

# Current Developments in India's Financial System

20<sup>th</sup> March 2009 · New Delhi, India



On behalf of



Federal Ministry  
for Economic Cooperation  
and Development

**inWent**

Capacity Building International  
Germany



## Workshop on Current Developments in India's Financial System

20<sup>th</sup> March 2009  
New Delhi, India

Workshop jointly organized by

Indian Council for Research on International Economic Relations (ICRIER), India  
and  
InWEnt – Capacity Building International, Germany



## Program Schedule

Workshop on

### 'Current Developments in India's Financial System'

20<sup>th</sup> March 2009 · New Delhi, India

**Venue:** ICRIER Conference Room, Core 6A, 4th Floor,  
India Habitat Centre, Lodi Road,  
New Delhi – 110 003

### Session I: Global Financial Crisis: Indian and International Perspectives

**Chair:** Mr. Shrawan Nigam, Senior Consultant, ICRIER  
**Panelists** 10:00 Dr. Mathew Joseph, Senior Consultant, ICRIER  
 10:20 Dr. Ulrich Volz, The German Development Institute (DIE)  
 10:40 Mr. Benno Graw, Financial Counsellor,  
 German Consulate General, Mumbai

11:00 to 11:45 Discussion



## Session 2: Legal and Regulatory Framework for India's Financial System

**Chair:** Dr. Mathew Joseph, Senior Consultant, ICRIER  
**Panelists** 12:00 Dr. A. V. Raja, Reader, Department of Economics,  
 University of Hyderabad  
 12:20 Prof. K. K. Krishnan, Associate Professor –  
 Insurance, BIMTech

12:40 to 1:10 Discussion

## Session 3: Recent Developments in the Indian Banking Sector and Capital Market

**Chair:** Dr. Rajiv Kumar, Director & CE, ICRIER  
**Panelists** 2:30 Dr. Mandira Sarma, Senior Fellow, ICRIER  
 2:50 Mr. CKG Nair, Director, Capital Markets,  
 Dept of Economic Affairs, MoF

3:10 to 3:40 Discussion

Vote of Thanks

Ms. Ina Dettmann-Busch, InWEnt



## Background

Against the backdrop of the global financial crisis and contagion to the developing world, discussion on recent financial market development and regulation in India has assumed a new urgency. India has witnessed a considerable development in the credit and capital markets both from a regulatory and legal perspective. In the past decade the Indian financial sector has deepened and more integrated globally. Taking stock of the impact of these developments on the health of the financial sector and on the overall economy, particularly in times of financial tumult, maintaining financial stability is imperative for future policy actions.

Against this background, Indian Council for Research on International Economic Relations (ICRIER), India and InWent – Capacity Building International, Germany have jointly organized a one day workshop for a policy dialogue. The aim of the workshop was to assemble the experts from academia, industry and the ministry to recount the recent developments in the Indian financial system and the impact of global financial crisis to broadly sketch out the policy prescriptions and perspective for the way forward for India and other developing countries.

The broad themes of discussion were:

### Global Financial Crisis: An Indian and International Perspective

This session was expected to discuss the impact of the crisis on the developing economy, policy initiatives in India and the initiatives taken by G20 to tackle the crisis. Especially a thorough analysis of the channels through which the crisis has spread to the developing countries was of great importance for future policy prescriptions.

### Legal and Regulatory Framework for India's Financial System

Broadly legal infrastructure determines the efficient flow of resources to their most productive use. Legal infrastructure consists of both broad insolvency and contract enforcement regimes and the administrative law that entrusts the government to regulate the industry. This session was expected to recount the theoretical developments in the importance of law and regulatory measures for financial sector development and recent initiatives in India in this respect.

## Recent Developments in India's Banking Sector and Capital Market

This session brought in both the academic researchers and the practitioners to recount the recent developments in the width and breath of the sector especially the outreach of the sector. Less discussed topics such as insurance industry and cooperative banking were analyzed.







## Main Findings of the Workshop

Francis Rathinam, Fellow, ICRIER

The input and the discussion of the workshop have revolved around the major themes in economics of financial markets. The importance of fundamental institutions for a vibrant financial sector such as property rights protection, bankruptcy law and contract enforcement were emphasized. The panelists agreed that the financial markets are overwhelmed by the information asymmetries and the resulting coordination problems and a strong regulatory structure to maintain the health of the system is inevitable. In this light, recent financial crisis originated in the US fueled by sub prime housing loans was attributed mainly to regulatory lapses and lenience. Further, international co-ordination in the early phase of the crises was critically reflected.

