Shyamala Gopinath: Special features of financial sector reforms in India

Inaugural address by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the 18th Annual National Conference of Forex Association of India, Bangkok, 6 April 2007.

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Ms. Nitaya Pibulratanagit, Asst. Governor Bank of Thailand, Mr. Appiah Chairman Forex Association of India, Mr. Lamba Secretary Forex Association of India, delegates from India and Asia/Middle East, ladies and gentlemen. It is a pleasure to inaugurate the 18th annual conference of the Forex Association of India which is affiliated to ACI in this historical city of Bangkok. I understand FIMMDA had held a similar conference in Bangkok in 2003 which was inaugurated by my senior colleague Dr. Rakesh Mohan. India and Thailand share a close association dating back to many centuries, which continues even in the present times, both culturally as well as economically. The past few years have witnessed increasing economic and commercial links and the signing of a number of Agreements leading to a further intensification of relations.

The economies of the Asian region are emerging as the new engines of growth in the global economy and I am sure in this year's conference many speakers will focus on the theme of the conference. For my address today, I intend to reflect upon the special features of financial sector reforms in India since the initiation of the reform process in early nineties covering banking sector and financial markets and certain actions taken and contemplated. There have been innumerable evaluations of the financial sector reforms undertaken by India, some of which critical of the pace but the results achieved are acknowledged by all. It is important to understand and appreciate the circumstances under which the entire process was guided through balancing the given systemic imperatives with the need for bringing about changes in a non-disruptive manner.

Financial sector reforms in India introduced as a part of the structural adjustment and economic reforms programme in the early 1990s have had a profound impact on the functioning of the financial institutions, especially banks. The principal objective of financial sector reforms was to improve the allocative efficiency of resources, ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. At the same time, reforms were also undertaken in various segments of financial markets, to enable the banking sector to perform its intermediation role in an efficient manner. With a view to making the reform measures mutually reinforcing, the reform process was carried forward through analysis and recommendations by various Committees/Working Groups and extensive consultations with experts and market participants.

I. Special features of the reforms in the financial sector

- The reforms were not driven by any banking crisis nor were they an outcome of any external support package. They were undertaken much before the importance of the financial sector to prevent crisis was recognized by international agencies and other countries in early 1990s before the Asian financial crisis.
- The reforms were carefully sequenced in terms of instruments and objectives. Thus, prudential norms and supervisory strengthening were introduced early in the reform cycle, followed by interest rate deregulation and gradually lowering of statutory preemptions. The more complex aspects of legal and accounting measures were ushered in subsequently when the basic tenets of the reforms were already in place. More recently, the regulatory framework has also focused on ensuring good governance through "fit and proper" owners, directors and senior managers of the banks. The preference has been for diversified ownership.
- While the focus of the first generation of reforms was to create an efficient, productive and profitable financial services industry, the second phase of financial sector reforms, beginning from the second-half of the 1990s, was aimed at strengthening of the financial system and introduction of structural improvements
- The need to prepare the financial system in a more globalised environment and to promote financial stability in the face of domestic and external shocks was on top of agenda of reforms. With increasing globalisation of the Indian economy, the reform process witnessed

a significant move towards adoption of international best practices in several crucial areas of importance such as prudential norms, banking supervision, data dissemination and corporate governance.

