutting experiments or using remote sensing data. Weather index insurance products could enhance NAIS, for example, through advance, part indemnity payments during the crop cycle based on weather indices, with final settlement based on the area yield assessment. This could represent a cost-effective combination of the best features of both area-yield and weather-based insurance and could be introduced as part of the proposed modifications to NAIS. Further, weather indexed products could continue to have a separate existence as standalone products, thereby, giving farmers choice in selecting risk mitigation measures. However, weather index insurance is mainly effective for select hazards like deficient and excess rainfall, and not for all perils and hence needs to be used judiciously. Lastly, where weather insurance is offered as a standalone product, government's role in fostering a level playing field for all providers of weather insurance would be critical in stimulating competition, innovation and providing benefits to farmers through better product features and services. An increase in post-harvest credit, which would in turn be greatly facilitated if warehouse receipts could be issued, can reduce price risks for small farmers. This requires building a network of credible ware-house agents, including assayers and the quick implementation of the Warehousing Regulation and Development Authority Bill.

Though India has three major and several smaller modern commodity futures exchanges with billions of dollars of transactions on a daily basis, small farmers are not able to benefit from these. This is because the key functions—quantity aggregation and price assessment (based on quality)—are currently played by *ahratiyas* (traditional commodity brokers), who often collude to make lower payments to small farmers. To ensure that *ahratiyas* do not exploit farmers, apart from wide dissemination of price information, which is happening already, farmers need the ability to sell to a processor right from the village (as is currently happening with ITC *e-Choupals*) if they find the price attractive.

Alternately, farmers bringing their produce to a *mandi*, but not finding the price attractive, should be able to sell to another distant *mandi*. This is being enabled by the new generation of 'spot' exchanges like NCDEX Spot Exchange Ltd (NSEL) and SAFAL National Exchange (SNX) but requires a network of reliable warehousing and assaying agents. It is important to support these legitimate functions and let banks finance them, so as to encourage the emergence of this commodity marketing ecosystem. Once again the implementation of the Warehousing Regulation and Development Authority Bill expeditiously will help.

Rethink targets, subsidies, and public goods

While a new, more market friendly approach is advocated, the role of public intervention must change to focus more closely on the excluded. Important policy actions are required in the following areas:

1. Priority sector lending framework
   The priority sector lending framework has historically had at least two, not mutually exclusive, objectives. One is to channel resources to areas that were deemed national priorities, and the other is to foster inclusion. The value of a developed financial sector is precisely to allocate resources to areas that are most valuable for the economy. By designating national priorities, the government or central bank vitiates this process by imposing political or personal judgements on what should be strictly a market driven, economic process. Why, for instance, are loans of up to Rs. 20 lakhs to students for undergraduate studies abroad deemed priority sector? The reality is that priority sector norms were set historically, at a time when the financial sector and the economy, were very different. Many Committees proposed a reduction in the level of directed lending through the priority sector for a number of reasons, but this suggestion was not implemented.[37] There appear to be very strong political constraints on revising these norms downwards. As a result, regulators have taken the next best option of broadening the categories that qualify for the priority sector.

   This Committee understands the imperative behind such actions, but strongly recommends the political will be found to revisit the norms. Failing that, it suggests the categories that truly impact the underserved (such as direct agriculture and the weaker sections category) be preserved and strictly enforced even as the process of broadening other categories continues. Keeping in view the growing importance of rural to urban migration, and the growing share of the urban poor, consideration should be given to including them in the overall agricultural share. The Committee further recommends certain steps below that would increase the flow of credit to these underserved segments as well as facilitate the provision of priority credit by specialized financial institutions that are better placed to provide it.

   The Committee recommends that all banks—domestic and foreign—should be subject to uniform priority sector lending requirements. In the interest of equitable treatment, and given the magnitude of need to provide credit to underserved segments, it is not clear why a differentiated framework should exist for foreign banks. Foreign banks do not have the branch infrastructure to provide agricultural credit, but free branching (see Chapter 4) will give them the capacity to undertake such loans if they desire. Moreover, the Priority Sector Lending Certificate scheme (see below) will help them bear their share of obligations without a branch network.

The RBI has proposed a scheme, which with a few modifications could prove very attractive in facilitating flows to the priority sector. The inter-bank participation certificates (IBPC) are a form of securitization of loans through which a bank buys the assets of another bank for a stipulated period that can vary between 90 and 180 days. The RBI allows a bank that is unable to meet the priority target of 40 per cent to make up the deficit by buying out loans disbursed by other banks for 180 days.

One problem in any securitization is that the buyer has to take on the credit risk of the loans, which is high in the case of the underserved priority sector. Moreover, loans have to be standardized, well documented, and serviced, all of which pose difficulties for loans to the truly needy. Perhaps this explains why the scheme has yet to take off. The Committee proposes a new scheme that will separate the objective of transferring priority obligations from the credit risk transfer and refinancing aspects, which are commingled in the IBPC.

New PSLC Scheme. Here is how the scheme would work. Any registered lender (e.g., MFIs, NBFCs, co-operatives, and eventually, registered moneylenders) who has made loans to eligible categories would get 'Priority Sector Lending Certificates' (PSLC) for the amount of these loans. The criteria for certification (say by NABARD or its agents) would simply be whether the loan is to an eligible sector, whether the interest rate follows the norms below including transparency, and whether the loan duration is greater than 180 days. After an initial period of verification, institutions should be allowed to self-certify, with periodic random monitoring to ensure adherence to criteria. Any bank that exceed priority sector norms should also receive PSLCs based on the amount by which the requirement is exceeded.

A market would then be opened up for these certificates, along the lines of the IBPC, where deficient banks can buy certificates to compensate for their shortfall in lending. Importantly, the loans would still be on the books of the original lender, and the deficient bank would only be buying a right to undershoot its priority sector-lending requirement by the amount of the certificate. If the loans default, for example, no loss would be borne by the certificate buyer. The certificates would foster the creation of small financial institutions that specialize in priority sector lending, much like the impact of the US Community Reinvestment Act on Community Development Financial Institutions (Box 3).

The IBPC scheme could continue, but would not qualify for priority sector norm—it would be simply a form of securitization and refinance. Of course, the seller could also transfer its associated PSLC certificates if it so chooses.

While all PSLCs could be used towards meeting overall norms, separate certificates could be issued for enforceable sub categories (e.g., direct agricultural credit), and these may carry a different price. If indeed banks

Box 3: The US Community Reinvestment Act and Its Impact on Financial Inclusion

The Community Reinvestment Act (CRA) was enacted in 1977 with the objective of getting mainstream financial institutions in the USA to increase provision of credit to low and middle-income communities. While there is much debate about CRA's effectiveness in achieving financial inclusion in the USA, an important benefit of the legislation—unanticipated at the time of its enactment—was its success in fostering the growth of specialized Community Development Financial Institutions (CDFI) that were instrumental in expanding financial services to low-income communities. CDFIs include banks, loan funds, credit unions—financing entities with the primary mission of serving underserved or economically distressed areas. In 1995 CRA reforms allowed banks to comply with the CRA by making loans to and investments in CDFIs. Since then, CDFIs have come to rely significantly on CRA qualified investments and loans from banking institutions as a major source of funding for their activities. A bank may receive two benefits from investments in CDFIs; first it receives CRA credit, and second it can apply for financial awards from the CDFI fund. The customer base of CDFIs is 68 per cent low income and 58 per cent minority in the US. Reports show that CDFIs significantly outperform regular banks in serving low income and minority communities.

The US experience shows that big banks' response to CRA type of regulations can be significantly enhanced by coupling the need to meet the mandate with creating dedicated entities like CDFIs, which can use CRA credits to serve the under-served market segments. In the Indian context, this experience suggests that priority sector lending could enhance financial inclusion if the lending requirements are coupled with incentives to create specialized financial institutions that can lend successfully to underserved segments in India. Specialized institutions can cultivate the local knowledge needed to reach informationally opaque markets and can develop uniquely tailored underwriting and risk management procedures as needed. Specialized knowledge coupled with specifically tailored and flexible operations are often necessary to reach under-served market segments. However, while the promotion of specialized institutions is highly desirable, established financial institutions should still be encouraged to directly serve these under-served market segments.

Source: 'The Community Reinvestment Act and Financial Inclusion', Yale Law School Community Development Financial Institutions Clinic, 2008.

find priority sector requirements unprofitable, there will be a high price for these certificates, and it will draw more lenders (including banks that want to specialize) into priority-sector lending. If the price is low or zero after the market is given time to stabilize, it would mean that priority sector requirements, as set, are not onerous.

However, this market also offers the government a way to expand lending—all it needs to do is purchase eligibility certificates and increase their price. Charities and NGOs that want to contribute to inclusion could also buy in this market. Also, over time, as bank privileges diminish, the priority sector requirements for banks should be brought down, with the government playing a larger role in purchasing certificates. The government could establish a predictable pattern of activity in this market (for instance, by stabilizing the price of certificates or by specifying its target volume of purchases) so that potential lenders have greater certainty about the rewards from lending.

The market would make explicit the subsidy to the priority sector (effectively the price of PSLCs), and allow the government to gradually take over the role of providing these subsidies from the banks in a minimally distortionary and disruptive way. While, a priori, this market may seem complicated to manage, there are really no additional complications than in managing say the market for bank reserves, which is easily accomplished across the world.

2. Interest Rates
   Finally, it would also be necessary to deregulate interest rates in order to unlock funds to activities that are commercially unviable and therefore denied credit (Box 4). Current priority sector norms—especially those focused on lending to the poor (loans below Rs 2 lakhs)—have interest rate ceilings that make lending

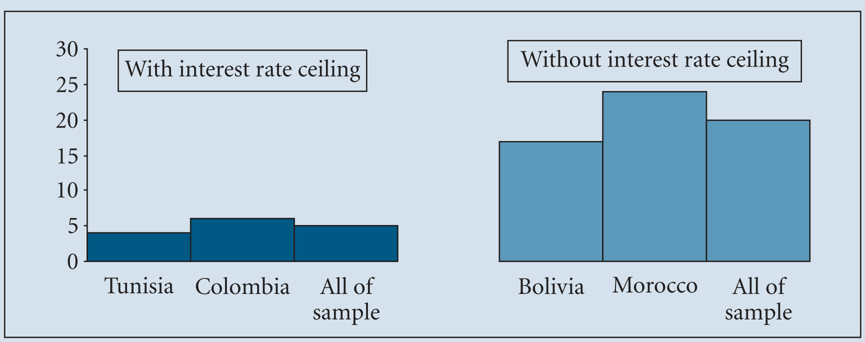
Box 4: Interest Rate Ceilings Hurt the Poor

A study by the Consultative Group to Assist the Poorest (CGAP) examined the impact of interest rate ceilings on microcredit penetration in 30 countries and found that on balance, interest rate ceilings deterred expansion of microcredit to higher-cost markets.

The study compared market penetration rates between 23 countries with interest rate ceilings and seven countries without ceilings. On average, the former had a market penetration of 4.6 per cent, whereas countries without interest rate ceilings enjoyed penetration rates of 20.2 per cent. In countries without ceilings, the study found that competition was an important force in bringing down interest rates. For instance, the microfinance portfolio yield* decreased from an average of 57 per cent in 1997 to 31 per cent in 2002 in four competitive markets without interest rate caps (Bolivia†, Bosnia, Cambodia and Nicaragua). Operating efficiency (defined as total administrative costs as a percentage of the average loan portfolio) improved during the period from 38 per cent to 24 per cent. The study cited specific examples of the impact of interest rate ceilings on microcredit expansion. In Nicaragua the market for microcredit shrunk after the national Parliament introduced an interest rate ceiling on microfinance institutions (MFIs) in 2001. The annual growth of portfolio of these MFIs fell from 30 per cent to less than 2 per cent post the imposition of the interest rate ceiling. In Kenya, the threat of a new interest rate-ceiling bill caused the Cooperative Bank of Kenya to put its plans for a major expansion into the rural microfinance market on hold.

In India, allowing MFIs and SHGs to charge market-determined rates from final borrowers has facilitated a significant expansion of microcredit. In sectors where interest rate ceilings exist, such as agricultural loans in the priority sector below Rs. 2 lakh to farmers, and such credit could not be provided via the MFI/SHG route, credit provision grew at a slow pace.

Microfinance Market Penetration in Countries with and without Interest Rate Ceilings, 2004



Source: CGAP, Occasional Paper No. 9, 'Interest Rate Ceilings and Microfinance, The Story So Far', September 2004.

Note: Number of microfinance borrowers shown as percentage of population living on less than US$2 per day. Sources: Calculations for 23 countries with interest rate ceilings and seven countries without ceilings based on Christen et al., *Financial Institutions with a 'Double Bottom Line',* and World Bank.

Notes: * Portfolio yield is defined as the ratio of income from lending to average outstanding loan portfolio. Income used to calculate yield includes all cash interest and fee payments, but does not include interest accruals.

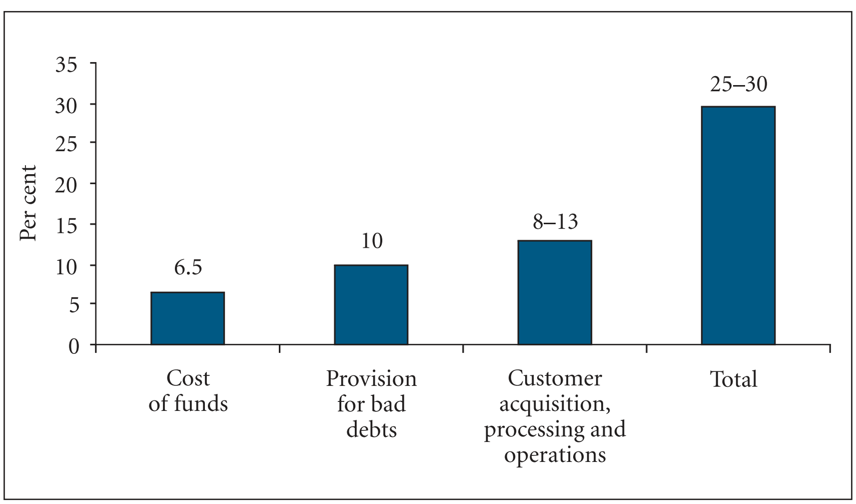
† Introduced ceiling in January 2004.

unattractive for the banks. In general, the true cost of small loans is very high (Figure 9). This is also reflected in the interest rates currently paid by the poorest borrowers, which is typically in the range of 36 per cent plus per annum.

The approach thus far has been to deregulate interest rates for certain activities in order to stimulate credit provision. For example, in 2000, RBI deregulated the interest rates on loans made by commercial banks to MFIs, and interest rates on loans made by MFIs to borrowers. Again in 2006, RBI emphasized that the interest rates applicable to loans given by banks to MFIs or by MFIs to SHGs/member beneficiary would be left to their discretion. This leads to an anomalous situation where loans to the same beneficiaries if dispensed through alternate channels of financing are priced differently. Indeed, these regulatory anomalies suggest yet another reason for avoiding interest rate ceilings—it tilts the playing field against the formal sector where such ceilings will be respected in favour of the informal sector, where they are much harder to enforce.

A related issue is the implementation of usury laws. While the Committee recognizes the value of usury laws to protect against unscrupulous lenders, the reality is that these laws are difficult to enforce, and are often misused. The Committee recommends that all financial institutions licensed and registered with the RBI or enacted under special state government statutes should be automatically exempt from usury laws.

Figure 9: True Cost of Lending for Banks for Small Ticket Loans



Source: ICICI Bank Staff Estimates (for cost of funds) and Boston Consulting Group (2007), *The Next Billion Consumers: A Road Map for Expanding Financial Inclusion in India* (for other costs).

The Committee recognizes that weaker sections are liable to exploitation. But driving them away from banks via interest rate ceilings into the hands of moneylenders is no solution. Instead, it proposes the following safeguards. A liberalized interest rate regime should be accompanied by a transparent way of communicating to borrowers up front what the all-in cost of a loan will be (a simple number which reflects the effective interest rate they are being charged when all fees are included), public disclosure of margins on loans to the priority sector relative to reasonable cost benchmarks,[38] and an effective system for tackling consumer grievances (see the financial ombudsman proposed in Chapter 6). However, the most important check will be that loans with interest rates that meet a 'reasonable margin' test imposed by the regulator based on prevailing costs will get priority sector lending certificates, which they can sell for an extra margin.

3. Subsidies and public goods

The Committee believes that well-targeted subsidies provided directly to the poor are a more useful option than subsidies to financial entities for provision of services. Notwithstanding this belief, there is still a case for the provision of subsidies for services in remote areas or to target underserved segments. A minimum set of services could be specified, which would satisfy the needs of a poor family (e.g., offering micro payments and micro savings) or standards set for an entire underserved area. The standards could be set in such a way as not to preclude innovative ways of offering them, including through technology. The service obligations in areas that are considered financially excluded could then be auctioned off, with (typically) negative bids indicating subsidies the government would have to offer. The subsidies could be set on a per account or a per area serviced basis. The hope is that such subsidies would be short term, with their need eliminated as these areas and segments exhibit signs of commercial viability.

An alternative would be to have those who provide financial services in underserved areas obtain certificates based on creating accounts or other services in underserved areas, and allow these certificates to be traded, much like the PSLC.

Instead of banks being obligated to open rural branches, they could incur a service obligation based on the number of accounts they have of the better off in urban areas (see Chapter 4). They would initially support the market for the certificates.

Another useful step would be to provide existing subsidies and cash transfers to the poor via bank accounts to encourage their use of the banking infrastructure. Recipients of payments from various anti-poverty schemes (SGSY, NREGS, etc.) as well as microinsurance and old age pension schemes could be asked to open no-frills bank accounts augmented by biometric cards (which will help reduce multiple or *benami* IDs and, hence, corruption). Payments could be channelled to these 'household development' accounts via a monthly cash transfer that is electronically swept into the account (rather than the current lump-sum transfer which is a large portion of the household's assets and is often misused). The precise modalities for these products will have to be worked out but channelling them in this way will help greatly in organizing payments from various existing schemes in a manner that the poor can get maximum leverage from the resources they receive.[39] The pattern of their usage of these funds will also help them build savings histories that can be the basis of formal credit later on.

Public intervention may be needed to promote simple low-fee savings instruments that are indexed to the stock market and available for purchase in small units by small investors, savings funds, etc. This would allow small investors to tap into the large gains that equity market investors have enjoyed the world over in recent times. It would also allow them a better savings instrument than savings accounts that have given them miserable real returns in the past. Currently, the lack of PAN numbers among the poor prevents the wider dissemination of such products. There may be a case to subsidize the provision of PAN numbers for poor clients who wish to participate in this scheme.

The government could also provide for (by arranging or paying for, not necessarily undertaking the function itself) common services that could help achieve scale and reduce the costs of financial intermediaries in providing financial services. For example, in Mexico, BANSEFI (National Savings and Financial Services Bank) provided centralized back-office services like electronic transfers, liquidity management, clearing house services, debit and credit card services, and foreign exchange and derivatives transactions to enable financial institutions scale up financial services to low-income households.

Mexico also offers other examples of innovative provision of public goods to facilitate financial inclusion that might be worth replicating in India. One is the securitization of trade credit through NAFIN, a Mexican development bank that has created an electronic system to facilitate this activity (see Chapter 7). A second example is that of FIRA, a Mexican development financial institution that provides increased finance to agriculture sector using structured finance transactions.

Use technology to reduce cost of delivery

A recent Boston Consulting Group report estimates that the cost of funds today is 9 per cent, provision for bad debts is 10 per cent and cost of consumer acquisition and transaction and operation cost is 13 per cent for the poorest customers, leading to banking for the poor becoming unprofitable.[40] The key role that technology has to play is to reduce the last two components drastically. Reducing these costs can translate into lower lending costs, which would help improve the viability of risky rural businesses and allay concerns that the high cost of lending to poorer segments is resulting in over-indebtedness. Equally, distances are large in rural areas and transport sparse. Here again, communications technology could play an important role by bridging the last miles between the customer and the provider and thus facilitating transactions.

Transaction and operation costs consist of front-end costs, network costs and back-end operation costs. Back-end costs for banks vary from Re 1 to 2 per transaction. Indian mobile companies however, have managed to reduce backend costs (for what are essentially similar operations to between 1 and 2 paise per transaction. While banks have done a good job in computerizing their operations, they need to learn from mobile operators and optimize back-end technologies and leverage volume to significantly reduce these costs.

The telecom network in India is rapidly evolving. The banks need to move towards leveraging this network and design their networks afresh to expand operations, reduce costs and increase reliability of their operations.

The front-end continues to be the dominant costs for banks. The use of ATMs has significantly reduced front end costs but they are still too high. Banks need to promote lower costs indigenous ATM technologies, especially for rural areas. Going beyond ATMs, front-end costs can be brought to negligible amounts by replacing cash transactions with electronic transactions. More than 80 per cent of India's financial transactions are processed in physical cash. Cash as means of payment has a large cost in terms of handling, transaction processing, holding and risk of loss. On the other hand, Internet banking transactions have zero front-end cost for the banks; efforts have to be made to make this a preferred mode of transactions for large corporations. Its extension to SMEs may have much larger impact. Rural Internet Kiosks can be used by all rural businesses to carry out such transactions.

Mobile banking is perhaps the most promising front-end technology for facilitating financial inclusion in India, especially for individual customers. Given the success of mobile phones in reaching out to segments and geographies not yet penetrated by banking and the simplicity of their operation, this may be one of the more preferred interface of choice for most banking clients. The telecom and the banking industry along with RBI has recently constituted a Mobile Payment Forum of India (MPFI) to examine technological, regulatory and business constraints related to the scaling up of mobile banking in India (Box 4). This Forum's recommendations would be the key to provide a roadmap for mobile banking. Additionally, Stored Value Cards would be another important vehicle for financial inclusion.

There is a need to create common payments systems with participation by multiple banks, to reduce transaction costs and substantially increase the deployment and utilization of POS terminals. An important advantage of all these interfaces is that they are essentially cash-less and minimize fraud and the costs related to cash handling.

Further, technology can be significantly leveraged for acquiring customers. Banking correspondents (BC) with Internet Kiosks at villages as well as BCs armed with mobile phones with back-end interface (e.g., the kirana shop) has to be used extensively. A unique ID for each citizen would help accelerate this.

Finally technology has to be used to reduce provisions for bad debt. Credit ratings for retail customers and a unique citizen ID are critical in this regard. Capturing all the transactions electronically and mandatory sharing of data with a credit bureau would significantly help in this direction (see Chapter 7). The absence of this and high provision for bad debts, is in fact hurting the poorest most.

The role of public policy is to enable the adoption and scale up of appropriate technologies while mitigating risks of their misuse. Public policy can play an important role in the establishment of a unique identification number and the promotion of biometric authentication, which would facilitate the development of credit bureaus (see Chapter 7). As mobile banking becomes widely prevalent, it may be worthwhile to map a citizen's unique ID to his/her phone number. Low cost ATMs will also play a major role in financial inclusion. Further development of real time inter-bank transactions would be essential for mobile banking to take off. To make mobile banking profitable, the costs of this system need to be very low. While the RBI in consultation with IDRBT can initiate a common payments platform, it would be useful to encourage private initiatives in this area in order to foster innovation and drive down costs. KYC norms should be made common for banking, telecom and insurance.

Government funds could be used to promote the use of technology among the poorest clients and small financial service providers. The Rs. 500 crore Financial Inclusion Technology Fund, proposed by the Rangarajan Committee on Financial Inclusion and announced in the 2007 Budget speech, could be used to finance the creation of common technology platforms or back office services for small financial services providers who are serving the poorest clients. It could also be used to promote mobile payments amongst the poor.

The most important way to figure out the appropriate technology would be through careful experiments. Many experiments are required. Many of these experiments would fail. But results from these experiments would help us get the answers. To the extent there is a role for the government apart from helping coordinate the setting of standards, it would be to fund experimentation in areas where there is a significant public goods component (such as payments).

An ambitious goal can serve to bring all these considerations together. The Committee believes that with some effort, 90 per cent of Indians can have access to the formal financial system, at the minimum through a 'no-frills' bank account if they so desire, and advocates that this goal be achieved in three years.[41] These accounts would be especially useful for households with migrant workers to receive remittances as well as for low-income households to receive cash trans-fers from NREGS and other programmes. As discussed in previous section under point 3 'Subsidies and public goods', providing such payments through bank accounts minimizes the logistical challenges associated with providing cash as well as the incidence of leakage.

In this regard, the Committee recommends the creation of a nationwide electronic financial inclusion system (NEFIS) that would link these bank accounts and allow funds to be transferred into them electronically. Such mechanisms can present a saving to the government, both in terms of administrative burden and in terms of cost. The cost per beneficiary of this infrastructure is largely a function of volumes. Fixed costs of the POS/mobile devices, computer servers and incremental communication networks to service about 50 crore un-served citizens would be around Rs. 1,000 crore. The variable costs are relatively small; if smart cards were used, the variable cost per user would be less than Rs. 40, while putting biometric capability on a user's cell phone would cost less. The cost per transaction of NEFIS could drop to a few paisas, as millions of outlets accept e-payments. Of course, for cash-in/cash-out transactions, requiring a human/machine interface, the cost per transaction could be as higher.

Once NEFIS is in place, it would enable transactions as small as Re 1 to be carried out with limited transaction costs, as long as these are cashless (indeed millions of these are being done and recorded, as in case of cell phone calls and SMS-es which are charged). If cash was to be out in or taken out, transactions as small as Rs. 100 could be

M–Banking Solutions for India

Mobile telephony has made significant impact in India, with India now adding 100 million mobile phones a year. The total number of mobile phones is likely to touch 500 million by 2010 or 2011. It is likely that most Indian families would own at least one mobile.

Mobile phones have a great capability of becoming devices for financial transactions, substituting cash and enabling funds transfer to become more widespread. Thus payment can be done from one individual's mobile to that of another; further the payment is equally possible whether the two individuals are at the same location or at different geographical locations. The transfer could be from one's bank account to another or from one's virtual account (held by a telecom operator or a third party) to that of another. The transfer would be secure, instantaneous and possible at anytime.

Mobile payments, though in their infancy, have made significant impact in several countries including the Philippines, Kenya, Japan and South Africa. The technology is quickly maturing and has great potential to substitute cash as well as help reach unbanked population. While today the authentication would be done by the possession of phones and a PIN (just like a card and a PIN for ATM machine), bio-authentication like fingerprint would be available in the next few years.

The question therefore is what is the best way for India to adopt this technology in its drive for financial inclusion? Many initiatives are underway as players—banks, telecom companies, other financial players—search for a viable M-banking model for Indian markets. Sensibly, the banking industry, telecom operators and technology providers have got together with academia and banking regulators to form the **Mobile Payment Forum of India (MPFI)**. The Forum examined the technology, business and regulatory issues to enable this service in India and its draft report has been released by the RBI for public comments. The early focus is on transactions from one bank account to another (as also from one card account to another) through mobile phones, given the need to ensure compliance with KYC and anti-money laundering guidelines, among other prudential requirements. Other modes of transfer will be explored in due course once experience is gained with the initial model. Right from the beginning, it is envisaged that the service would work in multi-operator (telecom) and multi-banking scenario.

The key is to discover the appropriate price point and consumer confidence in safety of transactions, only post which the Indian user would adopt mobile banking in a large way. Going by the experience of telecom operators, India adopts solutions only when it is very low priced, easy to use and safe, making it affordable to larger sections of people. The challenge would then be to develop the right technology so that the service providers and the banks consider this as a viable business.

done at a reasonable transaction cost. This would greatly incentivize the poor to make micro-savings and eventually become full-participants in the financial system. The government should explore on an expedited basis, together with deposit taking institutions, business correspondents, and technology providers, what aspects of the NEFIS could ride on the current backbone, what will need new infrastructure and common standards, and whether any incentives need to be provided to the system to undertake this task. The ambitious timeline should be adhered to.

Improving infrastructure for financial inclusion

The Committee believes that it is important to improve the infrastructure for inclusion. Section on 'Use technology to reduce cost of delivery' discusses the creation of NEFIS, which would be instrumental in facilitating the poor's access to the payments system. Chapter 7 deals extensively with the issue of credit infrastructure, including the creation of a national ID, the use of land as collateral, and personal bankruptcy, which are all measures that would improve the poor's access to financial services.

Another area that falls broadly in the ambit of financial infrastructure for inclusion is the provision of interest-free banking. Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region.

While interest-free banking is provided in a limited manner through NBFCs and co-operatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

Financial literacy

The Committee also believes that a significant investment in financial literacy is required if the poor are to make effective use of various initiatives to foster financial inclusion. A good understanding of the costs and benefits of various financial services, the impact of inflation on savings, and the trade-off between risk and return can help households choose the right products for their needs and weed out dubious schemes from truly beneficial ones. The Committee believes that efforts to promote financial literacy should start early. Starting around Vth standard, students could be introduced to terms such as income, expenditure, savings, deposits, interest, insurance, etc. In addition, TV channels could be encouraged to run educational programmes on financial issues such as household budgeting, savings, insurance, and pensions. The proposed Office of the Financial Ombudsman could aggregate the funds currently set aside by various regulators for this purpose, and sponsor these shows (for example, SEBI has the Investor Education Fund and IRDA has the Insurance Fund). These efforts could also be sponsored by individual banks, insurance companies, etc.

NOTES

1. This evidence comes from the results of the 2007 IIMS Dataworks survey that was used as an input to this chapter.
2. For example, for priority sector loans below Rs. 2 lakh, the interest rate is capped at the Prime Lending Rate (PLR). Banks do have some flexibility in determining their PLR, an in addition, a nominal additional charge is allowed over and above the PLR

for loans above Rs. 25,000. But for loans below Rs. 25,000, where much of the poor's borrowing lies, no additional charges are permitted other than the PLR. The interest rate cap is however not applicable on certain categories including loans for purchase of consumer durables, to individuals against shares/debentures/bonds, and other non-priority sector personal loans.

3. The analysis in this section is based largely on a household survey of 100,000 respondents carried out by the Invest India Market Solutions (IIMS) in 2006–07 (and referred to as IISS 2007 or 'the Survey' in this chapter).
4. Approximately three-fourths of the total working population, or 321 million people in 2006, earn cash incomes (the rest are primarily unpaid family workers). Of those only 193 million or 60 per cent reported having any financial savings in formal and informal instruments.
5. For instance Kerala, which has the highest incidence of savings has also the highest proportion of cash earning adults with bank accounts. By contrast, Bihar with the lowest incidence of savings also has the lowest bank account penetration.
6. Other surveys have similar findings. For example, a 2004 Survey commissioned by the Ministry of Finance titled 'Pension Reforms for the Unorganised Sector in India' found that 94 per cent of existing earners were not saving or building up assets for retirement. This was despite the fact that 40 per cent of respondents in urban India and 30 per cent in rural India reported that they did not expect their children to take care of them in their old age, the traditional mode of funding retirement in India. In contrast, the Max New York Life—NCAER India Financial Protection Survey found that nearly 69 per cent households save for old age financial security.
7. RBI Annual Report 2006–07, p. 32.
8. Of the population citing wealth creation as their prime motivation for savings, 13.9 per cent and 15.1 per cent had invested in mutual funds and equities respectively.
9. At an aggregate level, the investor base for mutual funds and equities is small—mutual fund investors represent only 2.8 per cent of the total population with savings, while equity investors represent 1.9 per cent.
10. Capital gains from short-term sale of equities attract taxes, while sale of long-term equities (over one year) are not taxed. However, all interest over Rs. 10,000 earned on bank deposits is taxed. Clearly, the poorest households are likely to be exempt from taxes on deposit interest, but as interest rates rise, more households will pay taxes on deposit interest.
11. For traditional life insurance products, a policyholder typically loses the entire investment if the policy lapses within the first three years. After that, only the surrender value is paid in the case of a lapse, which is less than 35 per cent of the total premia paid. IRDA reported that almost 5 per cent of life insurance policies lapsed between 2000 and 2005. This number was as high as 16 per cent among private providers, due to higher contribution of ULIPs and aggressive selling policies. Source: ISEC Securities, 'Indian Life Insurance', 7 December 2007, p. 43.
12. World Bank-NCAER Rural Finance Access Survey, 2003.
13. Task Force on Revival of Cooperative Credit Institutions, December 2004, Chairman: Prof. A. Vaidyanathan.
14. The cooperative banking sector is undergoing extensive reform based on the recommendations of the Vaidyanathan Committee. The revival plan has been accepted by 17 states 'in-principle', while 13 states have signed MOUs with the government. It is imperative that the revival package is implemented in full, without diluting the contingent legal, financial, regulatory, and institutional reforms that in turn would entail significant decisions on the part of the participating state governments and cooperative credit societies. This would have the effect of cleaning the balance sheets and strengthening the capital base of rural cooperatives, and allay fears that the implementation of the revival package may not provide any substantial remedy to the problem of financial exclusion.
15. Though priority sector lending norms initially focused on increasing commercial finance to sectors deemed as 'national priority' since 1980, the scope of the priority sector has largely evolved to give greater prominence to segments of the population that have traditionally been denied credit, thus making it a tool to address financial inclusion. In 1980 the Working Group on Priority Sector Lending and 20-Point Economic Programme (Chairman: Dr. K.S. Krishnaswamy) introduced a focus on 'weaker sections' within the priority sector by identifying underprivileged segments that required access to banking services. The Committee also recommended separate sub-targets for lending to the weaker sections within agriculture and SSI. The first Narasimham Committee (1991) proposed a redefinition of the priority sector to comprise small and marginal farmers, the tiny sector of small-scale industry, small business and transport operators, rural artisans, and other weaker sections. The C.S. Murthy Committee (2005) further redefined the priority sector to include those sectors that 'affect large sections of society, benefit small borrowers and involve small loans, and lead to substantial employment generation'.
16. The bulk of lending in that category appears to be in the form of large ticket loans to farmers with larger landholdings. While marginal farmer households comprise over 66 per cent of all farmer households, the share of credit accounts among this section of farmers barely increased between 1991 and 2005, while the share of credit accounts for medium and large farmers increased by 41 per cent over the same period. Similarly, credit access among the tiny enterprises under the small and medium enterprise category fell post-2000 (Chavand and Ramkumar, 2007).

17. World Bank, 2007, *India: National Agricultural Insurance Scheme: Market Based Solutions for Better Risk Sharing*. p. 3.
18. Indian microfinance had a late start, well after Bangladesh, Indonesia, and Latin American countries. The key policy change that jumpstarted microfinance provision in India was RBI's 1996 decision to allow commercial banks to lend to self-help groups without collateral.
19. The SHG-Bank Linkage programme has been described as the largest microfinance intervention in the world (Christen, 2006).
20. In 2001, over 70 per cent of SHGs were located in the four southern states of Andhra Pradesh, Tamil Nadu, Karnataka, and Kerala. This number has fallen to 45 per cent in 2007 (Thorat et al., 2007).
21. Goldberg (2005). *Measuring the Impact of Microfinance: Taking Stock of What We Know*. Grameen Foundation USA Publication Series.
22. Khandker (2005). *Microfinance and Poverty: Evidence Using Panel Data from Bangladesh*. World Bank Economic Review.
23. Chen and Snodgras (2001). *Managing Resources, Activities and Risk in Urban India: The Impact of SEWA Bank*.
24. Apart from loans, MFIs have been able to raise equity financing from private equity players. The securitization of MFIs portfolios also provides an attractive source of finance.
25. See Berger et al. (2005).
26. Thorat (2007).
27. The Local Area Bank Scheme, initiated in August 1996, was set up with the intent of creating new local, private banks with jurisdiction over three contiguous districts that would mobilize rural savings and make them available for investments in the local areas. Only six were approved initially, and four are currently in operation. The LAB scheme was never given a serious try, and this is unfortunate because every proposal for small banks meets the rejoinder 'the LABs did not work'. This largely inaccurate conclusion stems from over-interpreting a 2002 RBI internal review group, which examined the operations of the four existing LABs. While admitting that it was too early to make strong judgements, and despite the banks being profitable, meeting priority sector targets, and maintaining high credit-deposit ratios, the Review Group recommended that until existing LABs achieved a measure of financial soundness, no more LAB licenses were to be issued. The Review Group also recommended, on the basis of a priori reasoning, and the RBI accepted, that size was important in banking, and therefore the capital base of the existing LABs be increased from the initial Rs. 5 crore to Rs. 25 crore over seven years, and that LABs should maintain a minimum capital adequacy ratio of 15 per cent given the higher level of risks they face. The Khan Committee, which examined issues relating to rural credit and microfinance (2005) and the Rangarajan Committee on Financial Inclusion (2008) have supported the revival of the LAB scheme. The latest figures show LABs have profits to assets of about 1.2 per cent, which is about the same as other banks.
28. Committee members were hesitant to mandate an explicit loan ceiling, but the idea is that the average ticket size of loans made by small finance banks would be much smaller than those of SCBs.
29. Since these banks would be serving a large section of farmers, they would provide simpler derivative products to hedge price risks. They could simply aggregate the demands of farmers and purchase the necessary exchange traded or OTC products, without the need for hedging operations.
30. Examples include Rabobank in Netherlands and BANSEFI in Mexico.
31. In 2005, the RBI allowed banks to use business correspondents (BCs) and facilitators (BFs). A number of entities can serve as BCs—cooperatives, Section 25 companies, non-deposit taking NBFCs, post offices, etc.
32. The 2008 Budget announced that a number of additional categories would be eligible to be BCs, such as retired bank officers, ex-servicemen, etc.
33. The RBI report has proposed a Moneylenders & Accredited Loan Providers Bill, 2007. Under this proposed legislation, moneylenders who sign up to a model code of conduct detailed in the legislation could be offered finance from the formal system.
34. Brazil and South Africa are good examples. The South African low-frills Mzansi bank account can be accessed through various non-bank locations. In India, the underdeveloped organized retail sector has been a constraint in scaling up such partnerships. However the postal network of India Post, which has the largest number of branch offices in the country, is a potentially viable channel for expanding financial service delivery. India Post is already a large repository of household savings and the largest provider of remittance services. Unfortunately, India Post's past role in playing a larger role in financial services has been checkered. This is largely due to weak management and governance issues that must be tackled. Clearly a revamping is underway as evidenced by recent announcements of various tie-ups between India Post and various financial institutions.
35. An example is the Mahatma Gandhi Bunkar Bhima Yojana (MGBBY), a group insurance scheme for handloom weavers. The scheme offers insurance cover of Rs. 50,000 for natural death, and Rs. 80,000 for accidental death. In 2005–06, weavers had made claims of only Rs. 1.67 crore out of the premium amount of Rs.13 crore paid by the gov-ernment to insurance companies (Source: Press Information Bureau, November 2006 and *Hindu Business Line*, 6 September 2006).

    In contrast the NAIS, described in Section III, is unable to collect adequate premia to meet the required payout.
36. The government has announced plans for a subsidized national health insurance scheme for unorganized workers. This scheme shifts government spending to demand-side subsidies away from supply-side spending. A McKinsey &

Company report argues that this scheme could be enhanced by leveraging the country's civic institutions as 'social aggregators' uniquely capable of rapidly bringing large numbers of citizens into a health insurance system. Social aggregators can act as informed consumers on behalf of their members, while simultaneously improve risk sharing and reduce the likelihood of fraud and moral hazard.

37. The first Narasimham Committee (1991) proposed that the scope of directed lending under priority sector be reduced from 40 per cent to 10 per cent. This was not accepted. The second Narasimham Committee (1998) noted the reasons why priority sector obligations could not be reduced while stressing that priority loans be appraised on commercial considerations without any extraneous influences. The High Level Committee on Agricultural Credit through Commercial Banks (R.V. Gupta Committee, 1996) noted that the target of 18 per cent for lending to agriculture was fixed when the reserve requirements were 63 per cent. Due to progressive reduction of the reserve requirements over the years, the total lendable resources of banks have increased substantially. The Committee estimated that the base on which the target of 18 per cent was calculated had doubled; thus the banks would have to double their lending to agriculture just to maintain the same share in conditions where agricultural production itself was growing at 2.1 per cent per annum. It suggested that banks prepare special agricultural credit plans and set their own lending targets for agriculture based on Reserve Bank's expectation of increase in the flow of agricultural credit on an annual basis.
38. RBI could periodically collect and publish information on costs of lending to particular hard to reach segments and disseminate such information in its various publications, highlighting cases where entities have achieved significant cost reduction in providing such credit. Such information would exert pressure on banks to find ways to reduce the cost of credit provision in the priority sector, and could also be used to judge reasonable margins.
39. Government of Andhra Pradesh concluded successful pilot routing social security payments to widows, handicapped, old and eligible weavers through the use of smart cards and BCs.
40. Sinha, J., and A. Subramanium, 2007, *The Next Billion Customers: A Road Map for Expanding Financial Inclusion in India*. Boston Consulting Group.
41. The Committee recognizes that 90 per cent of households are likely to be covered in three years. The remaining 10 per cent would be difficult to reach, and the goal should be to cover those in the following two years.

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Levelling the Playing Field

chapter 4

In an efficient financial system, the playing field is level so that different institutional forms compete to provide a function, no institutional form dominates others because of the privileges it enjoys, competition results in resources being allocated efficiently, and society gets the maximum out of its productive resources. This is also equitable for only thus will the interests of the consuming masses be served, instead of the more usual trend of privileged producers being protected. However, it will be a challenge to level the playing field in India because history has given us a peculiar legacy of financial institutions and a set of interest groups ranging from employees to regulators and politicians, who will support special privileges to their favoured institutions.

The tilted playing field is central to understanding some of the features of the Indian financial system. In India, the liquidity, safety, and payment services, offered by bank deposits have made them an investment vehicle of choice for the public. Banks can provide depositors with the product they need because of their access to certain public institutions, including the discounting or repo facilities at the central bank, the deposit insurance system, the payment system, and credit enforcement rights. Access to depositors gives banks a source of low cost financing. In return for this, made possible in part by privileged access to state institutions, banks are required in India to fulfil certain social obligations such as lending to the priority sector, as well as meeting prudential norms such as statutory liquidity ratios that also have a quasi-fiscal objective of funding the government. This is the grand bargain underlying the treatment of banks in India.

For the bargain to hold, there must be a rough balancing of the costs and benefits of being a bank. Yet competitive changes are making it much harder to maintain the balance without standing in the way of development. Consider payments. With technological improvements and the advent of real time gross settlement systems, more institutions such as money market mutual funds can be allowed access to the payment system and given the ability to offer customers checking accounts, much as they are in industrial countries.[1] But then banks would be right to ask why they should bear unremunerated obligations, such as priority sector lending if money market funds are given a free pass. Should banks be absolved of priority sector obligations, or should it be imposed on money market funds? As these questions suggest, the grand bargain will become harder and harder to sustain, and require ever increasing intervention by the authorities, as competition increases. Moreover, intervention will come in the way of efficiency.

Rather than regulatory authorities trying to determine what institutions should be privileged, and how costs and benefits should be balanced, this Committee believes they should let competition decide. This would require steadily lowering privileges, obligations, and regulations that differentiate one institution performing a function from another institution performing that same function, so that the most efficient form can prevail. To the extent that differences serve a social purpose, this suggests more direct attempts to achieve that social purpose by the government. It would also imply greater tolerance for a variety of institutional structures and linkages so that needed products can be created. Institutional structure should drive regulatory structure rather than vice versa.

Artificial differences abound in the Indian system. For example, money market mutual funds have a tax advantage over deposit-taking institutions with what are effectively interest payments to holders being taxed at a lower dividend rate. This gives money market funds an undue advantage, best removed by equalizing interest and dividend taxes, or setting the personal tax rate on mutual fund dividends in proportion to the fund's receipt of equity and debt income—in other words the mutual fund should pass through tax obligations instead of distorting them.

While we will offer more examples of institutional privilege that should be done away within the chapter, we cannot be exhaustive for the Indian financial system has many. The ultimate aim is to have a level playing field where institutional form does not affect the costs of undertaking an activity other than for purely economic reasons.

Another important source of differentiation is ownership—whether private, government, or foreign. For example, government ownership automatically confers benefits (government guaranteed support, favours by regulatory authorities, guaranteed public sector customers) as well as costs (politicization of decisions, limitations on pay, unremunerated activities for the public or support for public sector entities, extra layers of oversight by government organizations and the resulting inflexibility, difficulties in raising capital). If government ownership made a structural difference, with government owned institutions performing certain activities better simply because they were government owned—for example, if public sector employees treated the poor better than did private sector employees—there might still be a case for differentiation. There is, however, little evidence that government ownership creates deep differences in employee actions and behaviour.

Indeed, it is increasingly evident that when asked to generate profits, public sector entities do exactly what private sector entities do, though less well because they have more constraints, a poorer skill pool, and poorer incentives. The danger is that unless they are unshackled and their privileges minimized, they will slow growth and increase instability. For instance, the skill deficit will make public sector firms less effective at pricing risk. But they may still be able to win business, given their access to low cost financing (resulting from government backing). This will crowd out the private sector, which will not be able to compete at such un-remunerative prices. The distorted prices will inhibit the financial sector's effectiveness in allocating resources and risks. And the costs will partially have to be borne by the government when the underpriced risk eventually hits public sector balance sheets.

The Committee believes the way forward is to make institutions 'ownership neutral'. For the public sector, this means removing the overlay of costs and benefits imposed by government ownership. One way is bank privatization, or reducing the government's majority stake so that even if the government has de facto control, the bank is not 'public sector'. The other is through serious governance reform. The Committee believes that while this debate has become entangled in politics and ideology, pragmatic steps are possible in both directions so that experience can guide future moves. It makes recommendations along these lines.

Consider next foreign ownership. Many arguments are put forward for treating foreign firms differently. Yet the country has had a generally good experience with foreign direct investment elsewhere. And given that there are strong domestically incorporated firms in almost every segment of the financial sector, 'infant industry' arguments for protecting domestic financial firms at the expense of domestic financial service consumers hold little water.

What would foreign financial firms bring? The past Indian experience may not have much bearing for the future, given the substantial changes in the Indian economy. But cross-country studies indicate foreign financial institutions would bring competition that would improve service and prices for the consumer—indeed a study finds foreign entry is the single biggest factor in enhancing domestic competition and efficiency.[2] They would also bring skills that are needed in the Indian economy, and the talent they bring to India, or train in India, would become part of the domestic labour pool, leading to cross-fertilization. Particularly useful might be evaluating and channelling credit to small and medium enterprises.[3] Finally, they will have access to foreign capital that will be available even if the Indian economy is doing badly, thus providing a valuable source of insurance.[4]

There are, no doubt, concerns about foreign financial firms. There is some academic evidence that their entry is not particularly helpful when an economy is at a low level of financial development.[5] India's financial sector is probably much above that threshold. Also, to the extent foreign financial firms are not domestically incorporated, regulatory authorities may not have full control over them. This is remedied by requiring domestic incorporation in exchange for full domestic business privileges. Yet another concern is reciprocity. Domestic banks would like to expand abroad and feel that some countries erect undue hurdles in their way. It is important for the Indian authorities to exert every pressure on foreign governments to extend reciprocal privileges to Indian banks. However, we believe that the expansion of foreign banks in the Indian economy is beneficial to the Indian public and should not be held hostage to the vagaries of foreign governments. In the same way as India benefited by liberalizing trade over and beyond its foreign commitments, India will benefit by welcoming foreign financial firms. The high road seems to be the most beneficial one for our country here.

The Committee would offer some cautions about any reforms. First, it may be impossible to level the playing field completely. Some differences may be warranted, for example, for prudential reasons. For instance, a bank making certain loans has a capital requirement that a NBFC does not have to meet. This is because the bank has issued demand deposits, which entail a higher supervisory burden (see Chapter 6). Of course, the more an NBFC approaches the characteristics of a bank by issuing short-term deposits, the greater should be the similarity in treatment. Indeed, this principle is being followed by the RBI in its approach towards deposit taking NBFCs.

There are, however, differences that are not essential, and deserve to be eliminated. These differences are often highlighted through competition, as one entity or product appears to gain a seemingly unfair advantage. There are obviously two ways of eliminating burdensome differences. One is to place the burden on everyone. The second is to eliminate it for everyone. In general, the Committee would favour equalization by removing burdens rather than by adding burdens. To the extent that a burden cannot be removed for sound economic reasons, it would suggest a 'warranted' difference that might have to remain, rather than a need to increase burdens for everyone.

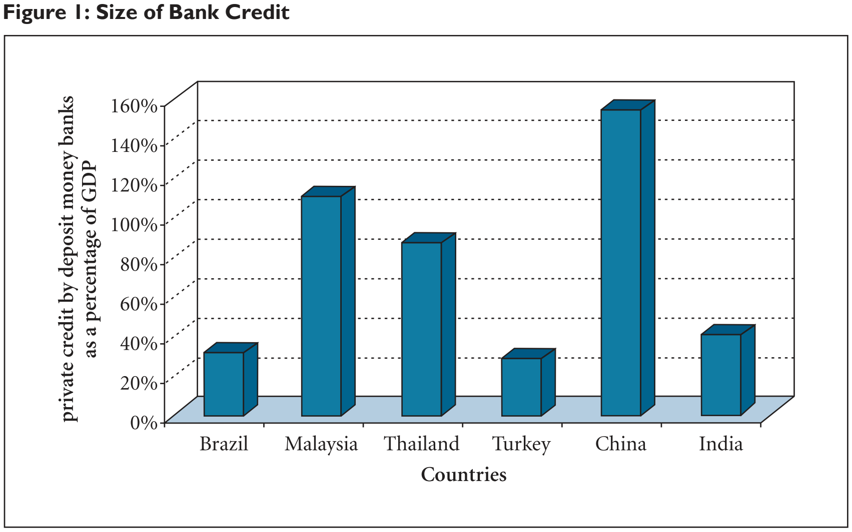
Second, institutions should be given time to adjust, so that legacy institutions can compensate for the loss of rents by developing new skills and businesses, or by shrinking gracefully, rather than by taking risks they do not understand or cannot manage. A time bound, pre-announced, steady withdrawal of differentiation is usually better than an overnight change.

