FINANCIAL SECTOR REFORMS

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

Dr. K.P. Krishnan, Joint Secretary, MoF
(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

<table>
<thead>
<tr>
<th>Country</th>
<th>Overall rank</th>
<th>Factors, Policies and institutions</th>
<th>Financial intermediation</th>
<th>Financial access</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Institutional environment</td>
<td>Business environment</td>
<td>Financial stability</td>
</tr>
<tr>
<td>Malaysia</td>
<td>22</td>
<td>22</td>
<td>30</td>
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<td>South Korea</td>
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<td>31</td>
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<tr>
<td>China</td>
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<td>35</td>
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<td>South Africa</td>
<td>32</td>
<td>27</td>
<td>36</td>
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<tr>
<td>Brazil</td>
<td>34</td>
<td>42</td>
<td>47</td>
<td>15</td>
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<tr>
<td>Thailand</td>
<td>35</td>
<td>33</td>
<td>31</td>
<td>36</td>
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<tr>
<td>India</td>
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<td>48</td>
<td>48</td>
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<tr>
<td>Russia</td>
<td>40</td>
<td>53</td>
<td>34</td>
<td>39</td>
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</table>

Source: WEF’s Financial Development Report, 2009
<table>
<thead>
<tr>
<th>Pillars and weight in the index</th>
<th>Sub-items</th>
<th>Weight of the sub-items</th>
<th>India's score on 1-7 scale</th>
<th>Overall score for each pillar</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Institutional environment</strong> (14.29%)</td>
<td>Financial sector liberalization</td>
<td>25%</td>
<td>1.9</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Corporate governance</td>
<td>25%</td>
<td>4.6</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Legal and regulatory issues</td>
<td>25%</td>
<td>3.8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Contract enforcement</td>
<td>25%</td>
<td>3.2</td>
<td></td>
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<tr>
<td><strong>Business environment</strong> (14.29%)</td>
<td>Human capital</td>
<td>25%</td>
<td>4.1</td>
<td>3.5</td>
</tr>
<tr>
<td></td>
<td>Taxes</td>
<td>25%</td>
<td>4.2</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Infrastructure</td>
<td>25%</td>
<td>2.3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cost of doing business</td>
<td>25%</td>
<td>3.4</td>
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<tr>
<td><strong>Financial stability</strong> (14.29%)</td>
<td>Currency stability</td>
<td>30%</td>
<td>5.4</td>
<td>4.2</td>
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<tr>
<td></td>
<td>Banking system stability</td>
<td>40%</td>
<td>4.0</td>
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<tr>
<td></td>
<td>Risk of sovereign debt crisis</td>
<td>30%</td>
<td>3.4</td>
<td></td>
</tr>
<tr>
<td><strong>Banking financial services</strong> (14.29%)</td>
<td>Size index</td>
<td>40%</td>
<td>2.3</td>
<td>3.1</td>
</tr>
<tr>
<td></td>
<td>Efficiency index</td>
<td>40%</td>
<td>4.8</td>
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</tr>
<tr>
<td></td>
<td>Financial information disclosure</td>
<td>20%</td>
<td>1.3</td>
<td></td>
</tr>
<tr>
<td><strong>Non-banking financial services</strong> (14.29%)</td>
<td>IPO activity</td>
<td>25%</td>
<td>3.8</td>
<td>3.1</td>
</tr>
<tr>
<td></td>
<td>M&amp;A activity</td>
<td>25%</td>
<td>2.6</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Insurance</td>
<td>25%</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Securitization</td>
<td>25%</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td><strong>Financial markets</strong> (14.29%)</td>
<td>Foreign Exchange markets</td>
<td>20%</td>
<td>2.0</td>
<td>3.0</td>
</tr>
<tr>
<td></td>
<td>Derivatives markets</td>
<td>20%</td>
<td>4.9</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equity market development</td>
<td>30%</td>
<td>2.7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bond market development</td>
<td>30%</td>
<td>2.6</td>
<td></td>
</tr>
<tr>
<td><strong>Financial access</strong> (14.29%)</td>
<td>Commercial access</td>
<td>50%</td>
<td>3.9</td>
<td>2.8</td>
</tr>
<tr>
<td></td>
<td>Retail access</td>
<td>50%</td>
<td>1.6</td>
<td>6</td>
</tr>
</tbody>
</table>
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

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

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

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