- With a view to increasing competition in the banking sector new private sector banks were licensed. A prerequisite for grant of the licence was that these banks had to be fully automated from day one. The results are self-evident as these banks have become high-tech banks. This has had a "demonstration" effect on the entire system. The Government ownership in nationalized and State Bank of India was brought down by allowing them to raise capital from the equity market up to 49/45 per cent of paid-up capital.
- A unique feature of the reform of public sector banks, which dominated the Indian banking sector, was the process of financial restructuring. Banks were recapitalised by the government to meet prudential norms through recapitalisation bonds. The mechanism of hiving off bad loans to a separate government asset management company was not considered appropriate in view of the moral hazard. The overhang of non-performing loans had to be managed by the banks themselves.
- The subsequent divestment of equity and offer to private shareholders was undertaken through a public offer and not by sale to strategic investors. Consequently, all the public sector banks, which issued shares to private shareholders, have been listed on the exchanges and are subject to the same disclosure and market discipline standards as other listed entities.
- The cost of recapitalization to GDP has been low relative to experience in other countries. On a cumulative basis it worked out to about one percent of the GDP. Furthermore, the market value of equity held by Government now far exceeds the recapitalization cost. With a view to carry the reform process further, as announced in the Budget last year the Government decided to convert the recap bonds issued as special securities (basically non-negotiable) to marketable securities indistinguishable from other Government securities . The process has already started and in 2006-07 the Government converted nearly Rs 80 billion to SLR securities. The balance special securities will be phased out over a period.
- Banks were also allowed to diversify into various financial services and are now offering a whole range of financial products like universal banks.
- Active steps were also taken to improve the institutional arrangements, including the legal framework and technological system. To tackle the issue of high level of non-performing assets (NPAs), Debt Recovery Tribunals were established consequent to the passing of Recovery of Debts Due to Banks and Financial Institutions Act, 1993. To provide a significant impetus to banks to ensure sustained recovery, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was passed in 2002.
- While transfer of NPAs of public sector banks to separate asset management companies was not considered, an institutional mechanism to deal with distressed assets of banks and financial institutions has been created. Asset Reconstruction Companies have been allowed to be set up which are in the private sector and operate as independent commercial entities to acquire non-performing assets from any financial entity and restructure and rehabilitate or liquidate them within a definite time frame. This has created a market for distressed assets in India.
- The government securities money and forex markets have significant public policy implications for an emerging market economy. These have developed during the reform period with impressive diversification of participants and instruments.
- The smooth functioning of the payment and settlement system is a pre-requisite for financial stability. The introduction of RTGS and setting up of the CCIL which acts as a central counterparty for securities and forex transactions and guarantees both the securities and funds legs of the transaction have enhanced the efficiency of the payments mechanism.
- In terms of the processes also, certain interesting features of the reforms are in evidence. The first has been its gradualism, wherein reforms were undertaken only after a process of close and continuous consultation with all stakeholders. This participative process with wider involvement not only encouraged a more informed evaluation of underlying content of

policies but also enhanced the credibility of policies and generated expectations among economic agents about the process being enduring in nature.

There has been a constant rebalancing of reform priorities predicated upon the domestic and global business environment, institution of prudential practices, upgradation of the regulatory and supervisory framework, institution of appropriate institutional and legal reforms and the state of openness of the economy.

Impact of reforms in the banking sector

(i) Performance indicators

Various measures initiated over the last decade-and-a half have significantly strengthened the commercial banking sector in terms of profitability, asset quality and capital position. The soundness parameters of the banking system, in particular, have shown sustained improvement.

The asset quality of the Indian banking system has improved significantly over the past one decade. The NPAs of all SCBs, which stood at 15.7 per cent of gross advances and 7.0 per cent of total assets in 1995-96, declined to 3.3 per cent of gross advances and 1.9 per cent of total assets in 2005-06 (Table 1). Similar trend can also be seen in the net NPAs ratios during the same period, reflecting better recoveries by banks and better allocation of funds. There has been a distinct improvement in the recovery climate in recent years facilitated by strong macroeconomic performance and institutional measures initiated by the Reserve Bank/Government. It is also significant to note that the asset quality of public sector banks has been better than private sector banks – both old and new – in terms of net NPL (*i.e.,* net of provisioning).