Third, as financial integration proceeds apace, a variety of institutional linkages may emerge to provide the products people need. For example, a loan linked with crop insurance (or alternatively, one where interest and principal payments are linked to rainfall) seems to be a felt need of farmers. Given the desire of investors for safety, an equity linked deposit account, with a guaranteed minimum interest rate, liquidity, and some (but not full) upside performance related to the performance of the stock market could be popular. Such products would require linkages across institutional and regulatory silos, some of which is already happening. More needs to be encouraged. Holding company structures could help facilitate such linkages, and we will offer some recommendations. Regulatory reforms will also be needed and we will offer views in Chapter 6.

Fourth, care should be taken that institutions do not misuse their freedom of activity and structure to create fragile institutions that impose charges on the system. Certain activities do tend to create fragility, and should be monitored particularly closely or, in extremis, even prohibited for certain structures. For example, key to open-ended mutual funds being safe is the fact that their assets are liquid and continuously marked to market. An open ended real estate mutual fund has neither characteristic and can be very fragile—mutual fund 'runs' have occurred in some countries like Germany. Similarly, banks, mutual funds, or insurance companies with guaranteed returns necessitate additional monitoring to ensure that the institutions are managing their assets to produce the guaranteed returns, else they too could suffer runs and become a public charge.

The point therefore is to proceed steadily, predictably, but with care to reduce privilege and obligations, while expanding permissible activities wherever possible. This chapter contains some proposals towards these goals but it cannot be exhaustive. The main focus will be the banking sector, but the annex offers examples from other sectors.

Figure 1: Size of Bank Credit



Source: Financial Structure Database, World Bank.

TAKING STOCK

Key to growth with equity is an efficient and competitive banking sector providing the full range of products and services to individuals of all incomes and locations, as well as corporations of all sizes. The system should be stable with banks and bank employees appropriately incentivized so that there is little systemic propensity for sloth, excessive risk taking, fraud, or customer abuse.

By some of these counts the banking system has been very successful. Steady growth has come without significant instability, in contrast to the experience of some other emerging markets. Historically, our banks have attracted some of the best talent available. Some of our banks are setting world standards in the use of technology, and the recent thrust into housing and retail credit suggest banks are prepared to meet demand when it arises. Banks are also in fairly good health, as suggested by low NPAs and sizeable profits.

One cannot be complacent though because periods of strong growth are also periods when banking system problems build-up. While the rest of this section will attempt to understand the deficiencies in the banking system and possible areas of concern, this should not detract from past successes, which are considerable.

1. The role of the Indian banking sector is still small relative to GDP. While the size of the banking sector relative to the economy has more than doubled between 2000 and 2007, with bank loans to GDP ratio rising from 22.7 per cent to 46 per cent, the banking sector in India is still relatively small compared to other emerging markets (see Figure 1).
2. Even the largest Indian banks are relatively small, and account for a small share of the banking sector. India has only one bank (State Bank of India) that features among the top 100 banks in the world in terms of assets with a rank of 80. By contrast,

four Chinese banks feature in the top 30 banks. While banks of all sizes can be efficient—with technology allowing even small banks to flourish by making local, relationship intensive loans, size can bring some scale economies and allow banks to make loans to large projects while remaining diversified.

Indian corporations are also relatively small, hence the size of the capitalization of the 10 biggest Indian banks to the 10 biggest Indian corporations is not disproportional to ratios elsewhere (2.72 in India versus 2.45 in the USA in terms of total assets though a lower 0.23 to 0.44 respectively in terms of market capitalization). But as Indian corporations and projects grow in size and ambition, especially through mergers and acquisitions, some Indian banks will have to grow in size and capabilities.

3. If countries are ranked by the share of the top three banks in total banking assets, India comes in at number 102 in 2005. Of course, this is assuming that public sector banks should all be treated differently. While public sector banks do compete with each other, they do have a common owner, whose policies thus influence the activities of 70 per cent of banking sector assets.
4. India is an outlier in the extent of state ownership of the banking sector. Out of 138 countries surveyed by Barth, Caprio and Levine (2006), only nine had a predominantly state owned banking sector. India and China are in this group, along with Bhutan, Libya, Algeria, Belarus, Turkmenistan, Egypt, and Costa Rica. No high income country has a state dominated banking sector, and we should note that China has recently made moves to introduce strategic foreign partners in its large state owned banks.
5. In March 2007, there were 82 scheduled commercial banks in India (see Table 1 and Figure 2). Together, they accounted for about 80 per cent of the total assets of all formal institutions in the Indian credit market. Among the scheduled commercial banks the public sector banks accounted for about 70 per cent of the total assets in March 2007, Indian private banks 22 per cent and foreign banks 8 per cent. Interestingly, the share of the foreign banks has remained steady at about 8 per cent over the last decade or so even while the private sector banks have gained. Among the commercial banks, only eight are 'new' private sector commercial banks—banks that have been allowed to enter since the beginning of reforms in 1991.

Table 1: Credit Market Structure in India

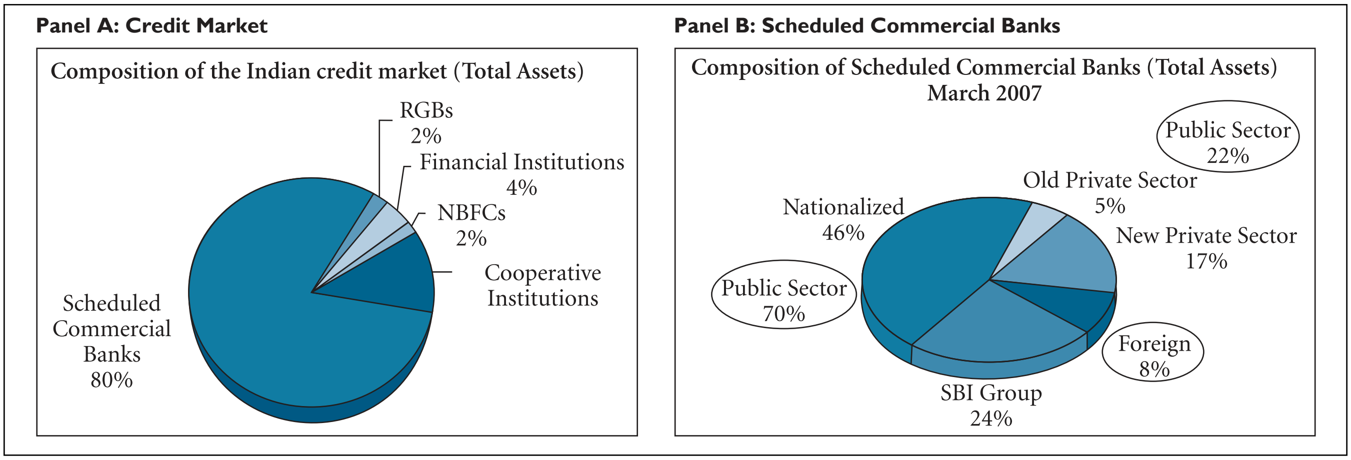
(Figures in Rs. Lakh Crores)

		Number of banks		Total assets		Loans and advances	
		2006	2007	2006	2007	2006	2007
1	**Commercial Banks**	**217**	**178**	**28.76**	**35.69**	**15.55**	**20.29**
	Scheduled Commercial Banks	84	82	27.86	34.63	15.17	19.81
1.1	Public Sector Banks	28	28	20.15	24.40	11.06	14.40
1.1.1	Nationalized Banks	19	19	12.34	15.30	6.82	8.95
1.1.2	SBI Group	8	8	6.92	8.06	3.72	4.82
1.1.3	Other Public Sector Banks	1	1	0.89	1.04	0.53	0.62
1.2	Private Sector Banks	27	25	5.72	7.45	3.13	4.15
1.2.1	Old Private Sector Banks	19	17	1.50	1.61	0.83	0.93
1.2.2	New Private Sector Banks	8	8	4.22	5.85	2.30	3.22
1.3	Foreign Banks	29	29	1.99	2.78	0.98	1.26
2.1	Regional Rural Banks (RRBs)	133	96	0.90	1.06	0.39	0.47
2	**Financial Institutions**	**55**		**1.45**	**1.67**	**1.11**	**1.32**
2.1	All India FIs	4					
2.2	Specialized FIs	7					
2.3	State Level Institutions	44					
2.3.1	State Financial Corporations						
	State Industrial Development	18					
2.3.2	Corporations	26					
3	**NBFCs**	**13,014**	**13,369**	**0.60**	**0.71**		
3.1	NBFC—D	428	401	0.38	0.48	0.11	0.11
3.2	RNBFC and Others	12,586	12,968	0.22	0.23		
4	**Cooperative Institutions**	**111,777**	**109,310**	**4.76**	**4.99**	**2.27**	**2.49**
4.1	Urban Cooperative banks	1,853	1,813	1.51	1.60	0.72	0.79
4.2	Rural Cooperative Institutions	109,924	107,497	3.25	3.39	1.56	1.70
4.2.1	Short Term	109,177	106,781	2.81	2.93	1.50	1.65
4.2.1.1	STCBs	31	31	0.72	0.76	0.44	0.48
4.2.1.2	DCCBs	367	369	1.33	1.43	0.66	0.74
4.2.1.3	PACs	108,779	106,384	0.75	0.73	0.39	0.43
4.2.2	Long Term	747	716	0.45	0.46	0.06	0.05
4.2.2.1	SCARDBs	20	20	0.24	0.25	0.03	0.03
4.2.2.2	PCARDBs	727	696	0.20	0.21	0.03	0.02

Source: RBI, Trend and Progress in Commercial Banking 2006–07. Number of reporting companies in case of NBFCs is 435 in 2006 and 362 in 2007. The total assets and loans and advances figures for the cooperative institutions are for the years ending 2005 and 2006.

India does not have many small private banks. The United States has over 7,000 banks, over 85 times the number of banks

Figure 2



Source: RBI, Trend and Progress in Commercial Banking 2005–06 and 2006–07 respectively.

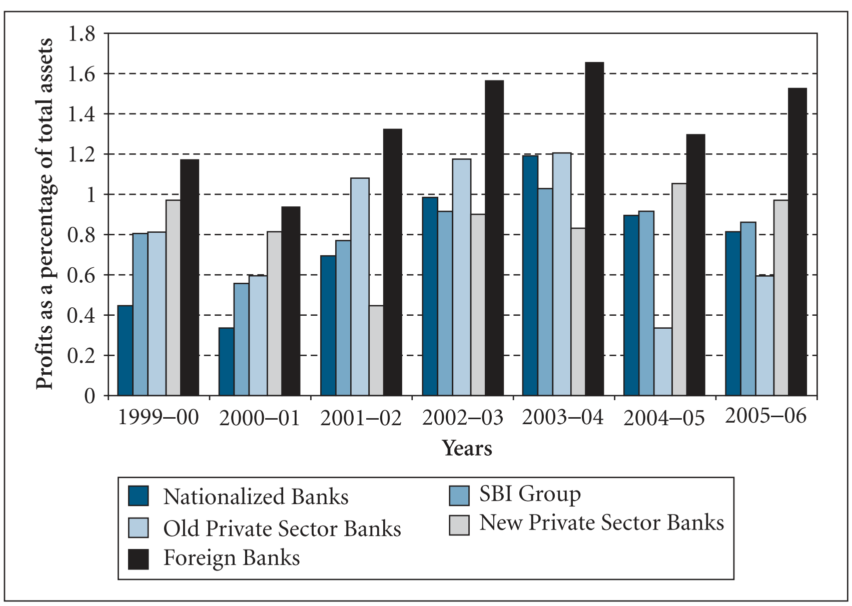
in India, handling total deposits that are merely over eight times larger. It should be noted that many of these banks are small community banks, comparable to our co-operative banks, of which we have a vast number. But these have a different governance and funding structure from the typical bank. While there are a number of notable exceptions, the experience with cooperatives has been mixed, in part due to problems with governance. These issues are addressed in Chapter 3, and the rest of this chapter will focus on scheduled commercial banks.

6. As a group, Indian banks have done exceedingly well in providing high returns to shareholders, registering the highest regional growth rate in assets, deposits, and ROE as well as one of the highest total returns globally according to a recent detailed survey of 14 leading public sector, new private sector and foreign banks conducted by McKinsey for the Indian Bankers Association (IBA).[6] Banks' contribution to GDP in India is comparable to the ratios in developed and developing world. Significant improvements were made in capital allocation between 2003 and 2007 reducing the share of industries with returns lower than cost of debt from 56 per cent to 22 per cent. NPA levels have been cut to about a third during the same period.

   Among the different bank ownership categories, foreign banks are clearly the most profitable (see Figure 3). Apart from fee-based activities, these banks enjoy a significantly higher interest spread (Figure 4). Part of their success in maintaining this margin lies in their ability to attract low interest corporate checking account deposits (Figure 5). The profitability levels of Indian bank groups are largely comparable.

7. With an average spread exceeding 5 per cent, intermediation costs in India remain high compared to other countries in the world as well as in the region. For example, spreads between borrowing and lending rates are 4 per cent in Thailand, 3.4 per cent in China, and only 2.4 per cent in Singapore. The high spreads are more than offset by unprofitable priority sector obligations and statutory requirements, as we will argue later. But this means that the burden of these social and public obligations are borne by the Indian saver, whose low return pays for the grand bargain described in the introduction.

Figure 3: Group-wise Bank Profitability

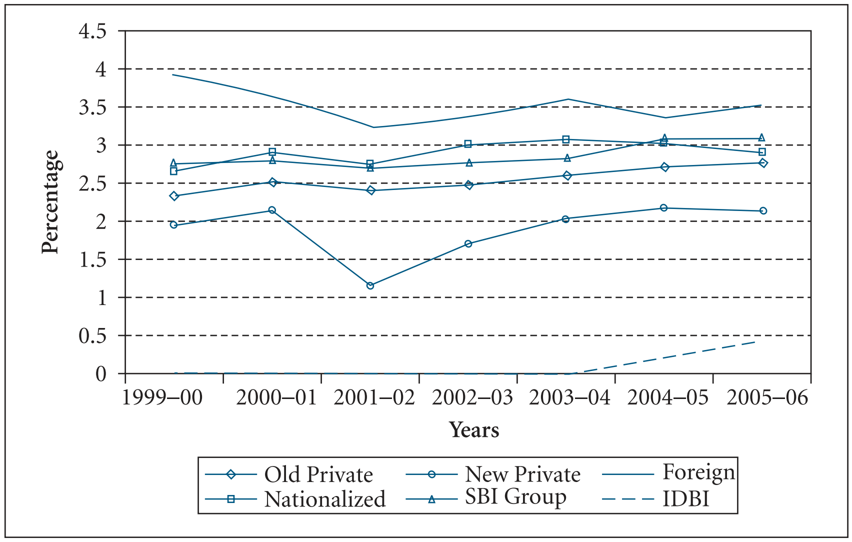


Source: RBI, Trend and Progress in Commercial Banking 2005–06.

8. While Indian banks are fairly efficient in their spending on IT, the use of technology to reduce transactions costs of outreach is still at a nascent stage. For example, there are 19 ATMs per million people in India, compared to 51 in China or 193 in Brazil. Clearly, the cost of human-intermediated transactions is still low in India, but it is sufficiently high that significant portions of our population do not have access to financial services.
9. There are, however, fundamental differences between new private banks and foreign banks on one hand (the 'attackers' in the IBA-McKinsey study) and the public sector banks and old private sector banks (the 'incumbents') on the other. The largely comparable profitability levels across leading banks today conceal critical differences in the underlying economics that is likely to shape the future. The first group enjoys significant relative advantages in terms of organizational capabilities, sales and distribution channels, credit and risk management practices and use of information technology and operation. Moreover, they target more affluent segments of the population in urban areas (see Box 1). Not surprisingly, therefore, since 2000 they have more than doubled their share of total assets, raised their share of total profits by more than 50 per cent, and account for almost half of the total market capitalization of the industry today enjoying over three times higher market valuation.
10. We have mentioned bank privileges and obligations a number of times. Before concluding this section, it is worth asking whether the banking system is benefited or hurt on net by obligations, pre-emption, and interest rate caps. While a detailed exercise is beyond the scope of this report, a quick estimate by McKinsey (see Figure 6), with all the caveats that accompany quick estimates suggests:

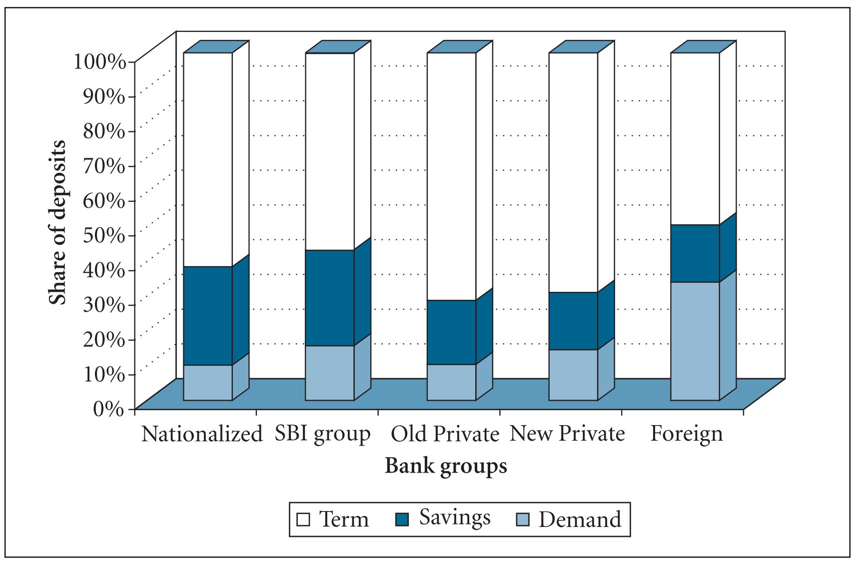
    (a) The banking sector is, on net, hurt to the tune of Rs. 10,000 to 15,000 crores by the 'grand bargain'.
    (b) The greatest benefit from getting rid of both the obligations and benefits would accrue to the public sector banks, whose profitability would rise by between 8,000 and 13,000 crores, a sizeable proportion of their current operating profits of about 42,000 crores.
    (c) The likely consequences are much smaller for foreign banks and private sector banks.

Figure 4: Net Interest Margin as a Percentage of Total Assets



Source: RBI, Trend and Progress in Commercial Banking 2005–06.

Figure 5: Share of Deposits: 2005–06



Source: RBI, Trend and Progress in Commercial Banking 2005–06.

In sum, while currently in robust health, India's banking sector is relatively small and intermediates less than half the country's household savings. The sector enjoys very high spreads, in part through controlled interest rates on savings and checking accounts, but this last benefit is more than offset by the pre-emption of bank assets into government mandated channels. Banking could become increasingly unprofitable as competition from other institutions increases. Moreover, the system is relatively unsuccessful in reaching

Box 1: Private and Foreign Banks vs. Public Sector Banks: The IBA-McKinsey Study

New private and foreign banks are much more profitable in wholesale businesses than the public sector and old private banks. The latter group mainly depends upon its valuable legacy retail franchises enjoying a massive ROE (return on equity) of about 33 per cent on their retail banking portfolios. Retail banking profitability is largely driven by access to retail banking and the 'attackers' today are investing heavily in building large-scale retail franchises.

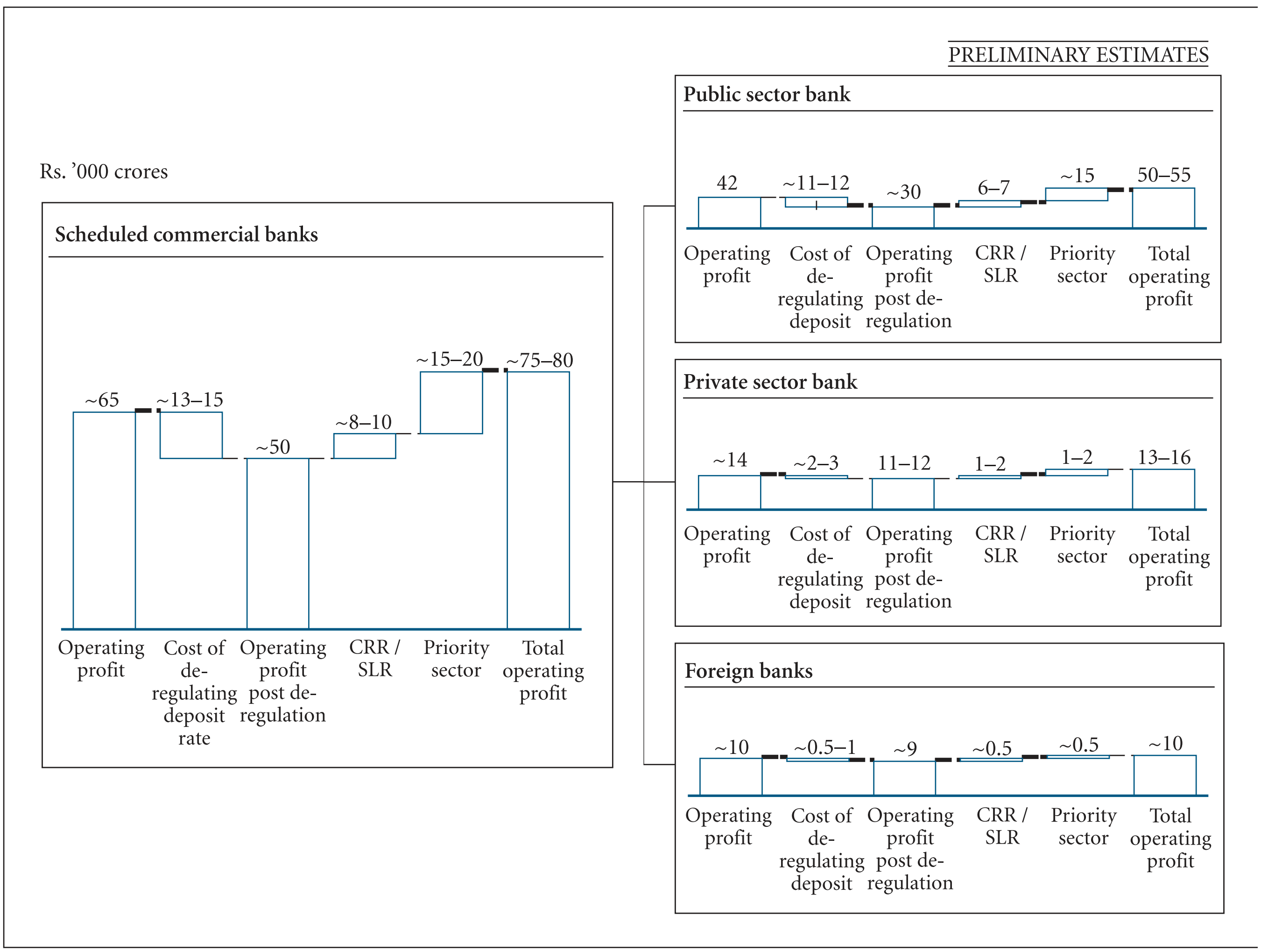
Customer experience is the critical value driver in banking anywhere and given that the young and affluent section of Indian customers are more demanding and discerning and are less credit-averse, customer experience and tailored offerings are increasingly becoming key to bank profitability. In this area foreign and new private sector banks have set themselves apart by superior levels of convenience and customer service. However they have also created more customers with negative experiences. Besides this customer segment is prone to greater diversification.

Indian banks have traditionally had better access to superior talent compared to other global banks leading to better average organization performance. However, public sector banks suffer from a crippling lack of specialist skills and new-age leaders. While foreign and new private banks are currently in a better position on this front, they will also have to deal with severe talent shortage soon.

Treasury is a significant contributor to bank earnings in India, managing capital market businesses and credit and market risk. Here while many foreign and new private sector banks are using sophisticated and world standard risk management techniques, public sector banks have fallen behind often simply conforming to regulatory and compliance measures.

In terms of use of information technology, in general Indian banks enjoy a competitive advantage even by global standards. But here too, new private banks and foreign banks have done better primarily because they could avoid legacy systems and had better governance practices. Most public sector banks have made large investments in technologies such as core banking solutions, are yet to use them effectively to enhance levels of customer service.

Figure 6: Costs vs. Benefits of Deregulating Interest Rates, CRR/SLR and Priority Sector Obligations



Source: McKinsey analysis, RBI.
*Operating profit as defined by the RBI

the very poor. Indeed, the strategy of attempting to reach the poor through large national banks branching into rural areas is reaching diminishing returns. The banking system therefore needs to change, both to prepare for a more competitive future, as well as to remedy current deficiencies. Perhaps the greatest area of concern is the public sector banks. That is what we turn to now.

PUBLIC SECTOR BANKS: AN OVERVIEW

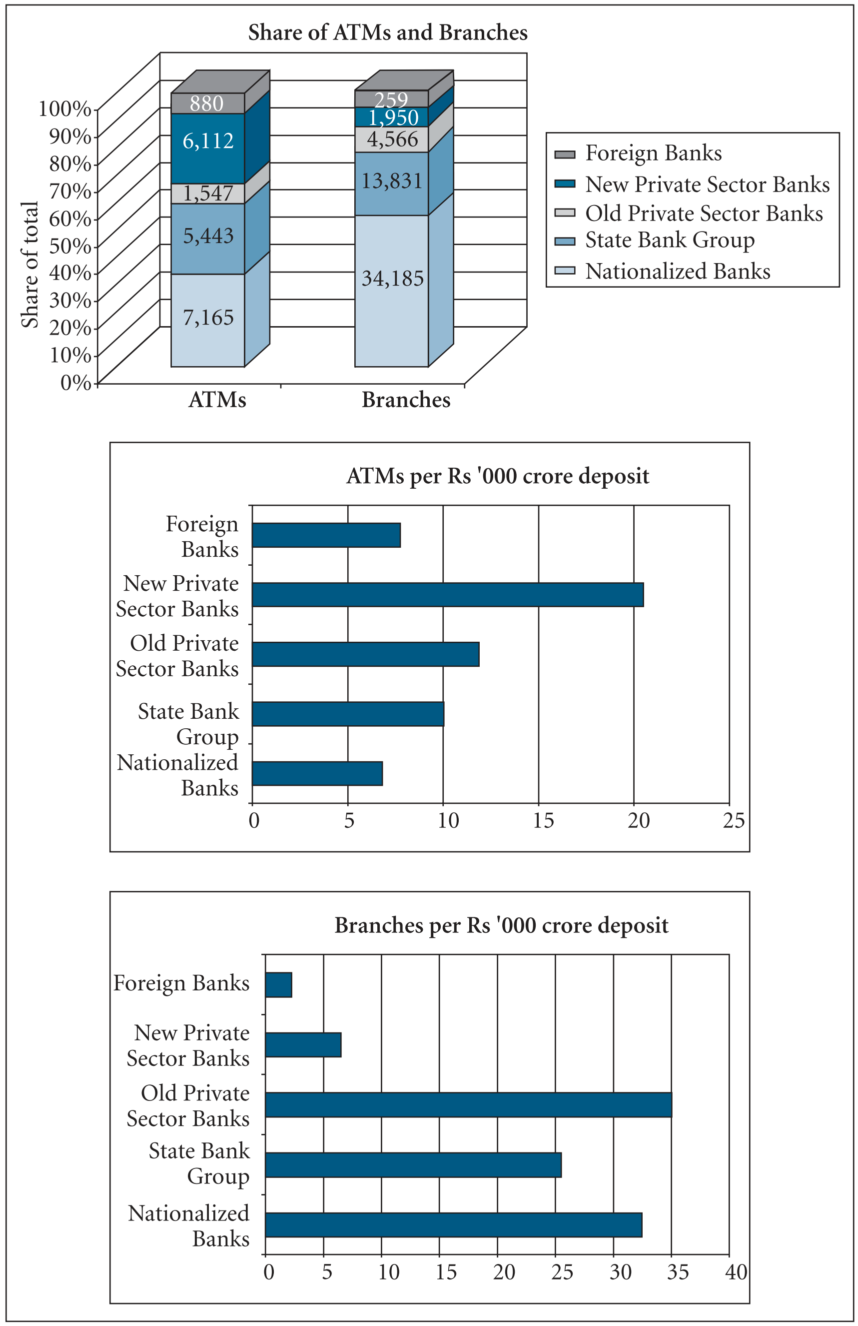
In simple profitability terms, the performance of public sector banks in India has, in recent years, been comparable if not better than that of other groups of domestic banks (see Figure 3). The future, however, looks more challenging for the public sector banks than those in the private sector, especially the 'new' ones.

In the past decade, public sector banks have witnessed a gradual erosion of their share in total assets of the banking sector from over 80 per cent to close to 72 per cent. During the period 2003–07, public sector bank balance sheets have grown at a compounded annual growth rate (CAGR) of 16 per cent, less than half that of private banks at 35 per cent. At these rates of growth, the public sector banks' share of total banking assets is expected to drop to about 56 per cent in 2012. Of course, given private sector banks started from a lower base, such differentials may not persist forever.

Public sector banks have lower productivity—profit per branch for public sector banks at Rs. 0.5 crores, is a fifth of the Rs 2.5 crores figure for private banks. Profit per employee at Rs 2.6 lakhs is only a third of the Rs 7.6 lakhs figure for the private banks. In part, some, but not all, of these differences come from a greater presence of public sector banks in lower profitability rural areas. For example, profit per rural branch for State Bank of India (SBI) is just 0.2 crores while profit per employee is 1.67 lakhs, and SBI has twice as many rural branches as urban branches.

In part, the differences come from better use of technology. For example, private and foreign banks' share of ATMs is significantly greater than their share of branches (see Figure 7). Moreover, they have been better at reducing costs by centralizing processing through the use of technology, even while using employees to get out of branches on to the street to sell products.

Figure 7



Source: Report on Trend and Progress of Banking in India 2006–07, RBI.

Equally portentously, the demographic profile of public sector bank customers is quite different from that for the private banks. While 60 per cent of foreign and private banks customers are below the age of 40, the corresponding share for public sector banks is only 32 per cent. Further, the economic profiles of the customers differ considerably as well. Public sector banks today have a much lower share of the more profitable ‘mass affluent’ segment of the population as compared to their private competitors. These differences have implications for the future growth potential of public sector banks, particularly relative to their private sector counterparts.

Another trend in banking—both global as well as in India—that does not portend well for public sector banks is the shift in revenues from traditional lending to more complex areas like bond-currency-derivatives products and fee-based wholesale and retail banking services like M&A advisory, institutional investments, and insurance. These are precisely the areas where public sector banks are at a relative disadvantage, primarily because of their inability to attract and retain talent or provide employees strong incentives, and their inability to make rapid investments in the technology necessary for being competitive in these segments.

The public sector market share in the bancassurance market in March 2007 stood at 32 per cent (compared to its 72 per cent share of assets) while in mutual fund sales it was about 5 per cent. Between 1997 and 2007, cash management throughout rose at a CAGR of only 16 per cent for public sector banks as opposed to 28 per cent for private sector banks. Between 2002 and 2007, the number of credit cards issued and spending in credit cards rose at CAGRs of 24 per cent and 44 per cent respectively as opposed to private sector CAGRs of 57 per cent and 71 per cent. In services like debt syndication and wealth management the public sector share has been a minuscule 2.7 per cent and 0 per cent respectively with foreign and private sector banks completely dominating the space. All these activities have taken-off recently, so the public sector starts from the same low base as the private sector, and should not, in principle, have a lower growth rate.

Perhaps most telling are the numbers on productivity. A McKinsey study in 2001[7] found that productivity of bank employees in India based on the number of transactions and the number of loan and deposit accounts opened per hour was a miserable 12 in comparison to 100 in the United States. The public sector banks were particularly backward on this dimension, scoring 10 while the old private sector banks scored 32 and the new private sector banks scored 55. By comparison, Brazil scored 32 and Korea scored 55.

These considerably poorer prospects of public sector banks relative to their private sector counterparts are reflected in their significantly lower valuation in the marketplace. At March-end 2007, public sector banks traded at an average price to book ratio of 1.11 while for private sector banks the ratio was 2.96. The price-earnings ratios were 6.85 and 25.19 respectively.

SERVING PUBLIC POLICY OBJECTIVES

It may be argued that profitability and valuation should not be the sole measures to capture the effectiveness of public sector banks in India since they have to fulfil important public policy objectives like inclusion and development of priority sectors in the country—objectives that often conflict with the profit motive. It is therefore important to evaluate the efficiency and effectiveness with which public sector banks have served these public policy goals.

Inclusion

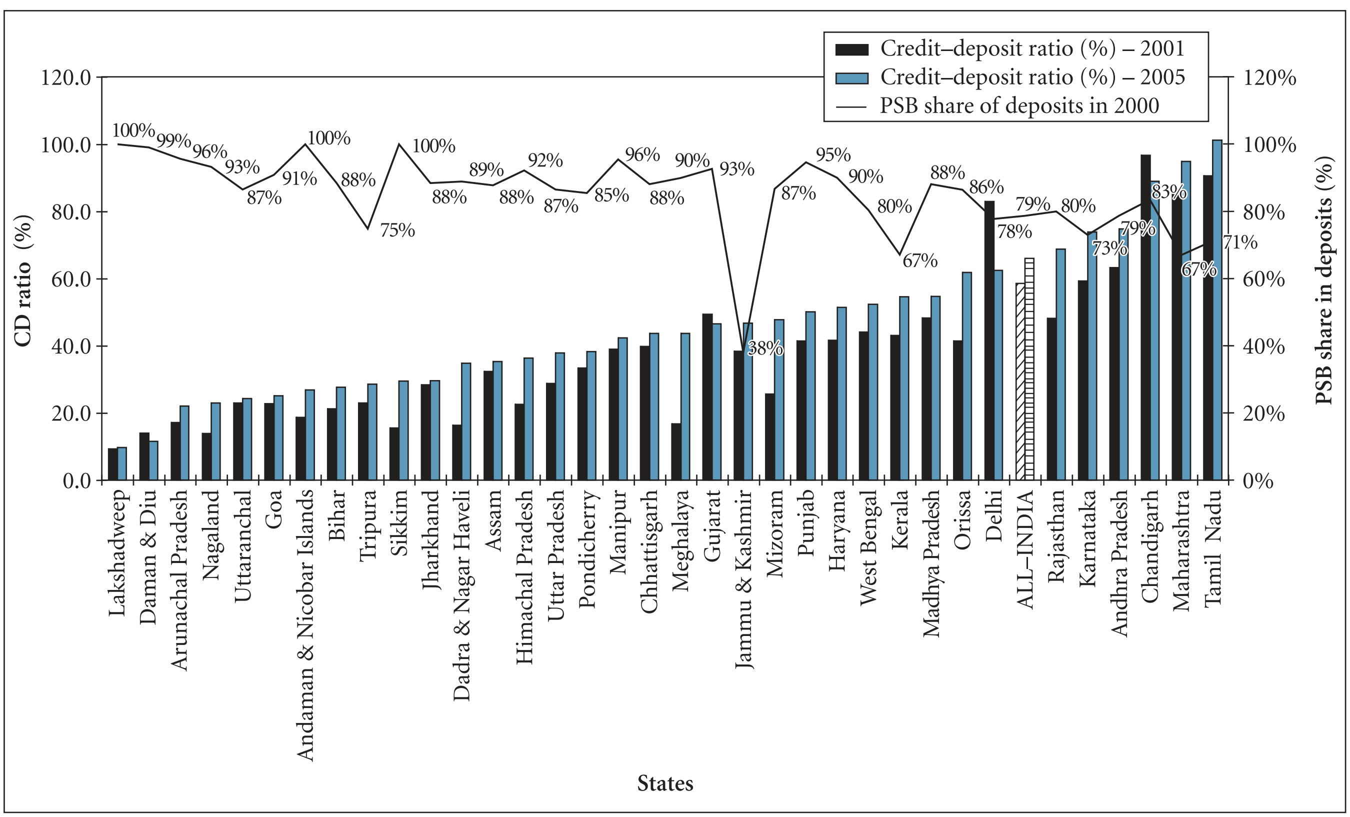
Inclusion has certainly been a public policy objective in the area of banking and it is undeniable that public sector banks have played a pivotal role in this area. Public sector banks account for 88 per cent of all commercial bank branches in India and in rural areas the proportion rises to 95 per cent.

Rural and semi-urban branches expansion was driven in the 1970s and 1980s by the 4:1 rule which required banks to open four branches in rural or semi-urban areas to get a license for opening a single new branch in the urban or metro areas. There are, however, differences in where they are to be found. Public sector banks expanded in rural areas where there were people—the correlation between the number of public sector branches in a state today and state rural population is 0.9. By contrast, private sector banks, perhaps because they have really grown after the period of enforced branching, may have been more selective in where they grew. The corresponding correlation for private sector branches is only 0.2.

Another demonstration of the private sector's location preference for areas with more lending opportunities (and thus probably more growth) is in Figure 8, which shows each state's credit-deposit ratio plotted against the share of public sector banks in total deposits in the states in 2000. The correlation of public sector bank share in deposits and the credit deposit ratio in 2001 and 2005 are –0.50 and –0.54 respectively, suggesting that in states with lower lending opportunities (lower bars in the figure) public sector banks are indeed the primary provider of banking (the dark line indicating the PSB share of deposits is higher). Interestingly, the correlation between percentage changes in credit–deposit ratio during the period and the deposit share of public sector banks in 2000 is a statistically insignificant 0.16, suggesting no systematic relationship between improvement in the regional credit disbursement and public sector bank presence during this period.

Since the reforms began however and the pressure to open new rural branches eased for public sector banks, the nature of branch expansion has also changed drastically. While

Figure 8: Credit–Deposit Ratio

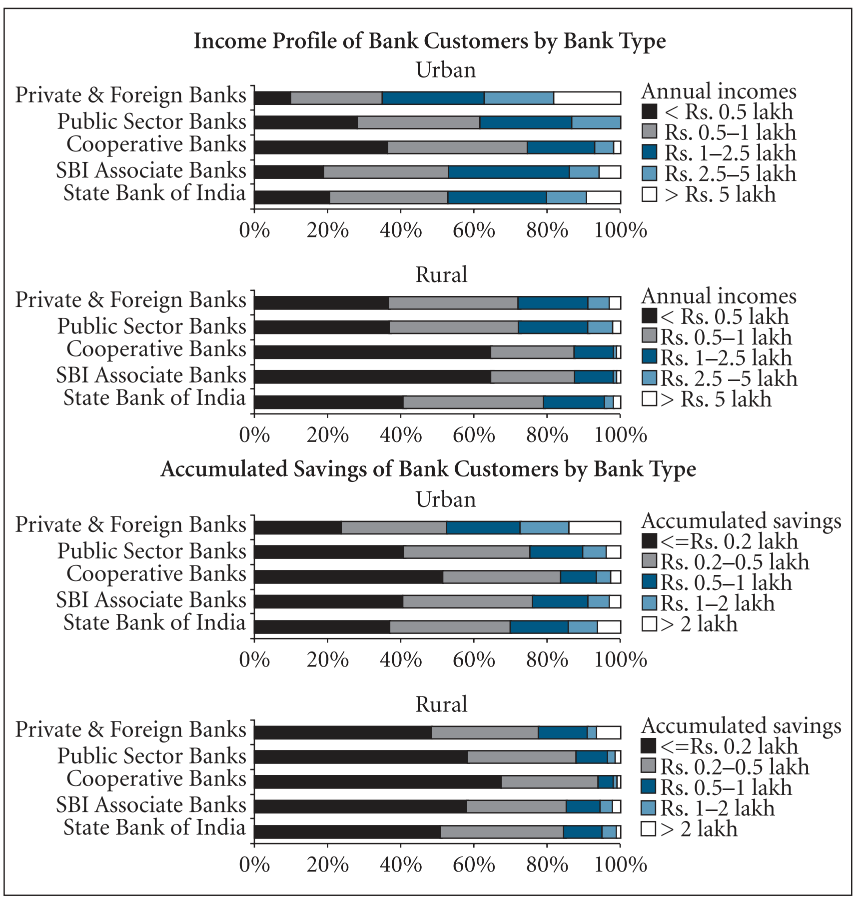


Source: RBI, Trend and Progress in Commercial Banking, several years.

the preference for private sector banks for the more profitable urban locales is clear, in 2005–06 public sector banks as a group did not open a single new rural branch though they added 486 branches to their network (in 2006–07, a total of 1,014 branches were added by PSBs of which 69 were rural). A variety of explanations for the paucity of rural branch openings are possible. It may be that rural coverage is complete so few new branches are needed. However, it may also be that banks have realized rural branches are really not the most cost-effective way to achieve outreach. It may also be that when public sector banks are tasked with being profitable, they gravitate to similar behaviour to private sector banks.

This last point of the relative similarity in behaviour between public and private sector when in the same environment and facing similar incentives deserves further reinforcement. Note from Figure 9 that the difference in customer profiles between public sector banks and private sector/foreign banks in rural areas is quite narrow (for example, just over 80 per cent of public sector bank clients earn incomes below 1 lakh per annum, while the comparable figure for private and foreign banks is over 70 per cent), while private sector/foreign banks attract a much richer clientele in urban areas. This suggests that in the rural areas they choose to be present in, private sector/foreign banks do serve the local clientele, and do not discriminate against the poor, at least not significantly more than the public sector banks. In urban areas though, where the public has more choice (and where banks can be more selective in their clientele), private sector/foreign banks have significantly greater share amongst the more affluent. Put differently, in markets where the bankable population is small, private/foreign banks go after nearly everyone the public sector reaches out to.

Figure 9



Source: IIMS Dataworks.

These observations have profound implications for the rationale of using public sector banks to facilitate branching and thus inclusion in rural areas. First, additional rural branching is not very profitable, and when given a choice, everyone stays away from it—public sector banks and private sector banks alike. Low rural incomes may not warrant the posting of an employee of a large national bank, who enjoys the same wages as an urban employee (and some hardship perks to boot) in the rural area. One alternative may be to recruit from the local area, at local wages, but such pay differentiation is typically not possible in a large bank (or, in RRBs, as history has suggested). A better alternative is the licensing of new small finance banks proposed in Chapter 3. But we also have to rethink modes of delivering financial services, abandoning the emphasis on fixed-location branches that cannot be used intensively, and focusing on electronic or multi-use delivery channels such as shops—the large bank linkages proposed in Chapter 3.

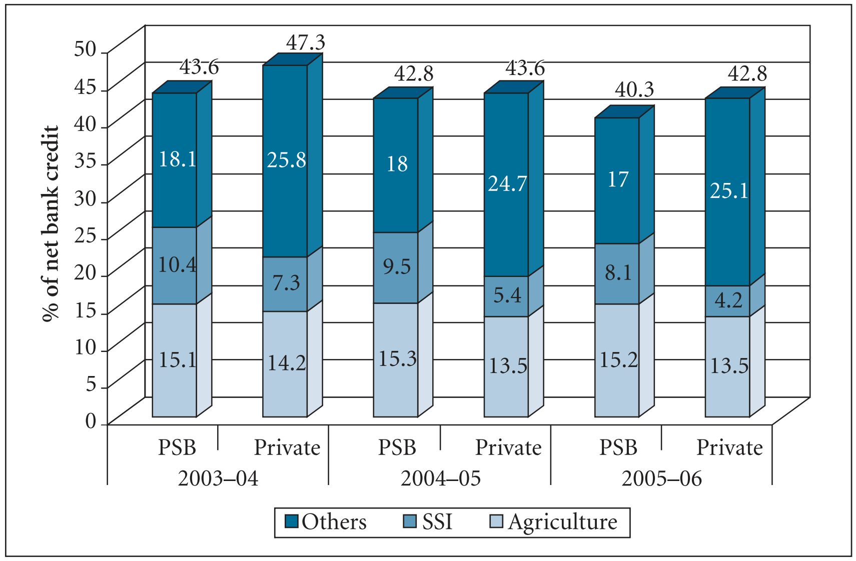
Second, when in a rural area, differences in bank ownership do not significantly affect the kind of clientele that is served. Money has no odour, and when there are profits to be made, the private sector will reach out for it.

The answer to inclusion is not to rely solely on the 'public spirit' of public sector banks but to make the poor worth competing for.

Third, efficiency and innovation are critical to reaching the underserved profitably. The relatively low productivity of public sector banks is an important impediment in using the public sector banks as the primary instrument to achieve inclusion.

Finally, there is large population of poor and unbanked in urban areas as well. The Committee believes the proposals for expanding inclusion in rural India will also address the concerns of the urban poor as well, perhaps a little more effectively given the large urban presence of banks.

Figure 10: Priority Sector Lending



Source: RBI, Trend and Progress in Commercial Banking 2005–06.

Directed credit

In recent years, private banks have actually done better than public sector banks (see Figure 10) in terms of fulfilling the overall priority sector quota, though in the sub-component of agricultural credit, public sector banks have done a slightly better job. When we consider the share of net bank credit to weaker sections (mandated at 10 per cent of net bank credit), however, public sector banks are significantly ahead at 7.7 per cent in 2005–06 as compared to 1.6 per cent for private banks. Taking a more long-term perspective, public sector banks have generated more credit to agriculture and rural areas and government enterprises, less credit to the trade, transport and finance sector, with little difference in credit to small-scale industries and industries identified for support in the post-1980 five-year plans.[8]

In terms of impact of the additional agricultural credit from public sector banks, agricultural investment and output growth do not reflect any effect of increased agricultural credit either, raising questions about appropriate end-use of agricultural credit provided by public sector banks (though the absence of supportive public investment could also be a factor). In terms of loan timing, in times of drought in a district, private sector banks appear to provide more agricultural loans, while public sector banks provide more consumption loans. On net, there is little difference in overall lending in times of drought between public sector banks and private sector banks, though private sector banks are significantly more likely to lend in times of plentiful rainfall than public sector banks.[9]

Finally, there is variance in the quality of directed lending. The share of non-performing loans in the priority sector lending has been higher for nationalized banks than for the private banks with some indication that political interference has reduced credit quality.[10]

In March 2007, though priority sector lending constituted a slightly higher share of total lending for private sector banks (42.7 per cent) than the public sector banks (39.6 per cent), less than 32 per cent of the former's NPAs came from priority sector activities, while for public sector banks, over 59 per cent of their NPAs came from priority sector lending. NPAs in agriculture constituted 3.1 per cent of total outstanding direct agricultural credit for private banks as opposed to 4.4 per cent for public sector banks. The corresponding figures for small scale industry were 4.9 per cent and 5.6 per cent respectively, and for other priority sectors, 1.8 per cent and 5.3 per cent respectively. Total priority sector NPAs constituted 2.4 per cent of total priority sector lending less indirect agricultural advances for the private sector banks as opposed to 5.0 per cent for public sector banks.

In this regard, it is disheartening that after a period when governments desisted from announcing waivers, agricultural loan waivers have returned to the policy discourse. As Chapter 3 on inclusion suggests, the poor are not the largest recipients of bank loans even though they are highly indebted, so bank loan waivers are typically poorly directed—though it is debatable whether they are more poorly directed than other government transfers. More problematic, the anticipation of a loan waiver, especially if only loans to defaulters are waived, creates enormous moral hazard and reduces everyone's incentive to repay. It also increases corruption as everyone attempts to get classified as a past defaulter. Politicians who exhort people not to repay loans are particularly irresponsible for they ensure that future credit dries up, in part because the lender is weakened, and in part because the lender has little confidence of getting paid. This Committee strongly counsels against short-sighted indiscriminate waivers, or loose talk about defaulting.

Finally, some would see the employment the public sector provides as an important function in its own right. While the public sector banks employ proportionately more people than private sector banks by most metrics, this does hamper their efficiency and their growth. Furthermore, overstaffing results in stagnation, which further hampers the banks' ability to retain talent. It is time to ask whether the nation would be better served by freeing public sector banks to generate jobs through efficient growth rather than through forced mandates and constraints that compromise their ability to compete, and will eventually shrink their share.

To sum up, it does not seem that public sector lending to the priority sector has been markedly higher or of better quality than private sector lending. Again, differences in bank ownership have limited influence on whether the public purpose is served, once mandates are imposed equally across banks. This then leads to the obvious question—is there any purpose in continuing the status quo for public sector banks when their ownership and governance structure offers little specific benefit for the nation, and possibly leaves these important national assets vulnerable for the future? We think not, and this is the rationale for the proposals that follow.

PROPOSALS

The intent of the proposals that follow are:

1. To free the public sector banks from factors that cripple their ability to compete.
2. To improve variety and efficiency in the banking sector specifically, and in the financial sector more generally.
3. To reduce the overlay of obligations and benefits on the banking sector as a whole.
4. To allow for a more effective provision of products that cut across financial activities.

Proposal 1: Reforming the public sector banks

The public sector banks (henceforth PSBs) have a number of strengths including their historic ability to attract talent (a number of successful private and foreign banks are staffed by former public sector employees), their vast branch network, their strong name recognition, and their association with safety, especially in rural areas. While these strengths offer an opportunity, their ability to compete is hampered, in part by their governance structure. Consider some of their handicaps compared to private banks:

- Both the level of pay as well as its sensitivity to performance are limited, making it hard to attract new talented employees, retain superior old ones, or incentivize them to perform better.
- Promotion is typically on the basis of seniority, and it is hard to let go of employees for non-performance. The talented young are more attracted towards private banks where they can get significant responsibility quickly. Public sector banks used to be

much larger than private banks, and thus be able to promise much greater influence and a broader range of experience eventually. As bank sizes become more equal, even that is not possible. Public sector banks have a legacy of talent from their past, but that talent pool is ageing and is not being replenished.
- The most important corporate decision, appointment and dismissal of the bank's top management, is not taken by the board, but by the central government. This limited delegation of power to the bank board, despite the board consisting of a majority of government nominees, inhibits the board's ability to guide bank strategy and limits the responsibility it has to shoulder for bank performance. At the same time, the government's power to appoint and transfer management introduces political influence over day-to-day decision making. Governments have differed in the extent they have used influence, but this issue, with important economic consequences, should not be left to the ballot box.
- Unlike private companies, the bank's board is not considered an adequate trustee for the interests of its owner. Instead, additional layers, for example, the Central Vigilance Commission, second guess all important bank decisions. This induces delay as every decision has to be documented for a possible future enquiry, risk-aversion, and an excessively bureaucratic decision process through all levels.
- Unions can be a very positive force in employer–employee relations, and indeed some public sector banks enjoy model management–union relations. To the extent, however, that public sector bank unions can use their proximity to political power to have an added influence over the management of some public sector banks (an influence that would be weaker in private sector banks), it creates an imbalance that can be detrimental to the bank as a whole.
- Because the government is strapped for resources, and because a number of PSBs are at the limit of their ability to issue shares to the private sector without altering majority government ownership, capital is increasingly constraining their growth.

