

**SPECIAL
POINTS OF
INTEREST:**

Committee on Financial Sector Assessment (CFSA) submitted its six-volume Report, India's Financial Sector - An Assessment, to the Hon'ble Finance Minister, Shri Pranab Mukherjee on March 25, 2009 at New Delhi

Comprehensive Assessment of the Indian Financial Sector focusing upon stability and development

(CFSA) constituted by the Government of India in consultation with the Reserve Bank of India (Chairman: Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India; Co-Chair: Dr. D. Subbarao, Finance Secretary, Government of India

Financial Sector Self Assessment finds System Broadly Robust but Identifies Specific Concerns

India's financial sector is generally sound, resilient and fairly liquid. The financial infrastructure is also assessed to be robust. But there are some concerns, according to the report of the Committee on Financial Sector Assessment (CFSA). These concerns include corporate governance in the cooperative sector, funding constraints of Non-Banking Finance Companies and the lack of up-to-date data to gauge household indebtedness. The report also finds serious gaps in the timely implementation of bankruptcy proceedings. This self assess-

ment of India's financial sector—a comprehensive health check-up of the country's financial sector --was carried out by the



Committee on Financial Sector Assessment (CFSA) set up by the Government of India and the Reserve Bank in September 2006. The self assessment is motivated by the desire to ensure compatibility of the Indian financial sector with international

standards and assess its overall stability.

The Committee on Financial Sector Assessment (CFSA) constituted by the Government of India in consultation with the Reserve Bank of India (Chairman: Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India; Co-Chair: Dr. D. Subbarao, Finance Secretary, Government of India) has undertaken a comprehensive assessment of the Indian financial sector focusing upon stability and development.

TO ASSIST THE COMMITTEE IN THE PROCESS OF ASSESSMENT, THE CFSA DECIDED TO CONSTITUTE FOUR ADVISORY PANELS RESPECTIVELY FOR THE ASSESSMENT OF FINANCIAL STABILITY ASSESS-

MENT AND STRESS TESTING, FINANCIAL REGULATION AND SUPERVISION, INSTITUTIONS AND MARKET STRUCTURE AND TRANSPARENCY STANDARDS.

The Advisory Panels prepared separate Reports

covering each of the above aspects. The Advisory Panels comprised of non-official experts with domain knowledge in respective areas and officials with similar expertise represented as Special Invitees.



THE ISSUE

HIGHLIGHTS ON THE FOLLOWING REPORT FINDINGS:

- **SUSTAINABILITY OF MACRO ECONOMIC GROWTH**
- **FINANCIAL INSTITUTIONS**
- **FINANCIAL MARKETS**



The Advisory Panel on Financial Stability Assessment and Stress Testing (Chairman: Shri M.B.N Rao, Chairman and Managing Director, Canara Bank) conducted macro prudential surveillance (including system level stress testing) to assess the soundness and stability of financial system and suggest measures for strengthening the financial structure and system and its development in a medium-term perspective.

The other three panels identified and considered the relevant standards and codes as currently prescribed and applicable to different areas, evaluated their implementation in the Indian context,

identified gaps in adherence to respective standards and suggested possible roadmaps towards compliance in a medium-term perspective. The Advisory Panel on Financial Regulation and Supervision (Chairman: Shri M.S. Verma, Former Chairman, State Bank of India) would consider the relevant standards and codes applicable for financial regulation and supervision pertaining to the banking sector, securities markets and insurance; the Advisory Panel on Institutions and Market Structure (Chairman: Shri C.M. Vasudev, Former Secretary, Economic Affairs, Government of India) considered the relevant standards and codes applicable to

bankruptcy laws, accounting and auditing, payment and settlement systems and corporate governance policies; and the Advisory Panel on Transparency Standards (Chairman: Shri Nitin Desai, Former Under-Secretary-General, United Nations) considered the relevant standards and codes applicable for transparency in monetary, financial, fiscal and data dissemination policies.

The Committee submitted its six-volume Report, India's Financial Sector - An Assessment, to the Hon'ble Finance Minister, Shri Pranab Mukherjee on March 25, 2009 at New Delhi.

Framework

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The financial assessment process is based on three, mutually reinforcing pillars: Pillar I (Financial stability assessment and stress testing), Pillar II (issues relat-

ing to the institutional and legal infrastructure) and Pillar III (assessment of financial standards and codes).