Regarding the contagion of the crisis to the developing countries the panelists felt the ‘decoupling theory’ that maintains that the developing countries have “decoupled” themselves from the business cycles of the developed countries, has failed. The developing




countries are more integrated than ever and the possible channels of contagion were foreign investment, remittances and trade finance. Especially as the stock markets around the world are highly interdependent, the idea of financial decoupling is a myth. The role of IMF, FSF and other International Financial Institutions in maintaining stability were also emphasized. Panelists agreed that global macro economic imbalances were also one of the important causes of the present crisis. The discrepancies in the international credit flows, especially the failure of the international financial system to channel the surplus resources efficiently, seemed to have contributed to the crisis.

The possible policy suggestions proposed in the workshop include crisis management including bank recapitalization, countrywise financial sector assessment programmes with the help of the IMF, and generally, the emphasis on stability by strengthening financial sector regulation. One of the discussed policy suggestions was to await the market forces to realign themselves before rushing into excessively countercyclical measures.

The overall discussion on the global crisis has suggested that the developing world is still vulnerable to the business cycles of the developed countries through both the real and financial channels. A strong prudential regulatory structure at the country level and a strong international co-ordination of the implementation of financial stability strategies is vital to check future crises. Further, maintaining the global macroeconomic balance would mitigate the triggers of future crises and contagion all over the world.

The second important theme of the workshop was to recount the recent sectoral, policy and regulatory developments in India's financial system. The major areas covered were the insurance sector, cooperative banking and capital markets in India. The panelists felt that the insurance industry in India could be boosted with a coordinated and proactive regulator and legislative reforms. Further, a coordinated attempt to financial literacy and inclusion would increase the depth and the width of the industry. Another aspect of financial inclusion, the Regional Rural Cooperative banks, a dominant institutional credit provider in the rural areas, was thought to be the right medium for the outreach. The major problems identified were the ambiguity in regulatory power sharing and the lack of regulatory independence due to political interferences. Further, inherent problems in the industry such as overexposure to the agriculture sector and lack of diversification of the loan portfolios exacerbated by laxity in the prudential regulation, make the whole system unsustainable. However, recent initiatives taken by the Government of India such as revival packages of 2006 and 2008 augurs well for rural credit in India.





The phenomenal success story of the capital market in India in the last decade is to be attributed to the cautious regulation and reforms such as establishing the Securities and Exchange Board of India (SEBI) in 1992, the alternative National Securities Exchange and a number of reforms such as dematerialization, screen based trading and so on. The discussion on the structure of the regulatory agency suggested a coordinated approach as against unified or multiple regulators for the financial sector. The panelists felt that a cautious approach to capital market reforms as suggested in the Raghuram Rajan's committee report on second generation financial sector reforms in India would significantly contribute to financial stability.



## Sessions Report by the Rapporteurs

### Session 1: Global Financial Crisis: Indian and International perspectives,


By Ms. Sirjjan Preet, Research Associate, ICRIER

The first presentation in **Session I** was made by Ulrich Volz of the German Development Institute (DIE) who gave an overview of the causes and effects of the current financial crisis. He remarked that unlike previous market crises, the present financial crisis originated in mature economies. The decoupling hypothesis, which had maintained that developing and emerging economies would be largely unaffected by the crisis in the US and Europe, proved to be a myth. According to him, the contagion effect works mainly through two channels i.e. the financial market channel and the real economy channel, which caused a steep decline in exports from developing and emerging economies, foreign direct investment into these economies, remittances and trade finance. While discussing the future outlook for India, he quoted the Indian Finance Minister P. Chidambaram who in October 2008 said that India was safe from the global turmoil and that “the only fear is fear itself”. This had clearly been a far too optimistic assessment, as in the meantime the crisis has also had its impact on the Indian economy with further downward revisions on Indian growth likely. Turning to the origins of the crisis, he emphasized regulation failure in financial markets as a major cause, but highlighted also the role that excessive liquidity caused by lax monetary policy in the US and global imbalances with the concomitant capital imports to the US played for the onset of crisis. He said that the policy responses should include reforming the international financial system to maintain financial stability. This calls for international cooperation in crisis prevention and crisis management. He is of the view that the Financial Sector Assessment Programs should be made mandatory for systemically important countries. Lastly, he stressed the need to strengthen the role of International Monetary Fund (IMF) and International Financial Institutions (IFIs), which would require governance reform of these institutions, and highlighted the importance of a further development of banking sectors and securities markets in developing countries and emerging markets to reduce dependency on financial intermediation in financial centers of industrialized countries. The presentation was followed by a discussion on the origins of the crisis and its possible solutions.

The second presentation was made by Dr. Mathew Joseph, Senior Consultant, ICRIER on the Global Financial Crisis: Impact on India. Tracing the roots of the crisis he said that the present crisis is an outcome of global “macroeconomic imbalances”.