Table 1: Gross and Net NPAs of Scheduled Commercial Banks

Year (end-March)	Non-performing assets			
	Gross		Net	
	As percentage of gross advances	As percentage of total assets	As percentage of net advances	As percentage of total assets
1	2	3	4	5
1996-97	15.7	7.0	8.1	3.3
1999-00	12.7	5.5	6.8	2.7
2002-03	8.8	4.0	4.4	1.9
2005-06	3.3	1.9	1.2	0.7

Source: *Handbook of Statistics on the Indian Economy 2005-06.*

The financial performance of SCBs had also improved during the recent past as reflected in their profitability. The operating profit to assets ratio of SCBs, which was 1.69 in 1995-96, increased to 2.03 in 2005-06 (Table 2). Net profit to assets of SCBs remained in the range of 0.47 to 1.13 during the period 1995-96 to 2005-06. The impact of greater competition and improved efficiency of the Indian banking system could also be seen from the significant reduction in interest spread over the reform period.

Table 2: Important financial Indicators –SCBs

Year	Operating Profit to Assets	Net Profit to Assets	Income to Assets	Expenditure to Assets	Operat-ing Expenses to Assets	Provisions and Contingencies to Assets	Spread (NII) to Assets
1	2	3	4	5	6	7	8
1995-96	1.69	0.68	-	-	2.94	1.54	3.13
1999-00	1.66	0.66	10.40	9.74	2.50	1.00	2.73
2002-03	2.39	1.01	10.14	9.14	2.24	1.39	2.77
2005-06	2.03	0.88	7.97	7.09	2.11	1.15	2.78

Source: *Report on Trend and Progress of Banking in India, various issues.*

One of the major objectives of banking sector reforms was to enhance efficiency and productivity through increased competition. That the competition has intensified could be gauged from the decline in the share of public sector banks in the total income, expenditure and assets of the commercial banking system since the mid-1990s, and increase in the share of new private sector banks (Table 3).

Table 3: Bank Group-wise Shares: Select Indicators

(Per cent)

	1995-96	1999-2000	2002-03	2005-06
1	2	3	4	5
Public Sector Banks				
Income	82.5	78.8	74.5	72.4
Expenditure	84.2	79.4	74.8	73.1
Total Assets	84.4	80.2	75.7	72.3
Net Profit	-39.1	70.0	64.8	67.3
Gross Profit	74.3	70.9	76.6	69.2
Private Sector Banks				
Income	8.2	12.3	18.5	19.7
Expenditure	7.4	12.0	18.6	19.7
Total Assets	7.7	12.3	17.5	20.5
Net Profit	59.3	16.8	15.6	20.3
Gross Profit	10.1	14.5	18.7	19.0
Foreign Banks				
Income	9.4	9.0	7.0	7.8
Expenditure	8.3	8.7	6.6	7.3
Total Assets	7.9	7.5	6.9	7.2
Net Profit	79.8	13.2	19.6	12.5
Gross Profit	15.6	14.6	4.7	11.8

Source: *Reserve Bank of India.*

Comparison with other countries

Several balance sheet and profitability indicators suggest that the Indian banking sector indicators are moving towards global benchmarks (Table 4).

Table 4: Select Banking Indicators: Cross-Country

(End-March)

Country	Return on Assets		Regulatory capital to risk-weighted Assets		Non-Performing Loans to total Loans	
	2005	2006	2005	2006	2005	2006
1	2	3	4	5	6	7
Emerging Markets						
Argentina	0.9	1.9	...	...	5.2	4.7
Brazil	2.1	2.3	17.4	...	4.4	...
Mexico	2.4	2.4	14.3	16.0	1.8	1.7
Korea	1.2	1.3	12.8	13.1	1.2	1.2
South Africa	1.1	...	12.3	12.6	1.5	1.3
Developed Countries						
US	1.3	1.4	13.0	13.1	0.7	0.7
UK	0.8	...	12.8	...	1.0	...
Japan	0.5	...	...	...	1.8	...
Canada	0.7	...	12.9	13.0	0.5	...
Australia	1.8	...	10.3	...	0.2	...
Memo:						
India *	0.9	0.9	12.8	12.4	5.2	3.3

... Not available.

Note: Data relating to Brazil, UK and Australia relate to the end-December, 2005 and 2006.

Source: Global Financial Stability Report (GFSR), September 2006.