In many ways, therefore, government ownership does not increase the efficiency with which state owned banks carry out their functions, and probably imposes constraints. Unprofitable activities, such as providing financial services in remote thinly-populated areas, which need to be carried out for the greater benefit of society, can be encouraged through targeted subsidies. What matters for the nation is how efficiently these activities are carried out, not who owns the bank producing the activities. Similarly, other activities can be better encouraged through a combination of mandates and incentives, with the latter being emphasized over time. Again, these should apply uniformly across banks, independent of ownership.

Some of the other discretionary activities forced on public sector banks are, of course, undesirable activities involving pure patronage. Even those that are not should either not be undertaken by government banks (such as supporting prices in various financial markets) or are more transparently undertaken by the government (such as providing fiscal transfers through debt relief to drought hit areas). Indeed, because the public has a direct sizeable minority shareholding in public sector banks, it is important that the government respect the minority interest (as promoters in the private sector are forced to) by allowing these banks to be run efficiently to maximize their value. That will also be in the national interest.

An immediate question then is how to distance public sector banks from the government. One option is privatization. The majority of this Committee does not see a compelling reason for government ownership. There are other activities where government attention and resources are more important. However, the Committee does recognize that public opinion in the country is divided on the issue of privatization. An alternative approach is to undertake reforms that would remove constraints on the public sector, even while keeping it under government ownership.

Unfortunately, ideology has overtaken reasoned debate in this issue. The pragmatic approach, which should appeal to practical people of all hues, is to experiment, as China does so successfully, and to use the resulting experience to guide policy. One aspect of the pragmatic approach would be to sell a few small underperforming public sector banks, possibly through a strategic sale, so as to gain experience with the selling process, and to see whether the consequences are acceptable or not.[11] This would allow some facts and experience to enter the public debate, something which is sorely lacking.

For the largest PSBs, the options are more limited. The selling of large PSBs to large private sector banks would raise issues of concentration. The selling of banks to industrial houses has been problematic across the world from the perspective of financial stability because of the propensity of the houses to milk banks for 'self-loans'. Without a substantial improvement in the ability of the Indian system to curb related-party transactions, and to close down failing banks, this could be a recipe for financial disaster. While large international banks could swallow our largest banks, it is unlikely that this would be politically acceptable, at least in the foreseeable future. That leaves a sale through a public offering. But such a sale would require confidence in the corporate governance of these enterprises so that a high price can be realized.

This Committee therefore believes that the second aspect of the pragmatic approach should be to focus on reforming the governance structure and perhaps also acquiring strategic partners for large and better performing public sector banks, with the eventual disposition determined based on experience with privatization, the public mood, and the political environment. Governance reform, we should emphasize, is needed not simply as a matter of fashion, but so that PSBs can survive the coming competitive onslaught. The reforms we propose would reduce the constraints imposed by government ownership, allowing public sector banks to hire more talent, make needed investments, and react more dynamically to the rapidly developing environment.

The major steps include:

1. Create stronger boards for PSBs.
   (a) Government nominees: Some governments have seen appointments to the boards of public sector banks as a means of distributing patronage. Other government appointees have limited understanding of the business of banking and are on boards simply because of their eminence in other areas. Board members must be chosen based on their capacity to guide the bank's business to maximize value creation for all its stakeholders and balance stakeholder interests in areas of conflict. This is why we suggest the government set up an independent Selection Board of eminently qualified individuals from varied backgrounds to propose board members for various PSBs. The Selection Board's members should retire at staggered intervals so that no future government can easily change its character.

   When an incumbent PSB director's term expires, the Selection Board will propose qualified individuals to replace them. So long as the individual meets 'fit and proper' criteria, the government should accept the proposal, or offer a written rationale for why the nomination is rejected.

   (b) Shareholders nominees: Non-government shareholders should be allowed to appoint board directors following the same regulations that apply to private companies—minority shareholders in public sector banks should not be treated any differently. Moreover, it should be possible for PSBs to seek out strategic partners among other financial institutions (including private and foreign ones), with partners allowed a voting stake of up to 20 per cent. Given that even Communist China allows this, it is time for India to liberalize.

   In addition, board seats allocated to shareholder directors should be more proportional to their voting stake. For instance, out of 14 directors on SBI's board, only four are elected by shareholders, even though the government only holds 59.7 per cent of the equity in SBI. Five directors are appointed by the government and the

RBI, three consist of management, and two are employee appointees. But since the government appoints management, eight directors are effectively government appointees. The balance would become more equitable if the board appointed management (see below). Pending that, it would be sensible to give more seats to shareholders.

Of course, given that the shareholding in PSBs is dispersed, the slate of potential directors proposed by management to the minority shareholders for election is likely to win easily. To prevent the formation of 'pet' Boards, it will be important to devise a transparent process of consultation with shareholders and independent directors in coming up with the proposed slate of directors. This is not to say that the process is perfect in private sector banks, but reasonable processes can be formulated for both. The process by which shareholders can also propose alternative nominees should be simplified, and the process of voting made easier.

(c) Delegate all decision making to the bank board: The bank board, which is closer to the real needs of the bank, should make all decisions including selecting the Chairman and CEO of the bank and all its important officers, as well as terminating them. While the appointment may have to go through the Appointments Committee of the Cabinet (ACC), such appointments should be approved as a matter of course. In the rare case the appointment is rejected, the ACC should explain the grounds for rejection and ask for a new nominee. In the long run, the ACC should not play a role in selecting bank management.

The board should also set performance bonuses for senior management and the objective and transparent parameters that will trigger these bonuses. Larger bonuses will make the job more attractive, and help attract talent, but the quid pro quo should be greater effort to achieve those bonuses and a greater risk of losing one's job (and bonuses) for underperformance.

With greater authority over top management, the board can help guide the company in the national interest, and also protect management, when it is performing its duties, from political interference. Greater pay for directors, of which a significant portion is stock-based, is also warranted in order to attract capable individuals and to give them a greater sense (and duty) of responsibility. This is a small price to pay to safeguard the value of the national assets that the PSBs represent.

The Committee recognizes that it will take time for boards to become fully self-governing, and the Finance Ministry will have to disassociate itself from decision making steadily. One useful change would be for the government, through its directors, to evaluate management and its performance through a broader set of parameters than just current profitability, inclusion, and growth. Forward looking measures including human resources development and the quality of risk management will need greater attention. Management institutes could help through comprehensive training programmes to acquaint new directors with their responsibilities and to impart skills to carry them out. Better governance will, however, have immense payoffs and will be worth the time and effort.

2. Delink banks from the government.

Part of the problem PSB managements face is that they are directly owned by the government, and therefore come under government administrative norms. Bureaucracy and business are fundamentally incompatible, especially in a dynamic open economy. It is also better that management decisions be vetted by boards rather than by criminal investigators. While there is growing acceptance of these truths, more effort should be made to remove management from the shadow of the government.

One possibility is that large PSBs create financial holding companies (see later), with the bank and other financial firms as subsidiaries, so as to better realize economies of scope from providing multiple financial services. The governance proposals listed above should then apply to the holding company board also, especially if the bank is a wholly owned subsidiary. As the PSBs become more indirectly owned by the government, and as their boards become more vigilant in safeguarding the value of the bank, and as their management are better paid and better incentivized, the rationale for maintaining oversight of the banks through administrative means such as the Central Vigilance Commission become weak. Indeed, when the PSB boards are functioning effectively, the government should legislate to remove the oversight of bodies such as the CVC over PSBs. Holding company structures could also allow the bank to sell more shares to the public even while the government retains majority control over the holding company, and thus over the bank. This would enable banks to raise more capital for growth.

A second possibility, which was recommended by the Narasimham Committee, is to reduce the government stake to below 50 per cent, so that the bank no longer comes under government statutes. The government will still have a controlling stake, so this could be politically more palatable than full privatization to some. Moreover, no large sale of shares is required for a number of banks. Nevertheless, such a move will require a change in the statutes, and the political difficulty may be no less than for outright privatization. Yet another option is to explore the possibility of divestment of government shares to other public sector entities (such as provident funds or insurance companies), if that process can reduce some of the aforementioned constraints on public sector banks, even while retaining ownership within the government broadly defined.

Proposal 2: Encourage, but do not force, consolidation

Given the fragmented nature of the Indian banking system and the small size of the typical bank, some consolidation may be in order for banks that aim to play on a larger stage. Of course, there could still be room for small banks that have different aims (see Chapter 3). The main concerns of the regulatory authorities should only be whether the takeover will impair competition in key areas and whether acquirer management has the capabilities of managing the merged entity without impairing stability.

Following these criteria, it should be clear that small, regional, and unprofitable banks would be a natural candidate for takeover by well-managed financial institutions that seek complementary assets.[12] The screening criteria for identifying weak banks may include parameters like capital adequacy ratio, proportion of NPAs in total credit, return on assets, return on equity and net interest margin. Responsible boards of target banks will recommend offers to shareholders that are in the larger interest of their bank. There is little role for the authorities here other than to welcome such consolidation and stay out of the way. One question is whether the authorities should interfere in direct approaches to shareholders, bypassing the target board (the so-called 'hostile' takeover). So long as potential acquirers are deemed fit and proper, there is no reason again for them to intervene.

(a) Takeovers of PSBs: A takeover of a PSB by a private or foreign bank will effectively be a privatization. Until the political will is found to amend the relevant acts, these takeovers will be ruled out. Till such time though, takeovers of PSBs by other PSBs or public financial institutions should not be discouraged (though there is no point in one weak bank taking over another). Takeovers of PSBs should be no different from takeovers of private banks, with boards playing a key role. This is yet another reason for strengthening the PSB boards.

The key problem, though, is that a number of interest groups in potential target banks have little incentive to be acquired, even if acquisition is in the larger interest of the bank. These include all those who will lose position or power in the enlarged entity, including some managers, board members, and union officers.

More incentives may be needed for banks to seek out matches. One is simply for matches to be brokered in the Finance Ministry. This will defeat the objective of decentralizing decision making, and may not be fair to shareholders. The

Committee recommends against such 'marriages made in heaven'. Another is to identify the banks the government wants reformed based on transparent criteria, and set a reasonable time horizon during which the board (perhaps led primarily by the non-government shareholders) has leeway to act—whether by merging or seeking out strategic partners. At the expiry of this time the government could take action, exercising its rights as majority shareholder.

(b) Takeovers by private banks and eligible financial institutions: Private Indian banks and eligible financial institutions (appropriately structured as holding companies—see below, and satisfying the fit and proper criteria) should have full freedom to take over other private banks today provided the above-mentioned concerns of regulatory authorities are met. They should also be permitted to take over small PSBs that are offered for sale.

A possible route for large public sector banks to acquire more talent, once they undertake the governance and compensation reforms suggested above, may be to acquire a smaller well-functioning private sector bank. While not minimizing the required cultural adjustment, and while recognizing the risk that talent may leave if the acquisition is not handled well, this Committee believes that such possibilities should be considered.

Foreign banks that create a separately incorporated domestic subsidiary in India should have the same rights that private sector Indian banks have from April 2009, as suggested in the RBI roadmap (2005). The RBI should allow such incorporation freely. Foreign banks that seek to operate through Indian branches should be accorded permission based on reciprocity. The Committee would strongly urge the government to pressure foreign governments to extend to Indian banks the liberal rights that are proposed here for foreign banks.

(c) Takeovers of large Indian banks: To the extent that takeovers of large Indian banks (or domestically incorporated subsidiaries of foreign banks) do not raise issues of excessive concentration or stability, they should be permitted. It may be sensible to start by being more liberal towards the takeover of small banks with a view to allowing bidders, targets, regulators, and market participants gain experience in how to manage takeovers.

Proposal 3: Reduce barriers to competition

1. Other methods of restructuring.
   Takeovers are just one way to improve bank structure. But they constrain the mode of restructuring to whole company transactions. Other actions should include:
   (a) Abolish branch and ATM licensing immediately (other than licensing for foreign incorporated banks in metro and urban areas based on reciprocity). While the RBI as supervisor could curb branch expansion for specific banks that it has prudential concerns about, the norm should be that once a bank is licensed, where it puts up branches is its own business decision. As suggested in Chapter 3, the differentiated license for small banks could include an initial constraint on the overall number of branches and asset size, but this should be removed on review.

   Domestic banks have not been able to set up branches freely thus far, and will not have anticipated such liberalization (which was not an element of the RBI roadmap). Given that foreign banks have deeper pockets, experience, and skills relative to domestic banks in rolling out a branching strategy in the newly liberalized environment, the Committee believes it necessary to allow a period of say two years from the announcement of the policy till the liberal licensing policy applies to domestically incorporated foreign banks. Till such time, the existing policy of branch licensing should apply to foreign banks. They will, however, be able to acquire branches through takeovers of existing Indian banks.

   (b) Part of the rationale for branch licensing is the RBI's attempt to force banks into under-banked areas in exchange for permission to enter lucrative urban areas. Regardless of what views are on overall de-licensing, there is absolutely no reason to not de-license under-banked areas immediately for all banks. Furthermore, banking in underserved areas can be encouraged by instituting a norm—for every x branches that are opened in urban branches, y branches have to be opened in semi-urban or rural areas. In other words, enforce the norm that is now implicit in RBI's licensing decisions, but allow banks the freedom to choose how many branches to open, where, and when. Since branches are likely to become less important channels for outreach, it may be better to focus the norm on more objective measures of service (which also focuses on including the urban poor, an increasingly important category as migration increases). For instance, the norm could be for every x savings accounts that are opened in high income neighbourhoods, y low-frill accounts have to be opened in low income neighbourhoods. Finally, it may be that the bank is not the best institution to offer financial services over the last mile to the poor. In that case, the service provision obligation could become traded (much as the priority sector norms earlier), with small banks or cooperatives acquiring certificates for the excess accounts they provide and selling them to deficient banks.

(c) Allow banks to freely exchange or buy branches, and close branches as alternative mechanisms of delivery of financial services emerge. If a branch closure will significantly impact services in an area, the authorities could negotiate a transition period.

Eventually all branches that are forcibly kept open to fulfil universal service requirements should be paid for through an auction where qualified banks bid for the minimum subsidy they need to meet an objective level of service.

(d) Entry into banking should be made more liberal. The purpose of this entry is not primarily to increase the level of competition, but to bring new ideas and variety into the system through entry. For scheduled commercial banks, the minimum scale for entry right now is Rs. 300 crores (of capital). This immediately means only large players can enter, and given the commensurate asset size (Rs. 3,000 crores at a 10 to 1 leverage), few banks can start out de-novo. The only entry is likely to be foreign institutions, or through conversions of domestic financial institutions to a banking license. But as India grows, it is hard to imagine that all the valuable financial ideas will only originate in existing institutions. The way to allow entry for smaller and possibly more innovative players is to license small banks thus facilitating both entry and competition (see Chapter 3 for details).

The Committee would also urge the licensing authorities to not focus overly on the level of capital. Large players are not necessarily the most capable, and in the dynamic financial markets of today, large quantities of capital can be quickly dissipated. What matters is not the quantity of capital but the quality of the promoters, their management capabilities, their capital adequacy (relative to the size of the tasks they undertake) and their systems. Provided regulators apply stringent entry criteria to banks on these dimensions, the minimum capital requirement could be relaxed considerably even for scheduled commercial banks, and the resultant entity nevertheless easy to supervise. While the process of freeing entry should be undertaken carefully, stability concerns can be alleviated by requiring high governance standards, higher capital and reserve ratios, more transparent and automated risk measurement processes linked to a vigilant supervisory regime, and a strict prompt corrective action regime. Indeed, the last two steps should accompany the process of liberalizing entry.

(e) More generally, the prompt corrective action regime (see Chapter 6) should be strictly enforced, after offering a period of notice, so that undercapitalized banks and cooperatives are forced to wind down. It will be particularly risky if they are allowed to continue to operate in a time of enhanced competition. Thus freer entry should be accompanied by stricter enforcement.

2. Levelling the playing field.
   (a) Banking privileges such as access to the payment system or check writing facilities should slowly be reduced

by allowing more institutions access, but in tandem with reductions in banking obligations such as priority sector lending and other modes of pre-emption such as the Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR). While the obligations are in place, though, all entities that are allowed to issue demand deposits should also have to undertake these obligations. Once the procedural improvements that are contemplated on priority sector lending are implemented, all foreign banks should be asked to meet the same obligations as domestic banks.

(b) The practice of the government giving preference to public sector entities in matters such as where to place deposits should also cease, as should unremunerated obligations such as forced support of public issues by other public sector entities. The preferences tend to be at a cost to the public exchequer and to the taxpayer, because the government could get a better deal through a more competitive bid. The obligations hurt the PSBs, and typically also tend to create other distortions because they are non-transparent and not paid for.

Proposal 4: Moving to holding company structures

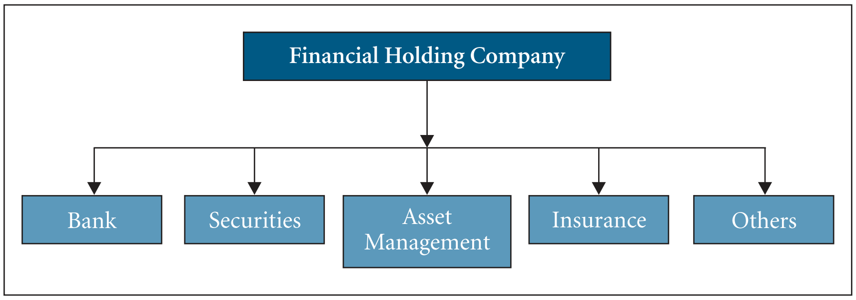
Increasingly, financial firms will provide services that come under different regulators, and products that combine different activities. While some entities may choose to remain specialized and provide services through joint ventures or collaborations with other specialized entities, others may choose to provide a variety of services under one roof. The best way to undertake these activities, while ensuring appropriate regulation, is through a holding company structure. The purpose of a financial holding company is to raise and allocate resources in various subsidiary companies depending on their needs, thereby using capital efficiently within the group as well as segregating risks across various financial businesses. The structure also allows the parent to coordinate and bring together activities of the different subsidiaries in providing products to customers.

The absence of a viable holding company structure means that parent companies that are fully engaged in regulated activities may have to hold subsidiaries in other (possibly differentially regulated) activities. This can create problems, especially in India, where banks are the typical parents, because:

1. The risks from its investment in lightly regulated and volatile businesses can feed onto the bank's balance sheet. This makes the task of the bank regulator more difficult. Also to the extent that the bank benefits from flat-priced deposit insurance, some of the costs are ultimately borne by the taxpayer.
2. The need to raise large resources for deployment in subsidiary companies strains the parent company's ability to fund its own core business. Moreover, under current regulations, a bank's aggregate investment in financial services companies (including subsidiaries) is capped at 20 per cent of the concerned bank's paid-up share capital and free reserves. This clearly limits its ability to grow those services (especially the insurance business where significant accounting losses accompany a start-up).
3. Regulatory restrictions on the heavily regulated parent bank's exposures (to capital markets and to single parties) can limit its overall ability to do business elsewhere.
4. Tax rules may prevent losses at a subsidiary from being offset against parent profits, even while they need to be recognized for accounting, disclosure, and capital maintenance purposes. Similarly, investments in a subsidiary may have to be carried at book value, even though the market value could contribute substantially to the parent's net worth and capital.

The holding company structure

Typically, the holding company does not engage in any operating activity and its leverage is limited (typically to not more than 20 to 25 per cent of the capital). The cash flows of the holding company come through dividends paid by the subsidiary companies and royalties received for use of the brand name.



It also does not raise short-term public deposits. It should, however, be allowed to raise resources through short-term debt, subordinated debt and hybrid debt for investment in its subsidiary companies. Both the holding company and the underlying subsidiary companies should be allowed a listing on the stock exchanges. This would enable the holding company and the underlying companies to access the capital markets from time to time. In particular, if the holding company owns a bank, the holding company will have to list and be well-diversified.

Regulation and supervision

The Committee envisages that each holding company will be supervised by the Financial Sector Oversight Agency (FSOA, see Chapter 6). Each subsidiary will be regulated and supervised by its activity regulator. Of course, the supervisors of the largest subsidiaries will play an important role in the supervisory discussions held at the FSOA.

Taxation related issues

The holding company should present its accounts on a consolidated basis. Currently, the Indian system of taxation does not permit consolidation of accounts at the holding company level for tax purposes. The holding company as a standalone entity and the subsidiaries in their individual capacities are liable to pay taxes on their profits. The double taxation within the group has to be done away with to ensure the effectiveness of the holding company structure.

The re-organizing of current structures into financial holding companies will entail either a transfer of assets or a share swap by the bank/financial institution to the newly created holding company. These de-merging/restructuring transactions will attract payment of stamp duty and will also have capital gains tax implications. A one-time waiver is required, along the lines of the benefits accorded stock exchanges at the time of demutualization.

Legislative issues

The creation of such a structure would require amendments to certain rules and regulations. For instance, Section 12 of the Banking Regulation Act, 1949 prohibits the exercise by any single shareholder of voting rights in excess of 10 per cent, irrespective of the level of shareholding. This would need to be altered in light of the holding company structure. The RBI's desire for diversified ownership of banks can be implemented at the holding company level, with the holding company listed and diversified. In addition, the holding company could also list the subsidiary bank and have only a simple majority holding in it. Diversification at this second tier will allow the bank a liquid stock, which can be used to raise capital when in times of need.

Conclusion

We have made a number of proposals for reforming the banking sector and to create a more even playing field, that can increase the level of competition, efficiency, and thereby growth and inclusion in the sector. In the annex that follows, we will offer some additional proposals for other segments of the financial sector.

ANNEXURE 4.1

We do not have the space to go exhaustively in how the playing field is tilted, sector by sector, and between sectors. Instead, we will offer a taxonomy of the kind of impediments that are placed in the way of efficient allocation of resources. There is no clear pattern of who is discriminated against, with foreign investors or producers being favoured sometimes relative to domestic ones, but also discriminated against on many occasions. Similarly, the public sector can be favoured or disfavoured relative to the private sector. We will not attempt to diagnose why the financial sector has arrived at these patterns. Instead, we should focus on reducing them to the essential.

Regulatory limitations on product offering

A recent controversy should make the point clear. Insurance companies offer products that look similar to mutual fund products, but with an insurance component (of varying magnitude). One such product is an unit linked insurance plans (ULIPs), which has been very successful. While mutual funds allege that this is because insurance companies have an unfair regulatory advantage, insurance companies deny any advantage whatsoever.

The purpose of this example is not to take sides on who is right. Instead, it is to suggest there are two fundamental ways of dealing with this problem. One is to keep insurance companies from providing cheap asset management products by forcing a more significant insurance layer on the products they offer. This hampers competition and is not in the best interest of the consumers. A better approach would be to diagnose more carefully why ULIPs are popular, and see if there are any government/regulator induced differences that make them so. To the extent that mutual funds have undue burdens, the focus should be on reducing them rather than on constraining insurance companies. To the extent that success stems from lack of transparency about costs or benefits, there is a need to increase transparency. But to the extent that insurance companies have devised a more attractive product, there is no reason why they should be prevented from selling them. Indeed, it should be possible for mutual funds to tie up with insurance companies so that each provides their specialty (funds management and insurance) more efficiently in a joint product.

Of course, products such as insurance will require some regulation, to ensure that the firm has the ability to deliver its promise. The mutual fund company will not be able to offer ULIPs without an insurance license. But this is why entry barriers into insurance should be kept relatively low so there are no excess profits in that industry.

Put differently, any institution should be allowed to offer any financial product provided prudential and consumer protection issues can be addressed. No product should be 'reserved' for a particular type of entity, simply because it has historically focused on it, or because it has a protective regulator. For instance, mutual funds and insurance companies should be able to compete to offer defined contribution pension schemes to firms and government organizations. Regulatory silos should be brought down.

Differences in taxation

Taxation should not create artificial differences between financial institutions. For instance, a corporate investor in the highest tax bracket will pay 34 per cent tax on interest from bank deposits and an effective 22 per cent tax rate on funds deposited in debt mutual funds. This immediately creates a preference for debt mutual funds, which has nothing to do with its inherent capacity to invest assets. Such artificial differences should be done away with.

As another example, foreign institutional investors who invest in India through Mauritius are exempt from taxes on short-term capital gains while Indian firms that manage foreign money while resident in India are not. This creates an incentive for Indian firms to send asset managers to reside abroad so that they enjoy the same tax treatment. While the magnitude of such tax-related migration is likely to be small, in the longer run it could come in the way of creating a strong asset management industry in India managing foreign money for domestic investment. While it is probably unwise to tax FIIs unduly some way of minimizing the difference in tax treatment may eventually become necessary to prevent an asset manager drain.

Differences in creditor rights

Some institutions are offered more rights than others. For instance, only banks, public financial institutions, and housing finance companies have the right to seize collateral under SRFAESI or Debt Recovery Tribunals. It is not clear, for example, why a registered deposit-taking NBFC should not have a similar right—after all, SRFAESI only helps enforce a secured creditor's rightful claim. This will assume importance if the economy slows, because of the increasing exposure of NBFCs to weaker credits in a search for yield. We discuss differential creditor rights in more detail in Chapter 7.

Another example is asset reconstruction companies (ARCs). Asset reconstruction companies have powerful rights (such as replacing firm management) when they hold sufficient secured debt of a defaulting firm. This is useful in securing repayment, and a source of value to the ARC, which is why there should be many more providers of ARC services—it should not be an oligopoly, let alone a monopoly. While the authorities have licensed a number of ARCs, high capital requirements and strong explicit and implicit restrictions on foreign participation and control make many inoperative, leaving only a very few active. While the reluctance of the authorities to confer such powerful rights on all and sundry is understandable, it is also unwise to create rights that only a few can be trusted with. In some ways, it may be better to have a more competitive industry with fewer rights than an oligopoly with powerful rights. Better still would be a competitive industry with appropriate creditor rights.

Differences in access to the sovereign, the regulator, or other public sector entities

Public sector entities have the possibility of a government bailout, which lowers their cost of funds considerably. Short of privatization, there is little one can do about this. And as we have argued, there are other government-imposed constraints on public sector firms that offset these advantages.

This does not mean, however, that attempts should not be made to make the playing field more level both in terms of advantages and in terms of costs. For instance, the LIC Act stipulates a sovereign guarantee for the policies issued by the Life Insurance Corporation of India (LIC). This explicit guarantee should be revoked through legislation so that the guarantee is left implicit for new policies.

In addition, public sector firms have a greater duty to follow prudential requirements so that they limit the advantage they get from the implicit government guarantee. In this regard, it is unfortunate that LIC, being governed by the LIC Act and not by the IRDA, does not need to comply with the solvency margin requirements stipulated by the IRDA. There is a strong need to repeal legislation that creates a special status for entities like LIC or SBI.

Finally, regulations or guidelines requiring public sector entities to favour other public sector entities are no longer warranted and should be repealed. For example, there is no reason why Navratnas and mini-ratnas, or the gems among state-run enterprises, should invest up to 30 per cent of their surplus funds in *public sector mutual funds only*. Similarly, private sector mutual funds should also be invited to bid to manage the pension contributions of central government employees, instead of reserving this for the public sector alone. From a national perspective, what matters is how efficiently the task is carried out, not whether a public or private fund manages it.

Different application of regulations

Regulators should not override more generally applicable regulations in order to favour particular entities. For instance, accounting rules are there for a purpose, to present a true and fair picture of a firm's condition. A regulator cannot simply decide to waive rules for its regulated entities because the rules would reveal inconvenient losses or reduce profits.

When the RBI allows small urban cooperatives to maintain lower SLR or extends to 180 days from the normal 90 days the period of delinquency before assets have to be provisioned for as non-performing, and relaxes these requirements in order to boost the cooperatives' capital and profitability, it is indirectly suggesting that the weaker norms will not affect their stability. In that case, all banks have the right to ask why they too cannot be subjected to weaker norms, so that they can boost profitability. Of course, no one would question the RBI if it tightened regulations beyond the norm for some risky banks—that is its job.

As another example, minority shareholders in public sector entities should have the same protections against mis-governance by the majority shareholder as do minority shareholders in private sector firms. The government should not have the right to erode the value of public sector firms (other than wholly owned ones) through directives to undertake unremunerated activities, at the expense of the minority shareholder. As a first step towards this, the rights of minority shareholders in PSUs should be brought on par with those of minority shareholders in private firms. A necessary step in this direction is for PSU

Banks' Accounts to be put to vote at the annual general body meetings by the shareholders.

Limitations in investment choice

There are many examples where the asset choices of an institution are limited through regulation. One reason is prudential—for liquidity or solvency reasons, the regulator requires some investment in safe assets. A second reason is the capability of the fund manager—when an industry like insurance or pension management starts out, it may be prudent to limit investment choices till the manager (and the regulator) acquires capabilities and confidence.

But maintaining such limitations beyond when they are strictly needed can be both inefficient and de-stabilizing. For example, given the strength of India's capital markets, there is really no need to use bank statutory liquidity ratio requirements to fund government debt. Instead, these should be lowered to a level consistent only with prudential requirements. Indeed, too much exposure to government debt has proved a source of significant banking system risk in other countries (though Indian bank exposure is certainly not at alarming levels today).[13] More important, a captive market for government debt prevents it from being priced properly, and from sending the right signals to the market and to the government.

Similarly, restrictions on the types of private securities that insurance companies and pension funds can hold tends again to artificially boost demand for government debt, while limiting their risk diversification. It also reduces the access important sectors of the economy have to long-term funds. For instance, there is no reason why these institutions should not hold diversified portfolios of domestic corporate assets, private equity positions, and securitized retail assets as part of their overall asset portfolio. This would give a boost to sectors of the economy like infrastructure, technology, and housing that provide the kind of long-term financial assets that insurers and pension funds like, and would end the anomalous situation where foreign pension and insurance funds are extensive users of the Indian equity market but domestic pension funds are not.

Equally important, given our enormous surplus foreign reserve position, it is high time we encouraged our financial institutions to diversify into foreign government and corporate assets (see Chapter 2). This can be done at relatively low cost.[14] Not only will this reduce the burden on the RBI of managing foreign inflows, it will provide useful diversification to our insurance and pensions—as it stands, they are overly exposed to India risk. Alternate asset classes may also be considered in due course.

In liberalizing restrictions, however, it is important not to attempt to direct flows to favoured sectors through selective liberalization, but to liberalize more generally. India's experience with directed credit has been abysmal, with flows historically going into sectors with low productivity that happen to be favoured.[15] Selective liberalization will tend to push resources to the selected sectors only, distorting prices, inhibiting resource allocation, and increasing risk. For example, it may be tempting for the authorities to allow insurance companies or pension funds to invest some of their assets in infrastructure. But if these asset managers have no other choices (other than government securities) they may under-price credit to the infrastructure sector, and finance too many unviable infrastructure projects, at great risk to their policy holders or pensioners. Infrastructure is risky, and while it is good to allow insurance companies and pension funds to build exposure to it, it should be out of choice and not because it is the least bad of their limited options. Liberalization of asset portfolio choices should be broad based so that credit is not directed, however well-meaning the intention, into the wrong places.

Finally, before closing this section, it is useful to note another example of how well-meaning policies can indeed build-up costs and risk. Currently GIC is the sole re-insurer in the Indian market, with the general insurers having to compulsorily cede 15 per cent of their business to GIC. Foreign re-insurers can only operate in India as joint ventures with the 26 per cent FDI cap. So far no foreign re-insurer has shown interest in entering the Indian market with a joint venture.

The net effect is that the prime source of re-insurance within the country is a domestic insurer, whose capital is likely to be greatly impaired if the country is hit by a calamity. Of course, GIC may have laid off the risk in international markets through re-insurance. But then it will have added multiple and costly layers of intermediation that could have been avoided simply by freeing insurers to reinsure with whomsoever they please. The point is requirements such as these tend to concentrate risk and increase costs. Moreover, there are some types of business—such as catastrophic re-insurance—that should be exported simply because foreign capital, not domestic capital, is most appropriate to insure Indian entities against large shocks (much as foreigner funded ARCs are appropriate). It is therefore entirely appropriate that the decision to steadily eliminate compulsory cessation has been taken.

Discriminating against service providers based on national origin

If India is to build a strong asset management industry, Indian asset managers should be able to provide foreign investment opportunities to domestic investors, as well as domestic investment opportunities to foreign investors. It is somewhat paradoxical that our system bars domestic asset managers from providing portfolio management services for overseas clients, unless they create asset management vehicles outside India. This creates additional transaction costs and makes Indian AMCs even less viable while competing with tax-favoured foreign asset managers for fund management business from foreign clients.

We also create roadblocks in asset managers taking money out—in their managing offshore equity under portfolio management schemes, or offering products that invest in domestic as well as offshore equity. All this while residents can move capital out of India and then purchase products offered to them by foreign product providers. At a time when India would like to export capital, as well as boost the asset management industry and the high-paying jobs it creates, these impediments may stunt growth.

NOTES

1. There are some restrictions. In the United States, for example, only checks over US$250 can be processed by money market funds. With time and inflation, this is becoming less and less of a constraint.
2. Claessens and Laeven (2004).
3. See Beck, Demirguc-Kunt and Macsimovic (2004).
4. See, for example, Schnabl (2008), who looks at the case of Peru in the 1998 crisis. Foreign banks brought in capital when capital dried up for domestic banks, and were a significant factor in financing domestic firms during the crisis.
5. This evidence comes from a study of very poor countries—Detragiache et al. The Mexican experience, where a huge part of the domestic banking sector was sold to foreign banks, which were cautious in lending, with attendant effects on aggregate credit growth, is also a salutary one.
6. McKinsey (2007).
7. McKinsey Global Institute (2001).
8. Banerjee, Cole and Duflo (2005).
9. Cole (2007).
10. Cole (2007).
11. The rationale for focusing on underperforming PSBs is simply that the need for governance improvement (and thus the possibility of transformation) is much greater there, and the political willingness to sell is likely to be higher.
12. We refer to weak banks only because there is greater value to taking them over, and less controversy. Nevertheless, no bank should be immune from takeover, except on grounds of excessive concentration.
13. Even in India, US 64 was included in the list of approved securities till the scheme ran into difficulty, forcing the government to bail it out. This highlights the hazards of labelling securities as preferred and hence safe investments.
14. For instance, moderate amounts of foreign equity or corporate debt exposure can be acquired by buying exchange traded indexed funds or investing in index portfolios, a relatively low cost way of acquiring exposure without significant management fees.
15. See Wurgler (2000) for evidence.

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Creating More Efficient and Liquid Markets

chapter 5

THE ROLE OF FINANCIAL MARKETS IN GROWTH, STABILITY, AND INCLUSION

Financial markets have a very important role to play in a modern economy. Specifically,

1. Well functioning financial markets allow risks to be borne by investors who are best placed to bear them. For instance, instead of farmers bearing the risk of crop price fluctuation or total crop failure, diversified investors in cities or from abroad can bear that risk through commodities futures markets or through crop insurance.
2. A healthy market also provides clear signals about which companies and sectors are doing well (the price of equity in those companies and sectors goes up), which commodities are likely to be in short supply (the futures price rises), and whether the RBI is doing a good job in keeping inflation under control (the inflation premium in long-term bond prices is low).
3. Financial markets can also bring the users of capital and savers together at low cost, eliminating layers of intermediation, and thus costs. One virtue of bond market finance over bank finance, for example, is that it allows investors to bear the credit risk of the firm they are investing in directly, without going indirectly through a bank. For high quality firms, this could entail substantial cost savings.

Better risk sharing, better information signals, and lower costs combine to:

4. Reduce the cost of finance for firms, households, and the government, allowing them to finance investment and innovation and grow. Since the poorer sectors are hurt most by high costs, this effect can be a substantial force for greater inclusion.
5. Allow for better allocation of resources in the economy, including taking away resources from declining sectors and re-investing them in sunrise sectors. This function improves both the efficiency with which scarce capital is used, as well as the overall stability of the economy.
6. Equity and bond markets also serve as a buffer, passing losses from risky ventures directly to households that would otherwise be passed on to more fragile institutions.
7. Improve macroeconomic policy setting as well as transmission. For example, the RBI has a better sense of how inflation might evolve by looking at the yields of long-term bonds, and its own actions in altering the short-term interest rate could have much stronger effects across the spectrum of government and corporate bonds if these markets worked well.

In what follows, we elaborate on some of these benefits of markets to the Indian economy. While these may be obvious to some, far too many people in positions of authority in India are unconvinced by the importance of markets, and hence the knee-jerk reaction to ban them or intervene in them whenever they send unpleasant messages.

Why are markets becoming more important in India today?

Corporations

In the last decade, Indian firms have been transformed by the forces of competition and the economy's integration with the world economy. Firms which were stagnant, eking out a respectable rate of return by doing the same thing year after year, were confronted with global competition. In response, Indian firms have improved productive efficiency and increased their focus on research and development. Some have turned themselves into multinationals with overseas investments. As firms move towards the technological frontier, there is greater technological risk.

Also, as India becomes richer, it will increasingly experience business cycles and the attendant risks. Corporations will have to have sufficient financial cushions to deal with downturns—they will have to live through inventory build-ups, and sustained periods of low demand and low profitability. Moreover, as India becomes more open, its corporations have to deal with new risks such as the effect of exchange rate movements on their competitiveness.

Equity financing

Even after corporations have obtained the full benefits of risk reduction through operational flexibility (such as the ability to alter workforces and production locations and schedules—far more needs to be done on this front in India) and through hedging markets, there will be a secular increase in the uncertainty faced by firms in this new environment. As profits become less reliable, and as research and development and new technologies become a greater part of firm activities, as India moves away from the asset-intensive mature industries of old to the human-capital-intensive industries of the future, equity financing will become more important.

In principle, equity financing could be obtained from development finance institutions or from universal banks. Among the virtues of obtaining finance directly from equity markets are: (1) Risk is spread across more shoulders so that riskier, higher-return projects can be financed; (2) The market is not dominated by one bureaucratic view, so that many varieties of technologies are financed, with some doomed to fail and others becoming a Google or Infosys; (3) Control is not concentrated in a few financial institutions which could limit competition in the market.

This is not to say that financial institutions have no role to play in equity markets. Institutions such as venture capital provide the financial nurturing and management support needed to take entrepreneurs from the garage to the market. Mutual funds and pension funds play an important role in the governance of existing firms, while institutions such as private equity and hedge funds help restructure firms that are poorly managed, and provide the risk capital and management to rescue failing firms.

Corporate and government debt

On the debt side also, markets will become more important. The size of some infrastructure projects such as power plants are so large that no bank can take a reasonable stake without breaching concentration limits. These projects require substantial amounts of bond market financing. Some institutions such as NBFCs offering long-term finance will also need financing themselves. By borrowing from bond markets rather than from banks, they can achieve a better asset liability match, as well as reduce the risks the banking system is exposed to. Corporate bond markets can work as effective buffers here. Unfortunately, the corporate bond market is still miniscule and will need to develop to meet these needs. Effective infrastructure finance would also depend on the existence of deep and liquid derivative markets where the specific risks associated with infrastructure projects can be managed.

The government will also need a vibrant government bond market to provide it low-cost financing, as it relies less on forcing banks through statutory requirements to hold its debt. A deep government debt market across all maturities will provide the benchmarks that the private sector needs for pricing corporate debt, and various kinds of hedging instruments.

International

As Indian firms turn themselves into multinational corporations, and engage more closely with the world economy, they will require international financial services, the production of which is impeded by an inward-looking financial system, missing markets for hedging products, and vestiges of the system of capital controls. Indeed, one of the themes in this chapter is that a fuller opening to foreign capital and institutions, as well as a more outward orientation of Indian financial institutions, can help achieve domestic goals such as greater financing for infrastructure, even while making Indian firms more competitive in the world economy.

Households and diversification

For far too long, the Indian saver has got short shrift. Too many Indians do not have savings that are protected against inflation, let alone earning decent real returns. Many do not have sufficient exposure to equity because of archaic rules on where the institutions they save in, such as provident funds, can invest. Even while foreign institutions have gained annual double digit returns from the rise in the Indian equity market (and deservedly so because they were willing to take the risk), some Indian institutions, forced by regulation to invest primarily in government securities, have completely missed the rise in equity markets. Indian investors are not even as well diversified against risk as they could be. Of course, the equity market fluctuates. While those who have owned equity over time have done well, many are overexposed to the Indian market and its fluctuations, and would well benefit from a more diversified global portfolio. Here again regulations and restrictions come in the way of mitigating risk.

Financial markets and institutions need to evolve considerably in order to keep up with the requirements of Indian firms and Indian investors in coming years. India has a strong equity market already in place, but the environment needs to be made more conducive to private equity, venture capital, and hedge funds. Mutual funds and pension funds (when they emerge) should play a more active role in governance. The corporate bond market is moribund and will have to be revived, and a number of missing markets will have to be created. Indian firms and investors need better access to international financial services, and the production of international financial services by Indian financial firms needs to be enhanced.

Are markets casinos?

Despite all the legitimate benefits of markets described in the previous paragraphs, a number of serious commentators have concerns about the development of what they term 'casino capitalism'. Is the financial world engaged in trading securities that have no links to reality? Is the stock market or futures market simply legalized gambling, which diverts time and attention from the worthy task of building the real economy? Are speculators setting futures prices for grain way before prices are actually realized and thus 'manipulating' the grain market? Without convincing answers to these questions, markets will have little legitimacy.

It is true that a number of investors are risk-seekers, much like gamblers, and that there is a certain amount of luck in who makes money and who loses money in any single market transaction. But unlike gambling, which is based purely on luck, the investor in financial markets has a view of future outcomes, and it is this that allows prices to be informative because the price aggregates collective information. And informative prices affect real decisions and thus help the economy, unlike pure gambling, which only involves transfers from losers to winners.

The important point that more commentators need to understand is that price fluctuation in financial markets does not mean more economic instability, and controlling prices can create economic instability.

For example, when bad news appears about a country, well functioning financial markets such as equity, currency, government bonds, corporate bonds, etc., all adjust. Thus, bad news about fundamentals creates price fluctuation. But the price fluctuation itself creates equilibrating forces. If the bad news results in reduced prices on the securities markets and currency depreciation, while some economic agents might panic and take money out of the country, many others would see reduced prices as buying opportunities. These purchases would act as an equilibrating influence. Flexibility of financial prices induces stability in the economy.[1] By contrast, if the government prevented price movements on the securities markets and currency market by propping them up, this would give the many smart participants who thought the market was overvalued a convenient exit route. The government action would *support* capital flight from the country, leading to a bigger fall when the government ran out of money. Far too many currency crises and banking crises have been created by governments; attempting to prevent price movements through intervention.

Flexible financial prices are a shock absorber. When times are good, if the exchange rate appreciates, this reduces the profit rate of corporations producing exports or import-competing goods and slows investment. When times are bad, if the exchange rate depreciates, this enhances the profit rate of these corporations and spurs investment. Through this, a flexible exchange rate acts as a stabilising force in the economy. Equivalently, high futures grain prices give farmers an incentive to invest, and an ability to lock in gains, so that production rises and brings down prices. The stability that matters is the stability of output and employment, and not stability of financial prices and exchange rates. Indeed, when government tries to prevent movements of prices on financial markets, this yields greater instability of output and employment.

A full set of financial markets thus acts as a source of information and enhances stability. When these markets are missing, systemic stability is worsened directly and indirectly. The direct impact takes place through the lack of financial markets as shock absorbers. The indirect impact takes place through the negative impact upon public and private decision making that comes from the lack of information.

Even the short term speculator who is interested only in pure profit plays a useful role, for example by taking the other side in hedging contracts. If farmers want to hedge the price of grain by effectively selling it in advance through the futures market, someone has to take the other side. There are often a few firms such as grain mills that want to lock in their future input prices. But typically there are too few of them. The speculator plays a useful role by offering a fixed price to the farmer, and betting that he will make some money in the process. Commentators who complain some market is full of speculators do not understand that the speculator is playing a vital role. Both sides are better off—the farmer because he gets price certainty; the speculator because he makes a little profit on average. What keeps the speculator from making outsize profits is competition from other speculators. This is why we need deep and liquid markets with many players—that is precisely what prevents market manipulation.

Finally, there is still tremendous distrust of certain products such as financial options, or more generally derivatives, which seem to involve pure directional bets rather than any financing. But there is now universal agreement about the importance of the infrastructure of transportation and communications, and a recognition of the role of the private sector in (say) building and operating a highway. When a private firm embarks on such a task, it requires financing from banks, equity, and debt markets. But sophisticated derivatives markets which enable the promoter to protect against fluctuations in exchange rates, interest rates, macroeconomic risk, natural disasters, etc., are as much a technological input into a road project as are the state-of-the-art construction equipment which is now being deployed in India. Greater sophistication in financing leads to reduced user charges and a larger pace of infrastructure investment. The sophisticated infrastructure of transportation and communications, which is desired by all, critically requires sophisticated financial markets.

In some areas, there are also opportunities for utilizing hedging markets in pursuing the goals of public policy in India. As an example, the goal of food security can be achieved at a lower cost if the government held long positions on commodity derivatives markets, through which the government could access physical grain under certain scenarios, instead of holding physical inventories of grain at all times.

More generally, financial markets are far from casinos when they function well. However, such an outcome cannot be taken for granted. The authorities have to create sound deep liquid markets by fostering transparency, competition, and enforcement against fraud. In the absence of that, financial markets can be worse than casinos in that, unlike a well-run casino, the odds will be stacked against the average investor. Similarly, derivatives offer very useful tools for laying off risk, and can thus increase the level of investment without resorting to less efficient devices like government guarantees. But derivatives are like dynamite—used properly in construction, they can move mountains; used improperly, they cause tremendous damage. The point then is to create all the conditions that will make markets work well, and participants behave properly, so that the nation can derive the maximum benefits from markets.

Financial markets and competition

When an entrepreneur has ideas but not capital, the financial sector plays a critical role in enabling firm entry and growth by infusing debt and equity capital. Competition in the economy is fostered by a financial sector which is able to perform this role effectively. Conversely, when finance is unable to nurture new firms and new projects, competitive pressure against incumbents is reduced. This has far-reaching ramifications for the meritocratic dynamism, the pace of technological change, and the rate of GDP growth of the country. This also has implications for inclusion: when finance does not support and enable entry against incumbents, the profit rates of incumbents are enhanced, and this leads to entrenched pockets of wealth and influence.

From the viewpoint of competition in the economy, *external* financing is important. A profitable incumbent generally has retained earnings, and is able to invest and grow using this. New entrants lack that internal cash flow; their entry is critically enabled by the availability of external equity and debt capital. For relatively safe projects, external debt financing is appropriate, and this requires a well functioning debt market. When risk levels are high, external financing must come in the form of equity financing. This requires a corresponding well functioning equity market. As an example, while borrowing made up 27 per cent of the liabilities of non-financial firms in India in 2006–07, the corresponding value for software companies was just 8 per cent.[2] This illustrates the unique role of equity financing in fostering high-risk, high-technology, human-capital-intensive projects.

Banks could play a role in nurturing new firms, but are typically far better at financing mature well-understood technologies than green-field projects. India has vibrant equity markets, and a significant number of sunrise industries like software or biotechnology that depend on these markets for financing. In this sense, it has already evolved away from a bank-dominated financial system characteristic of emerging markets.

The inclusion agenda

In India, over the 29 years for which data are available, a passive investment in an equity index generated average nominal returns of 19 per cent per annum.[3] Yet, equity portfolios are held by only a small number of households in India.[4] Equity investments are not a luxury, they are an essential element of any long-term savings plan, for they offer the only true protection against inflation. In a developing country like India, they also allow everyone to participate in the growth story, not just the rich. While equity is risky, two factors help mitigate risk to acceptable levels for even the poor. First, equity portfolios have to be diversified, not just domestically but also internationally. Stock picking is not for the average investor, indexation is. Second, equity needs to be invested over the long run. High returns of diversified equity portfolios have been observed all over the world over the long run, and we need to make sure all Indians have access to these returns.

The participation of more poor (and foreign) investors in Indian markets would also improve the markets' liquidity and depth, making them even less susceptible to unwarranted fluctuation. Thus the inclusion agenda should also be seen as part of the growth agenda.

The poor are not just savers—they can also be borrowers who need financing. More attention needs to be provided on finding ways to link up the capabilities of financial markets—in supplying equity and debt capital at a low cost in high volume—with the entrepreneurial energies of individuals spread all across the country. In Chapter 7, we discussed the importance of securitization in refinancing financial firms lending to the poor. Further progress requires greater competition and innovation amongst financial firms, which would induce new technological and business models through which transactions costs are lowered and barriers to access overcome. This Committee cannot predict what models will emerge, but it is confident that given the innovative spirit of Indians, new ones will.

Finally, we have argued in Chapter 3 that the poor need products that lower risk, even more so than the rich. Financial markets provide such products, but a financial intermediary has to interact with the poor to determine their needs, aggregate their demands into economical order sizes, and then place appropriate orders. Financial firms and NGOs have to improve their own levels of financial sophistication and the efficiency of their transactions processes to intermediate effectively, but when this happens, the poor will be great beneficiaries from hedging markets also. In the Chapter on Financial Inclusion, the Committee has recommended the setting up of a nationwide electronic financial inclusion system (NEFIS). This would enable payments as 'micro' as Rs. 100 in cash and as 'nano' as Re. 1 in electronic form (as a debit or credit to an account), to be carried out at reasonable transaction costs. Once transactions costs are lowered, the poor can hope to participate in a wide variety of financial markets, such as equities and commodity derivatives, beyond just savings, credit and insurance.