Huge cross-border capital flows from surplus to deficit countries and the failure of the international financial system to intermediate these flows caused the crisis. Hence, the visible outcome was the reversal of capital flows with FII equity outflows of over US \$ 15.4 bn from Jan 08. Stock markets plummeted from 20,873 on 8th Jan 08 to 9093 on 28th Nov 08 registering a 56% fall. Similarly the Forex reserves fell from \$315 bn in May 08 to \$246 bn in Nov 08 and the rupee depreciated by 20% from the end of Mar 08 to the end of Nov 08. When the capital markets dried up, corporates resorted to bank finance which initially rose to compensate for drying up funds but later turned negative in Jan 09. Speaking on policy responses, Dr. Joseph remarked that there was an initial reluctance to take aggressive policy measures due to high inflation but later the central bank made considerable policy rate changes injecting liquidity to the tune of 7% of GDP into the system. Exports collapsed, so did central tax revenue and corporate profits. Combined fiscal deficit rose sharply to 11% of GDP in 2008-09 and is likely to be over 10% in 2009-10. To deal with the crisis, the Central Government announced 3 fiscal stimulus packages in early Dec 08, early Jan 09 and early Mar 09



respectively. Dr. Joseph and his team made a forecast of GDP using an index of leading economic indicators (LEI). He explained that LEI predicts future growth based on the past (5 quarters in advance) so it cannot capture the effects of sudden external shocks. Therefore, they used a dummy variable to capture such externalities. Based on leading indicators and shock variable, the growth rate for 2008-09 was predicted to be 7.9% (in a no shock scenario) and 6.3% (with shock). Similarly, for 2009-10, GDP growth forecast is 8.4% (in a no shock scenario) while it is 4.8% (with shock). In conclusion, he remarked that growth would come down but not below zero and the recovery is possible in late 2009-10 or early 2010-11 if the government is able to push through massive investment in infrastructure with public-private participation.


The last presentation of the Session was given by Mr. Benno Graw, Financial Counsellor, German Consulate General, Mumbai. While presenting the global economic outlook, he stated that the world trade is projected to contract by 2.8% in 2009 and the global GDP is projected to shrink by 0.6%. He showed the negative impact of the crisis on the US, Eurozone (with special mention of Germany) and on the emerging economies (BRIC) citing evidence of declining GDP and falling exports in these economies. He also laid down the key objectives of the Washington Action Plan of the G20 to counter the financial and economic crisis. Thereafter, he discussed in detail the measures taken up in Germany and elaborated on the German discussion of further measures. He interpreted the German approach in consideration of the already implemented substantial stimulus packages, big bailouts and huge credit guarantees as a policy that also allows the automatic stabilizers, which have a big potential in Germany, to take their full effect to counter the crisis. At the end he pointed out that it would be useful to further deepen the analysis of financial and economic stability, expanding the Financial Stability Forum (FSF) to the G20 circle and to strengthen its role and the collaboration with the IMF with a view of forming an even more effective early instability warning system.

## Session 2: Legal and Regulatory Framework for India's Financial System and

By Ms. Sirjjan Preet, Research Associate, ICRIER

**Session II** started with a presentation of Dr. A.V.Raja, Reader, Department of Economics, University of Hyderabad. He described the institutional foundations of the regulation of banks and financial markets. According to him, property rights protection and contract enforcement are the twin pillars of growth and development, while moral hazard, opportunistic behavior and adverse selection are the roadblocks that can only be removed by effective legal institutions. Discussing the nature of the financial markets he said that in all financial markets, expectations play a major role in pricing financial assets, and with limited availability of information, price developments are difficult to predict and the market parties tend to adjust suddenly and collectively. Since money is at the core of the financial system, bank failures and financial panics cause negative macroeconomic externalities. In addition, unbridled competition is seen as a major





threat to the stability of the financial system. Though it reduces inefficiencies related to monopoly rents, it may also cause unwanted effects like suboptimal levels of screening, excessive risk taking or even break down of markets. He also discussed the role of regulation and corporate governance in capital markets. Later, he discussed the results of his study on causality between law, economic growth and the financial sector. He concluded that the phenomenal growth in India's financial sector could be in part attributed to legal developments and positive changes in regulatory environment. He emphasized that India should put together correct procedural laws in place which lend support to substantive law and argued that the institutional approach is the most effective way of analyzing the problems.

The last presentation of the session was made by Prof. K. K. Krishnan, Associate Professor-Insurance, BIMTech. He spoke on Insurance Regulations: Challenges and Responses. He started by giving a snapshot of the 190 year old insurance industry in India. With a current market size of \$47.89Bn, Indian Insurance Industry is ranked 5th in Asia. Though Insurance Regulatory and Development Authority (IRDA) is the official regulator of the insurance sector in India, there exists a Self Regulatory Mechanism in the form of Life Insurance Council and General Insurance Council who act as a liaison between the industry and the regulator. Major challenges facing the industry are the following: Low financial literacy among target audience, lack of a clear distinction between insurance and investment, capitalization constraints, rigid structural format, opaque costing practices, insufficiently trained intermediaries, lack of regulatory proactivity and pending legislation and reforms. He suggested a set of principles that aim at the creation of financial literacy, policy and financial inclusion, prudential regulations and market conduct regulations to meet the regulatory challenges.