(ii) Resolution of NPAs

The Narasimham Committee I had suggested the creation of an Asset Creation Fund to which the public sector banks would transfer the non-performing assets with certain safeguards. After deliberations it was decided not to adopt this approach. Instead banks were required to deal with all the non-performing assets themselves and it is clear from the performance indicators above that this strategy has been effective. Fiscal support has not been burdensome and legacy problems such as non-performing loans have been absorbed by banks and not transferred to fisc. Although subsequently the Government passed a legislation to create a new category of companies called Asset reconstruction companies, it must be noted that these entities are private commercial entities and work on a commercial basis to deal with distressed assets. These institutions as well as guidelines that permit banks to purchase and sell NPAs and the Corporate Debt Restructuring mechanism have enabled banks to deal with the "flow" and not merely the stock of NPAs. These measures enable the banks to deal with the NPAs on an ongoing basis.

(iii) Ownership structure

Since public sector banks could divest only by accessing the stock markets except for a few banks all the others are now listed on the stock exchanges. The Government holding in these banks range from 51 percent (OBC, Dena) to 76 percent (BOM). Of the privately held equity, significant portion (15 to 20 percent) was held by foreign investors in quite a few public sector banks as on 30 September 2006. All new private banks are listed and there is considerable foreign investment (both FDI and FII) in these banks. In five of the existing eight banks foreign shareholding had crossed 50 percent. Even among the old private banks all significant banks are listed.

(iv) Consolidation

The process of consolidation has also been taking place in India. Since 1990, 19 mergers have taken place in the commercial banking sector. Bank mergers have taken place in India mostly with the objective to synergise the strength of the merging institutions. Broad guidelines have been laid down by RBI for mergers for private sector banks from a regulatory and prudential perspective and these guidelines apply to public sector banks mutatis mutandis and to the extent relevant.

(v) Extension of coverage of reform process

The reform process initially focused on commercial banks. However, after significant progress was made to transform commercial banks into sound institutions, the reform process was extended to encompass other institutions such as regional rural banks (RRBs), cooperative banks, All-India financial institutions (AIFIs) and non-banking financial companies (NBFCs). The regional rural banks, urban co-operative banks and rural co-operative credit institutions can play a major role in financial inclusion and deepening of the financial sector, particularly in the rural areas. The co-operative credit institutions, both urban and rural, are now placed on the path of revival through a consultative method of policy formulation, ensuring a workable regulatory arrangement to overcome the incentive problems and financial support wherever necessary. The strategy has started showing results which is crucial for sustaining their role in financial intermediation among the rural and urban poor and small savers.

Recent initiatives

(i) Supervision of financial conglomerates

Financial conglomerates (FC) pose certain risks to the financial system which could be detrimental to the overall financial stability. These risks relate to the moral hazard associated with the “Too-Big-To-Fail” position of many financial conglomerates, the fact that financial difficulties in one subsidiary in a segment could have contagion or reputation effects on another subsidiary in a different segment on account of the “holding out” phenomenon, especially when using the same brand name, and the concerns about regulatory arbitrage, non-arm’s length dealings, etc. arising out of Intra-group Transactions & Exposures (ITEs) – both financial and non-financial. The financial sector in India has undergone significant liberalisation in all the four segments – banking, non-banking finance, securities and insurance and each of these sectors has grown significantly accompanied by a process of restructuring among the market intermediaries. The financial landscape is increasingly witnessing (i) entry of some of the bigger banks into other financial segments like merchant banking, insurance, etc. which has made them financial “conglomerates”; (ii) emergence of several new players with diversified presence across major segments and (iii) possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have a systemic impact. In view of the above, a Working Group had gone into all the issues and had laid down criteria for a group being identified as a financial conglomerate. Accordingly a system has been put in place for all the identified financial conglomerates whereby a designated entity within the conglomerate reports to its Lead Regulator. In order to monitor the intra group transactions and exposures, information from the designated entities of each FC is obtained by the principal regulators and a system for exchange of information among the regulators has been put in place. In addition, periodical discussions are held with the CEO of the designated entity in the FC by the Lead Regulator, along with other regulators, on the basis of available information for review and addressing concerns, if any. It is also necessary to back-test the efficacy of the reporting format in capturing the meaningful intra-group transactions/exposures and other “material” information and also enhance the regulatory understanding of the affairs of the conglomerates. Further work is being undertaken in this direction in consultation with other regulators.