However, cutting transactions costs of micro-payments is only one part of the task. Given the small size of transactions, such as say a Rs. 200 per month systematic investment plan (SIP) or a sale of five quintals paddy, would require aggregation, before willing counterparties are found. This aggregation infrastructure requires a new category of players in the market. For example, in case of the SIP, it could be a self-help group (SHG) of 10 women, saving Rs. 20 each and pooling it monthly to invest in a Rs. 200 pm SIP. This would require mutual funds to recognize SHGs as legitimate participants, just as ten years ago, banks began to permit SHGs to open bank accounts. The rule about a PAN number would have to be revisited for an SHG.

Similarly, to enable a minimum 10 ton transaction take to place on a commodity derivatives exchange, 20 small farmers with five quintals each will have to be brought together for a single options contract. This could be done by a farmers' cooperative or a warehouse keeper. The service charges of the aggregator will add to the transaction costs and to that extent make options less attractive. Thus it is important to develop simple aggregating mechanisms, with as much standardisation and electronic transaction recording as possible so as to minimize the need for discretion and cash handling.

Another important constituency that has not been reached by financial markets in India is the small business sector. Small and medium scale businesses are vital for growth and employment creation. There is a need to find innovative ways for small businesses to raise debt and equity, and to hedge their financial risks. By definition, small businesses are too small to directly access public equity markets, but their capital needs can be met through specialized funds that provide funds to small businesses and in turn are subject to market discipline.

Markets are driven by information, and systematic information dissemination can help direct capital to credit and equity pools of various sizes and segments. For example, if there was a monthly or quarterly posting of the analysis of bank NPAs by loan size and segments, and it became widely known that loans below Rs. 10,000 to Dalit women in Bihar have only a 0.1 per cent NPA while loans above Rs. 1,000,000 to MBA students have 4.3 per cent NPA, it is likely that some market participants will overcome their aversion to working with Dalit women of Bihar. Similarly, if it became clear that a cluster of small businesses in a particular industry can generate above market returns, investors will be willing to invest in funds that however, for such micro markets to be discovered, the information infrastructure has to be created as a public good. The CGAP Mixmarket data base of 1,000 plus microfinance institutions is an example of such an effort. While it is difficult to anticipate solutions, the approach should be to encourage intermediaries who are able to provide capital to those excluded today, but are in turn subjected to market discipline.

Getting the full range of markets and its effect on policy

The Bond-Currency-Derivatives (BCD) Nexus is the interlinked set of markets on government bonds, corporate bonds and currencies. In a well functioning financial system, all these prices—exchange rates, interest rates for government bonds and interest rates for corporate bonds—are tightly linked through arbitrage. The key policy goal in this area lies in fully linking the markets, and for these markets to (in turn) be linked to other financial markets such as the equity market. When India achieves a well functioning BCD Nexus, this would have a number of implications. It would enable funding the fiscal deficit at a lower cost and with reduced distortions. It would produce sound information about interest rates at various maturities and credit qualities, which would shape investment plans of firms and give them access to debt financing. In particular, this would strengthen financing for debt-heavy infrastructure projects. Monetary policy involves changes in the short-term interest rate by the central bank; the BCD Nexus would enable the 'monetary policy transmission' through which changes in the short-term policy rate reach out and influence the economy through the market process of changes in all other interest rates for government bonds and corporate bonds. Finally, the currency spot and derivatives market would link up the Indian bond market to the world economy and reduce excessive price or interest rate differentials.

In mature market economies, the full set of financial markets produce a unique array of *information* including forecasts of volatility of all traded products, estimates of expectations of the market such as beliefs about inflation in the future and expectations about the future course of monetary policy. This information plays an important role in informing and improving decision-making processes in both the public sector and the private sector. In particular, it is particularly important for the operations of the central bank. This is one important benefit of fostering a complete set of well functioning markets.

Markets and risk-taking

As we argued earlier, while capable of creating enormous good, every financial product is also capable of creating enormous losses for the holder. Participants have to develop a level of sophistication to use them well. Given the limited financial literacy in this country, there is a role for segmenting markets, so that only 'sophisticated' or institutional participants can participate in certain markets, while retail customers have to go through an intermediary. Even then, it sometimes turns out that the 'sophisticated' take excessive risks, or do not understand what they are doing and burn themselves.

This is normal—corporations make losses all the time making real products, and will make them in financial products also. The only way they will learn to be more circumspect is if they are forced to absorb the full consequences of their actions. Indeed, in many financial markets, for every side that loses, there is another side that gains, so unlike with real losses, the economy as a whole does not lose.

The real regulatory concerns are three. First, do participants have a reasonable level of sophistication so that they can understand the products and their consequences? Second, are products sold with adequate disclosure so that these participants understand (or can understand if they ask reasonable questions) the risks they are taking? Third, are the systemic consequences of price movements in any direction likely to be limited? In a developing economy like India's, the first two concerns are important, but slippage there can be absorbed provided the third concern is addressed. Indeed, in the process of learning, there are bound to be losses for some parties (such as recent unverified reports of large corporate losses on currency derivatives), but so long as the systemic consequences are contained, these should be viewed as the costs of market development. Indeed, such costs are borne by the economy in numerous situations when new technology enters the country for the first time.

In what follows, we will diagnose how well Indian financial markets are performing and the sources of the deficiencies, and offer proposals to rectify some of the problems.

THE NEED TO IMPROVE LIQUIDITY AND MARKET EFFICIENCY

Let us start with how one would measure the performance of markets. The two critical features of a well functioning financial market are market efficiency and high liquidity. Both these are 'outcomes' measures.

Market efficiency is the extent to which information and forecasts about the future are impounded into financial prices. Liquidity pertains to the ability to transact with low transactions costs. It has three dimensions: immediacy, depth, and resilience. Immediacy refers to the ability to execute trades of small size immediately without moving the price adversely (in the jargon, at low impact cost).[5] Depth refers to the impact cost suffered when doing large trades. Resilience refers to the speed with which prices and liquidity of the market revert back to normal conditions after a large trade has taken place.[6]

The two concepts of efficiency and liquidity are linked. In order for markets to be efficient, market participants who obtain information have to be able to trade on that basis and impound that information into prices. For economic agents to have an incentive to expend resources in information processing and forecasting, markets must be liquid, else any profits from the activity will be dissipated in the transactions costs alone. Expensive or infeasible transactions reduce the profits from successful forecasting. This (in turn) inhibits the investments made in information processing and forecasting. Market liquidity is thus a critical precondition for market efficiency. In turn, market efficiency assures uninformed participants that market prices are up-to-date and reflect fundamentals, so they can trade safely. This in turn provides volumes that ensure liquidity.

Table 1 summarizes the state of Indian financial markets on the three aspects of financial market liquidity. In the view of the Committee, resilience is found in the large stocks, their stock futures, and the index futures. All other markets in India lack resilience.

Table 1: Liquidity of Indian Financial Markets

Market	Immediacy	Depth	Resilience
Large cap stocks/futures and index futures	Y	Y	Y
Other stocks			
On the run government bonds	Y	Y	
Other government bonds			
Corporate bonds			
Commercial paper and other money market instruments			
Near money options on index and liquid stocks	Y		
Other stock options			
Currency	Y		
Interest rate swaps	Y	Y	
Metals, energies, and select agricultural commodity futures	Y		
Other commodity futures			

Depth is found, in addition, with on-the-run government bonds and interest rate swaps. Immediacy is found in a few more markets. A well functioning market is one which has all three elements. India has only one market where this has been achieved, for roughly the top 200 stocks, their derivatives and index derivatives.

When a financial market does not exist, or is inadequately liquid to meet the requirements at hand, or suffers from deviations from fair price, this constitutes market incompleteness. Economic agents are unable to enter into transactions that they require for conducting their optimal plans. Market incompleteness has many pernicious implications for resource allocation and ultimately GDP growth.

Many official documents have emphasized the efforts made by government in trying to create a policy environment that would foster liquidity and efficiency. As with all aspects of government, a greater focus needs to be placed on *outcomes*. Input measures—such as the policy efforts that have been put in—are unimportant in the final analysis. What matters is the outcome: whether a liquid and efficient market was achieved or not.

At first blush, a lot of activity is visible in almost all parts of Indian financial markets. A great deal of hardware and software has been acquired; an alphabet soup of new acronyms is in the air; many IOSCO checklists are filled out. However, it is important to not confuse the efforts being put in for the outcome. All the effort is a means to an end. That end is market liquidity and market efficiency. Inputs such as technology or trading systems are neither necessary nor sufficient. Some technologically primitive markets—such as the floor trading which once dominated the exchanges of Chicago—had achieved tremendous liquidity and market efficiency. Conversely, Indian finance is replete with advanced trading technology and trading platforms, but the end-goal of liquidity and market efficiency remains elusive on most elements of the financial markets. There is more to achieving liquidity and efficiency than setting up trading platforms using information technology, and ticking off some boxes in IOSCO checklists.

Table 1 highlights some genuine accomplishments in achieving liquid financial markets in India. At the same time, it highlights the journey ahead. Achieving a sound set of financial markets is synonymous with achieving a 'Y' in all the cells above. This requires diagnosing the reasons for the empty cells, and identifying policy paths through which those difficulties can be addressed.

A particularly important point, that would be apparent if we also saw the table for 2003, is the lack of progress. In the period 2003–08, three elements have come through: the onset of immediacy with near money options on index and liquid stocks, the onset of immediacy and depth on the interest rate swap market, and the onset of immediacy on some commodity futures products. In other words, in a table with 36 elements, the progress over the latest five years has consisted of going from 7 cells to 10 cells. This is disappointing progress, given India's rapid growth and India's urgent requirement of sophisticated financial markets. Policymakers should view it as unacceptable.

This calls for fresh effort in diagnosing problems and making a break with the policy frameworks which have failed to deliver results. The goal of financial sector policy must be to obtain a 'Y' in all 36 cells within five years. This requires getting 26 new 'Y' values into the table over the next five years, as compared with the 3 that were obtained in the last five years.

Some developing countries have suffered from the inability to obtain liquidity and efficiency in *any* element of the financial markets. India is in a better position in having achieved some elements of success. A careful understanding of the sources of success and failure is thus possible in the Indian setting. In addition, the areas of success have thrown up an institutional capability which will be useful.

DIAGNOSING THE SOURCES OF DIFFICULTY

Why are so many markets illiquid and inefficient? Some of the main reasons are:

1. Banning of products and markets.
2. Rules that impede participation of firms and individuals in certain markets for reasons other than sophistication.
3. Inadequacies of financial firms arising out of their ownership, size, and other reasons.
4. A silo model of regulation and the structure, incentives, and staffing, of regulatory institutions that results in barriers to innovation and competition.
5. Frictions caused by taxes.

Banned products and markets

Why are numerous financial markets illiquid and inefficient? The simplest element of the policy environment that comes in the way is the banning of products and markets. As an example, products such as currency futures and commodity options are banned. A market that is banned can obviously not attain liquidity or efficiency. Equally problematic, a missing market can hamper the efficiency of other markets also. For instance, the absence of interest rate futures can hurt the Treasury market.

The recent practice of closing down commodity markets when the price reaches high levels is unfortunate to say the least. Even if these markets are being manipulated at present, an allegation there is little concrete proof of thus far, the way to make them function better is to improve their liquidity and broaden participation so that manipulation becomes difficult (the exchange could also take steps to restrict the trading of those it considers to be manipulating markets if it has evidence). Creating uncertainty about whether the markets will remain open is probably the most effective way to kill liquidity. The damage done by these short-sighted policy moves need to be reversed by distancing market regulation from the government (one more reason why all market regulation should come under SEBI—see later), and making it much harder for the government to close markets.

Restricted participation

In many cases, while an outright ban is not in place, there are restrictions on participation. There are various shades of grey in restrictions. These include outright bans (e.g., domestic individuals cannot participate in currency markets) or regulatory restrictions on some kinds of activities (for example, banks are prohibited from adopting long positions on interest rate futures) or quantitative restrictions (for example, all FIIs put together are required to keep their aggregate ownership of corporate bonds below US$ 1.5 billion).

There are a variety of rationales for restriction, including the belief that some participants (and regulators) are new and therefore should proceed cautiously at the outset, and the desire to limit capital inflows and outflows so as to make exchange rate management easier. An often unvoiced, but important, rationale is the need to finance the government, and thus the need to pre-empt funds collected by various institutions through restrictions on investments other than in government securities. Table 2 from the BIS is enlightening: Among the countries in the table, India has one of the largest government shares in the public debt market—a staggering 91 per cent. Even China, which has a reputation for weak financial markets, has much larger public debt issuance by financial and non-financial corporations than India. The need for the government to finance itself, coupled with investment restrictions on the main domestic institutions collecting long-term public savings and a ban on foreign participation, results in a domestic bond market that is dominated by government securities.

Table 3 looks at the elements of Indian financial markets from this perspective. The equity market—the only element of Indian finance which has achieved immediacy, depth and resilience—has few restrictions on participation in both spot and derivatives markets (it does restrict foreign individual investors, and some institutional investors such as hedge funds). As a consequence, the equity market, especially for large stocks, has developed a distribution capability which reaches millions of market participants around the world. All kinds of economic agents come together into a unified market to make the price. Competitive conditions are upheld; for the most part, no one player is large enough to distort the price. The diverse views and needs of the diverse array of participants impart resilience, depth, and market efficiency. Competition between NSE and BSE has helped improve technology and reduce costs. The most important feature of the equity market has been free entry and exit for financial firms that become members

Table 2: Domestic Debt Securities—Amount Outstanding as on September 2007 (in US$ Billions)

	World	US	UK	Japan	India	China	Indonesia	Malaysia	Singapore
A) Domestic Debt Securities	**55,389**	**23,899**	**1,354**	**8,706**	**435**	**1,528**	**89**	**155**	**90**
B) Government	26,200	6,480	901	7,034	396	1,042	80	66	64
C) Govt securities as a % of total Domestic Debt securities (B/A)	**47%**	**27%**	**67%**	**81%**	**91%**	**68%**	**90%**	**43%**	**71%**
D) Financial Institutions	23,053	14,499	429	969	29	400	4	31	19
E) Corporate Issuers	6,135	2,918	23	703	8	86	5	57	6

Source: *BIS Quarterly Review,* March 2008.

Table 3: What Kinds of Participants are Permitted into what Kinds of Markets?

Market	Domestic institutions	Domestic retail	Domestic corporate	Foreign institutions	Foreign retail
Equities & Equity Derivatives	Y	Y	Y	Y	N
Government Bonds	Y	–	Y	–	N
Interest Rate Swaps	Y	–	Y	–	N
Other Interest Rate Derivatives	–	–	–	–	-
Corporate Bonds	Y	Y	Y	–	N
Credit Derivatives	N	N	N	N	N
Currencies & Currency Derivatives	Y	–	Y	Y	N
Commodity Futures	N	Y	Y	N	N
Commodity Options	N	N	N	N	N

Note: 'Y' = Yes. 'N' = No. '–' = Limited/Negligible.

of NSE and BSE, and the free entry and exit for the economic agents who trade on these markets through exchange members.

The Committee feels that such an open environment is of critical importance for achieving liquidity and efficiency in all the other elements of Indian financial markets. The trading rules of a market, such as placing collateral associated with a position, or position limits, must be neutral to the nature of the market participant. There should not be one rule for a bank and another rule for an FII. In principle, most financial firms would have adequate levels of sophistication, so rules should not prevent access to any market, especially if the firm can demonstrate competence to the regulator (see the discussion on professional markets below). Further, end-users of markets should have a full range of choices of the financial firms through which they access the market. In a healthy financial market, all players come together in a transparent market to make a price, while a regulatory framework ensures that competitive conditions are upheld so that no player has market power and distorts price discovery. While these conditions may not pertain initially, and may therefore require extra regulatory vigilance, the only way they will emerge is if an open environment is created. This approach needs to be applied across all financial markets in India.

Inadequacy of financial institutions

If the first difficulty lies in rules that impede participation of certain kinds of financial firms in certain markets, the next difficulty lies in the inadequacies of the financial firms themselves.

Table 4 summarizes the state of play with financial firms. As shown in the table, in numerous areas, financial firms have infirmities in India or are non-existent.

The institutional structure of market participants is shaped by the forces of competition and regulation. When firms face

Table 4: Capabilities of Financial Firms

Institution	Current status
Securities Brokers/Dealers	There are enough large, well capitalized, professionally managed brokers/dealers to support a vibrant market. However many poorly capitalized entities continue to exist.
Mutual Funds	There are enough large, professionally managed mutual funds. However, their success in channelizing retail savings into the debt/equity markets have been limited. They have been more successful in providing a tax sheltered investment vehicle for corporate cash surpluses.
Hedge Funds	Non-existent.
Other activist investors	Non-existent. Private equity players are the most hands-on investors today, but they rarely confront corporate management with a view to improving governance.
Pension Funds	Practically non-existent. Investment restrictions prevent provident funds from playing an important role in the financial markets.
Rating Agencies	The big international rating agencies have affiliates in India. However, the current debate over global rating practices offers an opportunity for Indian rating affiliates to leapfrog over global counterparts and adopt state-of-the-art technological and organizational practices.
Investment Banks	Compared with global peers, Indian investment banks are poorly capitalized.
Exchanges, clearing corporations, and depositories	Some of the exchanges are close to being world class as is the clearing, settlement, and depository infrastructure. New entry by professional exchanges catering to institutional/sophisticated customers could help, as could greater competition between elements of the infrastructure.
Insurance Companies	Much of the investable funds are with the state-owned behemoths. Private sector players are growing fast. Together, they could contribute to the development of a corporate bond market if investment restrictions were moderated.
Banks	State owned banks dominate the banking system. They have a tremendous branch network, as well as a strong image of trustworthiness among poorer sections, which could be used to provide more access for households to the markets. Some of the PSBs suffer from an inability to attract adequate human capital for skilled tasks and an inability to incentivize performance, which limits their ability to develop strong risk management. In turn, this hampers their ability to create new and appropriate products for households, or to invest effectively in the riskier part of the spectrum of assets.

competition for market share, they are forced to find new ways of serving their customers. It is this pressure that, over time, creates highly competitive companies that are able to bring down costs through technological innovation and better management of resources. The inadequacies of Indian financial institutions can be traced at least partly to the forces that restrict competition.

We do not have room for a full analysis of all factors that inhibit competition and innovation. However, two points are worth making. First, state ownership of financial institutions is a major factor that inhibits competition. This is compounded by the need for regulators to take into account the incentive structures and special circumstances that come from being government owned. A second factor is restrictions on ownership and shareholding. This applies especially to institutions like banks and exchanges, clearing corporations, and depositories. Limits on how much shares an individual shareholder can hold (5 per cent in exchanges, 10 per cent cap on voting rights in banks), and limits on ownership by foreigners makes it difficult for new institutions to be started, and for shareholders to exercise influence on management. This reduces competitive pressures on incumbents, and slows down the pace of development of market institutions.

Most such restrictions have been introduced with the good intention that such institutions should remain in the hands of that is 'fit and proper' persons. These restrictions are a recognition of the perception that the regulatory system is too weak to prevent misuse of management authority, and the only way to prevent institutions from falling into 'wrong hands' is to have rules on concentration of ownership. However, it is important to recognize the costs imposed by these rules.

In short, the deficiencies in Indian financial markets stem from missing markets and missing actors. The way to address the first is in opening markets, equalizing market rules for all kinds of participants, and in removing rules that ban specific players only from certain activities. It is relatively easy to resolve this problem. However, the second problem is deeper and requires more long-term efforts, that of improving the capabilities of financial firms. The way to do this is to increase competitive pressures in the market ecosystem by removing constraints in the way of entry of new players.

Infirmities in regulation

Two factors that have deleterious consequences for both markets and actors are:

1. India uses a 'silo model' where the financial markets are broken up across three agencies: SEBI, RBI, and FMC. There are hard constraints that separate firms and players in one silo from operating in other silos. These constraints reduce competition, hamper economies of scale and scope, and impede the flow of successful institutional arrangements and ideas from one part of the financial markets to others.
2. Steep barriers to innovation are in place. New ideas are banned unless explicitly permitted. A great deal of what would be considered ordinary activities in the world of global finance is incompatible with existing laws and subordinate legislation. In a well functioning market economy, firms are constantly on the lookout for new ideas in designing products and processes so as to reduce cost and better serve customers. A firm that comes up with an innovation obtains a temporary advantage and enhanced profitability for the time period that is taken by competitors to catch up. In Indian finance, the glacial pace of change has given out signals to financial firms that the rate of return on innovation is tiny. Approvals take years, so there is no question of obtaining a temporary elevation of profitability by innovation.

Frictions caused by taxes

We have earlier discussed the importance of having all types of markets, cash and derivatives, exchange traded and OTC, exist side by side, in order to allow customers to achieve their portfolio objectives at the minimum possible cost. One factor that makes this outcome difficult to achieve is the different tax treatment that is applied to different types of investments and transactions. Taxation plays an important role in determining returns generated by trading. The existence of a transaction tax reduces the incentive for day traders and speculators to provide valuable liquidity to the market. This difference may not be felt when the markets are doing well, and when the returns from trading are significantly higher than the friction imposed by transaction costs. However, liquidity tends to disappear when it is most desirable, that is, when markets go down. Investment behaviour is also affected by taxes. One of the side effects of having a low tax on Mutual Funds is that a significant portion of debt fund investments are made only to make use of the tax advantage. The same applies to small savings scheme, which attract a significant amount of savings.

PROPOSALS

To achieve the true economic benefits of markets, we need:

1. The availability of complete markets where agents are able to trade and hedge all the risks that they need to manage, and the existence of adequate liquidity (depth, resilience, and immediacy) in all these markets.
2. A regulatory structure that protects customers from fraud, but without imposing undue costs and without creating barriers to entry, innovation, and competition.

The reforms that would achieve the above objectives comprise of three broad elements:

1. Reforms within existing legal and institutional framework;
2. Capital account liberalization;
3. Merger of regulatory and supervisory functions for all organized financial trading into SEBI and strengthening the legal foundations of market regulation.
4. Implement Debt Management Office.

The first element consists of addressing the problems of missing markets and missing actors within the existing legal and institutional framework. This is low-hanging fruit that the government can implement relatively easily.

But the next two elements are essential to obtaining genuine progress. Capital account liberalization is important from the viewpoint of bringing in new kinds of players and new kinds of competition. Elsewhere in this report, we have commented on the fact that capital account restrictions do not work in practice. But they do drive liquidity away from organized financial markets. By placing restrictions on investment by foreigners in domestic securities, we force them away from the market and into other channels, thereby depriving the Indian financial markets from the opportunity to benefit from the participation of foreign firms.

Given the infirmities of financial firms in India, even if all problems of regulation were solved, there is likely to be a gap in liquidity and market efficiency. Foreign financial firms would play a valuable role in filling this gap. In addition, the entry of foreign financial firms into all markets would increase competitive pressure on Indian financial firms and markets. Indian households and Indian financial firms would be better served under convertibility, because they would have greater choice on the financial firms and financial markets that they choose to utilize. This competitive pressure would induce significant improvements on the part of Indian market institutions and Indian financial firms. The role of convertibility in increasing competitive pressure and fostering greater technological dynamism in finance is the same as the role played by trade reforms in the case of non-financial firms.

A key defect of financial markets lies in the separation between RBI, SEBI, and FMC. The Committee deliberated on this issue at length and emerged with two main conclusions: (*a*) there is a lot to be gained by unification of these functions; and (*b*) the right agency into which these functions

The Corporate Bond Market

The state of India's corporate bond market has been the subject of much discussion and analysis but little progress over the last 10 years. This is in contrast to the strong growth witnessed in the equity markets as well as the government secur-ities market. Starting in the late 1990s, RBI carried out a series of reforms in the government securities market. This included the following main elements:

1. creation of market makers in the form of specialized Primary Dealers of government securities, who were allowed to borrow in the inter-bank market to fund their government securities portfolios;
2. reforms intended to remove frictions in trading, such as removal of stamp duties and withholding taxes;
3. better trading, clearing and settlement infrastructure in the form of an online primary auction mechanism, a trade reporting system (NDS), an electronic order matching system (NDS–OM), the Clearing Corporation of India, and innovations like Collateralized Borrowing and Lending Obligations (CBLO).

These reforms occurred in the context of a secular decline in inflation and interest rates in the years following the 1997 Asian crisis, allowing traders in government debt to make significant trading profits, and encouraging the development of an active secondary market. Banks, insurance companies, and pension funds were large captive buyers of government debt, and the government's debt manager, RBI made use of this opportunity to reduce cost of borrowing, increase duration, and consolidate government debt into fewer but larger issues. Though significant challenges still remain, the government securities market is generally considered a success story.

In stark contrast, the corporate bond market remains practically non-existent. Most of the large issuers are quasi-government, including banks, public sector oil companies, or government sponsored financial institutions. Of the rest, a few known names dominate. There is very little high yield issuance, and spreads between sovereign debt, AAA debt and high yield debt are high in comparison to other markets. Very few papers trade on a regular basis. Trading in most papers dries up after the first few days of issuance, during which the larger players 'retail' the bonds they have picked up to smaller pension funds and cooperative banks. Most trading is between financial institutions.

often works out cheaper than issuing a bond. Add to this the issuance and compliance costs, and issuers do not find significant reasons to run a regular issuance programme.

5 Years Rates

Yields	US	India	China	Singapore	Korea	Japan
Gsec	4.92	7.62	1.89	2.52	5.23	1.52
AAA Bond	5.60	10.00	4.42	2.58	5.59	2.01
Spread	0.68	2.38	2.53	0.06	0.36	0.49

Source: 2007 CRISIL.

The reasons for the near-absence of a corporate bond market can be divided into constraints that limit the demand for the bonds, and constraints that limit the issuance of the bonds.

On the demand side, pension funds, who could be large buyers of corporate debt, are constrained by their prudential norms and conservative investment policies. Mutual Funds, and to a lesser extent insurance companies, are buyers of higher yield debt, but do not create enough demand for the market to grow.

Banks tend to prefer loans to bonds, because loans can be carried on the books without being marked to market, thus reducing the possibility of unexpected demands on bank capital. The internal organization of the bank also inhibits demand—corporate bond portfolios are managed by the treasury, while loans are managed by credit departments, creating barriers between the two forms of lending.

Foreign investors, who do not suffer from the same sources of risk aversion as Indian institutions, are allowed only to a very limited extent into the market (a total of US$ 3 billion). Given the very limited liquidity, they are not always eager to even take up the available quota.

Finally, the absence of a reliable system of resolving financial distress (see Chapter 7) must be a part of the explanation for why investors are reluctant to buy unsecured bonds (in contrast to lending secured debt), especially those of high risk firms.

Issuers do not have much reason to issue corporate bonds either. The high interest rates demanded by buyers, because bonds are illiquid and because bond holders are poorly protected in bankruptcy, means that bank debt is available at much more attractive terms. A syndicated loan

Also, until the recent credit crisis, larger corporate issuers had access to much cheaper funds in the offshore debt capital markets. Even after hedging their currency risks, the total cost of borrowing offshore is much lower than the cost of borrowing in the domestic market. This is reflected in the strong growth of External Commercial Borrowings (ECB) in recent years. While excessively easy credit conditions abroad must be part of the story, higher tolerance for risk on the part of foreign participants whose presence is limited in domestic corporate bond markets must also be part of the explanation.

The state of affairs in the corporate bond market is symptomatic of these deeper problems, and the attitude of regulators towards financial markets. Risk aversion of state-owned financial institutions, conflicts in policy objectives, unwillingness to let financial institutions manage their risks, all conspire together to keep the market in a stillborn state.

Among the recommendations that would help revive the corporate bond market are: (*i*) allow domestic financial institutions greater leeway to invest in corporate bonds; (*ii*) steadily raise the limit on foreign investment in corporate bonds; (*iii*) amend the bankruptcy code (Chapter 7) so that the rights of unsecured creditors are protected; (*iv*) reduce the transactions costs in issuing and trading corporate bonds, including repeated onerous disclosures (move instead to a shelf-registration scheme), as well as high stamp duties; (*v*) reduce the artificial preference of banks for loans by subjecting loans and bonds to similar mark-to-market requirements, especially for aspects such as interest rate exposure that are easily measured.

should be unified is SEBI. These changes will have their full impact on innovation only if we also rethink the legal foundations of financial market trading in India and move towards a more 'principles-based' approach. These issues are more fully discussed in Chapter 6.

Reforms within existing legal and institutional framework

We have to identify all situations where new products, new kinds of financial firms and new activities of financial firms are feasible under the existing legal and institutional framework. Permissions need to be given to enable such new activities to commence immediately. In addition, many other areas of incremental progress are feasible immediately. The 12 key areas for work, in the view of the Committee, are:

1. **Improvements in market design:** Many improvements in the market design are feasible within the existing legal and institutional framework. These include: (*i*) True auctions for primary market sale of securities, (*ii*) Reduction of the delay between the date of auction of a security and the date of trading, (*iii*) Unification of disclosure requirements for firms having multiple listed securities, (*iv*) Improved risk management at clearing corporations so as to do full cross-margining and portfolio margining, (*v*) The use of call auctions for the opening price and closing price on exchanges, and (*vi*) Removal of regulatory restrictions against algorithmic trading.
2. **Rapid and simplified product approval:** SEBI needs to establish a new approval process for new products as well as new methods of price discovery, clearing, and settlement. This approval process needs to be rapid, supportive of innovation, and keep the government out of issues of product design. The role of the regulator should be restricted to questions of systemic risk, fraud, contract enforcement, transparency and inappropriate sales practices. The task of designing products, markets and processes legitimately resides with the private sector. The uniquely Indian newspaper headline 'SEBI introduces long-dated options' needs to be replaced by 'Firm X introduces long-dated options', since a product launch is the task of a financial firm and not a government agency.[7]
3. **Professional markets with light regulation:** There is much merit in thinking of a three-tier world of financial markets, comprising 'public exchanges', 'professional exchanges', and the OTC market. Public exchanges would be exchanges such as NSE and BSE, where the full burden of regulation is applied because the general public participates in the market. Access to professional exchanges can be restricted on the basis of suitable criteria. For instance, a minimum transaction size of Rs. 10 million can be prescribed for professional exchanges so that the market is restricted only to professional investors doing large transactions. The criteria will have to be determined on the basis of the needs of the market being approved. Once this is done, the burden of regulation can ease considerably. Professional exchanges can thus be lightly regulated. They can be a hotbed of technological and product innovation.[8] Finally, there is the OTC market, which would involve bilateral transactions between economic agents. The presence of all three elements of the overall market would induce greater competitive pressure for all three elements.
4. **Domestic hedge funds:** Domestic hedge funds should be recognized and registered as a valuable addition to the landscape of financial firms. They would require a large minimum investment (e.g., Rs. 10 million) by any one customer; such customers have the wherewithal to judge the merits of the fund management activity by themselves. The role for SEBI would then be to ensure that hedge funds satisfy the trading and regulatory rules of the markets that they operate in, exactly as is required of all other market participants. The presence of hedge funds would induce greater competitive pressure for other regulated fund management channels such as mutual funds.
5. **Staffing of regulatory institutions:** The staffing and management of regulatory institutions needs to be considerably strengthened. Specifically, regulators should: (*i*) Acquire greater knowledge of modern financial products and markets; (*ii*) Offer greater clarity on what constitutes malpractice; (*iii*) Possess high quality investigation capabilities leading up to high quality drafting of legal orders. The regulator could also encourage a similar upgradation of skills and knowledge among market participants, including senior management.
6. **Uniform accounting treatment:** Regulations that give banks a bias to lend through loans as opposed to investing in corporate bonds need to be modified to have a level playing field. Similarly, regulations that give banks and insurance companies a bias to use OTC derivatives instead of exchange-traded derivatives need to be modified to have a level playing field.
7. **Securities transaction tax:** The incidence of the securities transactions tax falls upon trading strategies that require

more trading. While the quest of financial sector policy is to have low transactions costs, this tax directly increases transactions costs. To the extent that Indian financial markets face global competition (e.g., Infosys ADRs trading in the US) or aspire to achieving global customers (e.g., currency futures trading in Mumbai), the securities transaction tax puts India at a competitive disadvantage. There is a need to phase out this tax, or reduce it to token levels.

8. **Remove segmentation within exchanges:** NSE and BSE suffer from increased costs and operational overheads owing to 'segmentation'. As an example, the equity spot market is one 'segment' and the equity derivatives market is another 'segment'. Financial firms have to obtain separate memberships in each segment and suffer from a duplication of compliance costs. This separation reduces the ability of a clearing corporation to know the full position of a financial firm or its customer, and do correct portfolio risk calculations. This segmentation constitutes yet another silo system, *within* exchanges. There are no benefits from such segmentation, and there are many negative implications. The Committee feels there is much merit in ending this silo system within exchanges, so as to have only one concept of a member of an exchange, who then obtains a trading screen and is able to trade in all products. To the extent that some participants are not deemed sophisticated enough for certain activities (unlikely for an exchange member), their access rights can be restricted, but this should be by exception rather than as a default.
9. **Restrictions on participation:** The architecture of trading with SEBI-regulated exchanges is conducive to free entry for financial firms and free entry for participants. As an example, currency and interest rate derivatives could become immediately accessible to all financial firms and all market participants (e.g., FIIs) by bringing them into the existing policy framework of SEBI-regulated exchanges. In addition, the same strategy can be used with corporate bonds and credit derivatives for the same effect.
10. **Fiduciary responsibility based on investment objectives:** Institutional investors in India are often forced to buy government bonds. This 'financial repression' needs to be eased, thus making space for such institutional investors to play a more effective role in other financial markets. Prudential norms should be based on the basis of fiduciary responsibility to meet the investment objectives of the fund being managed. The regulator should be silent on what investments are allowed, and instead focus on how the fiduciary responsibility is being applied. Regulators have the right to question when things go wrong, not on the basis of outcomes, but on the basis of whether those investments were consistent with ones a prudent investor would have bought.

    Effectively, such a principle would move the test of reasonable investment strategy from whether the investments performed or not, to whether it was reasonable to think they would perform. Such a move need not occur overnight. Investment restrictions could be progressively lightened, while 'safe harbours' that meet the fiduciary principles could be developed so that risk-averse investment managers would be sure what investments would definitely meet regulatory approval.
11. **Currency derivatives:** Exchange-traded currency derivatives including futures, options and swaps, on all currencies, should be permitted. While capital controls inhibit settlement in foreign currency, rupee cash-settled derivatives are feasible immediately. These can trade alongside equity derivatives on NSE and BSE. In doing this, it is important to avoid special rules which inhibit participation of banks, NRIs, FIIs, and to avoid forced segmentation of the market where large positions on the exchange-traded market are prohibited in order to avoid competitive pressure against the OTC market.
12. **Interest rate derivatives:** Exchange-traded interest rate derivatives using both cash settlement and physical settlement should be permitted. These can trade alongside equity derivatives on NSE and BSE. Exchanges should have the freedom to structure products according to market needs. The issue of removal of 'segments' of exchanges becomes particularly important with interest rate derivatives. The BCD Nexus requires full integration between interest rate derivatives and currency derivatives on one hand, and between interest rate derivatives and corporate bonds and credit

derivatives on the other hand. If efforts are made on setting up a 'silo' structure that limits arbitrage, then the fully integrated BCD Nexus cannot come about.

Use capital account liberalization to deepen markets

In this subsection, we address specific areas of capital account liberalization that would directly impact on liquidity and market efficiency of Indian financial markets. Larger issues of capital account liberalization, their consequences for Indian finance as a whole, and the inter-linkages for macroeconomic policy, are addressed in the chapter on macroeconomics.

Capital account restrictions interfere with markets in two broad ways. When foreign players are not allowed to participate in the local markets, the expertise, risk bearing capacity, and capital they could bring to the market is lost. The volumes they contribute are also lost. Both factors reduce liquidity and efficiency. Indeed, this liquidity can be critical for kick starting a market. For instance, Indian investors have little experience with long-term corporate bonds, while foreign investors have this. The broader participation for foreign investors in that market could allow more attractive debt structures to emerge, greater liquidity, and eventually, more domestic participation also.

Quantitative restrictions presently inhibit FII participation in rupee-denominated government bonds, corporate bonds, debt-oriented mutual funds, and securities issued by asset reconstruction companies. These restrictions need to be eliminated, to place FII activities on these products and their derivatives on parity with FII transactions on equities and equity derivatives. For instance, as investment restrictions on domestic funds are reduced, freeing them from investing in government securities, foreign investors can take up the slack. This will allow domestic institutions like insurance companies and provident funds to benefit from higher returns (such as on equities) that they have been prohibited from accessing thus far.

Quantitative restrictions on domestic institutional investors currently limit their global diversification. As an example, all mutual funds (taken together) are permitted to invest no more than US$ 5 billion overseas. These quantitative restrictions need to be removed. Mutual fund schemes need to be designed to give customers the best risk/reward trade-off, which inevitably involves global diversification. As an example, an Indian institutional investor should have the full flexibility to buy an Infosys ADR in the US or to buy shares of Infosys in India, or IBM in the United States. Similarly, an Indian institutional investor should have the full flexibility to buy government bonds issued by governments all over the world, or to buy government bonds in India. These changes, which are analogous to removing barriers to imports, will improve the risk/reward characteristics obtained by their Indian customers, expose institutional investors and their customers to international practices and ideas, and increase competition faced by Indian financial markets. It will also set the stage for Indian institutional investors to *sell* financial products overseas. The removal of barriers to imports is an essential preamble to exporting.

While each individual in India is able to take US$ 200,000 out of the country per year, in practice, this is operationally cumbersome owing to restrictions that inhibit domestic and foreign financial firms from selling international financial products. These restrictions need to be eliminated. A customer of an Indian securities firm should be able to access unified screens where he is able to trade all financial products, all over the world. Conversely, an Indian individual should be able to become a customer of an international securities firm and obtain this same trading screen, with access to all global financial products (subject to this limit of a net outflow of US$ 200,000 per person per year). Foreign exchanges should be able to recruit members in India and place trading screens and Internet-based trading software in India, as long as the limit of US$ 200,000 per person per year of net outflow is adhered to. This would increase exposure for Indian customers and financial firms with global practices and ideas, and increase competitive pressure on Indian financial firms and markets. Foreign mutual funds should be able to raise money directly in India, and Indian mutual funds should be able to raise money overseas for investment in India, obtaining the same tax treatment as FIIs, without setting up a parallel apparatus or having to become FIIs.

As Chapter 2 suggests, these relaxations could also help India macroeconomically at the current juncture, by allowing outflows that keep the exchange rate from appreciating, and reduce the fiscal burden of reserve accumulation. These outflows will also create more room for foreign participation in Indian financial markets.

Modifications to legal framework and financial regulatory architecture

As discussed in Chapter 6 of this report, fragmentation of market supervision between multiple regulatory authorities increases transaction costs, creates frictions, and reduces liquidity in all markets. Market supervision is a specialized function, and it is not easy to get professionals who can detect insider trading, manipulation, and other abuses. Having multiple regulators makes it more difficult to staff these functions. Another argument for consolidation of regulators arises from the blurring of boundaries between different types of products. A futures contract on a commodity Exchange Traded Fund can become a proxy for commodity futures product. Financial engineering could create products that do not fall into any category and therefore escape regulation. A final reason for consolidation of market supervision under a single regulator is that there could be conflicts between market regulation and prudential supervision, and the structural bias of the regulator can potentially result in rules that favour one type of participant over another.

In view of the above reasons, the Committee believes that the merger of all market regulation into SEBI will reduce transaction costs and improve liquidity in financial markets. At present, regulation of different markets is covered under a large body of legislation. The Committee proposes the enactment of legislation that would bring all market regulations under a single roof, and ease the transition from a rule based approach to a principles-based approach to regulation. These issues are more carefully explored in Chapter 6.

While considering SEBI as a single market regulator, it is important to recognize that SEBI presently lacks the skill and sophistication to regulate new markets. It is beyond the scope of this chapter to present a detailed plan for institutional reform and strengthening of regulatory institutions including SEBI. However, we need to recognize the need for such reform, and start the process and recognize it as a prerequisite for moving all market regulation to SEBI.

Implement debt management office

At present, the 'investment banking' function for the government is performed by the RBI. In the past decade, a series of expert committees have commented on the undesirability of burdening RBI with the task of selling bonds for the government. This involves a conflict of interest, since the government would benefit from lower interest rates, which the RBI has some control over. Investors in the bond market may also perceive the sale of bonds by RBI to be informed by a sense of how interest rates will evolve in the future. Finally, the RBI is the regulator of banks. Banking supervision could be distorted by the desire to sell bonds at an attractive price.

Internationally, there has been a strong movement towards establishing independent debt management offices (DMOs) which sell bonds for the government. This is now considered best practice. Moreover, as rules that force financial firms to buy government bonds are relaxed, greater demands will be placed on the DMO, hence the need to move in an expedited fashion. The February 2007 Budget Speech had announced the creation of a DMO, and this now needs to be implemented.

CONCLUSION

We started this chapter by focusing on the role that markets for stocks, interest rates, currency, credit risk, and commodities play in driving economic growth. We discussed the need to take actions that improve the ability of markets to achieve better risk sharing and information signalling, to lower the cost of finance to households and companies, and to improve returns from savings. We then examined the current state of markets, the institutions that participate in these markets, and the quality of the regulatory framework in which they operate. We discussed the perception that markets behave like casinos, the distinction between price fluctuations and economic instability, and the dangers of government intervention in price formation. All these arguments were used to make the case for creating deep and well functioning markets in all financial asset classes and derivatives.

We also discussed the importance of lowering the cost of access to markets as a key objective of financial market reforms. Many of the long standing obstacles can be removed through the use of innovative technology. If the regulatory system is supportive of this effort, we will be able to handle very small ticket transactions, allowing people with very small savings, credit and insurance needs to participate in the market.

The second part of our analysis examined the sources of our difficulties, and traced these to a few key important elements, including banning of products and markets, rules impeding participation, inadequacies of financial firms because of constraints imposed on them, a silo model of regulation, and frictions caused by taxes. Each of these factors have to be analyzed in detail, and ways found to fix them. In this report, we have not gone into the minute details of recommendations. Instead, we have pointed out the large number of needed reforms that can easily be effected without requiring any significant changes in the legal and institutional framework. Of course, market reforms will have a significantly greater effects when we are also—prepared to take a fresh look at our macroeconomic and regulatory policies. These issues are considered elsewhere in this report.

NOTES

1. One well-known example which illustrates the issues at stake is the administered prices of petroleum products. The real economy would fare better in continually adjusting to small changes of prices which would result from a market process. The strategy adopted in India—of having constant prices for a period of time followed by a sudden large adjustment—actually induces greater instability in the economy.
2. The universe of large non-financial firms had total liabilities of Rs. 29 trillion in 2006–07. Of this, Rs. 8.1 trillion was borrowings. In the same year, large software companies had total liabilities of Rs. 944 billion. Of this, just Rs. 75 billion was borrowings.
3. This calculation uses the BSE Sensex from 1979 till 1990. Over this period, data for dividends is not available, thus understating the returns to an equity index. From 1990 onwards, the CMIE Cospi index is used, which includes dividends.
4. There are roughly 10 million depository accounts in the country. Assuming one account per family and assuming five individuals per family, direct ownership of equities does not exceed 50 million people.
5. Suppose a financial market offers bid/offer quotes of Rs. 99 and Rs. 101. In other words, a small buy transaction can be done at Rs. 101 and a small sell transaction can be done at Rs. 99. The 'ideal price' or the 'benchmark price' is defined as half-way between the bid and the offer. In this case, it is Rs. 100. Impact cost is defined as the extent to which a trade price diverged from the benchmark price. As an example, suppose a large buy order gets executed at Rs. 102. In this case, the impact cost is said to be 2 per cent, for this execution price was 2 per cent worse

than the benchmark price. In the electronic limit order book market, it is possible to have full transparency of the order book, and market participants can compute impact cost before an order is placed. In other methods of organizing markets, impact cost is generally known after the event but not before.

6. Susan Thomas. 2006. 'Resilience of liquidity in Indian securities markets,' *Economic and Political Weekly*, XLI(32): 3452–3454.
7. In one recent example of these lines not being drawn properly, a recent RBI report on interest rate futures specifies the time at which trading should start and stop each day.
8. Such a distinction was introduced by the Commodity Futures Modernisation Act of 2000 in the US, and made possible a proliferation of Internet-based trading platforms, particularly in the area of debt and currencies.

A Growth-Friendly Regulatory Framework

chapter 6

CURRENT REGULATORY FRAMEWORK

Sixteen years of reforms have created a fairly sound regulatory framework. There has been a convergence towards global best practices in areas like prudential regulation of the banking system, securities regulation, and insurance regulation. Substantial deregulation of interest rates, the shift from merit-based regulation to disclosure-based regulation of securities offerings, and the move towards de-tariffing of insurance products are significant steps towards the creation of a modern regulatory framework for the financial sector. Though the task is by no means complete, the groundwork that has been laid will allow us to move rapidly towards the regulatory architecture that is appropriate for a country of India's size and aspirations. While building on past successes, it is also important to remember there are deficiencies in the current regulatory system.

Low tolerance for innovation and excessive micro-management

A number of problems exemplify the substantial road that still has to be travelled in achieving an adequate financial regulatory and supervisory structure. First, the pace of innovation is very slow. Products that are sought to be introduced in India (though well established elsewhere in the world) take several years to see the light of day. The following examples illustrate the long delay from serious proposal by a potential innovator to actual successful launch:

- Index futures were proposed in early/mid-1990s and launched in 2000.
- Gold Exchange Traded Funds were proposed in 2002 and launched in 2007.
- Interest rate futures were proposed in 2003 (and there was also an abortive launch of an unviable variant) but have yet to be permitted in a viable form.

Second, attempts to exercise unduly strict control over the market and over financial institutions result in excessive regulatory micro-management, which leads to a counter-productive interaction between the regulator and the regulated. The regulated respond to the needs and opportunities in the market place while attempting to comply only with the letter of the law. The regulator then attempts to stamp out violations of the spirit through new rules and the regulated find new ways to get around them.

The Committee believes that low tolerance for innovation and excessive micro-management themselves stem from deeper rooted problems in the regulatory structure:

- Regulators often have unclear, sometimes mutually inconsistent, and infeasible objectives as in the case of the RBI's mandate regarding exchange rates, inflation, and growth. Objectives have not kept pace with changes in the economy.
- Regulators also suffer from conflicts of interest, some explicit (such as the one between monetary policy and management of the public debt, which is being resolved by separation of function) and some implicit, such as a widely perceived desire to protect certain kinds of institutions and certain forms of ownership.
- Regulated entities sense pervasive risk aversion on the part of the regulators, reflected in 'zero tolerance by the regulator for deviation from letter of law', and potential regulatory prohibition even if the activity is currently permitted by the letter

of the law. This could be partly due to the limited capacity, experience, and skills of regulatory staff. But it is also partly due to the atmosphere of distrust associated with vigilance processes in the government, and the open ended nature of parliamentary investigation into alleged or real regulatory lapses.
- Regulators confront immense heterogeneity in the entities they regulate, as well as in the investors and customers whom they protect. This heterogeneity is in terms of experience, capital, capabilities, as well as honesty. Regulators respond to this heterogeneity by targeting their regulations at the lowest common denominator.
- Frank communication between the regulator and the regulated could improve the regulatory environment, but all too frequently it is inadequate. The regulated have little incentive to be frank for fear it might elicit more micromanagement.
- Given difficult objectives, regulatory risk aversion, heterogenous regulated entities, as well as a legacy of command and control and substantial discretionary powers, regulators appear to protect themselves through a resistance to innovation, aversion to risk, as well as through micromanagement, even if the costs are obvious.[1]

The combination is a recipe for sometimes excessive, and excessively conservative, regulation, inhibiting innovation and growth. In some cases, the regulated have recourse to an appellate body (like the Securities Appellate Tribunal in the case of SEBI) and therefore regulatory excess can be publicly corrected. In other cases, regulatory overreach is neither identified nor corrected. With no mechanism for attenuating overreach, the constant fear of regulatory interventions distorts activity in the financial sector.

Regulatory gaps and overlaps

As may be seen from Figure 1 in a report by the World Bank, the current system involves half a dozen apex regulatory agencies, apart from several ministries in the government that retain direct regulatory powers. This structure leads to major regulatory overlaps and regulatory gaps.

Some examples of regulatory overlap include:

- Overlap between SEBI and MCA in the regulation of issuer companies.
- Overlap between SEBI and RBI in the regulation of foreign institutional investors as well as in exchange traded currency and interest rate products.
- Overlap between RBI and state governments in the regulation of cooperative banks.