What tests are performed as part of this financial sector

assessment? One such test assesses how the country's financial institutions would handle shocks. This is done through "stress tests" that show whether the individual institutions and



tests” that show whether the individual institutions and the banking system would remain solvent in the face of interest rate risks or changes in credit quality. The assessment also looks at indicators—called “financial soundness indicators” –such as capital adequacy, asset quality and profitability ratios, that signal the risks and vulnerabilities in the

system. The second pillar looks at the development issues of financial sector in particular focusing upon the legal, liquidity, governance and payment infrastructure to assess the strength and adequacy of financial infrastructure. The third analytical component looks at the observance of internationally accepted standards, such as the Basel Core Principles for Effective Banking Supervision, the IOSCO Objectives and Principles of Securities Regulation and the IAIS Insurance Supervisory Principles, the IMF codes of Good Practices for Transparency in Monetary and Financial Policies and Fiscal Poli-

cies, etc. This allows the regulatory authorities and the government to compare the country’s regulatory, supervisory and other practices against best practices else where.

The reports put forward by the Advisory Panels, inter alia identified gaps in adherence to international standards and codes and suggested possible policy actions. These advisory panel reports were also peer reviewed by reputed international experts in the field. These independent reviews have further ensured an objective and impartial assessment.



The Report’s Findings

Sustainability of Macro Economic Growth

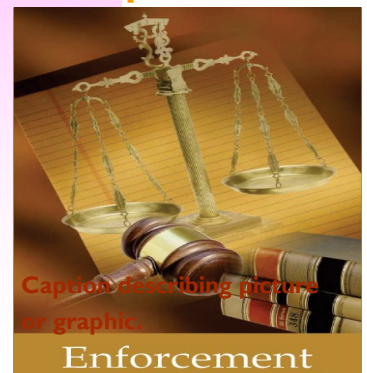
India’s growth in the recent period is contributed by several factors. These are high domestic demand, productivity, credit growth and high levels of savings and investment. The current global financial crisis, however, has resulted in the outlook being uncertain in the short term. Though India may face deceleration in its macro economic growth in the

short term, 8 per cent plus growth for India is sustainable in the medium-term. For growth sustainability, however, India needs to focus on revival of growth in agriculture, address quick restoration of the fiscal reform path, continue financial sector consolidation and development and address the infrastructure deficit. While fuller capital account convertibility (FCAC) is desirable, it should be concomitant with macroeconomic and market developments.

Financial Institutions

Commercial Banks

Based on the stability assessment and stress testing of the financial institutions, the CFSA has found that commercial banking system in India is broadly sound. While the banks were generally in a position to absorb significant shocks due to credit, liquidity and market risks, there were some concerns relating





**FINDING THE PATH
TO FINANCIAL
STABILITY**

to liquidity risk due to increasing illiquidity in banks' balance sheets. There is, therefore, a need to strengthen liquidity management. Looking forward, the stress tests need to be conducted on a more systemic basis, to capture second round and contagion risks. For this purpose, CFSA has recommended setting up of an interdisciplinary Financial Stability Unit.

The Government ownership of commercial banks poses dilemmas as it has been argued that this could lead to a conflict of roles and regulatory forbearance. The possibility of conflicts of interest could be minimised through even-handed regulation which has been the case in India. Also, the cost of recapitalisation of Indian public sector banks has also been relatively low.

The Government has, in the past, consistently shown willingness to contribute capital and the growth of public sector banks has so far not been constrained because of lack of capital. But, capital augmentation

of these banks in future could be a challenge. This could be managed through a variety of ways, such as, amalgamation where commercial synergies exist, raising capital through newer instruments (like issuance of perpetual preference shares in foreign currency). If no other alternative is available, there could be case for selective dilution of government equity which would require amendment of existing legislation.

There is a need for capacity building in the commercial banking sector with accent on training, succession planning, lateral recruitment and improved remuneration (particularly for public sector banks) while at the same time discouraging excessive risk-taking through an appropriate and balanced incentives structure. A well considered approach for entry of foreign banks in India needs to be followed, while adhering to the WTO commitment and norms. Recommending that competition must be encouraged, CFSA has advised encouraging market-based consolidation of banks.

The CFSA notes that the power of the Competition Commission regarding combination could result in delay of amalgamation of banks. Also, certain provisions in the Competition (Amendment) Act 2007 may result in regulatory overlaps and conflicts between the Commission and the statutory regulatory authorities. In the view of CFSA, Central Government could give necessary exemption under Section 54 of the Competition (Amendment) Act 2007 in respect of banks to avoid regulatory conflicts.

The CFSA highlights risk management as a priority area and notes that the counter-cyclical prudential norms imposed by the Reserve Bank have paid dividends in the recent times. It highlights the growing requirement of appropriate accounting and disclosure norms, particularly with regard to derivatives transactions as well as better management of liquidity risk. In this context, the report recommends earmarking a specific capital charge if dependence on purchased liquidity by a commercial bank goes beyond a threshold.