The inter-regulatory forum has also observed a need for the principal regulator to engage in dialogue with the principal auditors of the group. This could provide useful information on the impact of changes in the accounting standards and practices on the core earnings of the conglomerates and the likely trend in the future. The modalities for this purpose are being worked out in consultation with other regulators.

(ii) New capital instruments

In Jan 2006, RBI allowed Indian banks to augment their capital funds by issue of innovative perpetual debt instruments eligible for inclusion as Tier I capital; debt capital instruments eligible for inclusion as Upper Tier II capital; perpetual non-cumulative preference shares eligible for inclusion as Tier I capital and redeemable cumulative preference shares eligible for inclusion as Tier II capital. A number of banks have issued these instruments both in India and overseas to shore up capital

(iii) Procyclical prudential provisioning

Traditionally, banks' loans and advances portfolio is pro-cyclical and tends to grow faster during an expansionary phase and grows slowly during a recessionary phase. During times of expansion and accelerated credit growth, there is a tendency to underestimate the level of inherent risk and the converse holds good during times of recession. This tendency is not effectively addressed by the above mentioned prudential specific provisioning requirements since they capture risk *ex post* but not *ex ante*. The various options available for reducing the element of pro-cyclicality include, among others, adoption of objective methodologies for dynamic provisioning requirements, as is being done by a few countries, by estimating the requirements over a business cycle rather than a year on the basis of the riskiness of the assets, establishment of a linkage between the prudential capital requirements and through-the-cycle ratings instead of point-in-time ratings and establishment of a flexible loan-to-value (LTV) ratio requirements where the LTV ratio would be directly related to the movement of asset values.

The above aspect was first taken on board in the Monetary Policy announcement in October 2005 and since then, various measures have been announced.

In order to ensure that asset quality is maintained in the light of high credit growth, the general provisioning requirement on standard advances in certain specific sensitive sectors have been increased as also the risk weights. For instance the risk weight on personal loans (including credit card receivables) is 125% and the general provision is 2 percent. Similarly the general provisions for real estate loans is 2 percent and the risk weight 150 percent. The objective is to build cushions or buffers in upswings without taking a view on the future evolution of asset quality in these asset classes.

(iv) Credit information companies

An efficient credit information system enhances the quality of credit decisions and improves the asset quality of banks, apart from facilitating faster credit delivery. Accordingly, a scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions was introduced. In order to facilitate sharing of information related to credit matters, a Credit Information Bureau (India) Limited (CIBIL) was set up in 2000. With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect, process and share credit information on borrowers of banks and FIs, the Credit Information Act was passed in May 2005. The rules and regulations have also been notified. The RBI is now framing detailed guidelines on the basis of which it would consider applications from Credit Information companies. This will facilitate setting up of a few more credit information companies in India.

(v) Financial inclusion

Recognising the concerns with regard to the banking practices that tend to exclude rather than attract vast sections of population, the Reserve Bank has urged banks to review their existing practices with a view to aligning them with the objective of financial inclusion. All banks were advised in November 2005 to make available a basic banking "no-frills" account either with "nil" or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. With a view to encourage financial inclusion the KYC procedure for opening small accounts were simplified. Banks are allowed to use the services of NGOs/ SHGs, MFIs and CSOs as intermediaries in providing financial and banking services through the use of business facilitator and correspondents.