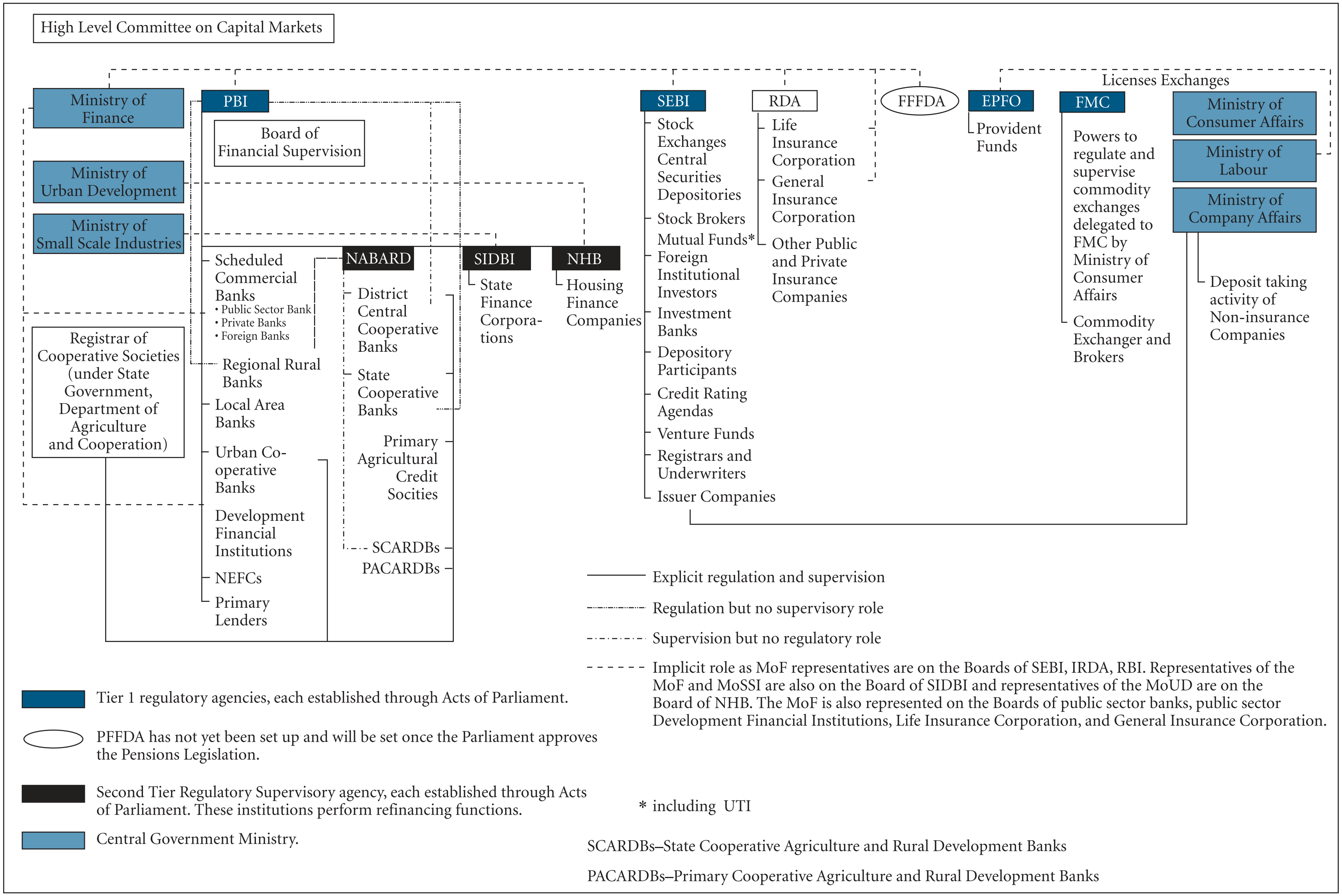
Some examples of regulatory gaps include:

- Absence of any mechanism for regulatory review of corporate accounting statements for compliance with disclosure requirements.
- The growing number of credit cooperative societies and MFIs involved in deposit taking or gathering, with little oversight.
- Absence of supervision of cross-market activities.
- Inadequate regulation of financial planners and advisors.

Sometimes the structure can also lead to regulatory arbitrage as similar financial services may be offered by institutions that come under different regulators and are therefore subject to different regulatory requirements. For example, investment linked insurance products include fund management services similar to that offered by mutual funds, but under completely different regulatory requirements regarding capital, expenses and disclosure. Competition is not bad if it eventually results in the right institution undertaking the activity. It becomes a problem when one institution has an advantage only because the other is excessively constrained by its regulator. With excess regulation in India, this is a real danger.

The overlapping regulatory structure also becomes a barrier to innovation as any new product might need approval from more than one regulator. In some cases, it is not even clear which regulator has primary jurisdiction over the product. While competition between regulators creates

Figure 1: Current Regulatory Architecture



space for innovation, as discussed above, competition with uncertain jurisdiction does not.

Balkanization and capture

Where jurisdiction is clear, regulators require activity to be carried out in separate subsidiaries of a financial conglomerate, each of which is separately regulated. This increases costs, reduces scope economies and makes it difficult to offer customers a one stop solution to their financial needs.

Another problem with the current regulatory structure is that it is much more vulnerable to regulatory capture because each regulator regulates only a narrow set of intermediaries. A narrow regulator is more easily persuaded to adopt regulations that shield its regulated entities from competition. A unified regulator is less vulnerable to this kind of capture because it faces countervailing pressure from different segments of the regulated.

Multiplicity of regulators creates severe problems in inter-agency coordination. Experience around the world suggests that this problem is very difficult to solve even with strong structural mechanisms for coordination. In India, these coordination mechanisms are also quite weak. Coordination problems are aggravated by the variation in skills and experience across regulators (sometimes related to novelty of area being regulated).

While the Committee will not propose India moves towards an integrated regulator and supervisor, it will suggest some new structures than can help improve coordination as well as eliminate regulatory gaps.

Lessons from the ongoing financial market turmoil

Any discussion of regulation has to take cognizance of the recent turmoil in financial markets in industrial countries. While it is too early to draw strong lessons, a number of issues seem apparent:

1. It is not sufficient for regulators to only look at the part of the system under their immediate purview. Because markets are integrated, any unregulated participant can infect markets and thus contaminate regulated sectors also. For instance, there is some evidence that unregulated mortgage brokers originated worse loans than regulated ones, contaminating the securitization process. While the immediate conclusion is not to regulate everyone to the same degree, it does suggest regulators have to be alert to entities that could have systemic consequences, including on markets.
2. Capital regulation is no substitute for ensuring the incentives of financial institution management are adequate—that the spirit of the regulation is being obeyed rather than just the rule. For example, the off-balance sheet entities of the major banks, including the structured investment vehicles (SIVs), met the rules of being off-balance sheet (and hence did not require a charge on capital), but in practice turned out to be effectively on-balance sheet. Indeed, there is increasing debate about whether the Basel II capital norms are adequate, both in good times in preventing excessive risk taking, and in bad times when strict capital norms can hold back bank lending and result in a downward spiral.
3. In a market-based system, banks are not the only source of illiquidity risk. Any entity that has mismatched assets and liabilities (mismatched in terms of duration or liquidity) is subject to the risk of becoming illiquid. To the extent that that entity is of systemic importance—either too big, too interlinked, or too many investors to fail—it will have a call on public funds. To the extent that regulators are likely to provide either liquidity or solvency support (and the line between these is very thin), they owe it to the public to monitor these entities and ensure the charge on the taxpayer is limited. Moreover, systems will have to be evolved to assess and maintain the overall liquidity position of the financial system, over and above its capital adequacy.
4. Deep markets with varied participants can absorb overall risk better. While indeed the risk that has infected world

markets started in the US sub-prime sector, in part because of excessive financial exuberance, despite its proximity and exposure the United States financial system has weathered the losses thus far surprisingly well. Indeed, US equity markets have held up better than the Indian stock markets! Part of the reason has to be its openness and variety. US banks could raise capital quickly by tapping into sovereign wealth funds elsewhere. Even while banks are hamstrung by overloaded balance sheets, hedge funds and private equity players are entering the markets for illiquid assets and establishing a bottom.

5. Consumer protection is important. Not every household is fully cognizant of the transactions they enter into. While the line between excessive paternalism and appropriate individual responsibility is always hard to draw, in a developing country like ours, it may well veer to a little more paternalism in interactions between financial firms and less-sophisticated households. It is important to improve consumer literacy, the transparency of products that are sold, and in some cases, limit sales of certain products in certain jurisdictions, especially if they have prudential consequences.
6. There is no perfect regulatory system. The problems with Northern Rock in the United Kingdom are being attributed to the fact that the United Kingdom had moved to a single supervisor, the Financial Services Authority (FSA), with the monetary authority having no supervisory powers. At the same time, the Bear Stearns debacle in the United States is being attributed to the absence of a single supervisor. What is essential is effective cooperation between all the concerned authorities, which transcends the specifics of organizational architecture.

In summary

In sum then, the Committee believes that there is no room for complacency. The imperatives of the need to grow the economy and improve inclusion will necessarily create more risk. The regulators cannot stand in the way, they have to monitor and manage the greater risk, and the public has to be more tolerant of regulators in that more losses are part and parcel of the greater risk. At the same time, we have to become more clever about managing the risks, focusing efforts better at warding off the really big ones, and making participants cooperate more in the process rather than making them adversaries. Furthermore, financial sector development can help the risk management process, both by reducing risks, and by shifting them to where they can be borne better, a theme through much of this report. This chapter therefore focuses on:

1. A better risk management process for regulators and the regulated, addressing both the environment in which they operate, as well as the way they tackle risks, while allowing the innovation needed to spur growth.
2. A more streamlined regulatory architecture that reduces regulatory costs, overlaps, silos, and gaps.
3. Better coordination between regulators so that systemic risks are recognized early and tackled in a coordinated way.
4. A coordinated process to protect consumer interests as well as raise literacy levels.
5. Strengthening procedures that reduce the level of financial risk—for example, through prompt corrective action.

TOWARDS THE SPIRIT RATHER THAN THE LETTER

A strength of the vibrant Indian financial market and its institutions is their ability to develop decentralized innovative solutions to India's vast problems. One-size-fits-all risk-averse micro-management by a regulator will deny the financial sector these very strengths. An analogy may be useful here. Think of the financial sector as water flowing downhill, that has to be channelled to irrigate the economy. It is best to allow water to find its natural course, rather than impose a centralized solution that fails to make best use of the topology. And when the regulator believes there is a better path, it is best for him to nudge the water slightly with gentle banks, using the water's natural propensities. Setting up roadblocks or dams will only ensure flooding and destruction, as the water finds disruptive ways around the block.

Principles vs. rules

These concerns would suggest a move from an exclusively 'rule-based' regulatory system to one with a greater share of 'principles-based' regulation. In the 'principles-based' system, entities would not be evaluated on their adherence to the letter of regulation. Instead, they would have far more latitude in making their business decisions, but would be held responsible by the regulator for the quality of their 'output', i.e. their fulfilment of certain pre-specified principles of sound and ethical business.

A regulatory system with greater emphasis on principles would avoid the centralized micro-management of the day-to-day operations of enterprises, increasing their efficiency and endowing them with greater nimbleness and agility to deal with a dynamic business landscape. It would help promote greater innovation in financial firms operating in India, an increasingly necessary feature for survival and success in the new world economy.

More focus on principles would also make better use of regulatory capacity. By shifting the onus of providing positive outcomes to the regulated, an emphasis on principles can generate a range of best practices from the regulated that would far outweigh the innovative capacity of the regulator. Indeed, its greatest benefits will come when the regulator learns from the regulated instead of imposing its own, more limited, views. Moreover, the time spent in 'box-checking' supervision and compliance, which eats up substantial capacity, can be devoted instead to understanding deviations that truly matter. Self regulation and confession by the regulated, a natural consequence of the shift in responsibility for regulatory outcomes to the regulated, would reduce the strains on regulatory capacity, and allow regulators to permit far more entry and growth in the system. As the relationship between the regulator and the regulated becomes more cooperative, efficiency and stability in the system will improve.

Concerns with a principles-based system

Can a 'principles-based' system work in India? Does it assume more capacity, trust, and probity among regulators and regulated than available in India? Is it a pipe-dream?

It should be understood that a 'principles-based' system is no magic solution. Indeed, it can have more rules written in than a rules-based system (see Box 1 on FSA). What is important is a change in mindset on the part of the regulator and the regulated. The principles based system offers a framework under which that change in mindset can take place, but it is no substitute.

It should also be recognized that 'rule-based' regulation is not merely reflective of the statute books of the nation, but is also reflective of the approach adopted by the regulator. A regulator that adopts a 'rule-based' approach pursues every minor breach of a rule, irrespective of its import in the larger scheme of things. This 'rule-based' mindset is further fuelled by the disinclination of the Indian regulator to admit that the accused may sometimes actually be innocent in principle. For example, SEBI very rarely, if at all, acquits a concern which has been issued a show cause notice, regardless of the severity of the violation. It may well be that the regulator's fear that an acquittal may result in a possible vigilance commission inquiry leads to this emphasis on the 'rule-based' approach.

By contrast, when adopting a 'principle-based' approach, a regulator may ignore a minor violation of positive law, so long as the spirit of the laws is retained.[2] It may therefore be better to term the 'principles-based' approach as an approach based on getting the regulated to adhere to the spirit of the regulation while a 'rules-based' approach is intent on the regulated obeying the letter of the regulation. Given the extensive outside use of the terms 'principles' and 'rules', we will however continue to use them.

'Principles-based' regulation is thus more than changing the statutes, the details of implementation matter. And there are indeed concerns with any implementation. Overly broad principles may not provide enough guidance to either the regulator or the regulated in terms of acceptable behaviour. The regulators' freedom to interpret broad rules may endow them with excessive powers and may lead to a fear psychosis among market participants. Ad-hoc application or disputed interpretation of principles may also lead to litigation, which, particularly given India's slow judicial process, may prove to be a major hindrance to efficiency. A more 'principles-based' system necessitates a certain level of trust between the regulators and the players and this can probably develop only with time as the regulated entities' perception of the regulators' fairness and even-handedness emerges, and as regulators develop a comfort level with the capabilities and probity of the regulated. Till such time, rules, or at least indicative quantitative norms, may provide safe harbours to which either party can resort to when in need.

Principles will also require adequate capacity on both sides. A low-level supervisor, accustomed to ticking boxes, is unlikely to suddenly have the ability to comprehend the overall risk management strategy of the regulated firm, or the confidence to sign off on it. Similar issues will apply to the regulated. Skills and capacity have to be built on both sides, and when coupled with experience and precedents, will result in the emergence of confidence.

This discussion suggests it would not be sensible to roll out such a system across the board. Indeed the entities that would most benefit from, and have the skills to manage, a principles based system, are large complex financial firms. And senior regulators who would deal with these firms have the authority to set precedents, have the experience to see the bigger picture, and can draw on the necessary skills to have a fruitful dialogue. We would thus advocate institutional change from the top, moving steadily down over time.

More generally, while a long-run switch to a more 'principles-based' regulatory approach is certainly the right prescription for a dynamic and increasingly market oriented economy like India, in view of these concerns, the transition must happen in a gradual and well-planned manner. Even as an end-objective, a more 'principles-based' regulatory regime does not mean the complete absence of rules. No system in the world is exclusively 'principles-based.'

The transition

Rule-based regulation starts from the statutes governing regulators and the financial sector (such as the Reserve Bank of India Act and the Banking Regulation Act) and the regulations specifying the regulator's powers and obligations under these statutes. For instance, the requirement that banks obtain regulatory approval for a range of routine business matters, including opening branches, remuneration to board members and even payment of fees to investment bankers managing equity capital offerings, is enshrined in the Banking Regulation Act. The obligations imposed on regulators under statute further leads them to frame regulations that are formulaic and result in micro-management of regulated entities.

The starting point for any transition therefore has to be with the legislation governing the regulators. This has to be re-written with clear objectives and regulatory principles outlined. However, this would have to be drafted carefully, as Indian courts are not likely to look upon excessive delegation favourably. The Supreme Court of India has held that the 'essential legislative function' cannot be delegated and a statutory delegate cannot be given an unguided or uncanalized power. It would be necessary for the draftsman to therefore formulate the

Box 1: The Financial Services Authority in the United Kingdom

The Financial Services Authority ('FSA'), the main statutory regulator for the UK, was set up on 20 May 1997. The Securities and Investment Board ('SIB') formally changed its name to the 'Financial Services Authority' in October 1997. By virtue of the Bank of England Act, 1998, the responsibility of banking supervision was transferred to the FSA, and through the Financial Services and Markets Act, 2000 ('FSM Act') the FSA took over the responsibilities of several other regulatory and self-regulating organizations. The FSA is financed by the financial services industry and regulates 29,000 firms ranging from global investment banks to very small businesses, and around 165,000 individuals.

The FSA formally gained its powers under the FSM Act on 1 December 2001. Additionally, the FSM Act also gave the FSA new responsibilities, e.g. taking action to prevent 'market abuse'. Since the FSM Act, Parliament has extended the responsibilities of the FSA to include mortgage lending and insurance broking. The members of the FSA board are appointed by the Treasury. The Board sets the overall policy of the FSA, but day-to-day decisions and management of the staff are the responsibility of the executive.

The regulatory objectives of the FSA are described as follows by the FSM Act: (*a*) market confidence; (*b*) public awareness; (*c*) the protection of consumers; and (*d*) the reduction of financial crime.

In discharging these functions, the FSA must have regard to certain principles, e.g. the principle that a burden or restriction which is imposed on a person, or on the carrying on of any activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

The FSA's general functions are: (*a*) making rules, (*b*) preparing and issuing codes, (*c*) giving general guidance, (*d*) determining the general policy and principles by reference to which it performs particular functions, (*e*) issuing statements/giving directions.

There are provisions in the FSM Act which regulate insurance, business transfer schemes, banking, the listing of securities, and 'market abuse'. The FSA may take disciplinary action against errant entities either by publishing a statement against the entity, or by imposing a penalty against the entity, or both.

'Principle-based regulation' means placing greater reliance on principles and outcome focused, high-level rules as a means to drive the regulatory aims that the FSA wants to achieve, as opposed to prescriptive rules. Under the risk-based approach adopted by the FSA, the FSA does not pursue every rule breach. Minor problems are usually resolved through the day-to-day relationships that the FSA has with regulated firms, without the need for any formal regulatory action to be taken. The FSA accordingly selects cases to investigate according to their seriousness and how they fit in with the FSA's priorities. This approach is underpinned by the principle that it is neither possible nor desirable to write a rule to cover every specific situation or need for decision that a regulated firm might encounter.

Over the last few years, the FSA has increasingly taken a principle-based approach. The FSA still relies heavily on a large number of detailed rules, and often specific process requirements. The FSA accepts that as an inevitable result of amalgamating the rulebooks of all its predecessor regulators, the FSA rulebook is a large document (which is popularly said to cover several bookshelves!).

'Principle-Based Regulation': The FSA Handbook lists the following as Principles For Businesses:

1. Integrity: A firm must conduct its business with integrity.
2. Skill, care and diligence: A firm must conduct its business with skill, care and diligence.
3. Management and control: A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial prudence: A firm must maintain adequate financial resources.
5. Market conduct: A firm must observe proper standards of market conduct.
6. Customers' interests: A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of interest: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers relationships of trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. Clients' assets: A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with regulators: A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

legislation as a binding rule of conduct. What should be left to the regulator is the ancillary function of providing the details. At the same time, it would have to be borne in mind that regulatory law is penal in nature, and vague penal law has been found by Indian courts to be void. Keeping this in mind, a 'principle-based' approach could be achieved by outlining principles which the regulator is to be governed by, in the statute itself. In the Indian context, these cannot be as broad as those of the FSA (see Box 1) but would probably have to contain further specificity.

In what follows, we attempt to sketch what 'principles-based' securities legislation might look like for a specific regulator, SEBI.

It is important to note that 'principle-based' regulation even in India would not be an entirely new phenomenon. SEBI, for example, has devised several codes of conduct (for instance, in insider trading law) which operate on principles rather than in an excessively rule-based manner.

We take as given our recommendation (see section 'Consolidation of all market regulation and supervision under SEBI') that all organized financial trading, spanning currencies, fixed income, equities, commodity futures, exotics (such as weather and decision markets), and spanning all trading venues and forms of trading should come under a single regulator, the SEBI.

In order to widen the ambit and functions of SEBI, the SEBI Act should be amended by the insertion of chapters which confer upon it the powers of other regulators to the extent that such other regulators regulate trading. Each of the amendment acts would concurrently repeal the statute governing the regulator sought to be integrated, or divest the regulator of some of these powers, and would either itself contain provisions for integration of personnel etc., of such other regulators or leave such matters to a statutory delegate.

SEBI's mandate should be devised at the level of principles, starting at the broadest level with overall objectives such as stability. At one level, this means that in devising the statutes, to the extent possible details about products/securities, players, institutions, market platforms and market mechanisms must be left out of the legislation, to be filled in dynamically by the regulator.

More specifically:

- Repeal the Securities Contracts (Regulation) Act, 1956; the RBI (Amendment) Act, 2006; and the Forward Contracts (Regulation) Act, 1952;
- Through a permissive, enabling framework, all organized financial trading must be brought within the ambit of SEBI. For this purpose, Section 412 of the United Kingdom's Financial Services Modernization Act is instructive, as it permits a statutory delegate to specify contracts that are exempt from wagering restrictions (and thus come under the ambit of securities trading and regulation). For our purposes, this may be better achieved through a negative, rather than a positive, list;
- The regulator must recognize that traditional trading venues can be transformed, with trading taking place in venues ranging from existing public exchanges such as the NSE and BSE (requiring full investor protection norms) to innovative Internet-based trading platforms for Qualified Institutional Buyers (the professional exchanges discussed in Chapter 5) and the Over The Counter markets, where required investor protection may be different. In order to facilitate innovation in trading platforms in the future, details about trading mechanisms should not be written into the legislation.

The transition to a more 'principles-based' regulatory system is a multi-dimensional and complex process. It is possible to be so overwhelmed by the task that one never starts. The status quo should be seen as an unacceptable drag on India's growth, which is why we must not delay. The next few sections will outline a number of other changes, which undertaken carefully, will take us to our goal. These include changing the incentive structure and talent pool in the regulator so that the regulatory mindset can change, as well as changes in the oversight process over the regulator so that regulatory powers do not go unchecked. It also includes changes in the structure of the regulatory architecture so that silos are broken down and gaps are reduced.

IMPROVING THE QUALITY OF THE REGULATOR

A move towards principles will require capable, motivated, regulators, who have the vision to focus on important essentials rather than on bureaucratic box-checking. Clearly, there are such regulators to be found in our system, but how do we ensure they are the norm?

Incentives

The quality of regulatory output is influenced by the overall environment in which the regulator operates, the consequent incentives they face, and the performance standards they are held to. In fact, the perceived inadequacies in the quality of regulatory output may have more to do with incentives and environment than with fundamental deficiencies in the quality of talent that regulators attract (though this is not always inconsequential).

Regulators at the highest level constantly run the risk of having to face roving enquiries that second guess specific decisions with the benefit of hindsight. As long as this risk is not eliminated, the response of regulators to the need for innovation and proactive behaviour will not change. The starting point for protecting regulators from open ended demands is a clear written directive from the government, acting in pursuance of the legislative mandate, specifying with the maximum possible clarity the principles the regulator will be held accountable for. Existing law has provisions that enable government authorities to do so. The fact that these provisions have not been used so far is sometimes held out as an example of the maturity of the actors involved. More likely, this is probably a reflection of inadequacy. We now specify how such a directive could be developed.

Accountability

An independent regulator can be held accountable only through a process of independent evaluation, given pre-specified objectives or principles. This Committee recommends that all financial regulators should be subject to a periodic external evaluation. In a parliamentary system of government, the ultimate locus of accountability is the parliament. Therefore, all financial regulators should be accountable to a standing Committee of parliament (possibly, the Standing Committee on Finance).

- Once in five years, a body of reputed outside experts (including possibly regulators elsewhere) would be constituted to propose guidelines for the evaluation of the regulator for the next five years, given the legislative mandate.
- Based on the report of experts, the government, in consultation with the Parliamentary Committee and the regulator, would finalize the specific principles (the 'remit') the regulator would be held accountable for, including any parameters for annual evaluation.
- The regulator would submit an annual report to parliament (this does happen currently for many regulators). This report would include the progress on pre-agreed evaluation parameters and would be discussed in the parliamentary Committee.
- The parliamentary Committee would be guided by the remit in its discussions with the regulator.
- The annual report, the statement of the regulator to the Committee, and a transcript of the Committee discussions with the regulator should be made widely accessible to the public.

Appellate tribunal

Checks on regulatory excess are necessary for any regulator but they are even more important for 'principles-based' regulators because of the greater discretionary powers that they enjoy.

This Committee recommends that there should be an appellate tribunal for all major regulators including the RBI. This should be a single tribunal which might through its own rules and processes create benches specializing in different aspects of financial regulation. The Securities Appellate Tribunal (SAT) that hears appeals from SEBI has served a very useful purpose and the proposed Financial Sector Appellate Tribunal should have similar scope, powers and processes and should subsume SAT.

Staffing

Of all the staffing decisions relating to the regulators, the most important is the choice of the head of the body. As at present, the respective statutes provide that the heads of these bodies are to be appointed by the government. The credibility of the selection process could be greatly enhanced by stipulating that selection Committees, with credible expert participation (including from the private sector), should prepare a short list from which the final selection can be made by the government.

The selection Committee should also recommend the remuneration package that should be provided; the statutory protection against variation of the conditions during the term of office should continue. Government should offer this recommended package as a matter of course.

With a competent and respected individual of proven integrity at the head of a regulator, substantial freedom would have to be provided to this person to choose the best possible individuals for key positions, offering them terms that are in line with the market. The recent proposals by the 6th Pay Commission for hiking compensation for top regulators are a step in the right direction. The pay of the head regulator, while substantial, should not, however, become a ceiling for pay among regulators. It should be possible to carve out key positions in respect of which the terms and conditions of employment are left to be decided by the head of the organization, or a Committee of senior officials. A staffing and remuneration sub-Committee of the regulator's board should provide the necessary guidance in this regard. This would enable the induction of talented young employees, and also provide for lateral entry at all levels. Every effort should be made to allow mobility to and from the private sector, though each individual organization would have to take reasonable precautions against conflicts of interest arising out of prior or subsequent employment.

With a restructuring of the staffing process in the manner described above, processes relating to performance measurement, accountability, training, and human capital enhancement can be redesigned.

To summarize, low compensation is often seen as the main impediment in improving the quality of regulators. While compensation is an important factor in attracting the right talent, it is not the only, or even critical, factor. Key positions in the regulators would be attractive for very talented individuals, given the great satisfaction that would undoubtedly accrue from shaping public policy and taking decisions of tremendous import, as also the value placed by the market on such experience. It is thus important to structure responsibility and mobility appropriately. Experience also indicates that, to the limited extent to which regulators have been able to break out of rigid staff and pay structures, there has been no real difficulty in attracting the talent required, at least no more than in other professions in India.

STREAMLINING THE REGULATORY ARCHITECTURE

Should India move towards a single regulator and prudential supervisor?

As the boundaries between financial activities blur, it makes sense for the boundaries between regulators to blur, and eventually, for supervision of financial services to be consolidated. Eventual consolidation will reduce overlaps, costs, eliminate gaps in supervision, and improve regulatory and supervisory coordination. It will allow the unified supervisor to take an overall view of risks, including risk concentration and risk transfer, across different kinds of institutions. The unified supervisor will be better able to handle large complex financial institutions. And an integrated regulator will probably offer 'one-stop-shopping', which will speed up innovation, as well as ensure consistency in regulation and supervision across institutions.

An integrated regulator is not an unmitigated blessing. An integrated regulator may have conflicts between objectives. Moreover, there may be a need for a difference in emphasis in different situations—in the case of insurance and banking on prudential supervision, while in the case of markets on business conduct and integrity. Such differences may not sit well within an integrated regulator. Furthermore, since a unified regulator is likely to be formed by the merging of existing agencies, it may result in a mammoth bureaucracy that, while on paper a single entity, is likely to experience the same divisions that characterize the existing set of regulators. The older and more established regulators may dominate and overrule fledgling ones within the integrated whole, to the detriment of the overall system. This, coupled with regulatory monopoly, could potentially negate the possible sensitivity of a unified regulator to the needs and changing realities of the market and its participants. Finally, there may be a public perception that the integrated regulator will bear equal responsibility for all supervised institutions, extending the safety net enjoyed by depository institutions more widely, with ensuing moral hazard.

As the chart below shows, countries are fairly evenly distributed across regulatory architectures. On balance, the Committee feels it is premature to move fully towards a *single* regulator at the moment, given other pressing regulatory changes are needed. However, regulatory structures can be streamlined to avoid regulatory inconsistencies, gaps, overlap, and arbitrage. Steps in this direction should include a reduction in the number of regulators, defining their jurisdiction in terms of functions rather than the forms of the players, and ensuring a level playing field by making all players performing a function report to the same regulator regardless of their size or ownership. In addition, the Committee feels it is prudent to start the process of unifying regulation and supervision at certain levels, and will recommend a strengthening and consolidation of regulatory structures to deal with large complex, systemically important, financial conglomerates on the one hand, and with the consumer on the other.

Consolidation of all market regulation and supervision under SEBI

At present, in India, the regulation of organized financial trading is spread between three agencies: RBI (government bonds and

A Snapshot of International Regulatory Architectures

Unified regulators		*Partly-unified regulators*			*Institutional regulators*	
Unified model (separate from central bank)	*Unified model (within central bank)*	*Banking and securities*	*Banking and insurance*	*All non-banks*	*At least one for banks, securities firms and insurers*	
1. Austria 2. Denmark 3. Estonia 4. Germany 5. Gibraltar 6. Hungary 7. Iceland 8. Japan 9. Latvia 10. Nicaragua 11. Norway 12. S. Korea 13. Sweden 14. UK	15. Bahrain* 16. Bermuda* 17. Cayman Islands* 18. Ireland* 19. Kazakhstan* 20. Malawi* 21. Maldives* 22. Malta* 23. Singapore* 24. UAE* 25. Uruguay*	26. Finland 27. Luxembourg 28. Mexico 29. Switzerland	30. Australia 31. Belgium 32. Canada 33. Colombia 34. Ecuador 35. EI Salvador 36. Guatemala 37. Malaysia* 38. Peru 39. Venezuela 40. Netherlands 41. Trinidad & Tobago	42. Bolivia 43. Bulgaria* 44. Chile 45. Jamaica* 46. Mauritius* 47. Slovakia* 48. South Africa* 49. Ukraine* 50. Namibia	51. Albania* 52. Argentina* 53. Bahamas* 54. Barbados* 55. Botswana* 56. Brazil* 57. China 58. Croatia* 59. Cyprus* 60. Dominican Republic* 61. Egypt* 62. France 63. Greece*	64. Hong Kong* 65. India* 66. Indonesia* 67. Israel* 68. Italy* 69. Jordan* 70. Lithuania* 71. New Zealand* 72. Panama 73. Philippines* 74. Poland* 75. Portugal* 76. Russia* 77. Slovenia* 78. Sri Lanka* 79. Spain* 80. Thailand* 81. Tunisia* 82. Turkey 83. Uganda* 84. USA*
As per cent of all countries in sample						
30%		5%	12%	10%	43%	

Source: How Countries Supervise their Banks, Insurers, and Securities Markets, 2004, London, Freshfields.

Note: * Indicates that banking supervision is conducted by the central bank.

currencies), SEBI (equities and corporate bonds) and FMC (commodities, futures). This unusual framework is the product of historical legacy and is suboptimal. It induces three kinds of problems:

1. It induces a loss of economies of scope and economies of scale for the government, exchanges, financial firms, and customers. There are strong commonalities between all kinds of trading—an electronic order-matching system for currencies or index futures or gold futures or interest rate swaps is largely the same. Government, exchanges and financial firms would be able to harness economies of scale and economies of scope by undertaking, or dealing, with all organized financial trading under a single roof.
2. It fragments liquidity, and encourages regulatory gaming. Arbitrage tightly binds all financial securities related to a given underlying asset. For example, exchange-traded Nifty futures are strongly linked to OTC derivatives based on Nifty. It is best that all channels for trade be open, so that traders seek the best one, and that the regulatory regime not impose differential costs. However, at present, OTC trading is either banned (e.g., equity) or dealt within a fragmented way (OTC trading on interest rate derivatives is supervised by RBI while exchange-traded interest rate derivatives are supervised by SEBI). Fragmentation creates all sorts of gaming opportunities for participants, as well as turf issues among regulators in favouring one or other venue for the firms they regulate, that leads to a loss of liquidity, price efficiency, and even stability.
3. Loss of competitive pressure. At present, Indian markets are carved into three silos, each regulated (and protected) by a separate regulator. An exchange or a clearing corporation or a depository working in one silo is prohibited from competing with entities in other silos. India's interests would be served far better if all these entities were in a unified industry with vigorous competition and innovation.

The Committee was persuaded by the importance of these three considerations to recommend unification of all regulatory and supervisory functions connected with organized financial trading into a single agency. This would include equities, corporate debt, government bonds, currencies, commodities, and other kinds of products. This would include both spot contracts and derivatives, exchange-traded and OTC products.

SEBI is ideally suited for filling these roles for several reasons. First, the equity market (both spot and derivatives) is India's most sophisticated and most liquid market; hence, SEBI's knowledge is rooted in the strongest market. Second, the legal foundations of SEBI are relatively recent, and it is less subject to legacy issues. Finally, the vigorous pace at which the SEBI Act and SC(R)A have been amended in the last decade—in response to the requirements of the equity market—have helped position SEBI to take on new challenges.

Note that in some markets, such as the government debt market or the currency futures market, some coordination will be required between SEBI and other regulators that have an interest in the market. For example, the RBI may have an ongoing legitimate interest in determining who participates in these markets—it might continue to determine who the Primary Dealers would be in the government securities market. Similarly, it may have an ability to influence participation (by altering bank SLR requirements for example). While the logic of SEBI regulation of trading is clear (and this will help the RBI by reducing the conflicts of interest created when it both trades in, as well as regulates trading in, markets), it is imperative that the regulators work out respective responsibilities so that the functioning of the markets is not impeded.[3]

Simultaneously with the merger of regulation and supervision of organized financial trading at SEBI, a clear effort needs to be undertaken to limit the role to regulation and supervision, while distancing other services from the regulator. This is similar to the clarification of the role of the regulator in (say) telecom, where TRAI is the regulator, and erstwhile government service functions have been corporatized in MTNL, VSNL and BSNL. Applying this principle, the bond market depository within RBI (SGL) will need to be corporatized. It would then compete with NSDL and CDSL as a third depository. Similarly, the bond exchange (NDS) will need to be corporatized. It would then compete with other exchanges in the country. The CCIL and its exchange subsidiary would be brought under SEBI regulation as an exchange.

Once unification is achieved; full competition should prevail between the pool of exchanges, clearing corporations and depositories. Low entry barriers should ensure that new players can enter in each of these areas, including innovative professional exchanges which target sophisticated or institutional customers, and foreign exchanges. The goal should be to achieve securities infrastructure which has world class economies of scale, world class efficiency and low prices, and a world class pace of innovation.

The Committee further recommends that the unification of trading under one regulator be further accompanied by steps to break down unnecessary barriers that prevent trading across exchanges or products. All kinds of financial products should be represented in unified exchange screens, and a firm with multiple exchange memberships should be able to trade them seamlessly. Finally, the SEBI has been dealing with exchanges as self regulatory organizations (SROs). The exchanges therefore assist SEBI in regulatory matters that pertain to their activities. There is, however, a need for a regulatory structure to assist SEBI in supervising cross-exchange activity, which will increasingly become more important. Greater integration of market regulation under SEBI will create the conditions to set up such a structure.

Consolidation of all deposit-taking entities under one banking supervisor

All banks and any other deposit taking entities should come under one supervisor as suggested by the Narasimham Committee Report on Banking Sector Reforms.

The RBI has historically been reluctant to take on the full responsibility for supervising cooperative banks and state governments have also been reluctant to give responsibility up. This is a potentially dangerous situation where no one really bears full responsibility for problems that might emerge. The recent trend towards memoranda of understanding (MOU) between state governments and the RBI to revitalize urban cooperatives while strengthening the powers of the RBI, is welcome. But given increasing competition and the wider powers that are proposed for banks, cooperative banks, whose managerial/administrative matters are currently partly under the State Registrar of Cooperative Societies, should be treated like commercial banks and brought completely under the banking supervisor over time. This will simply be a logical extension of the path currently being travelled with the MOUs.

This would require a considerable increase in central regulatory capacity, as well as political enterprise, but the alternative is to allow dangerous regulatory gaps to build. As this Committee repeatedly stresses, inadequacy of regulatory capacity cannot be acceptable as a long-term constraint on the financial system.

There is no point having a consolidated supervisor if that supervisor is weak. In addition to consolidating supervision, the system of prompt corrective action and resolution of weak banks should be strengthened and made more explicit, possibly under a revamped consolidated deposit insurer. It should be recognized that the continued existence of weak banks without resolution spreads weakness to the rest of the system, is a potential source of instability, and increases the regulator's reluctance to permit new entry.

Consolidation of monetary policy and banking supervision

The Committee considered carefully the question of whether responsibility for monetary policy and banking regulation and supervision should be separated, or consolidated under one roof. The arguments in favour of separation are strong. Any regulator tends to have sympathies for the entity it regulates, and not just because it has responsibility for the well-being of those entities. Monetary policy could be conducted with the intent of restoring the health of banks (as was arguably the case with Bank of Japan and Federal Reserve policy in the 1990s) to the detriment of inflation and growth objectives for the larger economy (in which bank health is just one, albeit important, component). Similarly, in an economy with fledgling markets, the incentive for the monetary authorities to intervene in markets so as to preserve the value of securities bought by banks can retard the growth of those markets and impair fair and transparent pricing, as well as information discovery.

In a financial sector dominated by banks, conflicts of interest may also go in the other direction. In order to achieve its monetary policy objectives, the central bank may use tools other than the short term interest rate, such as the Cash Reserve Ratio. Regardless of the debatable efficacy of such tools in achieving monetary policy goals, the problem is they have an asymmetric effect on institutions, affecting banks while leaving others like finance companies untouched. This is to be avoided for it tilts the playing field, giving undue advantage to some, creating competitive uncertainty, and inefficient allocation of resources. The use of prudential and supervisory tools to meet monetary policy objectives also reduces their effectiveness in enhancing stability, and their signalling value.

These concerns have to be set against the benefits of consolidation. The ability of the monetary authority to have intimate knowledge of the condition of banks can help it conduct monetary policy better, especially in times of distress when banks may be less effective conduits for transmission. And there may be occasions when the larger interests of the economy are served by using liquidity infusion and interest policy to help the banking system. A monetary authority with deep knowledge of the banking system will be best placed to undertake such intervention. There are also significant scope economies in the information needed for the conduct of monetary policy and for assessing bank health.

The international experience offers little guidance as to what might be best. The Bank of England does not supervise domestic banks, and neither does the Bank of Japan, but the Federal Reserve does supervise large bank holding companies. The European Central Bank does not supervise banks directly, but the heads of member central banks, which have regulatory and supervisory functions, sit on its monetary policy committee.

As with any issues to do with organizational structure, outcomes depend heavily on practice. Separation of powers can work well if the monetary authority and the regulatory & supervisory authority have clear responsibilities and strong channels of communication. Consolidation can work well if the monetary authority is transparent about its objectives and is sparing in its use of instruments other than the interest rate to achieve them.

In the final analysis, the Committee believes the move towards separation may be premature today, especially keeping in mind there are strong arguments to be made on both sides of the debate, as listed above. The rationale is as follows. First, the record of cooperation between regulators is mixed at best. Before separating functions, it would be sensible to make sure that we have a better understanding of what it will take to ensure seamless cooperation—it would be a recipe for systemic catastrophe if the monetary authority does not communicate with the banking supervisor. Second, we believe that important changes are warranted both in the monetary policy setting function (as outlined in Chapter 2) and in banking regulation and supervision. These changes are more pressing. Of course, one could argue that it is best to make all changes at once. The majority of the Committee believes that the area of banking supervision is probably one where changes should be measured rather than revolutionary, for the downside risks of turmoil here could be extremely detrimental to the economy.

Ultimately, as barriers between financial activities fall, India should move towards one consolidated prudential regulator and supervisor. Given this entity will be concerned with more institutions than only banks, it should be distinct from the monetary authority, but should cooperate closely with it. Thus separation of monetary policy and supervisory authority should likely emerge in the medium term.

Bring all financial intermediaries governed by special statutes under general statutes

Several of the key financial services intermediaries including SBI and its Associate Banks, Public Sector Banks, LIC, GIC, etc., are governed by their own statutes such as the SBI Act, the SBI (Subsidiary Banks) Act, the two Bank Nationalization Acts, the LIC Act and the GIC Act. These special statutes should be repealed, and statutory corporations should be corporatized or formed under the general statutes governing form of business enterprise (such as the Companies Act, 1956 or the proposed LLP law under consideration) and placed on a level playing field with all other financial services intermediaries (that are formed or organized under such general statutes governing form of business enterprise). The precedent exists for IFCI, UTI and IDBI, which previously operated under special statutes.

Consolidate regulation of pensions

While pension regulation is still in its formative stages, the aim should be to have a consolidated regulator for the industry.

Streamline tier 2 regulators

India has a number of regulators who are at a second tier, such as NABARD, SIDBI, and NHB. For example NABARD supervises Regional Rural Banks, as well as the state cooperative bank network (a shared responsibility with the state Registrar of Cooperative Societies). In addition, though, it plays a role in refinancing some of these organizations. Dual roles of this kind typically create conflicts of interest that impair effective regulation. The Committee would advocate focusing these bodies over time on the purely regulatory function (and consolidating these regulatory activities where possible with the single regulator for the function), and separating the refinancing and other commercial functions into a different body. Over time, markets should take up the commercial functions.

An improved system of audit for listed and unlisted companies

In India, annual accounts filed with the Registrar of Companies under the Department of Company Affairs in the Government of India. However there is no system of reviewing accounting reports even on a selective or sample basis. By contrast, in the USA, the Securities and Exchange Commission (SEC) has a division comprising hundreds of lawyers and accountants to review such annual reports and if necessary, seek clarifications from the companies in question.

The Committee believes that such a process of review is absolutely essential. To ensure that this does not add to red-tape, such review should not lead to any certification or clearance for the companies concerned. The reviews may be selective to begin with (perhaps starting with large listed companies) and the companies should be allowed to clarify questions. However if and when evidence of financial fraud is revealed, it should lead to penal actions against the offending companies. Given the additional regulatory capacity and personnel necessary to implement this, it may be desirable initially to have the review partially or fully outsourced to accounting or legal firms.

The Committee believes the responsibility for this oversight for unlisted companies should be with the Ministry of Corporate Affairs (MCA) because the statutory powers in respect of accounting statements under the Companies Act vests with the MCA. For listed companies, the Committee recommends vesting the review with the SEBI, which in any case reviews disclosure by companies when they issue securities.

In line with the Committee's general view that information technology can and should be leveraged to solve several problems in the financial sector, the Committee also recommends consideration of adoption of a standards-based way of communicating business and financial information to facilitate the regulatory review process. XBRL (Extensible Business Reporting Language) that has been adopted in several countries is one such platform. Use of such a format in the annual online filings of companies to MCA is likely to facilitate the review process considerably.

Oversight of audit firms is another area that needs significant improvement in India. Currently the auditors are largely governed by the Institute for Chartered Accountant of India (ICAI). An independent and credible body to oversee the audit industry—like the non-profit Public Company Accounting Oversight Board (PCAOB) introduced in the United States by the Sarbanes Oxley Act—would go a long way in enforcing high auditing standards and creating credibility in the corporate financial reports. Such a body could be set up by the authority regulating the accuracy of company accounts, and its members appointed by the SEBI Board in consultation with MCA. The Accounting Oversight Board should have a variety of functions, including moving towards international audit standards, verifying standards of transparency and governance of audits at public firms, and sustaining the capabilities of auditors at high levels. Care should be taken that appropriate powers move from ICAI to PCAOB so that there is no overlap in functions.

CONSOLIDATING REGULATION

As financial conglomerates begin to dominate the system, a consolidated system of supervision becomes more important. Moreover, spillovers between various aspects of the financial system necessitate constant communication between regulators at the highest levels. Even though our Committee recommends separate prudential regulators, it strongly recommends strengthening the ties between them and improving coordination, especially given the potential systemic consequences of regulatory gaps and unregulated entities on the financial system.

The Committee also notes the consumer faces an integrated portfolio of services. It is increasingly important for the consumer to have a 'one stop' source of redress for complaints. An integrated ombudsman for consumer issues may also be important for dealing with aspects like financial literacy and financial counselling that span regulators.

Current situation

The High Level Coordination Committee on Capital Markets (HLCC) was constituted by the Ministry of Finance to resolve any important regulatory and policy issues requiring consideration at a high level. The remit of this Committee has changed over time. At present, the HLCC is expected to consider only divergence in policy issues among different regulatory authorities. It does not have statutory backing, nor does it have a dedicated secretariat. Separately, the Ministry of Finance has constituted three separate technical Committees. Each Committee is headed by a senior level functionary in RBI, SEBI and IRDA and has representatives from other regulators or agencies. These technical Committees monitor developments in the markets and suggest action on early warning signals.

The Reserve Bank of India has now set up a system for conglomerate supervision as part of the activities of the Board for Financial Supervision. Data and information are now being regularly collected from the designated entities for the 12 financial conglomerates under its purview. These data are analyzed and semi-annual discussions are held with the CEOs of the designated entities in association with other regulators.

There is also some operational coordination amongst different regulators. For instance, SEBI's guidelines relating to the government securities market have been issued after consultation with the RBI.

Despite these structures, the general feeling among regulators the Committee spoke with was that coordination and communication was not as effective as it could be. For instance, meetings of the HLCC were often thought to be formulaic, with little of substance really being discussed. We believe this to be a worrisome state of affairs, which needs to be remedied.

Improving coordination and supervising conglomerates

There are essentially three broad sets of activities that need to be carried out in an integrated manner:

1. Coordination amongst regulators so as to remove gaps and overlaps, and to remove inconsistencies in approach;
2. Integrated regulation and supervision of systemically important financial conglomerates and organizations;
3. Overall monitoring of the entire financial sector and initiation of prompt and coordinated corrective action.

The need to establish the coordination mechanism on a firmer footing has been felt even earlier. The Advisory Group on Securities Market Regulation, 2001 (Chairman Shri Deepak Parekh) felt that there would be merit in formalizing the HLCC by giving it a legal status. It also felt that the HLCC needs to meet more frequently and its functioning made more transparent. Another view is that an umbrella regulatory legislation creating an apex regulatory authority, without disturbing the existing jurisdiction, is necessary. In this view, the apex authority would have, by law, jurisdiction to assign regulatory gaps to one of the agencies, arbitrate on regulatory overlaps, and ensure regulatory coordination (what is known as the Reddy formula).

The consensus of our Committee is that there is a need for a Financial Sector Oversight Agency (FSOA) that is set up by statute. The FSOA's focus will be both macro-prudential as well as supervisory; the FSOA will develop periodic assessments of macroeconomic risks, risk concentrations, as well as risk exposures in the economy; it will monitor the functioning of large, systemically important, financial conglomerates as well as large systemically important financial institutions that would otherwise be unregulated;[4] anticipating potential risks, it will initiate balanced supervisory action to support the action by the concerned regulator to address those risks; it will address and defuse inter-regulatory conflicts. The FSOA will take over the work now done by the HLCC as well as the technical Committees.

The FSOA should be comprised of chiefs of the regulatory bodies (with a chair, typically the senior-most regulator, appointed from amongst them by the government), and should also include the Finance Secretary as a permanent invitee. The FSOA should have a permanent secretariat comprised of staff including those on deputation from the various regulators. There should be a prescribed minimum frequency of meetings of the FSOA. All issues of regulatory coordination, and supervision of systemically important financial conglomerates and organizations will be taken up by the FSOA.

The FSOA should not lead to fractured responsibility, nor should it add, as far as possible, an additional layer of regulation. The FSOA will have a periodic 'principles-based' discussion with the managements of these systemically important financial organizations on the basis of material put together by the lead regulator for that entity, together with staff from other regulators. This will be the primary high-level discussions between the management of the institutions and the regulators, and should be attended by all regulators at a high level. However, while attempting to avoid repetitive discussions that cover the same ground already covered by the FSOA, each regulator will continue to have full responsibility for the portion of the conglomerate that falls under their purview.

The FSOA will also undertake periodic system wide stress tests of the financial system to assess the levels of liquidity, capital, and the build-up of risk concentration.

Care must be taken to ensure that the FSOA does not impose undue additional regulatory burdens on financial conglomerates and does not put entities within such a conglomerate at an undue competitive disadvantage vis-à-vis standalone competitors. The identification of financial conglomerates must also be strengthened and clarified, and all significant groups, whether or not they include deposit-taking entities, must be considered for supervision by this mechanism.

In addition, there is merit in setting up a Working Group on Financial Sector Reforms with the Finance Minister as the Chairman. The main focus of this working group would be to monitor progress on financial sector reforms (such as the proposals of the Patil, Parekh, Mistry, and this committee), and to initiate needed action. The working group's membership would include the regulators, as well as ministries on as-needed basis. The working group would be supported by a secretariat inside the Finance Ministry.

Finally, steps could be taken to improve the channels of communication between regulators. Cross board membership would be an important step (and not just between SEBI and RBI). Moreover, the necessary laws should be amended so that information can be shared between all regulators without violating secrecy rules.

An integrated ombudsman

Consumers typically face a range of products, not a single product. They have to choose between equity linked insurance products and mutual funds, each regulated by a different entity. Regulatory differences may create different levels of product transparency to the detriment of the customer. Similarly, many products contribute to their overall debt level, some that might come from banks, others that might come from their broker. Whether it be in improving consumer awareness of over-indebtedness, taking up grievances about excessive zeal in debt-collection, or encouraging amicable negotiation between an over-indebted individual and his creditors, no single regulator has the overall picture. This Committee believes there is a need for an Office of the Financial Ombudsman (OFO) to take over the disparate efforts at consumer literacy, protection, counselling, and arbitration, by replacing existing such efforts at the regulators.

The Committee envisages a number of functions for this office:

1. Take responsibility for improving financial literacy in the country using funds that are accumulating unused at the various regulators for this purpose. The OFO can conduct integrated educational and advertising campaigns that no single regulator can.
2. Monitor selling of different products, the degree of transparency about their pricing, risks, and other attributes, and their suitability for targeted customers.
3. Serve as the primary 'catchment' for consumer grievances that are not addressed through communication between consumer and firm, and serve as liaison between consumers and firm, and between firm and regulator, on repeated grievances.
4. Arbitrate compromises between over-indebted borrowers and creditors, heading off more costly conflict.
5. License investment advisors and the variety of other financial service counsellors who interact with retail customers.

