

MANAGEMENT OUTLOOK

VOLUME 1, ISSUE 9



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

Last issue was on Major Findings of CFSA Report - Sustainability of Economic Growth, Financial Institutions and Financial Markets

Current Issue highlights Major findings of the Report- Financial Infrastructure, Transparency and Data Dissemination and Development Issues in the Socio-economic Context

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

Financial Infrastructure

Regulatory Structure

The assessment of the regulatory and supervisory environment of financial institutions has been done with reference to the Basel Core Principles (BCPs). The coverage of the assessment has been made broader to include the non-banking sector as well because of the inherent linkages that such institutions have and their consequent impact on the stability of the financial system. The assessment of regulation and supervision in the insurance sector has been done with reference to International Association of Insurance Supervisors (IAIS) Core Principles. The assessments found the regu-

latory environment to be generally satisfactory, the major gaps being in risk management and cross-border supervisory co-operation.

Similarly, the International Organisation of Securities Commission (IOSCO) Principles for Securities Regulation are generally applicable to the equity and corporate bond markets. However, taking into account their importance for systemic stability, the Advisory Panel on Financial Regulation and Supervision has also assessed the foreign exchange, money and government securities markets against IOSCO principles as relevant and applicable. The overall assessment shows that the regulatory and supervisory infrastructure is generally



robust as evidenced by the fact that the recent market volatility has not resulted in any settlement failure though home-host co-operation remained a major gap across market segments.

The CFSA feels that the existence of multiple regulators is perhaps consistent with the current stage of financial development in India, but stressed the need for further improvement of effective regulatory coordination.



Managing Risks

Alluding to principles-based versus rules-based regulation, the CFSA observes that both needed to play a complementary role. Ideally it is desirable to identify a set of principles and then group the existing rules under them and consider validating the rules under these broad principles. This would also obviate the rules/regulations degenerating into *ad-hocism*.

There is no legislation specifically permitting regulation of financial conglomerates and holding companies in India. The Reserve Bank could, in the interests of financial stability, be armed with sufficient supervisory powers and monitoring functions in respect of financial conglomerates. Legislation of a new Act is required to empower the Reserve Bank to have regulatory jurisdiction of the holding company. Allowing 'intermediate' holding companies, however, may not be feasible till an appropriate regulatory structure for such an entity is in place. In the interest of financial stability, there is a need for strengthening inter-

regulatory co-operation and information-sharing arrangements, both within and across borders among the regulators.

There is a view that SROs could potentially enhance regulatory efficiency and optimise regulatory costs. As SROs are essentially trade bodies, issues relating to conflict of interest could arise. Hence, it is necessary that issues like arm's length relationship of SROs with the associated trade bodies and their corporate governance policies be looked into by the regulator before according SRO status to any entity.

Liquidity Infrastructure

Systems and procedures need to be developed for smoothing out volatility in liquidity and call money rates arising out of quarterly tax payments. Hence, there is a need to strengthen management of government cash balances. The introduction of auction of Central Government surplus balances with the Reserve Bank in a non-collateralised manner could be considered, though with

appropriate caution, which would also make available the government securities in the Reserve Bank's investment accounts for its own market operations.

There is a need for strengthening the asset-liability management of banks, including the development of the term money market as also the development of liquidity forecasting techniques. In the context of the management of the capital account, the key issue for the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or temporary and subject to sudden stops and reversals. There is a need to examine the likely implications of excessive inflows and outflows on monetary operations. Strategic management of the capital account would warrant preparedness for all situations. Since the currency risk has the potential to transform into credit risk, banks should strengthen monitoring of unhedged positions of corporates.

Accounting and Auditing Standards

The ongoing global financial crisis and subsequent problems relating to derivatives transactions in India have brought to the fore the necessity for early adoption of accounting standards AS 30 and 31 relating to financial instruments. The autonomy of the Accounting Standards Board (ASB) would be greatly enhanced if it is given the authority to issue the standards and the Council of Institute of Chartered Accountants of India (ICAI) confines itself to the administrative, but not the functional, control of the ASB. There is a need for the ASB to consider the development of standards on various subjects as also to provide sector-specific guidance. Similarly, there is a need to give functional independence to the Auditing and Accounts Standards Board (AASB) vis-à-vis the Council of the Institute by making it the final authority for drafting and issuance of the standards, with the Council confining itself to administrative, but not functional, control of AASB.

Business Continuity Management

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

Payment and Settlement Infrastructure

A smooth and efficient payment and settlement infrastructure plays an important role in maintaining stability in the financial sector. The CFSA acknowledges that significant progress has been made in improving the payment systems infrastructure in India with the introduction of RTGS, High Value Cheque Clearing System, setting up of Clearing Corporation of India Ltd. (CCIL) as the central counterparty in the government securities, foreign exchange and CBLO segments as also system improvements in the settlement of equities transactions. The legal framework for payment and settlement has also been strengthened by the recent notification of the Payment and Settlement Systems Act and Rules. This has made India largely compliant with international standards and codes in this area. The assessments have, however, highlighted some gaps in the system, particularly with regard to the adequacy of financial resources



improving its risk management measures. The current low utilisation of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to customers, thus optimising the use of this infrastructure and achieving greater financial inclusion.