Future work program

(i) Draft guidelines on accounting aspects

Recognising the importance of a robust accounting framework in the banking sector, the Reserve Bank had undertaken an exercise a few years back (in 2001) to assess the gaps in compliance by banks with the accounting standards issued by the Institute of Chartered Accountants of India. With the issue of relevant guidelines thereafter, the audited financial statements of banks are found to be in compliance with the relevant accounting standards. With a view to take things further in this direction, the Reserve Bank has taken the initiative to introduce the various elements of IAS 39 into the guidelines for accounting of the investment portfolio and the derivative portfolios of banks. We do not have a corresponding accounting standard to IAS 39 in India as yet. The ICAI is presently engaged in the process of issue of this standard and that process is likely to take some more time, hence the initiative from the Reserve Bank of India. The Reserve Bank has issued draft guidelines on the above two aspects, which are in the process of finalisation on the basis of the feedback received from banks and other market players.

(ii) Derivatives – comprehensive guidelines

Derivatives play a critical role in shaping the overall risk profile of banks. Over the years, banks have been increasingly using derivatives for managing risks and have also been offering these products to corporates. The Reserve Bank has issued several guidelines to banks from time to time on various derivative instruments. In view of the growing complexity, diversity and volume of derivatives used by banks, an Internal Group has been constituted by the Reserve Bank to review the existing guidelines on derivatives and formulate comprehensive guidelines on derivatives for banks. These guidelines are intended to cover broad generic principles for undertaking derivative transactions, management of risk and sound corporate governance requirements. The draft guidelines were placed on the Reserve Bank's website in December, 2006. The feedback received on the guidelines is being examined by the Internal Group and the draft guidelines are in the process of finalisation.

(iii) Draft guidelines on stress testing

Risk management practices in banks in India have undergone considerable improvement over the past few years with the introduction of the financial sector liberalization process in the mid nineties. The process gained momentum with the issue of regulatory guidelines and guidance notes on asset liability management and management of credit risk, market risk and operational risk by the Reserve Bank since 1999. Further, the announcement of implementation of the revised capital adequacy framework in India with effect from March 31, 2007 has brought the risk management capabilities of banks into greater focus.

Globally, banks are increasingly relying on statistical models to measure and manage the financial risks to which they are exposed. These models are gaining credibility because they provide a framework for identifying, analyzing, measuring, communicating and managing these risks. Since models cannot incorporate all possible risk outcomes and generally are not capable of capturing "event risks" and sudden / dramatic changes, banks need to supplement models with "stress tests". Internationally, stress testing has become an integral part of banks' risk management systems and is used to evaluate the potential vulnerability to certain unlikely but plausible events or movements in financial variables. There are broadly two categories of stress tests used in banks viz. sensitivity tests and scenario tests. These may be used either separately or in conjunction with each other.

Banks in India are beginning to use statistical models to measure and manage risks. Further, the supervisory review process under Pillar 2 of Basel II framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. Banks must demonstrate, under the internal capital adequacy assessment process prescribed by Pillar 2, that they have enough capital to not only meet the minimum capital requirements but also to withstand a range of severe but plausible shocks. In the above background, the need for banks in India to adopt "stress tests" as a risk management tool is being emphasised by RBI.

(iv) Basel II

The Reserve Bank and the commercial banks have been preparing to implement Basel II. The Reserve Bank had earlier intended in June 2005 that by March 31, 2007 all commercial banks would comply with Basel II. However, taking into account the state of preparedness of the banking system, it was decided in October 2006 to provide banks some more time to put in place appropriate systems so as to ensure full compliance with Basel II. According to the new schedule, foreign banks operating in India and Indian banks having presence outside India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009.

The Basel Committee on Banking Supervision (BCBS) had undertaken the Fifth Quantitative Impact Study (QIS-5) to assess the impact of adoption of the revised Framework. Eleven Indian banks, accounting for about 50 per cent of market share (by assets), participated in the QIS-5 exercise. An empirical analysis indicates that the combined capital adequacy ratio of these banks is expected to come down by about 100 basis points when these banks apply Basel II norms for standardised approach for credit risk and basic indicator approach for operational risk. Although none of the banks which participated in the exercise would be breaching the minimum capital adequacy ratio under the new framework, the net impact reflects a wide range. The draft guidelines on Basel II implementation has been placed in public domain but meanwhile RBI has asked the banks to undertake parallel calculation of the CAR based on the Standardised Approach on a quarterly basis from December 2006 and report it to RBI. These would enable RBI to assess the impact of the revised guidelines and enable banks to also assess /calibrate the capital requirements.