The OFO should take over all the activities by current regulators that overlap with 1–5. The Committee was mindful of the need to not create a costly new bureaucracy that would simply increase layers of regulation. At the same time, it recognized that without a reasonable and responsive structure to govern interactions between firms and customers, there was an increasing risk of outcomes that was in neither group's interest. It therefore suggests an organization that has much of the characteristics of a self-regulatory organization, with only a small permanent staff, and the rest on temporary deputation from existing regulators and industry. The OFO should establish strong links to NGOs and pillars of the community (for example, retired accountants, lawyers, judges, and bankers) for the broader educational, counselling, and arbitration activities it will need to undertake. It should work as a complement to consumer courts, resolving a number of situations directly and at low cost. And it should make maximum use of technology to expand its reach.

It is beyond the remit of this Committee to suggest the precise design of the OFO. That will depend on the ingenuity of the person(s) charged with setting it up. But it does emphasize the need for some such organization, especially as financial services expand their coverage and reach the weaker sections of the population.

PREVENTING CRISIS AND DEALING WITH FAILURE

One of the most important aspects of the stability of a financial system is the mechanism for preventing financial failure and the means through which the failure of financial firms is resolved. Clearly, both macroeconomic policy as well as prudential supervision will play a role, and we discuss those aspects elsewhere. In this section, we discuss the prevailing framework for corrective action and resolution, and proposals for reform.

When does failure of financial firms have public policy implications?

A healthy competitive dynamic economy is one in which there is a steady flow of entry of new firms and the exit or failure of weak firms. Under this 'Schumpeterian creative destruction', exit by weak firms frees up resources that are better utilized by strong firms, thus leading to the maximal growth of the country. Some failures of financial firms, while not actually to be welcomed, should be deemed as a necessary accompaniment to competitive dynamic conditions, and indeed a salutary reflection of those conditions.

So it is necessary to ask whether the failure of financial firms pose more public policy concerns than the failure of industrial firms, which would then necessitate greater efforts at prevention and resolution. Indeed, in some cases, failure raises no special concern. As an example, when a fund manager is the agent of a customer, and the losses of the portfolio are transparently and continually borne by the customer, negative portfolio returns are not a problem. Even if there is an extreme event and the fund manager goes out of business, this need not significantly affect the customer, for his assets can then be transferred to another fund manager (or returned to the customer) by the resolution agency.

Four broad concerns do arise, however, with financial firms. First, the fear of failure of a financial firm could lead to a run that actually causes the firm to fail. This has historically been the rationale for deposit insurance. Second, the failure of one financial firm could disrupt liquidity conditions in the market, which then causes other financial firms to fail—a rationale for liquidity regulation. Third, financial firms could be the repository of knowledge about small and medium borrowers, and their failure could disrupt credit, a critical input, to a vulnerable section of the local economy. Finally, in a developing country like India, 'buyer beware', which places the entire responsibility for judging the soundness of a financial firm upon a household, may not be an entirely feasible economic or political strategy. There will be a demand for a few products to be identified as safe (e.g., demand deposits), with the government implicitly guaranteeing their return.[5]

In general, this Committee believes that every effort should be made to narrow what is guaranteed by the government to the bare minimum. This is another reason to reduce the public sector presence in the financial sector, for that presence implies an implicit guarantee the government can ill afford, and places private players at a disadvantage. It is also a reason for regulators to pay particular attention to entities that are not just large but also service many customers, for those entities may have too many customers to fail. Finally, it is important for regulators to create awareness that the fact an entity is regulated does not imply its safety and continued existence is guaranteed.

Despite all attempts to ring fence the costs of failure and preventing it from spilling over into the public domain, the regulator/government will have to intervene in some cases. The role of prudential supervision is thus to minimize the probability of such occurrences, as well as the public costs when they occur, without unduly hampering growth. It is important to achieve the right balance between prudential caution and growth, for the surest (and clearly wrong) way to minimize failure is to ban all activities that imply any risk. A regulator who targets zero risk of failure may not be hitting the right balance.

Minimizing risk: Exchange traded vs. OTC

The first step in preventing financial system risk spillovers is to adopt preventative methods. We do not have the space in this report to address the many ways of risk mitigation and prevention, but illustrate with some examples from counter-party risk.

For simple derivatives—such as currency forwards—the exchange is a superior method for organizing the market as compared with the Over The Counter (OTC) market. Electronic trading on the exchange reduces the cost of search for counterparties; trading on an exchange involves transparency of both orders and trades; order matching by price-time priority ensures that buying is done from the lowest-cost order and avoids the potential of malfeasance where a dealer buys from an accomplice at a higher price. From the perspective of failure, however, the critical edge of exchange-traded derivatives lies in the risk management services of the clearing corporation. The clearing corporation becomes the legal counterparty for the net settlement obligations of all clearing members. Thus, if one clearing member fails, nobody else is affected because their exposures are against the clearing corporation and not the failed firm.

The clearing corporation, in turn, is a specialized risk management institution with a professional focus on measuring and controlling the credit risk of clearing members, in part through margin requirements. India has two successful clearing corporations—NSCC and CCIL.

While both OTC derivatives and exchange-traded derivatives undoubtedly have a role to play in a sophisticated financial system, there is merit in encouraging the migration of trading in standardized products to the exchange so as to mitigate risk. There is certainly no case for biasing public policy *against* exchange-traded, and in favour of, OTC.

Complex derivatives, because they are not standardized, must be transacted on the OTC market. Internationally, these have traditionally involved bilateral exposures. These can induce a 'domino effect' when one financial firm fails. However, for these transactions also, it is possible to engage the risk management services of a clearing corporation. Here, a clearing corporation would earn a fee by becoming the legal counterparty to both sides of a complex OTC derivative. It would impose margin requirements, and collect a daily mark-to-market margin, from both counterparties.

India was a pioneer in embarking on such thinking, with the Clearing Corporation of India (CCIL) playing such roles on the OTC derivatives market, such as the currency forward market. This method of risk mitigation needs to be strengthened and extended considerably. As an example, in the United States, the NYMEX clearing house has encoded hundreds of structures of OTC derivative contracts, and levies margins taking into account the entire portfolio of exchange-traded and OTC-derivatives positions of its clearing members. This is beneficial for the members, who benefit from the reduced margins on the aggregate portfolio (in contrast to the higher margin necessary if the member had to post margins on each individual position). This is also beneficial for NYMEX, which is able to have a sustained engagement with the OTC market, understanding the product structures that are successful on that market, which could then be launched on the exchange. Clever risk mitigation can thus be a source of substantial profits, as well as stability.

In sum then, India is likely to witness the explosive growth of derivatives positions, given the growing importance of risk management, the growing size of exposures by financial and non-financial firms, and the growing sophistication of financial firms. In order to control the associated systemic risks, a two-pronged strategy needs to contemplated. First, standardized products should be encouraged to migrate to exchanges. Second, clearing corporations such as NSCC and CCIL must be encouraged to offer risk management services for the OTC market. If these two strategies are applied fully, systemic risk will then be limited to the small class of OTC derivatives positions which are not understood by the clearing corporations. Finally, note that a market regulator can work to mitigating these risks only if they see the whole picture across all markets, another reason for integrating market regulation under one roof.

Minimizing risk: Related party transactions

The bane of any financial system is related party transactions. One way to ensure that related party transactions are limited is to ensure widespread ownership, or ownership by an entity that is unlikely to suffer serious conflicts of interest. Indeed, this has been one of the underlying rationales for the RBI's guidelines for ownership of banks. This Committee endorses those guidelines, while suggesting that an exception can be made in the case of a strategic stake held by a diversely owned financial company (where the voting share could go up to 20 per cent, with the permission of the RBI), and in the case of a stake held by a diversely held parent holding company.

The Committee also believes it is premature to allow industrial houses to own banks. This prohibition on the 'banking and commerce' combine still exists in the United States today, and is certainly necessary in India till private governance and regulatory capacity improve.

There are, however, fewer restrictions on ownership in other segments of the financial sector. Regulators should be more alert in those segments to possible conflicts of interest, and to related party transactions. For instance, it might be possible for a mutual fund to own a significant stake in companies owned by its promoter. While a blanket ban on such ownership might be excessive, strict limits on ownership should be enforced at all times, as should guidelines on excessive trading or trading before key announcements. More generally, promoters should not just be enjoined to follow a strict code of conduct but also have clear rules of disclosure for related party transactions (along the lines of Caesar's wife should be above suspicion).

Minimizing risk: Management and director education

The financial sector has developed enormously over the last few decades. Most senior managers, directors, and regulators, however, received their education when very few of the products that exist today were available. Moreover, India was a closed economy then, and many of the issues related to an open economy that need to be understood by senior players simply were not on the horizon then.

Some senior managers have kept abreast of developments through their own curiosity, reading, and experience. They are also not afraid to ask questions of their subordinates when they do not know. Others are not so bold, and they continue to fall further behind. This is not only a concern in India, it is a concern worldwide, and is often a factor in why boards and management do not question rogue operations in their institutions.

It is not easy for senior managers or officials to admit to a lack of knowledge, and to sign up to basic courses in finance and open-economy macroeconomics. Moreover, even if the institution is far-thinking and organizes education programmes for senior managers/directors, there is little immediate reward for the sceptical to pay attention. Yet these are precisely the people who can place the firm at the greatest risk through their lack of awareness.

There is merit for regulators in considering whether a basic certification should be required for all directors of financial institutions above a certain size (including both technical knowledge as well as material about director responsibilities), and all senior managers and regulators. The value of a blanket mandate will be that there will be no stigma attached to signing up (though participants could have the option of taking a test and opting out of some, or all, of the coursework). The regulator could cooperate with academia, industry groups and institutions, and regulators elsewhere in tailoring the course material to the needs of the particular sector (and the level) of the official. There could also be scale economies in running the programme for the entire industry, as well as little stigma for specific firms when they send participants to the programme. Finally, to avoid this becoming merely another industry conference in a nice location, it is important that there be a test of the knowledge acquired and a certificate at the end of the programme. As senior officials get re-educated, it will set an example for more junior officials to keep abreast of developments, and be an important factor in improving the governance of risk taking in the system.

Increasing buffers: Capital and liquidity

Another way to reduce spillovers is to ensure that buffers are maintained by the financial firm. Two important buffers are capital and liquidity. While we do not have the space to examine each in detail, a few points are worth noting.

Start first with capital. Capital is meant to accomplish a number of things. First, it is a buffer against losses, giving time for the firm to raise more capital, for regulators to take stock, and for counterparties to react. Second, it is an entry ticket to participate in financial activities—if a firm loses money but is not recapitalized by its shareholders, it has to curtail activities. As such, it is a requirement from regulators for the market to vote its confidence in the financial firm. Third, it constrains risk taking by requiring that the available capital be enough to meet the requirements of the risk that is being undertaken. The second and third objective leads to the fourth—a capital requirement serves to incentivize firm management to manage risk for they know they will be forced to shrink, or even close down, if they take too much risk and incur losses that the market is unwilling to recapitalize.

One reason this issue is important in India is because a substantial portion of the financial sector is state-owned. It is useful to ask whether any of the objectives capital is intended to achieve other than the first—serve as a buffer—really have any import in state-owned firms. To the extent that state owned firms are not allowed to go out of business, and to the extent they are automatically recapitalized, the role of a capital requirement is much diminished.

State-owned firms have other reasons to not take on excessive risk. However, it is important to recognize that, other things equal, state-owned financial firms cannot be given the same incentives through capital regulation as private financial firms because the former have an unlimited claim on the public exchequer. As we push state-owned institutions to do exactly what private institutions do, they could become an increasing source of risk, that can only be limited if the government is willing to insist that all new capital come from public issues, or it lets go of its majority stake.

A second concern about the use of prudential capital requirements in India is the increasing tendency to use risk weights to reward or penalize activities that are viewed as national priorities (such as infrastructure or small loans). This is an aberration that should cease. If the authorities want to encourage activities, they should subsidize them more directly (see Chapter 3) instead of tampering with prudential norms.

The recent turbulence in financial markets has renewed the focus on mandatory liquidity holdings by banks. While the appropriate quantum and mode of maintaining such buffers will be debated in the years to come, the time has come to limit requirements of statutory holdings of high quality securities or cash reserves to only prudential purposes, and not for the purposes of funding government debt or for attempting to conduct monetary policy. Regardless of their efficacy for these other purposes, their use tends to distort the playing field—being a burden only on banks—and tends to diminish the signal sent when prudential measures ought to be taken. While it is not in this Committee's remit to specify the technical factors that should determine appropriate regulatory levels, the norms in other countries suggest a lower level than the current ones in India. Indeed, the RBI seems to implicitly have recognized this by cutting SLR norms for small urban cooperatives in order to improve their profitability.

Resolution of distress in banks

At present, in India, the 'Deposit Insurance and Credit Guarantee Corporation' (DICGC) supplies deposit insurance. A generous limit of Rs. 100,000 per person (summed across all kinds of accounts) is protected. In practice, over 98 per cent of the deposits of most banks are protected since they fall below this limit. In other words, there is a very extensive safety net protecting unsophisticated consumers who utilize the services of a bank. DICGC does not distinguish between the soundness of different banks and charges a flat insurance premium of 0.05 per cent for all banks. While DICGC is technically a separate corporation, in practice, it is a department of RBI.

There are three difficulties with the present situation:

1. As measures of the failure probability of Indian banks suggest (see Box 2), the insurance premium of 0.05 per cent is an underestimate compared with the market price of a credit derivative against the failure of most Indian banks. By comparison, the premium in Indonesia is risk based and varies from 0.1 to 0.6 per cent, in Korea from 0.1 to 0.3 per cent, in Malaysia 0.5 per cent, in Phillippines 0.2 per cent, and in Hong Kong risk based, 0.05 per cent to 0.14 per cent. The extensive safety net at a low price constitutes a subsidy for banks. It is particularly inappropriate in India, where (as the graph in the box suggests) there is a substantial variation in the failure probability across banks. A uniform insurance premium tends to reduce incentives for weak banks to maintain soundness. By contrast, higher insurance premia for higher risk generates better discipline.
2. DICGC lacks the financial capital required to cope with the failure of one or more large bank in a business cycle downturn. It lacks the operational capability to close down a bank swiftly, cleanly and preemptively.

   The key principles that should guide the resolution mechanism for banks are as follows:

   - *A bank must be given the chance to recapitalize while it is still solvent, or closed otherwise.* If the DICGC waits too long, the net worth of a weak bank can become deeply negative, with substantial cost to the public exchequer. If the DICGC steps in early to resolve a bank that cannot raise capital from the market, the cost of resolution is much lower.

- *Distance the DICGC from RBI.* There are considerable benefits in separating the resolution mechanism from either the central bank or the banking regulator. Distancing the DICGC from the central bank helps reduce the feeling on the part of the DICGC that it has access to unlimited resources. Distancing the DICGC from the banking regulator helps induce independence of thought on the part of the DICGC, which must make pre-emptive decisions about the closure of a bank without worrying whether this will signal its past failure.
- *Build DICGC's capability for swift and clean intervention so that impaired banks can be resolved without delay.* The DICGC should be able to enter an impaired bank, assess its needs and the various resolution options, and restore access to insured depositors within the span of days. For deposit insurance to be effective, such speedy resolution is imperative, else deposit insurance will be ineffective in preventing bank runs. The Committee has not been able to determine whether any such capability exists.
- *Consider automatic triggers for corrective action and for bank resolution.* Given the tremendous amount of political pressure that is brought to bear for regulators to forbear on weak institutions, automatic and objective triggers for bank resolution are worth considering and possibly enacting. There is reluctance on the part of regulatory authorities in making explicit the prompt corrective action regime. This allows too much flexibility to the authorities to exercise forbearance, which defeats the purpose of such a regime. The authorities ought to make such a regime transparent.
- In India, a weak private bank has, in the past, been merged into a PSU bank. The negative net worth of the defunct bank is hidden in the larger balance sheet of the PSU bank. The managers of PSU banks are unable to refuse when called upon to 'help' in resolving a 'crisis'. This practice needs to be questioned, if nothing else, on the grounds of corporate governance: such a merger is not necessarily in the interests of the public shareholders of PSU banks. More importantly, this practice offers an easy but detrimental alternative to genuinely confronting the problems of resolution. The recent auction of United Western Bank is a commendable step in the right direction.
- *Strengthen the information coming into DICGC.* Various information sources, especially from public securities markets, can be valuable to deposit insurers, both in assessing risks and in pricing insurance. The DICGC needs to draw on more of these sources, as well as develop a better understanding of what to draw from them (see Box 3).
- *Strengthen disclosure about bank assets and liabilities so as to assist the information processing of the securities markets.* For public markets to work well in assessing risk, information disclosure by banks (and other financial firms) needs to be improved. Banks need to report a P&L and balance sheet based on the marked-to-market value of all assets and positions, even if certain assets are permitted to be held-till-maturity by the regulator. Information about the currency and maturity composition of assets and liabilities needs to be disclosed every month, in a summary fashion that allows information about exposures to be understood by the market. More work needs to be done by the regulator in devising such summary measures, so that they reveal enough without imposing an undue burden of disclosure. When distressed assets are liquidated or sold, comprehensive data on recovery rates needs to be revealed to the public market. All these initiatives can easily be undertaken by SEBI as part of rules that all listed firms have to satisfy.
- *Hold the limit of Rs. 100,000 per person until per capita GDP exceeds Rs. 100,000.* India's safety net is unusually generous: in many countries, the limit does not exceed per capita GDP, and in most countries, over 98 per cent of deposits are not covered.

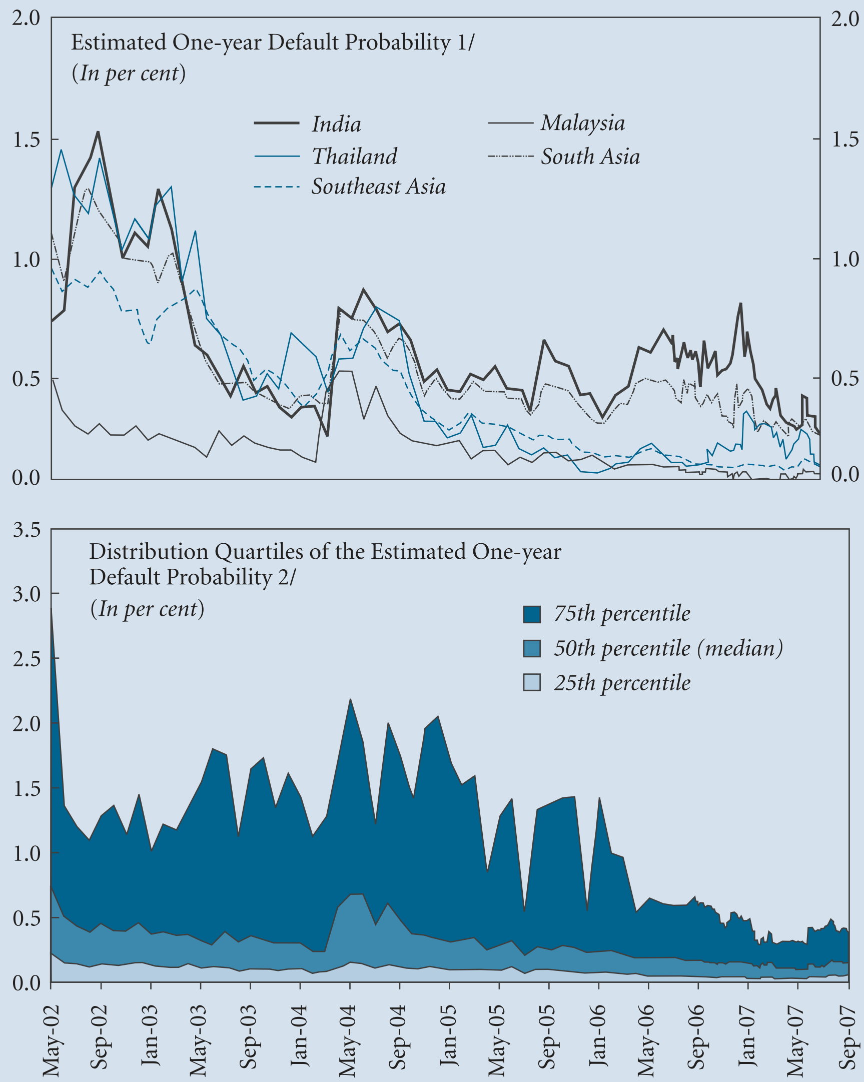
Box 2: How Risky are Indian Banks?

In recent years, there has been a heightened focus on measures of default risk that are derived from stock prices. The process of speculative price discovery on the stock market harnesses a diverse array of information—including information from within the company when insiders or their friends trade on the market—and reduces it into a publicly visible stock price. Using the analytical framework originating in Merton (1974), and extended by KMV Corporation, this strategy has come to prominence as one of the most effective ways for measuring credit risk. As an example, in the case of firms like Enron or IFCI, the stock price moved towards near-zero levels, thus signalling distress, well before traditional credit measures reported this.

This approach can be usefully applied to listed Indian banks in order to judge their failure probability. Some results on this subject, drawn from the IMF Article IV consultation report of February 2008 are illuminating. They are, in turn derived from Moody's KMV CreditEdge Plus.

The chart on the right shows the time-series of the failure probability on a one-year horizon of the average bank in the system. It shows that India (deep black line) has had a high failure probability when compared with many Asian countries.

The second chart, on the right, shows the cross-sectional dispersion amongst banks of this one-year failure probability. While the 25th percentile had always had low values of below 0.2 per cent, the 75th percentile has often taken values above 0.5 per cent, though it has come down in recent years. In other words, roughly a quarter of Indian banks have had a failure probability in excess of 0.5 per cent over the coming one year at all times over the 2002–07 period. With appropriate caveats on relying too much on one methodology, these substantial values for the failure probabilities of banks suggest that more thinking is required on reducing the probability of failure, and designing institutional mechanisms for coping with it.



Box 3: Source of Public Information about Bank Risk

As deposit insurance becomes more risk based, a variety of information sources can be used to supplement standard ratings in assessing premia. One good information source about distress is the public equity market. When a bank is in distress, the share price drops sharply. Good quality credit risk measures can be constructed from this share price and its volatility. RBI has made considerable progress in forcing large banks to be listed. This strategy needs to be pursued vigorously, with a requirement that at least 33 per cent of the shares of each bank be held by non-promoters. Bank bond spreads, where the corporate bond market to be liquid, could also provide valuable information about bank risk.

In addition, when the market develops, bank credit derivatives could be directly useful in pricing. A credit derivative can be defined as follows: *A security which pays Re1 in the event that the bank's subordinate bonds default over the next year*. For the top 20 banks, trading in these instruments could be initiated on NSE and BSE, and could be an input into determining the premia that are charged by the DICGC.

Note that such securities have been proposed elsewhere, but the lack of liquidity in the market for these securities has been a barrier. While DICGC could become an active participant in this market (thus insuring itself against bank default, and its consequent liability), that participation would have to be carefully managed so that DICGC does not become conflicted (between focusing on its portfolio of holdings of credit derivatives that increase in value when a bank defaults and its need to resolve a bank before failure becomes imminent).

When a bank has a significant failure probability, as judged by a combination of the three measures proposed above, as well as the subjective judgements of bank supervisors, many strictures can come into play before the DICGC decides to close down the bank. The most important stricture that should be employed is to require more equity capital, but limitations on business activity can also be imposed. Finally, a caveat: One should note that these securities are likely to be informative about the risk of private sector banks, but less so about the risk of public sector banks. Furthermore, a propensity for the authorities to bail out banks will render the risk measures far less informative.

NOTES

1. Chit funds have had much success in providing financial services to the poor, and in many ways are comparable to the microfinance industry in their record of reaching households underserved by mainstream banks (see Chapter 3). The Chit Fund Act, however, imposes substantial reporting requirements sometimes running into lakhs of documents that are required to be submitted annually. These levy enormous costs on the Chit Fund. Moreover, financial regulations, such as the need to post a security deposit for 100 per cent of the chit value, a ceiling of 40 per cent on the discount rate in chit auctions, and a fixed commission payable to the 'foreman' of the chit irrespective of general cost escalation have contributed to make the chit fund business essentially unviable. While chit funds need to be regulated because of their access to the very poor and the uneducated, the cost of regulation needs to be very carefully weighed against the benefits.
2. At a more basic level, every law is ennobled by a reason, and when the reason behind the law ceases, so does the law itself: cesante ratione legis cessat ipsa lex.
3. This is yet another reason to limit the use of changing SLR requirements as a tool of monetary policy.
4. For example, large non-deposit taking NBFCs may borrow from both banks and mutual funds, and are properly an inter-regulator concern, hence under the purview of FSOA.
5. In principle, there will be a constant pressure to expand this list to include products such as defined benefits pensions and life insurance. Of course, any such guaranteed products from the government reduces market discipline on providers, penalizes the healthy amongst them, and creates incentives for taking undue risk.

Creating a Robust Infrastructure for Credit

chapter 7

OVERVIEW

Debt claims are an important instrument of financing in an emerging market. Yet India's private credit to GDP ratio is low relative to comparable countries, its corporate bond market virtually non-existent, and retail credit growing rapidly but from a very low base. Part of the explanation for the low level of credit may lie in India's credit infrastructure, which is underdeveloped. Strong credit infrastructure is also useful when it comes to dealing with distress and reallocating resources to their best use. This will become increasingly important as India shifts out of mature low-skilled industries into high-skilled frontier technologies in the process of catching up. All this suggests a need for a very close look at the credit infrastructure to remedy what is deficient.

The flow of debt requires a number of facilitating mechanisms. Information about a borrower's credit history, if widely shared, and if it includes both positive information and negative information, could greatly help expand both access to credit and incentives to repay it.[1] For instance, a steady record of paying electricity bills or rent could alert potential lenders to a person's creditworthiness, and give them incentives to lend. The fear that a default would be publicized and would lead to a cut-off of further credit or of services can be the 'reputational' collateral that gives borrowers incentives to pay and lenders to moderate interest rates.

For credit information to be aggregated and shared, a primary requirement is a unique national identifier for each individual. Rules ensuring information accuracy, security, adequate privacy, and prevention of abuse are necessary, but they should take into account costs of implementation, as also the substantial benefits from information sharing. For instance, if most of the economy does not have access to credit from the formal financial sector, restricting the sharing of credit information to only financial institutions ensures that much of the economy, including the neediest sectors, do not benefit.

Most borrowing takes place against collateral/security. It is important to ensure that real assets can be pledged easily, information about pledged assets is easily accessible to potential lenders through collateral registries, and the security interest is easily enforced so it does provide security to the lender in case of default. Collateral registries that are universally accessible are another important aspect of credit infrastructure development.

Perhaps the biggest source of collateral value in India in the years to come will be land. This is also the form of collateral most easily available to rural India. Yet land mapping is uneven, land title is not final, land registries typically do not have complete records, records conflict with those maintained by the revenue department, and both are also typically hard to access. Expanding the use of land as collateral is one of the more important of the needed reforms, especially for the poor.

In order for debt financing to be available, creditor rights have to be protected. While it is easy to feel sympathy for the distressed debtor, too easy violation of creditor rights, or political agitation preventing creditors from enforcing interests, will make it harder for potential borrowers to get access to credit. At the same time, debt will occasionally be impossible to pay. Both the borrower (whether individual or firm), the society, and even lenders can be better off if the debtor can restructure unpayable debts using a low-cost, speedy framework that affords appropriate amounts of relief without vitiating the whole culture of repayment. The key word here is balance. Too harsh and rigid a system of debt enforcement will be both politically infeasible (in the sense that, even if enacted, politicians will intervene constantly and will have public support in doing so) and reduce borrowing as potential borrowers weigh the substantial costs of distress. Too lax a system of enforcement will weaken lenders and reduce lending.

Society therefore needs an effective system of debt enforcement and protection of creditor interests, a speedy and low-cost system of renegotiating debt outside the legal system, and a transparent, fair, and speedy bankruptcy process that can determine the best future use of the debtor's assets, while also determining and satisfying all legitimate claims on the debtor following a pre-agreed system of priority. Also, if some of the other improvements in credit infrastructure are implemented, such as the sharing of credit information, a better system of personal bankruptcy can be evolved.

It would take us too far afield if we were to detail all the infirmities in the current credit infrastructure. The most typical infirmities are the following: first, the system is fragmented in jurisdiction, operations, and coverage. An example of fragmented jurisdiction is that there are multiple avenues for bankruptcy resolution such as the Companies Act, the BIFR/SICA, and the Debt Recovery Tribunals. An example of fragmented operations is that collateral is registered both at state registries (e.g., immovable property) and the register of charges under the Company Act (for example, charges against equipment), and there is little communication between them, and between the various state registries. This multiplies the task for a potential lender who wants to verify encumbrances on a borrower's assets. One stark measure of the fragmentation in coverage is the fact that credit registries cover only 11 per cent of the population in India (data in the paragraphs that follow are from the World Bank's *Doing Business 2008* report), while they cover 40 per cent of the population in China and between 46 and 64 per cent of the population in Brazil.

Second, the system is slow and costly. For example, the time taken to register property among the BRICs is by far the highest in India at 62 days, and the costliest at 7.7 per cent of the property value. It is the lowest among BRICs for China, where it is 29 days and 3.6 per cent of property value. It is disquieting that transactions taxes and fees such as stamp duties and registration fees are very high in India and extremely variable across states. Such transaction taxes are a bad form of taxation because they inhibit transactions.

Third, because of the delays (sometimes endless), the system prevents the reallocation of assets to their best use, and greatly wastes asset values of impaired debtors, to the detriment of the economy. Closing a business also takes a long time in India—on average 10 years in India compared to 1.7 years in China. Among the BRICs, India recovers the least value at the end of the bankruptcy process—12 per cent of debts—while China recovers 36 per cent of debts.

These infirmities do impair the flow of credit. Credit to GDP averages 8 per cent for the 10 countries ranked at the bottom in the World Bank's 2008 Doing Business report on measures of credit registries and collateral laws, while it averages 130 per cent for the 10 countries ranked at the top. Indeed, as some of the comparisons above show, even though China is reputed to have an inferior financial system than India's, it scores much higher on measures of credit infrastructure, especially after recent reforms.

Finally, it is easy to be complacent in these times when reforms like the SRFAESI Act are 'working' in that debtors are paying up. While not downplaying the extent of reforms that have taken place, one should recognize that it is relatively easy to restructure and renegotiate debt during a boom, when debtors find it particularly attractive to repay and recapture the use of their assets, especially land. Matters may be quite different during an economic downturn. Now is the time to make serious reforms, for an adequate credit infrastructure will enhance the stability of the corporate sector, the household sector, as well as the banking system. While it would seem that all parties have to gain from such reforms, unfortunately, there seems to be little urgency at present. This must change.

CREATING A NATIONAL ID[2]

Every country needs some basic and robust identification mechanism for its citizens for various purposes. It will have two critical components—enumeration (assigning some unique number) and personalization (enabling positive identification of individual by his/her biometrics such as photo, etc.) For example, individual may have a number assigned but not a photo document (as is the case with the US Social Security Number); or, on the other hand, individual may have a photo document issued but no unique lifetime number associated with it (as would be the case with some national passport systems that would have a document number but not an individual number provided).

An identification system should ideally be unique, universal, and widely recognized. It should be provided through a mechanism that is universally supported by various agencies. A unique ID establishes a person's identity in a decisive manner and is a critical element of any functional credit infrastructure for financial inclusion. Countries lacking such system will be bound to have less efficient retail banking and credit systems.

ID schemes elsewhere

A number of identification mechanisms and national ID programmes exist across the world in various forms. The first ever smart card based ID scheme was launched by Malaysia, with multiple applications on the chip, and incorporating biometrics in the form of fingerprints of the holder. The Nigerian identity card is a plain plastic card issued to all above 18 years and provides identification based on profession and vital statistics like height, age along with personal information, photograph and fingerprints at the backend. The fingerprints are used for removing duplications in the system. The Nigerian card is required for commercial transactions, as an identity proof, for availing health care and other state provided benefits, educational admissions and for procuring other important documents like passport, driving license, etc.

In the Sultanate of Oman, the first to issue smart cards in the Middle East, the card comprises of high-end security features and applications like biometrics and digital signatures and capability to load new applications to the card post issuance. The card caters to multiple applications like driving license, passport and work permit. In Sri Lanka, the national ID is used widely by various public programs. The card itself is a simple laminated paper card; however, efforts are underway to modernize it by developing a database, introducing modifications into the number structure, and setting up a sound data collection process including the thumb imprint capture.

Perhaps the best in the region national identification system is hosted by the Government of Pakistan: it uses the medium of a smart card, storing photo and fingerprint information; it is broadly and universally used; it operates with a support of a very robust back-end electronic database and relies on the network of specially designated local offices.

ID programmes in India

India is still at an early stage of developing a universal national identification system. This allows the country to take advantage of the existing international experiences and state of the art technology. It is also important that various government bodies work together and fully coordinate their efforts to provide varied services to the same population. At present there seem to be few examples of such cooperation.

A number of current government programmes in India require the identification of a person or household. As a result, multiple identification mechanisms are in use, without any link between them, varying widely in terms of quality of the document issued or the process supporting it. The PAN card (Permanent Account Number) is used by the income tax department to identify income tax payers. The Elector's Photo Identity Card (EPIC) is used by the Election Commission and issued to people of 18 years and above. Yet another set of identity cards are used to provide various government cash transfers and benefits. The BPL card is an identification based on income criteria and used for the receipt of various benefits under government schemes. The Ration card used by the public distribution system is issued to a family unit as per the socio-economic criteria to enable low-income households purchase subsidized food and kerosene. Beneficiaries of the Rashtriya Swasthya Bima Yojana (RSBY, health insurance for BPL families) are issued smart cards, which not only offers a unique number, but also contains security keys, fingerprints and details of the family members, and a group photograph of all the enrolled members.

In the banking and financial sector, it has been difficult so far to use any of the above described government issued identity cards for the purpose of providing financial services. Recently there have been a number of pilots where private players have been assisting banks and microfinance institutions to issue smart card based identity cards to customers (see also Chapter 3). These initiatives have been used not only to open bank accounts and provide microcredit, but also to provide cash transfers via NREGS, pensions, etc. These cards are largely capable of relating a single identification number or account number to multiple relationships with the bank. Much of these efforts are sporadic and localized or specific to the bank and card service provider. In the absence of specific guidelines, the card service provider largely determines the mechanism for identification of customers and generation of a unique identification number.

Instituting a national ID number in India

In order to set the groundwork for a universal national identification system, the government needs to work out a strategy that would include: (*i*) a common set of criteria for identification of individuals; (*ii*) mechanisms for coordination among various government agencies at the central and state level to ensure universal enrollment and sound administration; (*iii*) nomination of a steering committee that would be in charge of design and implementation of the policy and an executive committee that would ensure uniformity and correctness of the system.

If a universal, centrally sponsored national ID system is a distant reality given the initial conditions, perhaps a workable second best solution could be identified. For example, an arrangement where multiple agencies are engaged in issuing identification documents to the groups they serve in a highly coordinated fashion could go far along in the process to provide an ID that is widely accepted and recognized.

To facilitate operation of such a decentralized system, some minimum elements would have to be defined. These include the following: (*i*) a common universal design of the numbering system that is used by all participating agencies and helps agencies recognize and process each others cards; (*ii*) a multi-purpose centralized database that ensures efficient monitoring of this decentralized ID system—updates on issued/cancelled IDs would be periodically uploaded into this system, and the system could help detect duplicates; (*iii*) minimum operational standards that all participating agencies would need to adhere to, to ensure a transparent and efficient system; agencies would also need to submit to periodic audits; (*iv*) a common card which could bear the logo of the issuing agency but would be identical in look and features and would have minimum information required for identification (name, address, date of birth, photo, fingerprint, etc.); and (*v*) if possible, this new system should integrate with other core systems of individual identification such as birth, death, and marriage registers.

Allowing different agencies to issue the ID in a coordinated fashion could deal with the problem that the burden of verification is different for some purposes than for others—for instance, verification for the purposes of establishing citizenship or voting can be different from the verification needed to issue a tax payer ID. Individuals would choose to get their ID from the organization that most addresses their specific needs, minimizing personal costs, and ensuring that coverage is enhanced.

Also, rather than establishing a new ID, it might be more useful to examine the existing schemes running in the country and adapt and scale up one of them to be more widely acceptable. Under any scenario, one of the agencies would need to take the lead in designing the card structure and the enumeration system and in coordinating the process by which all agencies would come together to collaborate on this effort. Box 1 provides a quick overview of the existing enumeration/identification mechanisms from the perspective of their potential for scaling up and/or adopting them as a core standard for a universal identification scheme.

Box 1: Features of Key Identification Systems Currently Available in India and Opportunities for Scaling Up

Identification system	Observations
PAN Card	Pros: Covers sizable group of middle/high income population; no limitations on other categories to join; centralized computerized system; efficient outsourcing of the enrollment process. Cons: Low incomes at present are not covered; perception of implicit tax liability; lack of biometric data on the card.
EPIC Card	Pros: Potentially close to universal coverage among the age eligible citizens. Cons: Weak institutional set up and poor card design.
EPFO ID	Pros: Covers sizable population of the formal workers; has an extensive network of offices for enrollment; introduced new and efficient numbering system. Cons: So far experiences seem to have been limited to needs of the pension programme; may not cater to the larger set of unorganized workers or non-workers.
CRA ID	Pros: Will gradually expand to cover all government workers and potentially members of other population groups participating in the new pension scheme; interlinked with the PAN numbering system. Cons: New untested system; phase-in will take a considerable time; highly centralized operation but no local infrastructure except possibly for some outsourced services.
MNIC Card	Pros: A step up from EPIC card in terms of numbering system design and media of information (smart card). Cons: Lack of institutional continuity; deteriorating quality of existing dataset.
RSBY Card	Pros: Will cover most of the low income population; potentially a robust centralized computerized system; smart card based identification with photo and fingerprint. Cons: Early stages of implementation, lack of experience; no dedicated offices for maintenance/enrollment; lack of identification of individual.
Income based IDs	Pros: Covers most low income population; has highly decentralized and represented service network. Cons: Lack of computerization and inconsistent records; weak institution and administration; lack of dedicated personnel at the local level; lack of systemic updates (critical revisions introduced on 5 year cycles); focus on family rather than individual.

Another possibility is a partnership in this area between the government and non-government organizations, e.g., to facilitate enrolment and verification. Though such models are commonly used in many areas of governance, a more robust structure would need to be formulated to ensure proper collaboration, monitoring, and accountability. If well defined guidelines and a strong accountability can be guaranteed, a public–private partnership could provide for a most efficient model, reaching out to certain population groups in a most efficient way, ensuring fast implementation and roll out of the new scheme as can be seen in the PAN issuance and is also envisaged in RSBY case.

Once established, the unique ID would be the basis for storing information in credit registries. Borrowing and savings behaviour could be tracked via this ID, with the shared information resulting in credit scores that could both reduce the cost of offering credit over time, as well as offer borrowers incentives to pay. The objective should be to achieve near universal information sharing (at least on negative information) by bringing banks, cooperatives, MFIs, and NBFCs into the sharing network.

GATHERING AND SHARING OF CREDIT INFORMATION

Credit information bureaus help bridge the information gulf between borrowers and lenders, by helping lenders identify good borrowers through their past credit history. The practical consequence of this is better risk management, which enables banks and other financial institutions to increase their volume of lending and extend credit to segments of the population that may have previously been excluded, such as small and medium sized firms (SMEs). Credit reporting helps lenders by reducing default rates and helps borrowers by allowing them to develop payment histories or 'reputation collateral' that they can use in securing more competitive loan rates. Once loans have been provided, sharing data on payment behaviour through credit bureaus can help to limit problems of willful default (where borrowers do not make a good faith effort to repay). This is because a borrower's cost of paying late or defaulting on a loan to one institution is greatly increased by the effect this has on his credit history and thus his future cost and access to credit across the financial system.

A study based on more than 100 developed and developing countries shows that the existence of credit registries is associated with a higher private credit to GDP ratio, after controlling for other country-level measures of development (Miller, 2003; Djankov, McLiesh and Shleifer, 2005). A study on credit reporting firms in over 40 countries shows greater information sharing increases lending as a per cent of GNP and lowers default rates (Japelli and Pagano, Forthcoming.)

The situation in India

The Credit Information Bureau (India) Limited (CIBIL) is the primary credit information bureau. It was incorporated in 2000. Banks, financial institutions, non-banking financial companies, housing finance companies and credit card companies use CIBIL's services. Data sharing has been based on the principle of reciprocity, which meant that only members who had submitted all their credit data could access credit information reports from CIBIL. However the Credit Information Companies (Regulation) Act 2005 (CICA 2005) has allowed for a set of 'Specified Users' like cellular companies, insurance company, credit rating agencies, etc. who can have access to reports. Currently 146 credit grantors, including 77 banks with over 90 per cent of total credit outstanding to individuals have accepted membership and have committed to give data.

CIBIL has two bureaus, one for consumer credit and the other for commercial credit. The objective of CIBIL's Consumer Credit Bureau is to minimize defaults and maximize credit penetration and portfolio quality, by providing comprehensive credit information pertaining to individual borrowers. It contains over 100 million records. CIBIL has more than 4 years of credit history on borrowers and has been able to introduce a number of value added products such as generic bureau scores for individuals.

The Commercial Credit Bureau aims to minimize instances of concurrent and serial defaults by providing credit information pertaining to non-individual borrowers such as public limited companies, private limited companies, partnership firms' proprietorships, etc. The bureau contains 1.5 m records.

Once it was established, CIBIL has grown rapidly in a short span of time. Strict and regular vigilance and monitoring of the borrowers is essential to ensure quality and reliability of the information, which, in turn, requires participation by a large part if not all credit-granting institutions in the country in the information sharing exercise. CIBIL has taken significant steps in this direction. Nevertheless, there are some concerns about credit information sharing in India. These have to do with what is collected and shared, data security and integrity, and the degree of competition in the industry.

What is collected and shared

CIBIL typically collects and shares credit information. While CIBIL does a good job in covering the most important institutional sources of credit by volume, there are a large number of small credit institutions such as cooperatives and microfinance institutions that make a large number of loans in small volumes. To play a more effective role in inclusion, CIBIL will eventually have to cover these institutions, and should be given permission to do so. It could even contemplate extending coverage to registered moneylenders who follow an accepted code of conduct, a necessary step when so much of credit to poorer sections still comes from moneylenders.

For corporate borrowers, information on credit rating, as well as assessment of accounting and auditing standards and corporate governance may be useful, though these items, being third party evaluations should be purely advisory inputs in decisions. Perhaps most important of all in sheer volume would be performance on inter-firm credits, of the kind collected and disseminated by Dun and Bradstreet in the United States, which CIBIL is in the process of collecting.

Creditworthiness can be gauged from more than just past credit-related behaviour. Many individuals make steady payments outside the formal credit sector that could be used to gauge creditworthiness. Expanding coverage for individuals from just loan payments to other common payments, including rent, utilities, and cell phone bills, would draw in a lot more information, and cover a lot of potential borrowers who are now outside the formal credit system, resulting in better credit assessments and inclusion.

One constraint on coverage and sharing information is the principle of reciprocity—only those institutions that provide information to CIBIL can access reports. CIC Act 2005 provides for specified users, notified by the RBI, who can get access. The list of specified users, as well as non-credit contributors needs to be expanded as India gains experience with credit information. For instance, in the United States, landlords can access credit information. We need to move to a system where any person having a written authorization of the borrower or entity on whom information is being sought, ought to be able to have access to the credit records in question, with only the truly necessary safeguards. Among potential users should include a prospective employer, landlord, or creditor, whether bank or non-bank.

A number of specified users have data, and could well share it under the principle of reciprocity. But for some, the gains from using data are low, while the value of their data is high. For other users (such as potential employers), there is little data they can contribute. As more such users come into the system, the notion of reciprocity (I get to use data if I share data) becomes more strained. India should move from a system of reciprocity to one of subscription, where a subscriber gets access to data subject to verification of 'need to know and authorization to use' of the subscriber by the credit bureau. At the same time, efforts should be made to persuade non-users to share data (including through an appropriate mix of mandated sharing and payments).

Finally, how long a history should be shared? International best practice is to establish time limits on the length of the credit history available to a potential lender. Economic research shows that recent credit payment record is of most relevance for predicting future default. Moreover, the fact that after a certain period of time information, especially regarding defaults, will not be distributed to lenders creates additional incentives for the borrower to improve credit repayment behavior and to 'clean up' the record. For example, records are available only for 5 years in Australia, Brazil, Germany, Ireland, Peru, and Spain, and for 7 years in the US, and Mexico. In the case of bankruptcy, records are kept for 10 years generally. It is essential, though, that all information in the file is kept for this set period. Deleting records, or parts of records, significantly lowers the predictive power of the data in the registry and weakens the incentive the bureau creates for repayment.

Data security and integrity

The key to making credit bureaus and registries effective, reliable and profitable lies in widespread data sharing. This can only happen when data providers and users are assured that their 'trade secrets' are safe and when regulations ensure that the individual borrower is not exploited or discriminated against using the information available from credit bureaus. The regulations necessary to ease the operation and success of credit bureaus, therefore, include those concerning bank secrecy; data protection laws; laws on consumer protection; fair credit granting and consumer credit regulations; and provisions regarding privacy and personal or corporate secret in existing laws.[3]

In most countries there is a tendency to rely on industry self-regulation for ensuring data safety. Credit bureaus as well as their members have strong incentives to establish proper mechanisms for data processing and data protection. In general, development of mechanisms for data processing is driven by competition within the industry and developments in technology, while data security standards are set high to avoid the significant costs a loss of data or an unauthorized access may cause. However, an independent audit of data security for credit information firms should be mandated in India by the RBI to ensure compliance with best practices.

Some other aspects of protecting consumer information deserve consideration. The key aspect in ensuring privacy and authorized access to the data is to define a set of legitimate purposes for access. This set of purposes usually include not only consideration for granting credit or a lease, but also monitoring of existing credit, collecting on a credit, etc. and even for employment purposes. In some countries, the law requires consent of an individual to authorize issuance of a credit report by a credit registry. While requests from regulated financial institutions may not require authorization, as the set of specified users is expanded it may be necessary to require authorization when the request is from an unregulated or non-financial entity.

Identity theft is becoming increasingly common in developed countries. Concomitant with expanding the set of users will be the need to verify that the authorization from the object of the credit report is valid. While there are no easy solutions, the sooner the system moves to unique national identification numbers accompanied by biometric validation, the more it will be able to contain the problem of identity theft.

The object of the credit report, whether an individual or a firm, is in the best position to know who has a valid reason for accessing their report. They know where they have requested credit or employment and whether other firms or individuals have a valid reason to request the information. Therefore, one of the best ways to limit unauthorized use of credit information is to develop systems, which record all queries for an individual's report. Consumers can review this information if they think their data has been used in an inappropriate manner. This simple reporting tool can greatly help to detect misuse of the data by lenders and others who may request this information, as well as by staff of the credit reporting firm.

Currently potential borrowers in India can find out why they have been refused credit only from the lender and not from the registry, which goes against international best practice that allows the subject to view his/her own impaired record free or at a low cost. Notice of refusal of credit also serves as a good educational tool informing consumer of the importance of building good credit history and improving payment discipline. One impediment currently in the way of direct access is that the credit information bureau may have no way of verifying that the individual who is trying to rectify his record is who he is. As national IDs and biometric identification becomes more widespread, the credit bureau and the individual should be encouraged to deal more directly.

Procedures should be in place to facilitate challenges to erroneous data. Consumers should be able to review their reports and identify reporting errors via the Internet and by phone. It is particularly important that consumers have access to reports when an adverse action has been taken. Clear procedures should be established in regulations specifying the steps in the dispute resolution process and the time that credit reporting firms have to verify and respond to complaints. These regulations should seek to facilitate consumer access without hampering the functioning of the system or allowing its abuse. The CICA 2005 provides a number of guidelines for dispute resolution, and these should be implemented.

Fostering competition in the industry

Competition in the area of credit information provision is the key for expanding coverage, and improving the use of credit information. However, a few roadblocks need to be removed to pave the way for easier entry of, and greater competition among, credit information companies in India. The Committee notes that liberalizing access to credit information through a change in the information collection and sharing model is an important condition for the success of competition. Licensing too many bureaus without expanding access will simply fragment the market for credit information and affect the growth of this industry.

Moreover, dispersed ownership may have been necessary when the owners were credit-granting institutions, so that a single owner could not monopolize information. As new players who are essentially in the information-sharing business enter, this is less of a concern. Furthermore, with CIBIL already in existence, it is unlikely that new entrants would monopolize information. It would be sensible to allow experienced

Quality of Credit Information in India

At the moment, there is no independent verification of the data submitted by the bank to the bureau. CIBIL does not carry out verification of information using third party sources including courts, government registration department, company registry etc. An important reason is that these sources have not centralized information, or made them accessible in electronic form at remote locations. This is likely to be remedied over time as more information is captured in electronic form. The data is as good as the integrity of a bank's data. Also the information submitted by lenders does not use similar criteria. For instance, some use RBI loan classification requirements (standard, substandard, etc.) and others use 'days past due'. In addition, the PAN number does not serve as a unique identification number as not all customers register for a PAN number. Also, the PAN number is only given to the tax payer. While banks try to use date of birth and other information as a way to identify a person, it is still a poor substitute for a unique identification number. This will become a serious issue as the consumer credit bureau expands. National identification numbers are needed for data validation and matching accurately, but also to contain identity theft. In the absence of its availability in India now, the CIB industry is severally handicapped. Thus there is paramount need to shift quickly to biometric identification and validation, and a rapid roll out of a national ID.

