FINANCIAL SECTOR REFORMS

NIPFP-DEA research programme
Policymakers roundtable
10th March, 2010

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(Views mostly personal)

Key messages

- Expert committee findings on financial sector
- Dualism characterizes Indian financial sector
- Data based analysis seem to confirm this
- What explains this differential development?
- Next steps in India’s financial sector reforms?

Expert committee findings

- Nearly world class equity/equity derivatives market/institutions
- Adverse environment for innovation-banned products & restricted participation
- Segmentation of markets and regulatory gaps and overlaps
- Conflicts of interests in Central Bank being a debt manager also
- Underdeveloped corporate debt markets
- Universal inclusion still distance away

Measuring financial development

- World Bank’s database on financial development and structure across countries
- Paper of the European Central Bank (2009)
- World Economic Forum’s Financial Development Report 2009

F D Index: India Vs other EMEs

Country	Over all rank	Factors, Policies and institutions			Financial intermediation			*Financial access*
		Institutional environment	***Business environment***	***Financial stability***	***Banks***	***Non-banks***	***Financial markets***	***Financial access***
Malaysia	22	22	30	13	12	25	29	*22*
South Korea	23	31	16	28	22	18	20	*52*
China	26	35	40	23	10	12	26	*30*
South Africa	32	27	36	31	30	32	30	*47*
Brazil	34	42	47	15	35	15	37	*31*
Thailand	35	33	31	36	34	47	36	*29*
India	**38**	**48**	**48**	**46**	**39**	**17**	**22**	***48***
Russia	*40*	*53*	*34*	*39*	*55*	*4*	*41*	*49*
Source: WEF's Financial Development Report, 2009								

Financial Development Index :India

Pillars and weight in the index	**Sub-items**	**Weight of the sub-items**	**India's score on 1-7 scale**	**Overall score for each pillar**
Institutional environment (14.29%)	Financial sector liberalization	25%	1.9	**3.4**
	Corporate governance	25%	**4.6**	
	Legal and regulatory issues	25%	**3.8**	
	Contract enforcement	25%	3.2	
Business environment (14.29%)	Human capital	25 %	**4.1**	**3.5**
	Taxes	25%	**4.2**	
	Infrastructure	25%	2.3	
	Cost of doing business	25%	3.4	
Financial stability (14.29%)	Currency stability	30%	**5.4**	**4.2**
	Banking system stability	40%	**4.0**	
	Risk of sovereign debt crisis	30%	3.4	
Banking financial services (14.29%)	Size index	40%	2.3	**3.1**
	Efficiency index	40%	**4.8**	
	Financial information disclosure	20%	1.3	
Non-banking financial services (14.29%)	IPO activity	25 %	**3.8**	**3.1**
	M& A activity	25%	2.6	
	Insurance	25%	3.0	
	Securitization	25%	3.0	
Financial markets (14.29%)	Foreign Exchange markets	20%	2.0	**3.0**
	Derivatives markets	20%	**4.9**	
	Equity market development	30%	2.7	
	Bond market development	30%	2.6	
Financial access (14.29%)	Commercial access	50%	**3.9**	**2.8**
	Retail access	50%	1.6	

Securities markets

- Demutualised stock exchanges
- Straight Through Processing
- Growing number of participants and transactions
- Reduced transaction costs
- State of the art risk management framework
- Turnover – USD 756 billion (2008-09)
- Market capitalization- USD 645 billion (2008)
- Equity derivatives volumes- NSE- 8th in the world in 2008

Debt markets

- **Money markets**
  - Increased activity, market repo and CBLO segments developed, pure inter bank market, decrease in volatility.
  - However, structural barriers and institutional factors create distortions
- **G-secs markets**
  - Manifold increase in volumes and investor base
  - However, benchmark yield curve non-existent, isolated pockets of liquidity, limits on FII investments
- **Corporate debt markets**
  - Suboptimal development

Key banking sector reforms

- Liberalized branch Licensing policy
- Foreign banks’ entry liberalized
- Private sector banks FDI enhanced to 74%
- Deregulation of interest rates
- Progressive benchmarking of capital adequacy reforms against international standards
- Progressive reduction in non-performing assets
- PSU domination continues