### Session 3: Recent Developments in India's Banking Sector and Capital Market.

By Ms. Manjeeta Singh, Research Associate, ICRIER

Mandira Sarma gave a presentation on “**Current Developments in Cooperative Banking in India**”. She started by providing a general picture of the cooperative banking system in India and was of the opinion that since the share of rural cooperatives in the total institutional credits was around 53% in 2006-07 and since they had an impressive network in the rural areas, they could be a potential vehicle for financial inclusion in India. She then listed out the main issues that confronted the cooperative banking segment. These included the governance issues, management and HR issues and issues relating to finance. Talking about the first issue she said that as the cooperative societies are governed on the one hand by the Cooperative Societies Act of the State and on the other hand by certain provisions of the Banking Regulation (BR) Act, 1949 and as the precise demarcation of the powers between the two regulators was ambiguous it had given rise to serious problems in the governance structure which included State Government interference. Also, since the structure was driven by borrowers with depositors, whose money is being intermediated, having no say in the management of their own money there is no incentive for good governance. The second issue relating to the Management and HR arose due to the impairment of Governance. The Vaidyanathan Commission also found that the staff was characterized by an ageing profile and had inadequate qualification and training. Lastly, the issues of Finance included, poor recovery of outstanding credit by the rural cooperative banks making the whole system unsustainable, lack of standardised business models and risk management systems, overexposure to the agriculture sector and lack of diversification of the loan portfolios. She ended her presentation by talking about the reforms GoI has initiated to revive this sector. These comprised of the Revival package (2006) for Rural Short Term Coop Credit Structure which has picked up in a big way, Draft revival package (2008) for Rural Long Term Coop Credit Structure, and to address the issue of dual control RBI has come up with the vision document (2005) for Urban Cooperative Banks.

CKG Nair, Director, Capital Markets, Ministry of Finance gave a presentation on “**Recent Developments in Capital Markets**”. He stated that the capital markets in India have gone through various stages of liberalization which had brought about fundamental and structural changes. The transformation of the Indian securities markets was initiated with the establishment of the Securities and Exchange Board of India (SEBI) in 1989, initially as an informal body and in 1992 as a statutory autonomous regulator. A series of reforms were then introduced which included dematerialization, disclosure based

regulations, screen based trading, rolling settlement on T+2 basis etc. Moving on to the recent developments he talked about the amendments to the Securities law to give more investigative powers to SEBI and the SARFESI Act, 2002 which helps to provide for legal framework for trading of securitized instruments. Other developments include making PAN as the sole identification number, short selling and securities lending and borrowing schemes, simplification of processes etc. He ended his presentation with the issues that have emerged recently. These according to him are whether there should be a unified (as in the UK) or multiple (as in India and USA) regulatory and supervisory body, should there be more emphasis on principles or on rules, enhancement of coordination and convergence, the importance of moving with innovations and if we should adopt a rushed approach to reforms or a harmonic approach.





## Impressum

Published by:

InWEnt – Internationale Weiterbildung und Entwicklung gGmbH

Capacity Building International, Germany

Friedrich-Ebert-Allee 40

53113 Bonn, Germany

Phone +49 228 4460-0

Fax +49 228 4460-1766

[www.inwent.org](http://www.inwent.org)

April 2009

Picture credits:

© ICRIER-Regional Office, New Delhi

Photo on the title:

© Berthold Hoffmann

Design:

Rüdiger Metzler

[www.fgl-werketage.de](http://www.fgl-werketage.de)

Printed by:

Druckerei Bunter Hund

[www.bunterhund.com](http://www.bunterhund.com)

## InWEnt – Qualified to Shape the Future

InWEnt – Capacity Building International, Germany, is a non-profit organisation with worldwide operations dedicated to human resource development, advanced training, and dialogue. Our capacity building programmes are directed at experts and executives from politics, administration, the business community, and civil society. We are commissioned by the German federal government to assist with the implementation of the Millennium Development Goals of the United Nations. In addition, we provide the German business sector with support for public private partnership projects. Through exchange programmes, InWEnt also offers young people from Germany the opportunity to gain professional experience abroad.

InWEnt – Internationale Weiterbildung und Entwicklung gGmbH  
Capacity Building International, Germany  
Friedrich-Ebert-Allee 40  
53113 Bonn, Germany  
Phone +49 228 4460-0  
Fax +49 228 4460-1766  
[www.inwent.org](http://www.inwent.org)