Information Collected by Credit Bureaus in the US

1. **Identification and employment information—**Name, birth date, ID number, employer, and spouse's name. The credit bureau may also provide information about employment history, home ownership, income, and previous address, if a creditor requests this type of information.
2. **Payment history—**Accounts with different creditors are listed, showing how much credit has been extended and whether it has been paid on time. Related events, such as referral of an overdue account to a collection agency, may also be noted.
3. **Inquiries—**CBs must maintain a record of all creditors who have asked for a person's credit history within the past year, and a record of those persons or businesses requesting credit history for employment purposes for the past two years.
4. **Public record information—**Events that are a matter of public record, such as bankruptcies, foreclosures, or tax liens, may appear in a report.
   - Bankruptcy information may be reported for 10 years.
   - Credit information reported in response to an application for a job with a salary of more than US$75,000 has no time limit.
   - Information about criminal convictions has no time limit.
   - Credit information reported because of an application for more than US$150,000 worth of credit or life insurance has no time limit.
   - Default information concerning US Government insured or guaranteed student loans can be reported for seven years after certain guarantor actions.
   - Information about a lawsuit or an unpaid judgment against a person can be reported for seven years or until the statute of limitations runs out, whichever is longer.
5. **Accurate Negative Information—**When negative information in the report is accurate, only the passage of time can assure its removal. Accurate negative information can generally stay in a report for 7 years. There are certain exceptions:
   - Information about criminal convictions may be reported without any time limitation.
   - Bankruptcy information may be reported for 10 years.
   - Credit information reported in response to an application for a job with a salary of more than US$75,000 has no time limit.
   - Credit information reported because of an application for more than US$150,000 worth of credit or life insurance has no time limit.

Information about a lawsuit or an unpaid judgment against a person can be reported for seven years or until the statute of limitations runs out, whichever is longer.

foreign players to take significant stakes in new entrants so that they can transfer technology. Of course, a liberalization of ownership norms should also be extended to CIBIL so that it too can attract experienced strategic partners if it so desires. Finally, the Committee emphasizes that the multiplier effect from the credit information industry can be substantial, especially for inclusion, and hence urgent steps are needed to expand it so that it can support growth.

COLLATERAL, SECURITY INTERESTS, AND REGISTRIES

Overview

Let us now turn to the process of obtaining security or collateral for debt. Security is essentially a claim on a borrower's asset if a debt is not repaid. Security interests typically have to be registered with a public registry so that everyone knows the asset is pledged.

The law should allow for the following features:

1. Security interests in all types of assets, movable and immovable, tangible and intangible, including inventory, receivables, and proceeds; future or after-acquired property, and on a global basis; and based on both possessory and non-possessory (where the creditor does not hold on to the asset) interests;
2. Security interests related to any or all of a debtor's obligations to a creditor, present or future, and between all types of persons;
3. Methods of notice that will sufficiently publicize the existence of security interests to creditors, purchasers, and the public generally at the lowest possible cost, as also permit swift, inexpensive, and reliable searches using multiple fields (owner of asset, type of asset, location, amount of encumbrance, etc.);
4. Clear rules of priority governing competing claims or interests in the same assets, with the highest priority typically given to security interests.

Land as collateral[4]

Land is probably the single most valuable physical asset in the country today. Unfortunately, the murky state of property rights to land make it less effective as collateral than it could be. The current state of land rights has many other adverse effects, including preventing agricultural land from migrating to its best use, slowing land acquisition for industrial and infrastructure projects, clogging courts with disputed cases, and elevating the level of political conflict. While making land rights clear and transparent is expensive, it is probably one of the most pressing needs of the country today.

Land can be used more effectively as a source of collateral, first, through clear property rights in the form of clean title to land, and, second, through improving the menu of land tenure options so that tenants with secure tenure can borrow against evidence of their tenure.

The process of establishing clear title to land is not easy. India has two principal systems of land records: a deeds registration system and a land revenue system of record of rights (RoR). Multiple agencies and multiple systems exist in most states. Typically, a Survey, Settlements and Land Records Department prepares and maintains survey and mapping records and property cards where they exist. The Revenue Department prepares and maintains the record of rights and a Department of Registration and Stamps maintains the deeds registry with records on land transactions. These systems are neither comprehensive nor consistent with one another. In the past, maintaining accurate land records has been the prime responsibility of fiscal authorities, given the importance of land records in facilitating revenue collection. As a result, the use of land records in confirming property rights has been neglected. This has to be remedied now.

The deeds registry simply gives public notice of a transaction. However, registration of a deed does not imply any inference about the legal validity of the transaction or that the parties were legally entitled to carry out that transaction. Indeed, the registration office in India will, in principle, register any transaction, and in practice officers invest more time in verifying the identity of parties to the transaction than the physical location and attributes of the land.[5] This means that someone who has registered a past purchase cannot use the deed as proof he owns the land—in fact, there is always the possibility that some prior seller did not have ownership, so all subsequent transfers are invalid. Clearly, the uncertainty this creates over ownership is substantial. By contrast, under registration of titles, the register itself serves as the primary evidence of ownership.

One possible long-term goal could be to establish a single computerized title registration system that includes conclusive information about rights over land and the spatial extent of these rights. This will ensure security of title to landowners and provide plot information to the government and private users. This system is often referred to as the Torrens system of registration and has been implemented in various parts of the world (in various forms), including Australia, New Zealand and parts of the US and Europe. In India, a title registration system broadly along the lines of Torrens is being piloted in a number of states. To establish such a system it is important to have clear titles, make registration compulsory, facilitate complete computerization of records, and ensure consistency between the various government databases. Given the current state of affairs of land records and land administration, meaningful implementation of title registration is clearly a long-term objective.

Regardless of whether single title registration is the ultimate goal—and much can be achieved without going all the way—it is of critical importance to improve the deeds system. A number of states—Karnataka, Maharashtra, Andhra Pradesh and Gujarat—have taken this approach. The next step would be to functionally integrate the different databases used in land administration, namely the deeds and RoR systems, to provide land owners with a certificate that contributes relevant and current information pertaining to a plot, for example ownership status, transaction history, current and past mortgages and liens, and a map that allows identification of neighbours and general boundaries. The decision on whether to make the transition towards a full title registration system will depend on a number of factors, including political will to make the necessary legal and institutional changes, consensus on the desirability of incurring the costs entailed, and agreement on the establishment of a guarantee fund which is required for a title registration system.

The immediate steps that need to be undertaken include:

- **Full computerization and integration of land records.** Efforts towards computerizing land records were initiated in 1988 through central assistance, but progress remains highly variable (see box below). Government measures to encourage computerization could include (*i*) clarifying the policy and establishing clear criteria and accountability mechanisms for allocation of central funds on this; (*ii*) identifying and publicizing best practices on technical and legal issues and promoting exchange and communication among technical staff across states; and (*iii*) prioritizing full functional integration between records and registry.
- **Full cadastral mapping of land.** An important problem is that existing cadastral survey records are largely limited only to agricultural land. The inhabited portions of villages, as well as towns and cities, have largely remained unsurveyed. Identification of urban property is, therefore, only by means of description of boundaries. This has to be remedied.

  Even for agricultural land, surveys are dated. Even though resurveys are under way, the process of cadastral survey in India has not yet taken full advantage of modern low cost technology available in surveying and mapping. Though the state government departments undertake most of the cadastral surveys in India, the private sector is now becoming involved in these surveys. A relatively low cost method to implement basic cadastral mapping is to combine satellite imagery with existing village maps and other readily available spatial products. A central body to establish a regulatory framework and enforce technical benchmarks and standards could speed up the roll-out of proven models for cadastral mapping and avoid costly trial and error on the more complex issues of generating spatial data.

- **Settlement of land disputes.** Land disputes need to be settled to establish validity of titles for land. These would require special land courts (or administrative tribunals) that will deal exclusively with land disputes. A possible policy initiative in this regard is to set up some fast track land courts for the settlement of land disputes in rural and urban areas. This was done in Mexico, where 42 land courts and one appeals court were created, which dealt with nearly half a million conflicts in five years. In addition, a special institution to provide legal assistance to small landholders and represent them in court dealings was set up; this helped the poor access this dispute resolution system.[6] An out of court settlement procedure with binding effect could be pursued in parallel.
- **Reduction of stamp duty.** India has among the highest rates of stamp duty in the world. With Stamp Duty on the conveyance of immovable property ranging from 15 per cent in Bihar to 6 per cent in Gujarat and 5 per cent in Maharashtra and Andhra Pradesh, and an additional registration fee ranging from 0.5 per cent in Andhra Pradesh to 2 per cent in Bihar, India is clearly an outlier among countries, where the Stamp Duty rates range from 1 per cent to 4 per cent. It is necessary to reduce the rate to promote land transactions in a transparent manner and ensure the sustainability of any improvements made in land administration. Some Indian states, namely Andhra Pradesh, Jharkhand, and Maharashtra have significantly reduced stamp duties. Reduction of stamp duty has been included as a condition for accessing funds from the Government of India under the Jawaharlal Nehru National Urban Renewal Mission. All States who have signed up to access funds from this mission have had to provide a roadmap for reducing stamp duties to no more than 5 per cent in a definite timeframe. This is a welcome step. Revenue neutrality could be maintained by combining a reduction of stamp duty with an increase in the land tax.
- **Compulsory registration of all transactions.** A large number of land transactions, especially in case of succession, do not need to be registered, partly because it is deemed unreasonable to charge stamp duty on these. Requiring that any change in the revenue records as a result of succession triggers a corresponding change in the land registry, without any payment in stamp duty, will go some way in ensuring registries are complete.
- **Remote and easy access to registration procedures and to land records.** The use of Internet kiosks to access land records has proved very useful in increasing transactions in states where it has been tried.
- **Standardization of forms and computerization of land office.** Petty corruption, loss of records, delay in transactions and threat of fire or flood to records are some common problems that can be dealt with easily through standardization and computerization.
- **Elimination of restrictions on land markets.** Widespread prohibition of land leasing is not consistent with efficient resource allocation. It raises the cost to rural–urban migration as villagers are unable to lease their land, and often have to leave a family member (typically the wife) behind to work the land. Lifting these restrictions can help the landless (or more efficient large land owners) get land from those who migrate, and allow those who currently lease land informally to formalize their transactions and thus obtain institutional credit and other benefits. To the extent that liberalization of land leasing enhances owners' security and may allow adoption of long-term contracts, it is also likely to increase investment incentives for all parties.

A prerequisite to formalizing tenancy agreements would be to put in place a system of guaranteed titles that capture details on proprietorship, property extents, rights and encumbrances. Compulsory registration of lease-holds and on the owner's title would then provide tenants protection. Registration fees should be minimal and procedures simple in order for both tenants and landlords to formalize their contracts. The formal tenancy agreement would provide tenants the legal collateral to access credit based on tenancy. Of course, for such a leasing market to take off, owners should be confident that long-term tenancy would not lead to their losing ownership. With a vibrant market for land, and clear title, there would be little political justification for such a step.

It is also important to drop restrictions on the sale or transfer of interests of agricultural land to non-agriculturists which has little economic justification. If farmers were allowed to freely transact their land, they could retain more of the windfall profits from such transactions, without resorting to less profitable subterfuge. While the Committee understands there are important historical rationales for such prohibitions, the whole issue needs to be reconsidered as urban and non-farm employment increases, cities and towns expand, and the need to sell land and exit agriculture increases.

In sum, three steps would help facilitate access to credit from financial institutions based on tenancy of property: (*i*) Eliminate prohibitions on tenancy; (*ii*) Create a climate of judicial balance between landlord and tenant rights; (*iii*) Institute formal contracts between landlords and tenants that are clear, easy, affordable, and reliable, that protect the tenant's tenancy while not impairing the landlord's right to reclaim or dispose off the property after the period of contract, and with appropriate notice.

Status of Computerization of Land Record in India

Computerization of land records was launched as a centrally sponsored scheme in 1988–89. Though progress under this scheme has not been consistent across states, many large states have digitized basic land records data and have started the process of recording sales (mutations) and distribution of record of rights (RoRs) using computers. As of 2007, states that had completed data entry of RoRs included Andhra Pradesh, Goa, Gujarat, Karnataka, Tamil Nadu, Chhattisgarh, Madhya Pradesh, Maharashtra, Rajasthan, Sikkim, Uttar Pradesh, Uttarakhand and West Bengal. The states of Karnataka, Tamil Nadu, Gujarat, Madhya Pradesh, Maharashtra, Uttar Pradesh, Uttarakhand and West Bengal have stopped manual issue of RoRs.

Since land is a state subject, every state has independently pursued initiatives towards computerization of land databases. For instance, the RoR has been computerized under the *Bhoomi* project in Karnataka, *Mahabhulekh* in Maharashtra, LRMIS in Andhra Pradesh, *Tamil Nilam* in Tamil Nadu, and SWAN in Gujarat. Similarly, computerization of the land registration (mutation) has been implemented through the KAVERI project in Karnataka, SARITA in Maharashtra, CARD in Andhra Pradesh, C-STAR in Tamil Nadu, and RajCREST in Rajasthan. Progress has remained skewed, as despite efforts since 1988, most states have not progressed much beyond just data entry or piloting on a limited scale. In this regard, it will be important to disseminate more widely the best practices of successful states and design incentives that encourage lagging states to overcome resistance and bridge the gap with the progressive states.

The integration of textual and spatial data, linkage of registration with mutation and a comprehensive and standard database of land records across the country will be essential for efficient administration and policy making. As of today, these are stand-alone in nature, as there is no comprehensive framework to collate and integrate the data into a seamless system of land information management that could run on a geographic information system (GIS) platform and provide land data.

In fiscal year 2007–08, the central government announced a major reform initiative under the National Land Resource Management Programme (NLRMP). This initiative includes computerization, updating and maintenance of land records and validation of titles, as well as plans to provide a comprehensive tool for development planning. Under this programme, the following three layers of data: (*i*) spatial data from satellite imagery/aerial photography; (*ii*) topographic maps and other data from Survey of India and Forest Survey of India; and (*iii*) land records data—both RoR and maps, will be integrated into a GIS platform. The primary focus of this effort is to provide citizens with RoRs with maps to scale and other land-based certificates such as income certificates (particularly in rural areas), domicile certificates, information for eligibility for development programmes, land passbooks, etc. This would also act as a comprehensive tool for land-based development planning.

Source: Ministry of Rural Development (http://rural.nic.in); World Bank report, *India Land Policies for Growth and Poverty Reducation, 2007*.

Creating and registering security interests: Operation

We have examined concerns with the single largest form of collateral, land. Let us turn now to the process of registering a security interest in this and other property.

1. **Benefits of registering security interest**
   In order for creditors to establish they have a secured claim to an asset, and in order that prospective lenders or purchasers be made aware of prior claims, a well organized system to register and publicize security interests is essential. Registration of security interest is beneficial to all parties concerned:

- Debtors, because it allows them to obtain access to credit at a lower cost and more expeditiously than in systems where information about the encumbrances on the assets of the debtor is not readily available;
- Creditors, because it allows them to extend credit with relative certainty as to their rights:
  - Registration enables prospective secured creditors to ascertain whether the relevant assets have already been collateralized in favour of a prior creditor. In the absence of registration, secured creditors must rely on debtor assurances or undertake extensive factual inquiries.

- Registration is needed to deal adequately with the consequences of an unauthorized disposition of the encumbered assets by the debtor.
- Third parties, because it puts them on notice as to potential encumbrances on the assets of the debtor. Registration establishes a clear date stamp, which together with the principle of first-in-time priority, provides an objective mechanism for establishing priority (and avoids litigation associated with falsified dates on securities).

2. Preconditions for realizing the benefits of registration as outlined above

Security interests are usually recorded in documents. In case of non-possessory security interest (where the creditor does not hold on to the asset), documents are the only place where the creditors' rights and interest are recorded. This makes registration critically important. Moreover, widespread registration increases the use of registration as creditors attempt to protect their interests.

Given the importance of expanding coverage, it is disconcerting that, as with several transactions discussed in this report, exorbitant stamp duties under state laws deter borrowers and creditors alike from obtaining security, or registering it. Given the benefits discussed above, stamp duty (and registration fees) should be reduced to such a level that it does not deter transactions, with the state benefiting from the increased economic activity it engenders (as well as the moderate taxation of larger transaction volumes).[7] The stamp duty rates and registration fees should also be uniform across all the states in India.

The registration system should be set up to permit the indexing and retrieval of information using some reliable identifier of the grantor such as his name or tax payer ID. The need for unique national identifiers is again obvious. The registration system should permit the creditor/ or the borrower to register the security interest within a reasonable timeframe. Reasonable public access to the registry should be assured by setting fees for registration and search at a cost-recovery level and making available remote modes, and points, of access. The system should also provide for registration of notices of securitization (or transfer of receivables/credit facilities which are secured). The system should dispense with the requirement of registering the security interest when the asset falls under asset specific registration requirements (see table below) that are already prevalent in India. It should integrate all registry databases (many of the state databases are not computerized, let alone linked to a common searchable facility), and be user friendly so as to facilitate efficient registration and searching. This will require some central coordination.

There should be a movement towards a conclusive proof of the transactions as found in modern registries so that creditors and others can rely upon their title search with certainty. The law should provide for reasonable rules on the allocation of liability for loss or damage caused by an error in the administration or operation of the registration and search system.

3. Current regime for creation and registration of security interest in India

In India, there is a well established system for registration of security interests created by companies incorporated under the Companies Act, 1956, but there is no registration process mandated for certain types of security interests created by individuals, partnership firms, cooperative societies, trusts, etc. Additionally, for certain categories of movable assets, there are asset specific registration systems in operation, and registration is required in respect of charges created on such assets irrespective of who holds the asset. The following table offers a brief snapshot of the existing structure, which underscores the lack of a Single comprehensive framework for registration of security interest covering all types of borrowers and all types of assets.

Other assets including intangibles such as copyrights, trademarks, or units of mutual funds, or government securities lack formalized systems of recognition and registration of security interests. Security interests in these are usually obtained along with mortgage or hypothecation of other assets, or require outright transfer/ assignment by way of security.

4. Way forward to achieve a comprehensive registration regime

The Committee sees three main options to register security interests in a comprehensive way.

(a) Using the existing network of Registrar of Companies and the Ministry of Corporate Affair's MCA 21 e-governance initiative.

The benefits of starting with the infrastructure the Ministry of Corporate Affairs

Applicable law/Enactment	Applicability to persons (All or specific)	Types of security interest covered for the purpose of registration	Security interest excluded
The Companies Act, 1956	Companies (governed by the Companies Act, 1956)	A charge on: • Debentures; • Uncalled share capital of the company; • Immovable property; • Book debts; • Movable property; • Floating charge on any property; • Calls made but on paid; • Ships; • Goodwill; • Intellectual property right.	Pledge
The Registration Act, 1908	All persons	Deeds pertaining to: • immovable property viz. mortgage deeds; and • debenture trust deeds.	• Equitable mortgage[8] • All movable properties (registration optional)[9]
The Merchant Shipping Act, 1958	All persons	Mortgage over ships	—
Motor Vehicles Act, 1988	All persons	Hypothecation[10] of Motor Vehicles	—
The Patents Act, 1970	All persons	Mortgage of the Patents	—
The Depositories Act, 1996; (NSDL/CDSL Business rules and bye laws)	All persons	Pledge of securities	—

already has in place are clear, especially because MCA21, its e-governance initiative already stipulates electronic filing of documents and has remote access through the Internet in place.

It will be important, though, that the system of registration of charges should be opened to individuals, partnership firms, cooperative societies, trusts, etc., and should extend to all assets through an extension of the mandate in the Companies Act, 1956.

(b) Using the nascent credit information companies (or alternatively, the depository infrastructure—which serves the capital markets).

Credit Information Companies (CICs) formed under the Credit Information Companies (Regulation) Act, 2005, are licensed and regulated entities with the infrastructure capabilities of undertaking the registration of security interests. Another alternative are the electronic depositories—the National Securities Depository Ltd and Central Depository Services Ltd. The use of CICs or depositories will require legislative action (amending the CIC Act or amending the Depositories Act).

(c) Using the yet-to-be-notified SRFAESI Act provisions dealing with the registry of security interests.

The SRFAESI Act envisages an entity to register security interest. Clearly, implementing this will require starting a registration system afresh.

This Committee believes that there is some merit in creating competing registration systems, especially in the private sector, but we should also guard against fragmentation of the databases. The database maintained by each competing registry should be accessible to anyone accessing other registries (on payment of the requisite inter-registry fee), and the search process should make the boundaries between registries seamless to the searcher (much as is envisaged for credit information bureaus). With this proviso, the Committee would advocate exploring all three options with the focus on making registries compete on registration fees, search fees, and ease of access.

INSOLVENCY AND CREDITOR RIGHTS: PRINCIPLES AND TAKING STOCK

Principles

A well functioning system of credit should provide mechanisms for dealing with corporate distress. It should broadly have four key elements:

1. An effective legal framework for creditor rights. A well-functioning system of credit should be supported by mechanisms that provide efficient, transparent, fair and reliable methods for recovering debt, including the seizure and sale of immovable, movable and intangible assets. This is particularly true in India where the bulk of business financing is debt financing, especially at the SME level.
2. An effective legal framework for corporate insolvency. Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation of the assets of the business to maximize recoveries for the benefit of creditors. Piece-meal liquidation often generates less value than the preservation and sale of the business itself to new owners, and whenever feasible, this will be the preferred form of liquidation. Sometimes, though, the economic value of the enterprise is fundamentally sound, even in its existing form, and preserving the enterprise as a going concern will generate the most value for all concerned. The enterprise then needs to go through a process of rehabilitation, where claims are renegotiated, new finance obtained for investment, and certain organizational, managerial, and ownership changes made to preserve the confidence of claimants. The process of rehabilitation should be quick, easy to access, and cheap when deemed necessary, protect all those involved, permit the negotiation of a commercial plan, enable a majority of creditors in favour of a plan or other course of action to bind all other creditors (subject to appropriate protections) and provide for supervision to ensure that the process is not subject to abuse.
3. An effective legal framework for informal workouts**.** The formal legal process necessitates additional costs and delays that, whenever possible, should be avoided. Out of court informal corporate workouts are therefore preferable wherever possible. Informal workouts are negotiated in the 'shadow of the law', with the legal insolvency framework providing both a threat point if informal bargaining breaks down, and a way of giving legal status to agreements that are reached informally. Accordingly, the enabling environment must include clear laws and procedures that require disclosure of, or access to, timely and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, rescheduling, restructurings and debt-equity conversions; and provide favourable or neutral tax treatment for restructurings; and
4. Effective institutional and regulatory capacity for implementing the law. Any legal framework is only as good as the integrity and capacity of both the institutions and the personnel needed to carry it out.

Let us now consider the existing system for dealing with corporate insolvency in India.

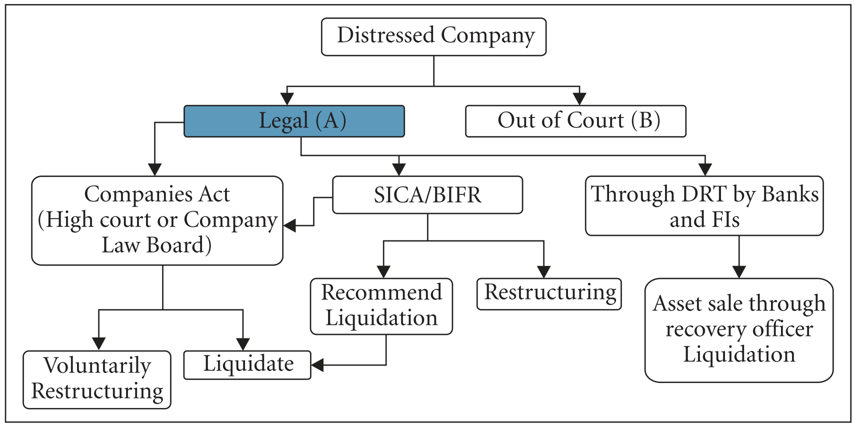
Bankruptcy/restructuring framework in India: An overview

Legal framework

A rough sketch of the legal framework for restructuring would look as below.

Revival and rehabilitation provisions under the Companies Act, 1956 and the Companies (Second Amendment) Act[11]

The legal, court-driven framework in India is characterized by three processes: (*i*) the Companies Act, 1956 ('Companies Act'); (*ii*) the Sick Industrial Companies (Special Provisions) Act, 1985 ('SICA'); and (*iii*) the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ('DRT'). At the outset, it is instructive to note that the Companies (Second Amendment) Act, 2002 ('Second Amendment Act') created a new quasi judicial mechanism, namely, the National Company Law Tribunal ('NCLT') which would encompass the power and jurisdiction of the Company Law Board, the Board for Industrial and Financial Reconstruction, the Appellate Authority for Industrial and Financial Reconstruction and of the High Court relating to company law matters.



The NCLT has not, however, been put into operation as yet. As the SICA has not yet been repealed, sick Companies however continue to be governed by the Board for Industrial and Financial Reconstruction ('BIFR') and the Appellate Authority for Industrial and Financial Reconstruction ('AAIFR') which are defunct. The legal structure is therefore, to put it charitably, in a state of transition, and this state of affairs needs to be remedied quickly. Fortunately, the economy has been doing well, but this state of affairs will not last forever.

The Board of Directors of the industrial company classified as a 'sick industrial company'[12] under the Companies Act shall make a reference to NCLT within 60 days from the date of adoption of final accounts, and submit a scheme for its revival. On conducting an enquiry into the working of the sick company, NCLT may pass any of the following orders:

- That the company be given reasonable time to make its net worth higher than the accumulated loss or pay its debt;
- If the above is not possible, NCLT may direct an operating agency to submit a scheme of rehabilitation within 90 days, which may entail financial reconstruction; change in or take over of management; amalgamation with any other company; sale or lease of assets or rationalization of management and personnel. The scheme may also provide for financial assistance by way of loans, advances or guarantees or relief or concessions or sacrifices from the Central Government;
- If NCLT comes to the decision that the company cannot be revived, it may record its opinion to recommend winding up of the company and initiate winding up proceedings.

Winding up under the Companies Act, 1956 (the 'Companies Act'):

Under the Companies Act, 1956, there are two modes of winding up of a company:

- Winding up by the Court [13]
- Voluntary winding up which may be:
  - Members voluntary winding up
  - Creditors voluntary winding up
- Conduct of winding up proceedings.

Every winding up, whether it be by the Court or a voluntary winding up, is undertaken by appointment of a Liquidator, who takes under his charge all of the Company's assets and manages the affairs of the Company in a manner which would prove to be the most beneficial to the interests of the creditors, shareholders, and the Company itself.

Recovery under the recovery of debts due to banks and financial institutions act, 1993 (the 'DRT Act')

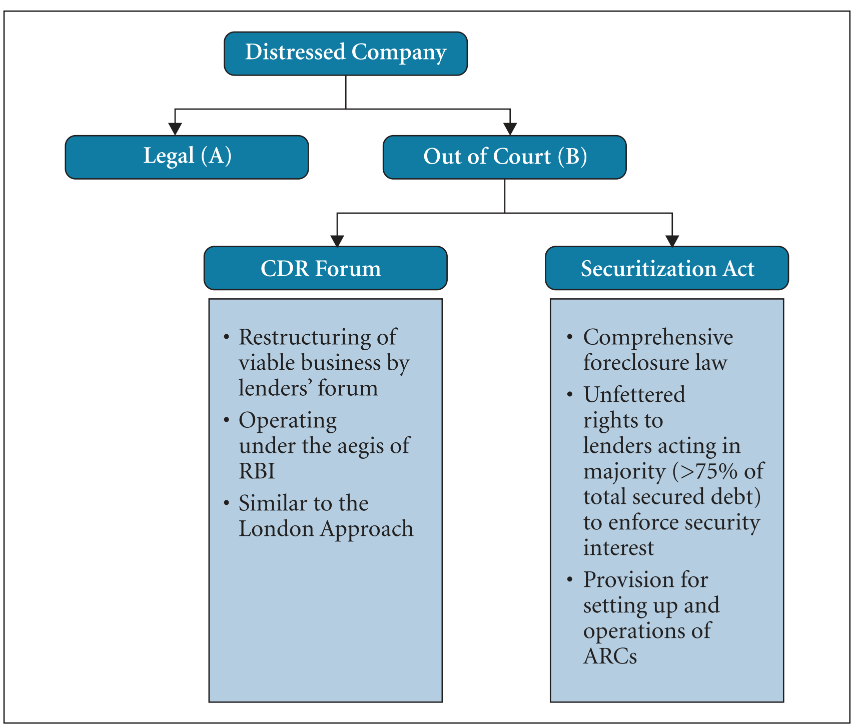
The DRT Act provides for the speedy adjudication of matters relating to recovery of debts that are due to notified banks and financial institutions. Every case pending before the Civil Courts, where the debt amount has exceeded Rs. 1 million, gets automatically transferred to the Debt Recovery Tribunal ('DRT' or 'Tribunal') established under the DRT Act. Once the Tribunal passes a final order, the recovery process is automatic and a separate application is not required to enforce the orders of the Tribunal. An appeal against an order of the Tribunal must be made to the Debt Recovery Appellate Tribunal within 30 days from date of receipt of the DRT order.

The DRT suffers from a number of weaknesses including the following:

- The DRTs were hampered for a long time, due to an insufficient number of tribunals and Presiding Officers—an urgent need to train Presiding Officers and cut down delays remains. Only 22 DRTs with 5 Appellate Tribunals located in five centres have been established so far.

- Though DRTs follow summary procedures for deciding cases, the recommended statutory timeframe of 6 months for deciding cases is rarely complied with. The proceedings before the DRTs often take more than 2 years and, fail to produce significant recoveries for unsecured creditors. If the matter goes into appeal to the DRAT, further time is taken and 3 years elapse before any recovery takes place.
- Recovery Officers by and large, lack sufficient judicial experience and are not adequately trained for their appointment. There is no transparency in the appointment of auctioneers by Recovery Officers.
- Different DRTs follow different procedures, leading to inconsistency and lack of clarity in approach of DRTs in matters involving the serving of summons on debtors, filing of original documents and evidence, permitting cross-examination of creditors, procedure on day-to-day conduct of proceedings etc.
- A Working Group to examine the functioning of DRTs was set up, but no further steps have been taken so far.

'Out of Court' Framework



Other creditors than banks and financial institutions must typically resort to the ordinary civil courts under the Code of Civil Procedure ('CPC') or pursue a foreclosure action under the Transfer of Property Act to recover debts. Both proceedings are cumbersome and time-consuming. The 2002 amendments to the CPC simplified procedures, but cases still take 5 to 7 years to get resolved. Decrees granted to unsecured creditors have little enforcement value.

Corporate Debt Restructuring (CDR) framework

The CDR Mechanism is a voluntary non-statutory system based on Debtor-Creditor Agreements (DCA) and Inter-Creditor Agreements (ICA) and all banks/financial institutions in the CDR System are required to enter into the legally binding ICA.

The CDR system in the country has a three-tier system:

- CDR Standing Forum and its Core Group
- CDR Empowered Group
- CDR Cell

The CDR Standing Forum is the representative general body of all financial institutions and banks participating in CDR system, which is required to meet at least once every six months and has the task of reviewing and monitoring the progress of the corporate debt restructuring system. Individual cases of corporate debt restructuring are decided by the CDR Empowered Group. The CDR Empowered Group is mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the Company and approve the restructuring package within a specified timeframe of 90 days, or at best within 180 days of reference to the Empowered Group.

The CDR Cell scrutinizes the proposals received from borrowers/creditors and puts up the matter before the CDR Empowered Group within 30 days to decide whether rehabilitation is prima facie feasible. If found feasible, the CDR Cell then proceeds to prepare a detailed Rehabilitation Plan with the help of creditors and, if necessary, experts engaged from outside. If not found prima facie feasible, the creditors may start action for recovery of their dues.

Securitization and reconstruction of financial assets and enforcement of security interest act, 2002 ('SRFAESI Act')

SRFAESI Act addresses the interests of secured creditors'. Its purpose is to promote the setting up of asset reconstruction companies to take over the Non Performing Assets (NPAs) accumulated with the banks and public financial institutions. The Act provides special powers to lenders and asset reconstruction companies to enable them to take over the assets of borrowers without first resorting to courts.

In the event of default by a borrower, the Act empowers the lender to issue demand notice to the defaulting borrower and guarantor, calling upon them to discharge their dues in full within 60 days from the date of the notice. If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures: (*i*) Take possession of the security; (*ii*) Sale or lease or assign the right over the security; (*iii*) Manage the security; (*iv*) Ask any debtor of the borrower to pay any sum due to the borrower.

In case of financing by more than one secured lender the rights under the Act can be exercised only if supported by secured creditors representing not less than three-fourth in value of the amount outstanding. Such action is binding on all secured creditors.

The framework for bankruptcy resolution, as we have seen, is fragmented, complex, and fraught with delay. Some of the delays are because key resources such as trained judges are in short supply. Better legal management, more training, and more outsourcing of less central tasks could help reduce delays. But the framework itself needs consolidation and clarification. As more ventures are contemplated, such as infrastructure projects, that could result in complex bankruptcies and tie up enormous resources, the need to clarify the framework becomes even more imperative. The Second Amendment, when implemented, will improve bankruptcy resolution, while SRFAESI has improved creditor rights outside bankruptcy, but as discussed below, there is scope for improvement. We deal in sequence with reforms to the process of enforcement and out-of-court negotiation (section VI), and to the bankruptcy system itself (section VII).

DEBT RECOVERY AND REORGANIZATION OUTSIDE BANKRUPTCY

CDR

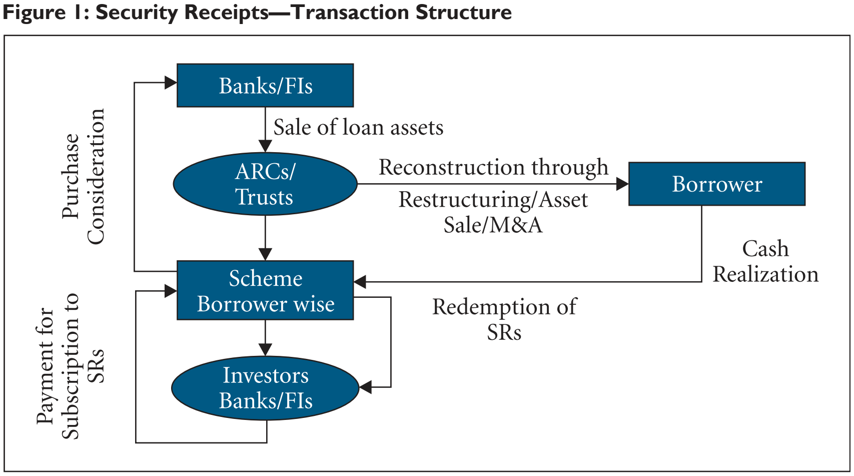
The RBI's Corporate Debt Restructuring (CDR) rules have facilitated many informal and out of court workouts of troubled companies. Nevertheless, there is significant room for improvement. An unintended consequence of the success of the CDR rules has been a proliferation of debt re-scheduling or, at best, 'balance-sheet restructuring' as opposed to more comprehensive operational restructuring. In the absence of an effective formal framework for reorganization (discussed below), this can have the effect of masking NPLs and creating latent, systemic problems. It is important to balance the CDR mechanism (which is largely creditor-driven) with a debtor-led formal process.

SRFAESI

Although potentially more efficient and time-sensitive than ordinary courts, the DRTs remain unable to complete the debt recovery process within a reasonable amount of time (the typical case takes approximately 3 years). SRFAESI presented a realistic and attractive alternative to DRTs and, indeed, after its implementation, the number of new DRT cases filed was reduced by almost 40 per cent.[14] Today, even after the SRFAESI amendments that placed certain limitations on creditor enforcement rights, SRFAESI remains generally popular amongst its core constituency, commercial banks. Nevertheless, there remain a number of key roadblocks within the system that should be addressed.

Although the experience with SRFAESI has not been uniformly positive,[15] there is a strong sentiment in the business community that 'it works'. By facilitating out of court enforcement, SRFAESI promotes the type of certainty that allows lenders to more accurately price risk and creates a legal environment conducive to lending. The tools available under SRFAESI should now be expanded to other lenders besides banks, public financial institutions, and housing finance companies. At a minimum, asset-based lenders (such as equipment financiers) should have access to SRFAESI-type provisions. Because SRFAESI encompasses non-corporate borrowers, expanding the definition of who can be a lender under SRFAESI would have the added effect of creating a single statutory regime for secured lending, applicable to virtually all business forms. This not only contributes to both transparency and simplicity, but also allows for greater competition amongst lenders as all lenders, will have access to the same legal provisions on enforcement. Of course, due regard will have to be had to potential abuses of the extraordinary enforcement powers in the act, but there is no evidence to suggest that these would be worsened by expanding SRFAESI's users.

Figure 1: Security Receipts—Transaction Structure



Asset reconstruction companies (ARCs) in India

Asset Reconstruction Companies world-wide can be classified into: (*i*) Government owned/ supported ARC; (*ii*) Bank owned ARC—workout units and bad bank models; (*iii*) Private sector ARCs. India follows the 'Private sector ARC' structure, where ARCs may be set up by lenders, specialized investors in non-performing loans (NPLs) or corporations. There is a restriction that no shareholder in an ARC may have a controlling interest with the intent of preventing a lender from using an ARC as a 'warehouse' for its NPLs. Indian law allows the sellers of bad assets to double up as investors. So, when an ARC buys bad assets from banks, it issues Security Receipts (SRs) to such banks and instead of being a lender to bad assets, the banks become investors in such assets. Bad assets bought from different banks are pooled and SRs are issued against such a pool (see Figure 1). Banks are repaid as and when ARCs recover on the assets, and if the recovery is above the purchase price, the difference is shared by the investor and the ARC involved. This is, however, for such deals where SRs are issued. ARCs can buy bad loans paying cash also. In such cases, banks do not get a share of the extra money made through recovery.

ARCs bring some specific attributes to debt recovery. First, they can aggregate debt claims from a number of lenders, and from different classes of creditors, thus obtaining the legal and intrinsic leverage from being a large lender, as well as reducing conflicts between creditors. Second, they can acquire the specialized skill sets necessary for debt resolution. The SRFAESI Act has also provided wide-ranging powers to ARCs for resolution of NPLs. ARCs have access to all possible powers available to banks/FIs for resolution as also access to additional powers such as step-in rights and the ability to change management, and sell or lease the business [Section 9(a) & 9(b) of the Act].

The primary impediments to the more effective functioning of ARCs in India can be classified under three broad headings:

1. Limited supply of impaired assets coming on the market.
2. Limited set of buyers and capital entering the business.
3. High transactions costs.

Limited supply of impaired assets

The book value of the NPLs that banks/FIs hold on their books is higher than the 'market value' ARCs are willing to pay. The need to recognize an additional loss when assets are transferred comes in the way of transfer. This has real consequences since NPLs typically lose value over time as the impaired borrower's assets deteriorate. The solution is to require that NPLs be marked down on the books to market values that prevail in the ARC market. In turn this requires that prices ARCs pay be realistic assessments of value (and that banks have enough capital to absorb losses).

Such prices can be realistic only if the market is deep, with many sophisticated players on both sides. One step to expand the number of sellers is to amend SRFAESI to include a variety of other non-bank lenders under the definition of secured creditor under SRFAESI, and to allow these non-banks (such as NBFCs) to sell their assets to ARCs.

Limited set of buyers and limited access of ARCs to capital

On the other side of the transaction, the number of buyers can be expanded by licensing more ARCs. The institutional capacity to run ARCs can be found amongst foreign players. There is really no sensible case to keep foreign direct investment out of Asset Reconstruction Companies. The kind of risk capital as well as the kind of expertise foreign investors bring is useful in the economy, and can help provide a valuable buffer. From an economic perspective, capital that comes into the country when the banking sector is distressed, and a flood of assets are sold to ARCs is particularly valuable, and foreign investors, not domestic financial institutions, are most likely to be flush with capital at those times. The danger of ARCs buying from their parent financial institutions can be eliminated through specific regulations against self-dealing, and is anyway small for foreign institutions who do not have local operations. If there is a fear that ARC powers are too draconian to entrust certain players with (such as provisions of Section 9), it should be dealt with by amending the law rather than keeping out players with reasonable probity.

It should be noted that in a number of countries in Asia, there is active encouragement of foreign participation. In Taiwan there are no restrictions on foreign ownership of ARCs. Indeed, a tax incentive is provided to encourage foreign entry. That incentive is given by way of a reduction in the rate of withholding tax from 35 per cent to 20 per cent on dividends distributed to foreign shareholders in ARCs. Likewise, both the People's Republic of China and Korea have encouraged international participation in the market for NPLs promoted by the ARCs in those countries. In the case of Korea's ARC, KAMCO, it has used international bidding to dispose of NPLs. Some of those auctions have been conducted with put-back options enabling the successful bidder to resell NPLs to KAMCO as an additional incentive for investors to participate.

Finally, as with other forms of investment, it would help if mutual funds, insurance companies, and FIIs were allowed to invest in the senior claims and SRs issued by ARCs. Banks prefer cash for the assets they transfer to ARCs, and requiring them to hold SRs instead on their balance sheet is a poor use of bank capital. But ARCs will not have the cash to pay for the assets they buy unless they can access a wider pool of investors.

Transactions costs

As with every other financial transaction, the transfer of assets to ARCs is held back in some States on account of high incidence of stamp duty on such transactions. Several states have lowered or capped stamp duty on such transactions and this has helped facilitate transfers to ARCs. The SRFAESI has made an attempt to deal with this issue of high stamp duty in Section 5, which provides for the acquisition of financial assets by an ARC by way of an issue of debentures to the originators. However, this section does not contain clear provision for the vesting of the title to such assets in the acquiring ARC and further, it is not clear whether such an acquisition would attract the stamp duty payable in respect of an assignment/ conveyance of financial assets. SRFAESI need to be amended to provide for a clear vesting of title in the ARC on an acquisition of financial assets by way of an issue of bonds or debentures under Section 5(1)(a).

DEBT RECOVERY AND REORGANIZATION IN BANKRUPTCY

Introduction to formal rehabilitation

By far, the most difficult and most pressing issue facing India's ICR system is the need for a functioning and realistic reorganization scheme, capable of being either debtor or creditor led. SICA and the related BIFR are considered failures. The Second Amendment proposed certain turnaround provisions for the Companies Act, but is generally viewed as not having gone far enough and, without the operation of the NCLT, has not had much effect in India.

There are myriad issues to consider when designing a rehabilitation scheme. Each issue raises a series of competing policy decisions that will be informed by, among other things, the experiences India has had with BIFR and SICA and their perceptions as failures, as well as the dramatic structural changes within India which demand flexible reorganization methods on par with those in more developed economies. The next section deals with the key elements that will need to make up an Indian reorganization mechanism. This list is by no means exhaustive, but identifies the critical elements that cannot be overlooked.

Key elements of an Indian formal rehabilitation scheme

Eligibility

The restructuring law needs to clearly define who it applies to. The challenge in India is to avoid both over- and under-inclusiveness. Certain types of entities in India, such as banks, insurance companies and major utilities, serve important economic and social functions. The ramifications of these entities becoming insolvent go far beyond the predominantly commercial considerations associated with ordinary businesses and, accordingly, it is perhaps best to exclude these entities from the restructuring law. At the other end of the spectrum, while it should be noted that the protections afforded and discipline imposed by a sound insolvency law should be as widely available as possible, in the Indian context it may be inappropriate to allow small businesses the right to a complex restructuring mechanism that could cause undue delay. This goes back to the important issue of ensuring a balance between liquidation and rehabilitation and, also, to the balance between using the law to facilitate debt collection (and access to credit) or to serve broader socio-economic purposes such as stability.

There is international precedent for a bi-furcated approach, which may be appropriate in the Indian context (subject to any specific constitutional concerns). Such systems are typically split along the lines of highly objective criteria (e.g., the total amount of debt owed to arms length creditors) that are not, themselves, likely to be contested. For entities that exceed the threshold, the full process should be available and, for those that do not, a more truncated process (without, for example, complex tools such as post-commencement financing and with shorter timelines) would be utilized.

Moreover, for all entities, there should be clear, bright-line rules for transferring a proceeding out of restructuring and into liquidation. This transfer could occur at a number of 'trigger' points, including determination by the court or insolvency office holder (in India, preferably the latter) that the restructuring process is unlikely to be successful or not in the best interests of the stakeholders. It could also occur immediately upon the failure of the restructuring plan and, in some cases, after a fixed length of time from the commencement of proceedings. This helps to balance the concepts of certainty and flexibility, and also addresses the often-expressed concern that the restructuring law should not undo SRFAESI's successes.

Commencement of proceedings

As noted in the Dr. J.J. Irani Committee Expert Committee on Company Law Report, the most appropriate commencement test in India is the 'liquidity' test. This requires that the debtor has generally ceased making payments and will not have sufficient cash flow to service its obligations as they fall due in the ordinary course of business. It is generally accepted that this test can be applied on a fairly objective basis and helps put a company under the insolvency law's protection before it is too late.

Moratorium and timeframes

One of the most contentious issues in designing the restructuring scheme will be the nature, applicability and duration of any moratorium on seizure of the debtor's assets. The moratorium is at the heart of the restructuring because it is the formal mechanism by which the debtor is given the breathing room to reorganize. At the same time, the SICA moratorium was widely abused and led to the need for, amongst other things, SRFAESI. Closely linked to this issue is the general question of time limits, which also poses some difficulty for India. Leaving the courts with unlimited discretion in determining timeframes opens the process to abuse, relies heavily on the judiciary's constant involvement in the case and creates too much uncertainty for creditors. Very tight timelines may, on the other hand, leave too little flexibility.

When a debtor has failed the liquidity test and approached the courts with an application for restructuring or rehabilitation, he should simultaneously be able to file for an automatic stay on creditors proceeding to seize assets. The automatic stay should begin upon filing and last until the first hearing by the courts. Given the delays that are otherwise likely in the Indian context, the first hearing of petition should be required by law to be heard within a short period (say 15 days) from the date of filing.

The automatic stay should stand vacated by law on the date of first hearing, whereupon, if the debtor wants to have the stay granted/continued for a further period (which again the law should prescribe), the court should consider this only after affording an opportunity to the creditors to be heard, and provided a majority of creditors by value support the continuation of the stay.

The law should specify clear and very narrow circumstances under which a judge can grant a further stay overriding the wishes of the majority of creditors in value. Among the necessary conditions for granting a further stay over the objection of a secured creditor (in respect of that creditor's assets) is if the court believes that the asset is vital for the restructuring and, importantly, that the secured creditor will not be materially prejudiced by the stay. A secured creditor or the insolvency representative should have a mechanism to seek extraction of a specific asset from the estate on explicit grounds during the life of the restructuring. Typically, these grounds relate to whether the asset is dramatically being reduced in value without some form of protection being provided to the secured creditor, or where the asset is deemed by the insolvency representative to not be necessary for the purposes of the reorganization. Whether the exceptions in this paragraph lead to substantial debtor abuse, or whether they offer some necessary respite from excessive creditor power is something only actual experience will tell. The legislation should be altered with experience.

Extension of the stay should be in fixed intervals (for example, 60 days) with a maximum number of stays (say 3) during the lifetime of the restructuring.

There should be reasonable timelines for the regular distribution of cash flow statements to the court and creditors, filing of the restructuring plan, voting on the plan and implementation of the plan. In the case of the latter three, the consequence of failing to meet the timelines should be a transfer of the case out of restructuring and into liquidation.

Control of the debtor

There is no universally agreed upon approach to the issue of control of the debtor company during reorganization. Many systems prefer the debtor-in-possession (DIP) approach, with existing management running the company, while others prefer the appointment of the insolvency administrator to control the company. There are some advantages to the DIP approach in that the existing management of the company are usually best equipped to continue the company's operation during restructuring in a cost effective manner (i.e., without the retention of outside professionals). On balance, however, DIP systems tend to be considerably more court-intensive in that, while the debtor remains in possession, creditors and the insolvency administrator often feel the need for the security of the court's direct involvement on specific issues.

By contrast, the 'administration approach' (where the insolvency administrator takes possession and control of the company, subject to court oversight) has seemed to result in somewhat less contentious proceedings and, in any event, less court involvement. While the court's involvement is not, in and of itself, negative, it has tended to make DIP systems considerably more expensive and, where DIP has been applied in countries where the courts have difficulty in quickly advancing cases, it has caused considerable delay. The Committee therefore recommends that whether the debtor be allowed to continue to manage be put to vote in the initial hearing, and it be allowed only with the approval of the majority of the creditors. Else the 'administration approach' should be followed and a cadre of well-trained professional bankruptcy administrators should be developed to implement it.

Post-commencement financing

In the vast majority of cases in which a company enters a restructuring, the company does not have sufficient liquidity to operate during the time it takes to restructure. The continued operation of the business during this period has been shown to be vital to the business' health. Employees and suppliers must continue to provide services and be compensated and the company must continue to trade so that its customer base is not eroded. Many countries, therefore, have adopted provisions by which a debtor in reorganization can obtain additional financing. In some countries, this is a purely academic question in the sense that no realistic market for financing troubled companies exists. In India, however, it is reasonable to hypothesize that a market for this type of financing could develop.

Post-commencement financing itself comes in many forms. At the most basic level, many companies need trade credit to order inventory. The most common approach to this issue, particularly when possession and control of the company is in the hands of an insolvency administrator, is to permit the administrator to take on such credit in its personal capacity, with such costs forming a priority charge over all of the assets of the estate. In practical terms, this is not usually a problem because, if the initial tests for restructuring have all been met, the continuity of trade is a foregone conclusion and the purchase of inventory will bring new assets into the estate for the benefit of the creditors.

More contentious is the ongoing payment of operating expenses when the company is operating on a negative cash flow basis. Although two broad approaches are prevalent here (one where the court can order a 'super-priority charge' ahead of all secured creditors on all assets for the purpose of obtaining additional capital and one where the debtor can only grant security over unencumbered assets unless secured creditor consent is obtained) in practice, there is little difference. Even in jurisdictions where courts are empowered to override secured creditor objections, they rarely do except in the most extreme of circumstances. Nevertheless, it would seem that, given the novelty of this concept globally, a more conservative approach is warranted. Such an approach would necessarily require the debtor to work towards a consensual solution with its largest secured creditor so that, in most cases, that creditor would be the one providing the additional financing in restructuring.