Legal Infrastructure

The CFSA notes that though there have been improvements in legal infrastructure in the financial sector like setting up of Debt Recovery Tribunals (DRTs) and the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, the major concern is that, despite the robust insolvency laws, the time taken for completion of liquidation proceedings is one of the highest in the world and the recovery rate one of the lowest. The operationalisation of the Companies Act (Second Amendment), 2002 will address the current problems relating to delays in completion of liquidation proceedings. The CFSA considers that a separate insolvency regime for banks and other categories of financial institutions is vital in the context of financial stability, as any inefficient handling of insolvency of such institutions could have a serious contagion effect and repercussions across the economic system that will destabilise economic activity.

Corporate Governance

In India, there is a comprehensive corporate governance framework in place for listed

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

Safety Net - Deposit Insurance

The coverage limit of deposit insurance offered by the Deposit Insurance and Credit Guarantee Corporation (DICGC) is comparable to international levels. Stress tests to ascertain the adequacy of the Deposit Insurance Fund shows that the DICGC would be in a position to meet the claims even under a worst-case scenario. While there is an element of cross-subsidisation of the flat premium charged by the DICGC, a risk-

adjusted premium could prove to be expensive for weak financial entities. An increase in ceiling of flat rate premia could, therefore, be considered to strengthen the deposit insurance fund, if required. The delay in the failure resolution process and the non-involvement of the DICGC in the failure resolution process remain major concerns. In order to enhance the efficacy of the deposit insurance system in India, it is felt that the pros and cons of DICGC's involvement in the bankruptcy process need to be deliberated upon. Alternatively, delinking of DICGC claims from liquidation proceedings by amendments to the DICGC Act and Banking Regulation Act could be considered. There is a case for providing exemption from income tax to the DICGC.

Review of AML/CFT

Major areas where action needs to be taken to further strengthen Anti-money Laundering and Combating the Financing of Terrorism (AML/CFT) practices and align them with international standards are the effective implementation of recordkeeping requirements and a robust regime for submission of Suspicious Transactions Reports (STRs) and inclusion of money transfer agencies in Prevention of Money-Laundering Act (PMLA).



Transparency and Data Dissemination

India has made significant progress in enhancing transparency in monetary and financial policies, fiscal arena and data dissemination. There are some areas where further transparency and disclosure can be achieved.

Transparency in Monetary Policy

India is largely compliant with the IMF's Code of Good Practices on Transparency in Monetary Policy. The roles, responsibilities and objectives of the Reserve Bank are well-defined. The Reserve Bank has explicit multiple objectives of monetary policy with changing relative emphasis. It also follows a multiple indicator approach, which has been reasonably effective. The present legislative framework provides enough room and manoeuvrability for the Reserve Bank to operate monetary policy in consonance with evolving needs and circumstances. The key element of the framework at present is the flexibility enjoyed by the Reserve Bank while

going about its assigned task of maintaining the monetary stability of India. The main issues that have come out of the assessment of transparency in monetary policy pertain to the review of legislations with regard to the objectives of monetary policy, the issue of operational independence and accountability of the Reserve Bank and the separation of debt management from monetary management.

As far as the issue of operational independence of the central bank is concerned, the Reserve Bank enjoys independence vis-à-vis the executive arm of the state through conventions, agreements and MoUs in specific areas. The specification of procedures and reasons for the removal of the Governor/Deputy Governor as also for supersession of the Board could potentially lead to the loss of well-established de facto independence. Any modifications that might be required to strengthen monetary policy as also the regulatory framework might be carried out by necessary

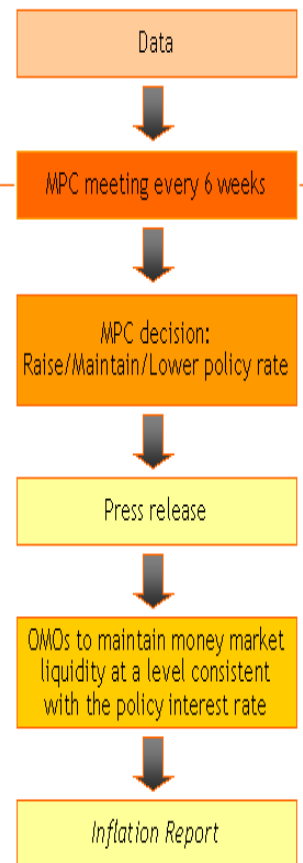
amendments to existing legislations as needed, which would not call for a fundamental review of legislations or an overhaul of the existing legal framework. The CFSA feels that an overhaul of legislation may not be appropriate at the current juncture.