Foreign exchange market

- OTC markets
  - High liquidity
  - Increased turnover
  - Avg daily volume of USD 29 billion in 2008
  - Only participants with "crystallized exposure" and hence limited participants
- However
  - Exchange traded markets still in nascent stage- Interest rate futures and currency derivatives
  - Severe restrictions on participants/products

Insurance sector

- Insurance Regulatory and Development Authority set up in 1999
- 37 private companies operating now
- FDI permitted upto 26%
- Wide range of products
- Life and non-life market in India (total premium) was USD 54.38 billion in 2007-08

Snapshot of India’s 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			

Complex regulatory structure

- Multiple regulators:
  - RBI, 1935
  - FMC, 1952
  - SEBI, 1992
  - IRDA, 1999
  - PFRDA, 2003
- Policy making by Government of India
- Functions of the regulators: conduct regulation, supervision, investor protection, creation and development of new markets
- Overlapping jurisdictions

Explanations for the differential development

- Conscious decision to treat debt flows differently
- Does that fully explain the dualism?
- Fresh de-novo approach in securities markets
  - New law
  - New institutions
  - Appropriate institutional design
  - Not tinkering with existing law/organization
  - Structure of the Government department

Comparison of developments in debt & other markets

Institution	Original development	Adoption for debt market
Electronic trading on a single platform	Equity, 1994; Commodity futures, 2004	2005, 11 years later
National access to trading	Equity, 1994; commodity futures, 2004	Absent
Clearing corporation	Equity, 1996	1999, three years later
Independent regulator	Equity, 1992; Insurance, 1999	Not yet even considered
Competition between exchanges	Equity, 1994; commodities, 2004	Absent
Entry barriers	Removed for equity, 1994; Commodities, 2004	Barriers present

Source: Thomas Susan, "How the Financial Sector is India was reformed", in `Documenting reforms: Case studies from India' edited by S. Narayan, Macmillan India, pp 171-210, 2006.

Next steps in India's financial sector reforms

- Regulatory reform & convergence
- Regulatory coordination and financial stability
- Financial literacy & inclusion
- Banking/insurance legislative changes
- Developing BCD nexus
- DMO

Steps already taken

- Budget (2010-11): The announcements
  - Para 37:*Financial Stability and Development Council (FSDC)*
  - *Para 101 : Financial Sector Legislative Reforms Commission*

FSDC

- FSDC is NOT a super regulator
- FSDC will do what is currently not being done
  - Development
  - Improved regulatory coordination
  - Financial stability
  - International interface on FSB, FATF, FSAP

Why FSDC?
The need for coordination

- Product Related
  - Hybrid products
  - Products that straddle different regulators
  - Products that impact different regulators

- Cross cutting issues
  - Financial stability
  - Financial inclusion
  - Financial literacy
  - Regulation of investment advisers
  - Financial sector reforms

Why FSDC?
Improved international interaction

- Interface with the Financial Stability Board
  - Plenary and 4 standing committees
  - Working groups, expert groups and networks under each of these
  - Continuous engagement through conference calls/meetings
  - India's comments (in areas insurance, securities markets and banking supervision) repeatedly sought
  - Need for enhanced, effective inter regulatory coordination to supply quality information on time
  - Need to prevent divergent views in international fora

Why FSDC?
Improved international interaction..ctnd

- Financial Action Task Force (FATF)
  - Plenary and 4 standing groups
  - 3 meetings of Plenary and 3-4 meetings of each group every year
  - Mutual evaluation process is very intense
  - Regular follow up process even after membership
  - Need to take a coordinated financial sector view on major issues

Why FSLRC?

Problems with existing regulatory architecture

- Most financial sector legislations very old
  - RBI Act 1934
  - Insurance Act 1938
  - Securities Contract Regulation Act 1956
- Stand alone amendments have made legislations complex
- Regulatory gaps, overlaps and inconsistency
- Confusion among market participants

FSLRC: The agenda

- Simplifying and streamline legal framework
- Relook at all financial sector laws
- Workout the standard principle of financial regulation
  – Rules Vs principles?
- Governance issue of regulatory institutions
  – Structural objectives
  – Accountability and autonomy
  – System of appeals

THANK YOU