Approval of the reorganization plan

The desired result of any restructuring is the creation and approval of a plan that allows the debtor to emerge from restructuring in a viable state. Determining how this plan will be arrived at is therefore critical. In India, it is important that reorganization plans not be used as a tool to subvert the essence of commercial bargaining. In the long run, this will simply have a negative effect on the availability and cost of credit and, again, will cause the reorganization scheme to be viewed as just another tool by which debtors can avoid paying their obligations. As a result, there are some key principles to be observed: creditors should be grouped according to classes that are determined based on having a set of shared interests and rights; approval of the plan should be dependent upon a formula that requires both some form of majority approval within classes and of the classes as a whole; creditors of a similar class should receive the same treatment under the plan; creditors whose rights are being compromised in any way should have the ability to vote on the plan; if any class of creditors dissents but is being bound by the plan, the proponents of the plan should be required to demonstrate that such class is receiving no less than they would under liquidation.

Priority

The statutory priority of different claimholders to bankruptcy proceeds is typically a compromise between political and economic compulsions. While the need to protect employee claims such as overdue pay is important, there should be a limit (say six months) to which pay is protected, after which employees should also join the ranks of unsecured creditors. The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors. But perhaps most important, the statutory priorities of a firm should be well disclosed so that creditors can act well in time, before they get crowded out by other claims.

Personnel issues

Virtually all modern insolvency law frameworks rely upon a highly competent adjudicative body. Although truncating judicial processes may be an effective way of speeding up simple contract and secured credit enforcement, reorganizations will require an effective judicial or quasi-judicial authority. India possesses a large body of highly qualified, experienced judges and a relatively strong judicial branch of government. This is a strength that needs to be drawn upon in the design of an Indian restructuring system. In particular, the creation of a true specialized court, with appropriate training and resources (the NCLT), is a realistic option for India. Such a court would facilitate the implementation of more sophisticated restructuring tools that rely on an effective judiciary to constantly balance the interests of creditors and debtors.

In addition to facilitating the training of the judiciary in the finer points of finance, business, and bankruptcy practice—something that can be undertaken by joint programmes between some combination of the National Judicial Academy, business schools, law schools and expert judges/lawyers in India—there is also a need for a whole host of supporting staff such as the bankruptcy administrator or the official liquidator. It would be efficient to outsource these tasks to professionals such as business lawyers, consultants, or accountants on a case by case basis, making the chosen individuals 'officers of the court' in the same way that legal practitioners are (and holding them to the same ethical and professional standards). Alternative compensation structures such as a fixed percentage of the overall realizations, or a fixed percentage of the realizations for creditors, or a fixed amount plus a sliding scale of percentages, could be considered to give these professionals the right incentives. Reappointment to future cases should be on the basis of a sound track record.

More generally, specific guidelines will have to be created for the licensing, training, remuneration, supervision, and discipline/suspension of these individuals. Ideally, a self regulating body of bankruptcy professionals should undertake many of these tasks except for the last, which should be the charge of an external board set up by the NCLT.

Cross-border insolvency

Although briefly touched on in the Irani Report, cross-border insolvency is rapidly becoming a 'hot-button' issue in domestic insolvency reform in emerging market countries. As one of the largest recipients of foreign direct investment in the world, India has an urgent need for a mechanism of dealing with foreign judgements, cooperation and assistance amongst courts in different countries and the transnational nature of corporate entities.

India's ICR framework does not recognize the jurisdiction of foreign courts in respect of the branches of foreign banks operating in India. As such, if a foreign company is placed into liquidation outside India, its Indian business will be treated as a separate matter and will not automatically be bound by the same proceeding unless Indian stakeholders commence a separate proceeding. This results in confusion, multiplicity of proceedings and unnecessary costs.

The UNCITRAL Model Law on Cross-Border Insolvency provides a roadmap, adaptable to India's needs, for the treatment of foreign entities and foreign proceedings.

Review

No bankruptcy system, especially given India's complexities, will be born perfect. Whatever the bankruptcy legislation that emerges from parliament, a process of review should be undertaken every few years to examine its success in practice. Easy-to-collect metrics such as the duration of bankruptcy, the extent of creditor recovery, the number of successfully rehabilitated companies, the administrative costs of bankruptcy, etc. should be collected, and features of the bankruptcy code continuously examined to understand their practical impact. This will be especially important because new factors will emerge that will require change in the laws.

For instance, it is possible using credit default swaps (CDS) for a debt holder to completely hedge the risk of default of the debt he owns, and even stand to gain from default, despite owning debt. Such a debt holder has perverse incentives, and may frustrate the restructuring process based on a hidden interest derived out of his CDS position. This is an issue that is relatively minor in India today, but will undoubtedly become more important in the future. How bankruptcy code will have to be amended to take such issues into account is a task best undertaken by a future review.

PERSONAL BANKRUPTCY

The wave of farmer suicides has highlighted the importance of personal indebtedness. While suicides are a complex phenomenon, and cannot be attributed solely to indebtedness, it does raise the question of whether there are sufficient mechanisms to write down or even forgive the value of individual debts when they get too high.

Current provisions for personal bankruptcy essentially place severe penalties on an individual who is declared insolvent, with various statutes treating insolvency as a disqualification on par with insanity or moral turpitude. It may be worthwhile to debate whether a reform of personal insolvency provisions should be considered, that provides workout opportunities to individuals while protecting creditor interests. Because Indians have become more willing to take on debt, and not just in the agricultural sector, many more will experience difficulties. As the business cycle becomes a feature of the Indian landscape, many small businessmen without the protection of limited liability will be overwhelmed by their debts, and many middle class households will find themselves unable to their monthly installments.

We indeed need an urgent review of personal insolvency laws, as well as a framework within which debts can be renegotiated if excessively onerous, without making it too easy for debtors to escape obligations (which will hurt the debtors themselves as they will be unable to borrow). Such a framework should recognize that many debt claims may be from informal sources, that the most indebted may be very poor, that they may need counseling and financial advise as much as debt rescheduling, and that they may have little resources to navigate the legal system.

A first step towards credit counseling and mediation could be the Office of the Financial Ombudsman that is proposed in Chapter 6. That office can be a first stop in bringing creditors together and attempting a mediated settlement with the debtor. Such an out-of-court settlement may be the most efficient way to consensually renegotiate excessively onerous debts, with the shadow of the courts (such as the Lok Adalat) providing the backstop. At the same time, as the provisions for tracking credit histories become better, it may be possible to reduce the current penalties for bankruptcy substantially, imposing financial penalties (limited and costly future access to finance) on the bankrupt rather than moral or criminal penalties.

SECURITIZATION

Background

Securitization as a means of raising finance or transferring credit risk has existed in India since the early 1990s. Initially, it consisted primarily of quasi-securitizations[16] or Direct Assignments (DA). Portfolios or individual loans simply moved from the balance sheet of the originator to the investor (such as a bank), without any type of tradable security being created. Over time, the market has moved to more formal securitization involving special purpose vehicles (SPV). The individual loan(s) are assigned to an SPV (normally a trust) which issues tradable securities in the form of pass-through certificates (PTC) to investors.

The Indian market saw a significant increase in securitization activity in the period 2000–06, partly because of increases in retail consumer loans such as car loans, commercial vehicle loans, unsecured personal loans and residential mortgages. Despite the flexibility provided by direct assignment transactions, SPV transactions continue to grow since one of the most significant investors, mutual funds, can only invest in tradable assets.

Turning to assets being securitized, auto loans were the mainstay of the securitization market in the 1990s. Since 2000, residential mortgage backed securities (RMBS) have also contributed to market growth, though RMBS activity has slowed significantly during the last two years. Corporate loans, commercial mortgage receivables, project receivables, toll revenues, etc. have also been securitized. According to ICRA estimates, issuance volume in the Indian structured finance market grew at a CAGR of 34 per cent between FY 2003–07 and by 44 per cent in FY 2007. Asset-backed securities (ABS) claimed the biggest share in the market, accounting for 63 per cent in FY 2007, followed by CDO/LSO (32 per cent). RMBS, hindered by limited investor interest, amounted to less than 5 per cent of the total in FY 2007. The total size of the new issues was INR 370 billion.

Given that the underlying asset classes being securitized are largely retail and short or medium term corporate loans, the issuers are typically private sector banks, foreign banks, and non-bank finance companies (NBFC). The key motivations for originators are raising finance, generating a lower cost of funds (especially because securitization proceeds are not subject to capital requirements or reserve requirements), and management of asset liability mismatches. Key investors are mutual funds in SPV transactions and banks in DA transactions. The transactions are purely domestic with no cross-border securitization because there is little regulatory clarity on treatment of participation by foreign institutional investors (FIIs).

Need for securitization of trade credit

As yet, corporate accounts receivables (trade credit) are not securitized. The existing RBI guidelines do not make it clear whether revolving assets such as trade credit or working capital loans etc. can be securitized.

However, trade credit is a critically important source of finance for Indian firms across the board. For all firms together, the share of trade credit in total corporate financing has grown steadily from 7.25 per cent to almost 16 per cent during 2001–05. In 2005, it was the biggest funding source. Further, the proportion was much higher (26 per cent) for SME's.

SMEs could reduce their investment in working capital, and thus their need for finance, significantly if the receivables due to them from large firms could be securitized. In principle, such receivables, if accepted, are essentially commercial paper with the high credit ratings of the large firms. Further, if the SME can securitize and sell its receivable claim, its resulting smaller and better capitalized balance sheet would improve its credit worthiness.

Though the securitization process is similar to factoring, it could be more cost-effective than bank funding, factoring, and letters of credit. A negotiable Bill of Exchange (BoE) issued by a buyer against goods received provides a form of securitization of trade credit. The supplier can have the BoE discounted with any financial intermediary in a private transaction. The supplier and the intermediary can also endorse the bill in favour of any other party. Currently, mostly banks deal in BoEs, and usually the acceptance and discounting are kept under the credit limit set up for the buyer. However, the

Sources of Funds for Non-financial Indian Corporations

Year	All firms		SMEs		Manufacturing		Services	
	2005	Average 2001–05	2005	Average 2001–05	2005	Average 2001–05	2005	Average 2001–05
	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Internal Sources	67	61	44	24	74	67	44	46
Equity	13	12	13	29	9	7	13	6
Debt	–3	0	1	0	–6	0	5	19
Banks & FIs	1	8	15	12	0	4	11	9
Group Cos/Promoters	1	2	4	2	1	2	2	0
Trade Credit	16	11	11	26	15	14	19	8
Others	5	7	12	8	6	7	10	12
Number of Observations	4,766	24,658	752	3,760	3,242	17,426	1,524	7,232

Source: CMIE, Prowess.

nature of the transactions and the physical format of BoEs rules out a sizable secondary market in them.

The Mexican development bank, NAFIN, created an electronic system where any small firm could present receivables on a number of large firms to it. NAFIN had set up arrangements with these large firms beforehand to have these receivables presented and accepted electronically. The accepted receivables, now full-fledged claims on the large firms, were then auctioned off in the market, and the proceeds paid out to the small firms. Nothing prevents a private sector entity in India from setting up this exchange, but the government could provide significant encouragement, as well as any needed legislative support. Therefore, the Committee proposes measures that will dematerialize trade credit receivables and enable them to trade in a similar way to commercial paper.

Specifically, we propose that:

- An organization like NSDL should provide dematerialization capability.
- An intermediary along the lines of NAFIN could tie up with large buyers and an authorized list of their suppliers to have automatic bill presentment and acceptance facilities. Such bills could then be auctioned, and the existing exchanges and reporting mechanisms (NSE/BSE/CCIL) should be used to trade and settle these instruments.
- Additionally, since most of these instruments are not rated, a formal rating programme along the lines of commercial paper could be instituted to enhance secondary market tradability.

Potential for freeing up balance sheets of small banks and cooperatives

Another important area where securitization can help is in refinancing small banks and cooperatives. This is an area where public entities like NABARD have typically played a large role in the past. If, however, the market for securitization became more effective, standardized loans made by small banks or cooperatives could be packaged and sold. Of course, a number of safeguards would have to be in place so that the kind of aberrations we now see in industrial country markets do not emerge. For instance, originating banks would have to retain a significant portion of the 'first loss' so that they have an incentive to originate higher quality credits, and so that they keep close tabs on the borrower.

With reasonable safeguards, the securitization market could be an important way of refinancing small and medium lenders such as cooperatives in rural and semi-urban areas, as is already the case in urban areas. One set of potential investors would be other banks. If the only buyers were banks through direct assignment, this would be equivalent to extending the Inter Bank Participatory Certificate (see Chapter 4) scheme to a wider category of institutions. The set of investors with a formal securitization process in place could, however, be even broader and eventually include mutual funds, insurance companies, and pension funds.

NOTES

1. Positive information typically refers to a past record of successful repayment of loans, rent, utilities bills, etc., but could also include information about the borrower's financial assets such as deposit accounts. Negative information typically refers to defaults on commitments.
2. This section was adapted from a note titled 'Inventory of the Personal Identification Mechanisms in India', prepared by Financial Information Network and Operations Ltd (FINO) for the Committee.
3. ISO 27001 is the most widely recognized information security standard in the world. This international standard has been prepared to provide a model for establishing, implementing, operating, monitoring, reviewing, maintaining and improving an Information Security Management System. CIBIL is ISO 27001 certified.
4. This section has benefited substantially from the World Bank report, *India Land Policies for Growth and Poverty Reduction*, 2007, and the interested reader is referred to that report for details.
5. *India Land Policies for Growth and Poverty Reduction*, 2007, p. 31.
6. This was also tried in Andhra Pradesh with some success.
7. The reduction of the stamp duty can be to nominal amounts, say of Rs. 100, or if calculated on an ad valorem basis, then at 0.01 per cent subject to a statutorily prescribed cap, say of Rs. 100,000. The registration fee itself can be a fixed nominal amount.
8. Equitable mortgage or mortgage by deposit of title deeds is most prevalent in home mortgages—the reforms to the stamp duty and registration law could facilitate a move to mortgage deeds being obtained and diminish the utility of equitable mortgages.
9. Optional registration also lacks the pre-requisite of mandatory registration—it does not amount to public notice, which other registrations, as listed, ensure.
10. The Act also deals with finance in nature of lease and hire-purchase, and consequent recognition of separation of ownership (with the financier) and user (the person availing of finance).
11. The Companies (Second Amendment) Act, 2002 incorporates the regime governing sick industrial companies from SICA, 1985 into the Companies Act, 1956, in the form of part IV A – the provisions of which are yet to be notified.
12. 'Sick Industrial Company' means an industrial company which has the accumulated losses in any financial year equal to 50 per cent or more of its average net worth during four years immediately preceding such financial year; or failed to repay its debts within any three consecutive quarters on demand made in writing for its repayment by a creditor or creditors of such company [Section 2 (46AA)].
13. Substituted by 'National Company Law Tribunal' by the Companies (Second Amendment) Act, 2002, w.e.f. a date yet to be notified.
14. Reserve Bank of India Report on Trend and Progress of Banking in India, 2004–05.
15. Amongst other complaints, borrowers suggest that SRFAESI's tools remain too draconian, even after reform, and lenders assert that the limited appeal rights available under SRFAESI are still open to abuse.
16. High Level Committee on Corporate Bonds (2005) has used this term.

Special Topics

chapter 8

INFRASTRUCTURE FINANCING

No discussion on financial sector reforms in India can be complete without reference to how they will help infrastructure finance. First, it is well recognized that significant improvement in infrastructure is required not only to sustain the growth momentum but also to distribute the benefits of higher growth to a larger population. Financial sector reforms therefore cannot be oblivious to the requirements of such a critical segment of the economy. Second, infrastructure creates certain special demands on the financing system. Infrastructure projects are capital intensive with long gestation periods; their revenues accrue over a long period of time; they involve higher sunk costs; and their output is non-tradable. These characteristics translate into certain demands on the financial system (in terms of scale, tenor, and risk) that are very different from those of other goods and services.

Given the criticality of infrastructure and its peculiar demands on the financing system, it is important to know the quantum of India's infrastructure financing needs and how are they going to be met. A consultation paper by the Planning Commission has envisaged an investment in infrastructure of Rs. 20.3 trillion (at 2006/07 prices) or US$ 494 billion during the Eleventh Plan (April 2007 to March 2012), substantially above the realized investment in the Tenth Plan (Rs. 8.8 trillion at 2006/07 prices) in order to sustain a real GDP growth rate of 9 per cent.[1] Of this, about 20 per cent would be spent exclusively on rural infrastructure. Some of the salient points made by the paper are:

1. Gross capital formation in infrastructure is envisaged to grow rapidly from 5.6 per cent of GDP in 2006/07 to 9.2 per cent of GDP in 2011/12, the last year of the Eleventh Plan and be sustained at that level from then on.
2. The share of private sector will rise from 20 per cent of total infrastructure investment in 2006/07 to about 30 per cent in 2011/12.
3. The budgetary support in total infrastructure investment, would gradually decline (from 43 per cent of total infrastructure investment in 2006/07 to 31 per cent in 2011/12), implying that user charges will play an increasingly bigger role in financing infrastructure.
4. Budgetary support would be directed 'largely towards rural infrastructure and the North East, leaving little room for funding other infrastructure projects'.

If the current savings trend growth continues into the medium term, much of this need can be financed domestically, provided other sources of investment demand do not increase rapidly also. But, adequacy of domestic financial savings is not enough; they have to be intermediated into infrastructure on a scale that would achieve the investment target. This is where the problem is expected to arise, as some of the deficiencies of the current financial system may not allow the intermediation to be scaled up to the required level.[2]

For the most part, until quite recently, India's spending on infrastructure investment was low enough (about 3–5 per cent of GDP) to be financed largely from budgetary allocations and the internal resources of infrastructure-focused government enterprises. Under these conditions, infrastructure financing placed little demands on the financial system. It is only now that infrastructure spending has picked up enough momentum that the financial system must cope with new and enlarged demands, for which it is arguably under-prepared.

At the institutional level, constraints have emerged for all three major classes of domestic financing institutions: commercial banks, NBFCs and insurance companies. With rapid increase in exposure in recent years, commercial banks are now the predominant financiers of infrastructure.[3] They may not, however, be able to sustain the growth rates recorded in the past, primarily due to the fact that long duration infrastructure projects create significant maturity mismatches for banks, given the essentially short-term nature of bank financing. Also sectoral caps[4] and limits on single and group borrower exposure (emerging because of the enormity of project size relative to bank capital size) will place further constraints on financing. While it might be tempting to relax prudential norms in the cause of infrastructure, this would simply be wrong—infrastructure finance can be risky, and it would be short-sighted to sacrifice the health of the banking system on the altar of infrastructure finance. Instead, banks need to raise capital. Particularly constrained here are the public sector banks, since more capital means either a dilution of the government stake or further investment by the government.

Specialized NBFCs have begun to play an important role in infrastructure development; but their future growth may be constrained by banks' growth potential, since banks are the primary source of funding for NBFCs and there are limits on bank exposure to NBFCs.[5] Though insurance companies are well suited to finance infrastructure because of their long-term liabilities, they have been constrained due to their own risk aversion and preference for government, or government backed paper, restrictive investment guidelines and the lack of liquidity in the market for longer term corporate bonds. In addition, a number of insurance companies will have to develop their own capacity to evaluate infrastructure projects.

Infrastructure requirements are too large for the risk of associated financing to be concentrated directly or indirectly in the banks. In this context, the need for a well functioning, deep and liquid corporate bond market at the longer end of the maturity spectrum cannot be overemphasized. By tapping the growing pool of long-term funds available with the insurance and pension funds, as also foreign investors, the corporate bond market can significantly benefit infrastructure investment, by (*i*) better distributing the risk of financing such investments more widely across the financial system, and (*ii*) facilitating a better match between the maturity profile of infrastructure assets and the liabilities needed to fund them. This can only lend stability to the financial system.

Second, the scale of banks' balance sheets needs to expand to keep pace with the scale of infrastructure financing requirements. This is an important underpinning for the Committee's call for a more liberal approach to consolidation in the banking system. Consolidation would mean more efficient use of infrastructure risk appraisal skills (which are limited and whose distribution is skewed), and at the same time, greater opportunities to use unutilized exposure limits.[6]

Third, the banks need access to more instruments to manage the interest rate risk for infrastructure lending induced ALM mismatches. The Committee's recommendation of a more enabling regulatory environment towards instruments such as credit default swaps and interest rate futures is key to helping this process along.

Fourth, steps to nurture the evolution of a variety of institutional forms, including hedge funds and private equity, would help the financial system cater better to the complexity of the financing requirements for the infrastructure sector which needs not only long-term debt financing, but also significant equity capital.

Finally, initiatives that help investors better manage the credit risk associated with infrastructure financing deserve special attention. Infrastructure lending is typically cash flow based, not asset backed. The Committee's suggestion for strengthening the rights of unsecured lenders would help reduce losses in the event of default for infrastructure loans, make it easier to securitize such assets or borrow in the bond markets against them. Not only will this reduce the direct costs of infrastructure finance, the added liquidity for infrastructure-backed loans could help Asset Liability Management for financial intermediaries engaged in infrastructure finance.

OLD AGE PENSIONS

The problem

With the elongation of longevity, individuals have to plan for living for decades after they have ceased working for a living. Changing social mores have reduced the extent to which children satisfactorily solve this problem. Hence, households critically require a way to obtain consumption in old age. This is where formal pension provisions come in.

Back of the envelope calculations show that the amounts of pension wealth required by a household, to support consumption for two or more decades, vastly exceed the sums of money involved in issues such as spells of unemployment or ill-health. Hence, the most important reason why ordinary households require the financial system is preparing for old age. In a well functioning financial system, pension-related savings is a large part of the savings of household, and pension funds are amongst the largest pool of investible assets.

The problems of defined benefits pensions

One strategy that can be adopted to address the problem of consumption in old age is to socialize the problem; to require the State to make payments to all old people. The numbers involved in this are substantial. A modest pension of Rs. 1,000 per month, paid to 20 crore people, works out to a cost of Rs. 240,000 crore per year.

This approach, with payments made by the State or underwritten by it, was used with civil servants for the traditional civil servants pension, and with employees of firms with over 20 employees through EPFO. Many problems were encountered in this path.

The fiscal liability on account of civil servants alone—who make up a tiny fraction of the workforce—exceeds 65 per cent of GDP. Hence, this strategy is not scalable to the general population. Attempts at funding have been made: the Employee Pension Scheme (EPS) which is run by EPFO is a defined benefit programme which requires payments by participants and has some assets. However, defined benefit systems tend to suffer from inherent political problems. There is an incentive to make generous payments, to cut corners on the required contributions, and to make improper asset management decisions thus leading to poor asset returns. As a consequence, the unfunded liability of EPS has steadily built up over the years, as has happened with defined benefit pensions all over the world.

In countries where there are large defined benefit pension systems, where promises have been made about future pension payments to a large fraction of the population, this yields a difficult combination of fiscal stress and political intractability. Fiscal stability requires cutting back benefits, while populism pushes in the opposite direction. In Europe and Latin America, where there is the longest experience with defined benefit pensions, these difficulties have exerted considerable pressure on both politics and economics.

Defined contributions, individual accounts

In response to these experiences, there has been a worldwide shift towards 'individual account, defined contribution' pension systems, which avoid the political and governance problems of defined benefit systems. Under an individual account defined contribution pension system, individuals hold a pass book, much like a bank account. The individual makes payments into the pension account every month, but is prohibited from withdrawing money from this until he reaches old age. This money is invested by pension fund managers. The value of pension wealth is strictly based on the net asset value of the investments made by the pension fund managers. At all points in time, the individual can see how much pension wealth has been created, and can adapt his savings rate in order to achieve desired consumption in old age.

Prefunding pensions—as opposed to making promises about payments by the State deep in the future—is particularly feasible in India given where India is in the demographic transition. A vast army of young people will come into the labour force between 2008 and 2025. The dependency ratio will only start worsening from 2025 onwards. This suggests that policy decisions on pension reforms by 2010 have an opportunity to make a substantial dent on the problem, by catching young people early in their careers, and helping them build up pension wealth in time. In countries such as China, where the dependency ratio will start rising from 2010, such an opportunity for prefunding does not exist. The space for policy in India is, thus, luckily greater.

Investment management for DC pensions

From the investment management perspective, the two central insights on how these assets should be managed are: (*i*) Equity investment and (*ii*) International diversification.

Economic reasoning, and the empirical evidence from all countries, suggests that over long time-periods, equity investment yields the highest returns. For a person who is saving money from age 20 to age 65, which will yield consumption from age 65 to age 85, the time horizons are long indeed. Looking forward, assuming a full array of macroeconomic policy reforms are undertaken, India might experience stable inflation of 2 per cent, the nominal return on government bonds might work out to roughly 5 per cent, and the nominal return on the equity index might work out to 13 per cent on average. This equity premium of eight percentage points makes a massive difference to pension wealth, given the long time horizons involved. There will, of course, be substantial swings in the stock market index from year to year. But the returns to an equity index will outperform investing in government bonds, over a 25 year horizon, with high probability.

The swings in the stock market index from year to year can be significantly alleviated by spreading pension assets all across the world. A portfolio spread across indexes from all over the world has a volatility which is roughly half of a portfolio invested only in an Indian index. There is, thus, a powerful case for equity investment, into stock market indexes from all across the world, in pension fund management in India.

Simple-minded pension reforms do not work

The application of these ideas might suggest a simple-minded strategy of establishing a regulatory framework through which citizens obtain their own pension products in a decentralized way from financial firms. This approach has run into difficulties in many countries, and is particularly inappropriate in India.

If private financial firms offer defined benefit (DB) pension products, then there is a difficult regulatory problem attached to it. For a young person, a DB pension makes promises about payments 40 to 65 years into the future. Over 40 to 65 year horizons, in a healthy and competitive financial system, most financial firms normally exit the business through acquisition or bankruptcy. DB pensions sold by financial firms thus require a considerable apparatus of State regulation, and inevitably involve messy problems for the State when the firm experiences bankruptcy. This underlines the importance of defined contribution pensions where there are no such problems.

The central difficulty with 'simple minded pension reforms' lies in the high fees and expenses charged by financial firms. In some countries, as much as a third of the lifetime contributions end up as payments to financial firms. Financial firms have an incentive to spend a lot of money on marketing and distribution, which helps them gain market share, and this money is paid by the pension accounts of their customers. Individuals worldwide have tended to be remarkably uninformed about the size of payments being made to their fund managers. Fund managers have an incentive to devise a large number of non-comparable products, so as to evade accountability through comparison of returns, and to confuse customers with high-pressure sales campaigns which encourage customers to buy each of these products.

These problems—of financial firms spending a lot of money on marketing and distribution—are alive and well with Indian mutual funds and particularly insurance companies. They illustrate the pitfalls of simple-minded pension reforms.

Another source of costs is the inevitable transactions costs and administrative costs. Transactions inevitably involve costs, and these costs generally have a fixed rupee value. When the transaction size is small, the rupee value of the transactions cost looms large. In India, where a large number of small-value customers would engage in a large number of small-value transactions, this is an onerous challenge. Similarly, each pension fund manager would inevitably suffer administrative and record-keeping costs. These costs would be large, in percentage terms, when there are small value account balances.

Put together, the implementation of individual accounts in India through simple-minded pension reforms suffers from daunting problems where a large fraction of the contributions would be used up for transactions, recordkeeping, administration, distribution, and marketing costs.

The new pension system (NPS)

In the late 1990s, the Ministry of Social Justice and Empowerment set up 'Project OASIS', which led to the New Pension System. The key ideas of the NPS are the centralization of recordkeeping, standardization of fund management products and competitive procurement of fund managers.

On the core tasks of transactions and recordkeeping, there are economies of scale. Instead of each fund manager maintaining a client database, it is cheaper to have a single centralized database. This is termed the 'Central Recordkeeping Agency' (CRA) in the NPS. Contribution flows from all individuals go up to the CRA, where netting takes place, and pension fund managers only get a single big transaction every day. This reduces costs of transacting and administration. The CRA also plays a useful function in enabling competition: through a single computerized instruction, a customer can switch from one fund manager to another. This is much easier, and cheaper, than the switching process seen with mutual funds or insurance companies today.

An extensive literature in financial economics suggests that the dominant determinant of investment performance is the asset allocation, and not security selection. The NPS envisages exactly three kinds of asset allocations. Scheme 'A' would have mostly government bonds, and a small share in corporate bonds and corporate equities. It would look similar to the existing EPFO-style asset allocation. Scheme 'B' would have a greater emphasis on corporate bonds and equities. Scheme 'C' would have a further emphasis on corporate bonds and equities. All fund managers selected into the NPS would produce exactly three products. Equity investment within all three schemes is expected to be implemented using index fund investment, thus yielding reduced cost and regulatory complexity.

From the viewpoint of the consumer, this simplification would simplify decision-making. Fund managers would be forced to compete on performance and not on advertising, given the head-on comparability of performance. There is a lower role for high-pressure marketing when there are only three products.

Fund managers are recruited into the NPS through auction. Bidders are required to pre-commit a consolidated number for the grand total of fees and expenses that they would charge. A small number of lowest bidders would be the fund managers of NPS. So far, very low bids of 3 to 5 basis points per year have been obtained in these auctions. These prices compare favourably with the lowest prices seen worldwide in pension fund management.

Through these innovations, the NPS appears to be headed to becoming one of the lowest-cost individual account pension systems in the world. In an interesting and parallel set of developments, ideas much like the NPS were put into the 'Thrift Savings Plan' (TSP) in the United States which was set up in recent years for civil servants.

The NPS has been adopted by the centre and almost all state governments for new recruits after 1 January 2004. Three fund managers have been recruited through an auction, and a private firm (NSDL) has been contracted for construction of the Central Recordkeeping Agency. The NPS is expected to come to life in late 2008.

In 2008 and 2009, the primary task is that of making the NPS work, and of bringing in all employees recruited by central and state governments after the cut-off date. By 2010, the NPS should be fully operational. At that point, it should be possible for the State to reduce its pension liability by giving employees recruited before 1 January 2004 an option to shift into the NPS. Employees who choose to do this would be paid a certain amount into their NPS account on the first day, reflecting the pension wealth that they would have built up in the NPS if they had been part of it all along from their date of recruitment. This will further increase the size of the NPS, and reduce the pension liability of the State, albeit at the cost of a one-time payment.

Reaching into the unorganized sector

The NPS solves the problem of the pension liability of civil servants. However, civil servants are a small part of India's labour market. The real significance of the NPS lies in the fact that in the process of building the NPS for civil servants, some valuable institution building is taking place, and economies of scale are being achieved. The most important benefits of the NPS will come when it is scaled up to reach into the vast unorganized sector. Here, it will play a role in addressing the inclusion agenda, of bringing sophisticated finance to help improve the lives of millions of households.

In the unorganized sector, the NPS would, for the first time, offer an efficient mechanism for transferring consumption into old age. However, there are onerous difficulties of distribution, of reaching out to households all over India. The international experience suggests that voluntary participation in individual account pension systems is low. If the NPS uses the sales practices of mutual funds and insurance companies, then it would lose its core attributes of low cost. If the NPS does not use these sales practices, it might obtain few customers.

A few elements of a strategy for bringing the NPS into the vast unorganized sector can be outlined:

> Outreach will be critically enabled by harnessing occupational groupings. As an example, UTI has established a pilot involving dairy farmers in Bihar. When the farmer sells milk to his cooperative, 10 per cent of the price for milk is deducted and sent upstream into a pension account. Organizations such as Sewa Bank have been active in carrying the idea of a pension account to their audience. They can be a valuable intermediary through which accounts are opened and contributions collected. These approaches would avoid the low cost of selling to individuals and interacting with them.
>
> At a conceptual level, when a microfinance firm such as Sewa Bank interacts with a household, it would require a series

of financial products through which various problems of risk management and consumption smoothing of the household are addressed. NPS constitutes the upstream infrastructure through which one element of this—pension planning—can be delivered by Sewa Bank to households at a low cost.

The government runs many welfare programmes, and generally faces daunting problems of achieving effective delivery of these programmes. The administrative strength of the NPS gives an alternative through which money can be delivered at a very high efficiency. This can best be done through co-contribution by the government.

Roughly speaking, if a person in the unorganized sector brings in a contribution of Rs. 500 a month, the government could come through with a co-contribution of Rs. 50. If a person brings in lower or higher contributions, he would not be eligible for this co-contribution. There would be leakages to the extent that some rich people would harness this benefit. However, it constitutes a transfer of only Rs. 600 per person per year and constitutes a small leakage. Such a co-contribution strategy has been used with much success in countries such as Mexico in increasing participation in the formal pension system on the part of individuals in the unorganized sector. This expenditure can be seen as replacing the direct poverty-alleviation expenditures that the State might have to otherwise undertake if the same individuals are destitute in old age.

The expansion of NPS into the unorganized sector through such methods would inevitably take time. Policymakers have to have fortitude in patiently applying these strategies to obtain results over time. There are no quick results to be had, and the short-cuts through which (say) 1 crore accounts can rapidly come about in the unorganized sector generally do violence to the essence of the NPS.

Over the years, a combination of low costs, equity investment and international diversification will yield superior results for households, and this message will go out by word of mouth. The tremendous price advantage—where charges such as 3 to 5 basis points in the NPS are 20 to 50 times smaller than those seen with mutual funds and insurance companies—will gradually influence the views of households.

The NPS has a great asset in terms of having millions of civil servants who are part of it, who will experience it and talk about it to their friends and colleagues. Civil servants are spread all over the country and are respected in their community. Over the long haul, patient communication with users of the NPS, and with the unorganized sector at large, will yield results in terms of expansion.

SUGGESTIONS FOR IMPROVING INDIAN DATA COLLECTION

Introduction

In a vast, diverse, largely rural country, the challenge of gathering information that is both relevant and accurate is daunting. These challenges have become even more complex with faster economic growth, the shift to greater deregulation of the economy (particularly in infrastructure and manufacturing) and with increased international openness in trade, finance, investment, and human movement.

This is not to suggest that the Indian data system has not been responsive to the changing needs of the economy. Over the last decade, the Indian data system has undergone significant changes in terms of institutional structure, improved methodology, reduced time lags, and expanded coverage.

In this regard, two recent landmark events have been the report of the National Statistical Commission chaired by Dr. C. Rangarajan (2001, see Box 1) and India's subscription to the Statistical Data Dissemination Standards of the IMF on 27 December 1996. Each of these initiatives has led to a large work programme to improve the statistical base of the Indian economy; and these efforts continue.

These initiatives have been complemented by continuing domestic efforts to modernize standards in corporate accounting (through SEBI and the Institute of Chartered Accountants of India (ICAI)) and in government

Box 1: Organizational Reforms Proposed by National Statistical Commission (Chair: Dr. C. Rangarajan)

The Report of the National Statistical Commission (2001) made a number of suggestions for improving the administration of the statistical system in India.

The Commission recommended the setting up of permanent apex statutory body 'National Commission on Statistics' which would be an independent statistical authority. The NCS was expected to be responsible for policy making, coordination and maintaining quality standards in statistical data. NCS was set up by an act of Parliament in 2006.

The Commission also made recommendations on organizational aspects of the Central CSO and NSSO as well as methodological issues related to statistical data generation to make them more effective. They had proposed a methodological unit in NSSO to conduct studies in order to improve survey methodology.

The Committee emphasized the need to enhance the professional capabilities of staff that produces national statistics and recommended a number of steps towards achieving it.

One of the critical requirements of a good statistical data is strong legal backing for collection of data. Lack of this is now seriously impacting collection of key statistics like industrial production and wholesale price index. The Committee had recommended changes to the Collection of Statistics Act, 1953 to give it effective while taking into account the informant's right to privacy.

Source: Report of National Statistical Commission.

accounting (through the Government Accounting Standards Advisory Board, which is supported by the Office of the Controller and Auditor General). Both the World Bank and the International Monetary Fund remain deeply engaged with India's data collection institutions.

Given the span of issues covered in the present report, one can distinguish the following purposes and constituencies which would benefit from improved data.

First, there is a continuing need for a range of timely and credible leading and concurrent indicators of the cyclical position of the economy. These are essential both for sound policymaking and to help the financial markets to take a view of the likely future path of the economy, and price this view into financial instruments.

A second broad group of indicators has to do with risk management and the vulnerability of the economy. These are the indicators typically needed for multilateral (and financial market) surveillance. As such they are covered by the IMF's SDDS, and a review of the current status of these indicators is provided in the IMF's 2007 Article IV Consultation Staff Report.[7]

A third broad group of indicators has to do with the economic and distributional impact of government policy, of particular importance in an environment where 'inclusive growth' is an established overall goal of economic policy. These needs are substantially met by the various surveys of the National Sample Survey Organisation, which now also undertakes the All-India Debt and Investment Survey previously conducted by the Reserve Bank of India.

However, as noted below, the huge share of informal employment in total employment, and the growing share of the services sector in total output mean that infrequent surveys, no matter how careful, leave large gaps in our understanding of the mechanisms by which policy actions translate into household welfare. These gaps can only partially be filled by the efforts of data-gathering organizations outside government, commendable though these efforts are.

A related and much commented upon issue, is the widening gap between parameters (such as personal final consumption) estimated from household surveys, and their equivalent in the national accounts statistics (NAS).

Fourth, for planning development of new products, the business sector has a need for timely, geographically differentiated data on a range of topics. While some of this can be gathered by private enteritis, information is better treated as a public good, where the raw material is best financed by government, with subsequent analysis being performed by private firms.

Business cycle indicators

For effective decision making by investors, managers and policymakers information on business cycles (their leading, lagging and coincident indicators) is essential. The main leading indicators presently available come from the financial sector. Even here information on some key indicators, such as the actual rate of interest paid by the borrowers is missing; what are available are the prime lending rate (largely ignored by commercial banks in actual loan pricing) and a range of interest rates on treasury instruments. Despite the enormous importance of informal finance to the bulk of India's economic agents, data that formerly was reported on cost of credit in informal financial markets has been discontinued.

A major lacuna in the leading indicators for the economy is the lack of seasonally-adjusted time series. While this can be done mechanically by many econometric packages, it is useful to have uniformly produced, official data for analysts.

Availability of data on consumption, investment, employment, capacity utilization, inventories and housing starts help to identify cyclical movements in the economy. Some issues in this regard are pointed out below.

- Private Final Consumption Expenditure data from the national accounts is now available at quarterly frequency with a three-month lag (Source: CSO). A monthly series (e.g., retail sales) with a shorter time lag would be desirable.
- Inventory/stock data is available at broad sectoral and manufacturer level but not at the retail level. Also the sales data on most variables is available at the manufacturer level and not at retail level. Data on retail orders for consumer durables or orders for new construction or for new machinery are not available on a monthly basis/quarterly basis. Deficiency of such data hinders the identification/prediction of turning points in industry.
- In case of construction, which has been an important driver of growth in recent years, there is no systematic information on housing-starts or housing prices. The information on housing loans provides only a partial coverage of the construction activity. Collating information on housing stocks, housing starts and housing prices should be given top priority. Regular collection of a few series on rural housing would also be helpful given the enormous importance of this sector for rural activity, employment, and the demand for such important industrial products as steel and cement.
- The lack of a comprehensive and reliable indicator of inflation is widely recognized. The existing measures of inflation (WPI, CPI and GDP deflator) differ with respect to coverage, time-lag, associated markets and purpose of use, but none of them can be considered as a representative measure of inflation in India. The key measure of headline inflation—WPI—misses out on over 50 per cent of the economy. The need for a representative, comprehensive, and timely measure of inflation from the point of view of monetary policy targeting as well as financial market participants is very critical. Efforts have been on to construct a Producer Price Index (PPI) and a comprehensive CPI for urban and rural areas for quite some time. These efforts need to be intensified as existing measures of inflation are losing their relevance. The suggestions made by the National Statistical Commission are documented in Box 2.

Economic activity, employment, and asset behaviour

The unorganized sector forms an important part of the Indian economy, and bears the brunt of cyclical adjustment in the economy. Despite this importance, information on this sector's output is only available through the five-yearly Economic Census and the Enterprise Surveys conducted by the NSSO. The National Account Statistics do bring out estimates of value added for both the unregistered and registered parts of the manufacturing sector but not for the other sectors of the economy.[8]

Data gaps are equally serious in the services sector, which is now the largest and

Box 2: Recommendations of the National Statistical Commission for Improving Price Statistics

Currently the Wholesale Price Index is the measure of headline inflation in India. The latest data covers 435 commodities with 1993–94 as the base. The Commission had recommended frequent revision of base year to capture the changes in the structure of the economy, particularly the industrial structure. Since services sector which accounts for over 50 per cent of GDP is not covered by WPI, NSC had recommended a separate indicator for the services sector. No progress has been made on these suggestions.

The Committee had stressed the need to bring about uniformity in WPI compiled by various state governments and Union Territories in terms of base year, num-ber of items, weighting diagram, data sources etc.

The Consumer Price Index (CPI) is used for a variety of purposes including the increments in wages. There are four different CPI measures in India; CPI-Industrial workers, CPI-Urban Non-manual Employees, CPI-Agricultural labourers, CPI-Rural Labourers. Coverage of each measure is limited to specific part of the population and none of them can serve as an all-India measure of inflation. The commission had recommended development of all-India consumer price index for rural and urban areas in 2001. It is yet to be released.

In the absence of legislation for collection of price data, the Commission had recommended that possibility of bringing it under the umbrella of Collection of Statistics Act, 1953 should be explored.

Source: Report of National Statistical Commission.

fastest-growing part of the economy. In many cases, output is indirectly estimated (such as in the estimates of value-added from trading activity). Even the value added from transportation is based on indirect estimates as direct information is available only for the registered sector. There are difficulties in collection of data through the Follow-up Enterprise Surveys of Economic Census for the household and unregistered sector which constitutes all unincorporated enterprises including proprietorship and partnerships run by individuals. The services sector includes a large segment of business and professional services. Moreover, newer services are coming into existence very rapidly which further complicates collection of data on this sector (see Box 3).

Reliable estimates of value-added at the sub-national level (state and district) consistent with national estimates of GDP published by the CSO would fill a major data gap. The need for sub-national GDP data is also being increasingly felt by businesses to facilitate their decision making, and would be of particular interest to modern, service-oriented small and medium enterprises who might wish to concentrate their activities only to a small geographic area. Coordination between state statistical departments and the CSO would need to be improved for timely compilation and release of these statistics.

At present, the following important data gaps exist at the level of most states, particularly the poorer ones:

- No state-level data on savings and investment are available.
- Only partial data on export and import are available (inter-state).
- There are no official input/output tables.
- Time series estimates of GDP and Value of output at two or three-digit level for manufacturing (organized and unorganized) are not available.
- Sectoral Disaggregated GSDPs are missing.
- Government Final Consumption Expenditure data are only available at the aggregate level.

As noted below, the introduction of state-level Value-added Taxes (VAT), the expansion of the coverage of the Service Tax and the move to an integrated Goods and Services Tax (GST) generates data that might be used to fill out these gaps.

Box 3: Data on Employment, Productivity, and Skills

In a country like India where the share of population in the working age group is already very high and is projected to rise in future, careful monitoring of both the employment situation and availability of skilled manpower is indispensable. This information is critical for designing policies, which will match skills and opportunities to generate sustained increases in productivity and growth.

The NSSO's Employment–Unemployment Surveys are the standard source of structural change in the employment picture. These are only undertaken at intervals of five years. Non-availability of employment data at shorter frequency is an important gap in the existing data set for effective policy/business decision making. Related to the employment is the information regarding education level/skill set of the workforce/prospective workforce. While the Population Census and the/NSSO does provide some information on these aspects, frequency of updates remains a serious issue. A data set on an annual basis is definitely needed/desirable.

Today we are faced with a situation where a large part of population is virtually unemployable due to the lack of requisite skill sets, in other areas there is a severe shortage of skilled manpower. For instance, the surplus labour from agriculture is potentially unemployable in the manufacturing sector and a large part of the services sector due to lack of skills. Without doubt the availability of a large workforce is inconsistent with emerging formal and sophisticated work environment. At the same time the financial sector is facing manpower shortage, which is pushing up wages. Availability of information on supply and quality of labour can facilitate a timely policy response to such a situation.

Public finance data

Emerging markets have been prone to a range of so-called 'capital account crises', largely stemming from perceived inconsistencies and mismatches of various agents in the economy. In India, according to the IMF source cited earlier, the external trade and finance accounts are reasonably transparent, although some issues remain in regard to remaining maturity of external debt and trade credit.

Weak public finances and a high gross public debt stock even though largely denominated in rupees, are known sources of vulnerability, and this vulnerability may well increase with further liberalization of the capital account. In such a situation, transparent disclosure can be an important mitigating factor, while also assisting in the deepening of the market for public debt. Some of the issues related to inadequate disclosure are highlighted below. Absence of such information also constrains fiscal analysis at both national and sub-national levels:

- Finances are maintained on a cash-flow, instead of accrual, basis. This militates against any objective assessment of operating efficiency of the governments, i.e., the parameters like collection efficiency, debtors, etc. cannot be ascertained.
- There is an inadequate segregation of transactions relating to revenue and capital expenditure. The problem is compounded by the fact that there is limited accountability of end-use of funds received towards a specific purpose.
- Project-level budgeting is absent, resulting in inadequate project monitoring and control over cost-over runs, if any.
- For many entities financial accounts are not audited for years together; as a result, the correct position of opening and closing balances are not available. In many instances, even the financial accounts are not prepared on a regular basis.
- Overall, lack of adequate transparency in financial disclosure reflects and reinforces low accountability in utilization of public funds.
- No disclosures are done with respect to public assets, their economic use, market value etc. The level of detail on both on-balance-sheet and off-balance sheet liabilities could be significantly enhanced.
- The estimates of debt at different levels of governments are also available with varying time lags. The debt of the public sector enterprises is not provided along with the government debt. The off-balance sheet borrowing is also only now beginning to be disclosed at the central government level. Corporate debt data are not available at more frequent intervals.
- Public accounts standards need to be reviewed and standardized to ensure that the data at the central government, state government and the local government and governmental bodies are consistent and follow fair accounting standards. The degree of divergence seen in treatment of accounting heads even between revenue and capital classification leads to disharmony and undependable data on public finance currently. (As already noted, a work programme to generate relevant standards in this area is currently underway under the auspices of GASAB.)

Data useful for financial product design and innovation

A critical organizing framework for any financial system is the flow of funds matrix for the economy. The flow of funds data captures the movement of financial flows from the sectors that serve as sources of capital through intermediaries like banks, mutual funds to the sectors that use capital to acquire assets. This is an essential tool to understand the relationship between financial sector and the real economy. The flow of funds accounts open up possibilities of examining the wealth effect and savings behaviour. In US, the Federal Reserve Board produces the flow of funds data. The flow of funds data was being reported for India till 1995–96. Its publication needs to be revived.

Although income data are collected by the NSSO for households earning wage and salary income, the standard indicator of household well-being collected by the NSSO is household consumption expenditure. As already mentioned, there are large and increasing gaps between growth in per capita household consumption as measured in the survey data and growth in per capita private final consumption in the national accounts.

While difficulty in collecting income data is understandable, consumption data alone cannot help much where income data becomes crucial for decision making. For example, decision-making with regard to insurance/health policy or products can be more effective only if income data is available. Regular time series data, preferably annual would be an important addition to the existing data set. Some surveys could also be specially designed to capture high income categories.

Other data issues

The split of the population as between urban and rural is reported only at the time of the decennial census. It would be helpful if these data could be periodically updated based on purposive surveys.

With suitable privacy safeguards, there is need to put in place a system to capture the identity and key statistics of each citizen. A robust information infrastructure based on unique personal identifiers is critical to many areas of economic and financial activity such as directed citizen programmes (like food subsidy or unemployment benefit) and security perfection and repossession. Priorities include a system to capture the identity of nationals (like the social security number in the US), and a system to digitize land records (as done by the NSDL for equities).

With increased globalization, it is also essential that data on Indian securities and currencies that are held actually or nominally overseas be tracked through effective licensing of Indian leg of the transactions.

Another important issue relates to the reliability of data. With the liberalization of the economy, the inducement to industry to furnish regular and timely data to the government has reduced with adverse implications for quality and timeliness of data, particularly industrial production data. More teeth should be provided to the official data collection agencies to get the required data.

Harmonization of the data classification across activities, e.g., harmonization of National Industrial Classification (NIC) codes with trade data classification, would greatly enhance the combined utility and value of the data system.

A number of new initiatives/reforms in the last few years are generating a lot of useful information. The framework for centralization and integration of databases should be strengthened to ensure that new sources of information are captured in the database regularly and are also integrated with other databases. One prominent example is the introduction of the Value-added Tax (VAT). It is important to integrate the information collected through VAT filing with other data bases in the economy. For example the VAT data base should be integrated with customs, excise, income tax, credit data from banks, etc., to improve its usefulness. This will facilitate efficient decision making and help in plugging revenue leakages.

Given rapid development of the financial system, and simultaneous divergence in service levels and penetration levels of various financial sectors, it is essential to formally track the provision of financial services to the entire population. The segments of population not serviced by basic financial services such as banking, insurance, pension and investment need to be tracked both in the urban and the rural sectors. This would be critical in shaping policy and direction of financial sectors' evolution towards more inclusive growth.

NOTES

1. See 'Projections of Investment in Infrastructure during the Eleventh Plan', Planning Commission, Government of India, October 2007.
2. According to our estimates, which use optimistic assumptions about India's savings performance, the share of financial savings to be channeled into infrastructure would have to rise from 23 per cent in 2006/07 to 33 per cent in 2011/12.
3. Between March 2001 and March 2007, commercial banks' infrastructure credit outstanding has grown at a CAGR of 53 per cent, partly due to a small starting base.
4. Many banks are close to cap on power projects, for example.
5. NBFCs can and do have access to mutual funds and insurance companies, but such access is typically limited.
6. Several banks in India have little or no exposure to infrastructure.
7. IMF Country Report No. 08/51, February 2008. Annex. V. www.imf.org.
8. For a more extended discussion of Indian output and employment data, and their implications for estimates of economic growth and productivity, please see, Barry Bosworth, Susan M. Collins and Arvind Virmani, 'Sources of Growth in the Indian Economy', in *India Policy Forum 2006/07*. Sage, New Delhi, 2007.