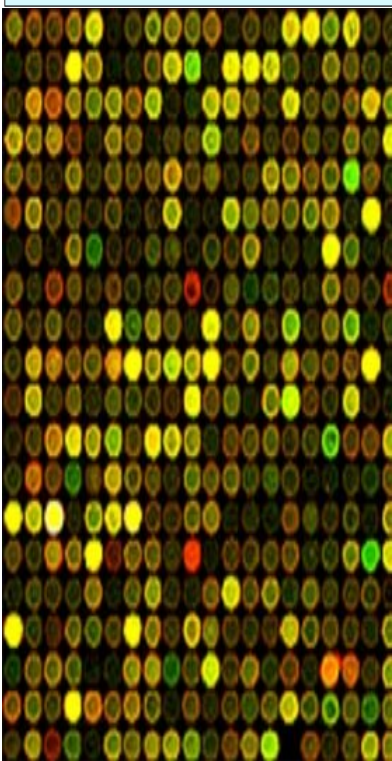
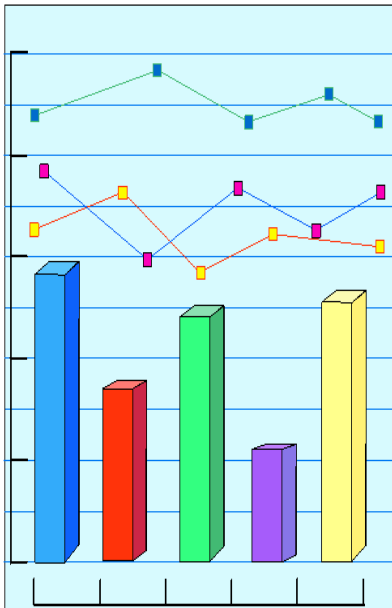
Following the announcement in the Union Budget 2007-08, the Central Government is proceeding with the establishment of a Middle Office, as a prelude to setting up of a full-fledged Debt Management Office (DMO). While most members of the CFSA concurred with the proposal to set up a DMO, one member felt that the DMO should be an independent body. The Chairman, however, was personally of the view that the time is not ripe for the complete separation of debt management from the Reserve Bank at the current juncture.

Transparency in Financial Policies

The Reserve Bank, SEBI and IRDA are compliant with the relevant standards in transparency in financial

Monetary Policy Process





policies. Any move to institutionalise the High Level Coordination Committee for Financial Markets (HLCCFM) could prove to be counter-productive as it could reduce flexibility in the formulation of financial policies; however, the present information-sharing mechanism could be improved.

Fiscal Transparency

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

Data Dissemination Standards

There has been significant improvement in the data dissemination practices of various agencies, namely, the Central Statistical Organisation, the Office of the Economic Adviser in the Ministry of Commerce and Industry and the Reserve Bank. There is an urgent need to strengthen the functioning and data dissemination practices of the CSO, which had weakened

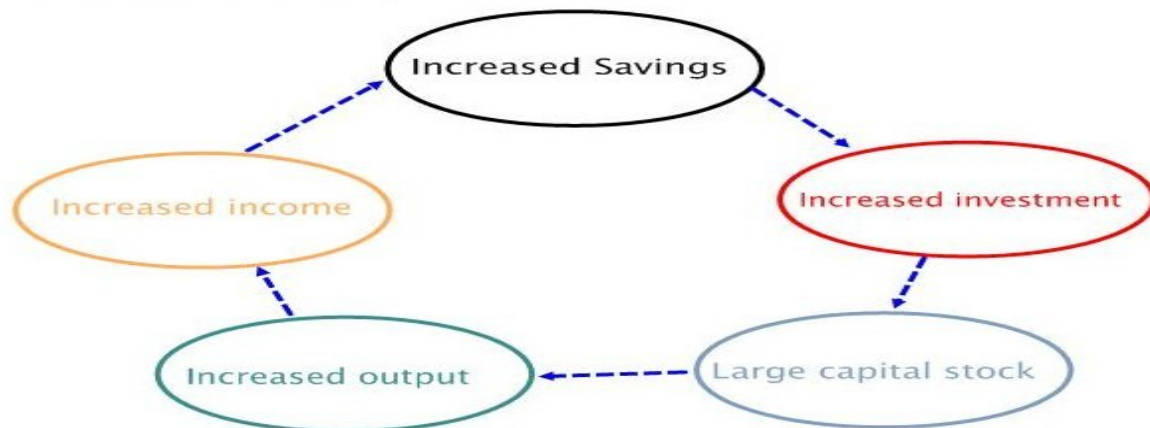
after data submission became a voluntary process. There is also a need to consolidate the process of compiling labour data and this should be done by a professional statistical organisation. As far as price indices are concerned, updating the weights and inclusion of new products in the basket of goods needs to be expedited.

Development Issues in the Socio-economic Context

A stability assessment of the financial sector should also address broader development aspects in the socio-economic context, which affect social stability and have an indirect bearing on financial stability.

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

Harrod-Domar Growth Model, the rationale:



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 FEEDBACK AT
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