Co-operative Sector

While the financials of urban co-operative banks have improved, these entities still remain vulnerable to credit risk as observed in the stress tests conducted for this sector. The financial indicators of the rural co-operatives throw up some cause for concern. Noting that co-operative and rural banks have dual control, the CFSA has stressed the need for better governance in these institutions.

Non-banking Financial Companies

The CFSA notes that while Non-banking Financial Companies (NBFCs) are important players in financial markets and their financials

were broadly satisfactory, funding of this sector is constrained. Development of the corporate bond market would ease funding constraints of this sector. Further strengthening of prudential regulations of NBFCs has also been suggested.

Housing Finance Companies

For the growing and important segment of housing finance companies, the CFSA has noted that having a National Housing Price Index and a Housing Starts Index is a priority.

Insurance Sector

The CFSA noted that the insurance sector has significantly grown in size,

penetration and diversified products, has comfortable solvency and capital adequacy. According to the CFSA the following measures need to be taken for further development of the sector:

- Supervisory powers of Insurance Regulatory and Development Authority (IRDA) need to be improved;
- An effective policy for group-wide supervision needs to be put in place;
- Risk management processes require to be improved;
- There is a further requirement of skilled professionals – actuaries and treasury managers.



Financial Markets

The equity, government securities, foreign exchange and money markets along with their corresponding derivatives segments have developed into reasonably deep and liquid markets and there has been significant increase in domestic market integration over the years. However, the credit derivatives market is yet to

take off in any significant manner. Though the primary market in corporate bonds has seen an increase in issuance, the secondary market has not yet developed commensurately.

Equity Market

The equity market has witnessed wide-spread development in infrastructure and its functioning is comparable to

that in advanced markets. It has seen significant increase in growth and diversity in composition in the past two decades. Certain areas, however, could be further developed. Among the major steps to be considered are:

- According Self-regulatory Organisation (SRO) status to certain trade and industry associations to enhance regulatory efficiency, subject to appropriate safeguards;
- Further improvements in



infrastructure and risk management systems;

- More focussed monitoring of market intermediaries; and
- Streamlining of issuance procedures by setting up of a central integrated platform.

Foreign Exchange Market

With the economy moving towards fuller capital account convertibility in a calibrated manner, focussed regulation and monitoring of the foreign exchange market assumes added importance. There is though a need to strengthen infrastructure, transparency and disclosure, and product range in the forex derivatives segment. Strengthening the trading infrastructure, market con-



duct, transparency of Over-the-counter (OTC) derivatives in the forex market, accounting and disclosures in line with international practices, including disclosures by non-bank corporates, needs to be done on a priority basis. The recent introduction of currency futures is a step in this direction.

Government Securities Market

The government securities market has witnessed significant transformation in its various facets: market-based price discovery, widening of the investor base, introduction of new instruments, establishment of primary dealers and electronic trading and settlement infrastructure. This is the outcome of persistent and high-quality reforms in developing

the government securities market. Increased transparency and disclosures, gradual scaling down of mandated investments and development of newer instruments are some major areas which could be considered for further development. Regulatory incentives to increase the size of trading book could also be considered as a measure to further develop the government securities market.

Money Market

The money market is an important channel for monetary policy transmission and India has generally conformed to being a liquid market. In the ongoing global financial crisis, the Indian money market has continued to function normally. The gradual shift towards a collateralised inter-bank market, phasing out of non-bank participants from the call and notice money market, policy direction towards reductions in cash reserve requirements, the introduction of new instruments, such as, Collateralised Borrowing and Lending Obligation (CBLO), implementation of Real Time Gross Settlement (RTGS), significant transformation of monetary operations framework towards market-based arrangements and facilitating trading through Negotiated Dealing System – Call Money (NDS-CALL) are some of the reform measures that have contributed to the development of a relatively vibrant and liquid money market. However, the limitations of market participants in taking a medium-term perspective on interest rates and liquidity, coupled with the absence of a credible long-term benchmark, constraining further market development that needs to be addressed.

Corporate Bond Market

The development of the corporate bond market could be a source of long-term finance for corporates.

The development of this market currently suffers from lack of buying interest, absence of pricing of spreads against the benchmark and a flat yield curve. It requires further regulatory and legislative reforms for its development and reforms in the pension and insurance sectors to aid in the emergence of large institutional investors.

Credit Derivatives

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

NEXT ISSUE WILL HIGHLIGHT ON OTHER MAJOR FINDINGS OF THE CFSA REPORT LIKE—FINANCIAL INFRASTRUCTURE, TRANSPARENCY & DATA DISSEMINATION AND DEVELOPMENT ISSUES IN THE SOCIO ECONOMIC CONTEXT