(v) Mortgage guarantee companies

As announced in the Budget RBI has now placed in public domain draft guidelines on mortgage guarantee companies. These will be a new category under the NBFC sector and the activities will be in the nature of mortgage guarantees and not mortgage insurance. Mortgage insurance falls within the jurisdiction of the Insurance regulator.

(vi) FSAP – self assessment

A Committee on Financial Sector Assessment to undertake a self-assessment of financial sector stability and development has been constituted. For the purpose of carrying out the task under the terms of reference, the Committee has decided to set up four Advisory Panels which would be assisting the Committee in its assessment exercise and would be drawn from non-Official experts in relevant areas related to financial stability assessment and stress testing, transparency standards, financial regulation and supervision, and institutions and market structure respectively. To provide necessary inputs to the Advisory Panels, it has been decided to set up Technical Groups comprising mainly of Officials directly working in respective areas of regulatory institutions.

Finally a few comments on reforms in financial markets

Well developed financial markets enable the central bank to effectively conduct monetary policy and help in improving the allocative efficiency of resources. Interest rates on benchmark Government securities facilitate appropriate pricing of other financial assets. It has, therefore, been the endeavour of the Reserve Bank to promote development of all the segments of financial market under its regulatory provision. This is sought to be achieved by easing restrictions on transactions, reducing transaction costs, increasing the width and depth of the market and introducing trading and settlement systems in line with international best practices.

In the money market, there has been a significant transformation after the introduction of financial sector reforms in terms of instruments, participants and technological infrastructure and transparency. Various reform measures have resulted in a relatively deep liquid and vibrant money market. Further development of the market depends among others on better ALM practices by banks.

In the Government securities market, several measures have been initiated since 1990s including guaranteed settlement in respect of all government securities trade through the RBI and I do not want to go into each of them. However from the fiscal year 2006-07, as per the provisions under the Fiscal Responsibility and Budget Management (FRBM) Act 2003, the Reserve Bank's participation in the primary market for Central Government securities stands withdrawn. This has necessitated significant changes in the setting and operating framework of monetary, debt management and regulatory policies of the Reserve Bank.

One of the initiatives taken in this regard is broad basing of Primary Dealership system: Till last year, primary dealer activity was confined to Primary Dealer institutions. In order to broad base the activity, the structure of Primary Dealership business was expanded to include all Scheduled Commercial Banks (excluding RRBs), which fulfill certain minimum eligibility criteria. An option was given to the existing Primary Dealer entities to fold back the PD business into their parent bank or group companies. Consequently, the configuration of the PD system changed from 17 standalone entities at the beginning of the year to 8 standalone entities and 10 banks undertaking PD business departmentally by the end of year 2006-07.

Reserve Bank has been undertaking passive consolidation of securities by reissuing the existing securities to build up stock at key maturities. During 2006-07, the reissues accounted for 91% of the total issuances made. Since passive consolidation takes longer time to make an impact on enhancing the liquidity, Active consolidation was proposed by way of buying back illiquid bonds and reissuing liquid bonds. The Scheme has been finalized in consultation with the Government and the budgetary provision of Rs. 25 billion has also been made in this regard. Further action is being taken by RBI.

To create and enhance market liquidity even during the phases of falling prices, select participants have been permitted to short sell securities in G-sec markets. The short sales were initially permitted (February 28, 2006) on an intra-day basis where the participant can short during the day but was required to cover it by the end of the day. After assessing the market feedback and after consultations with the participants, the short sales have been extended to five day period there by permitting participants to carry forward their short positions beyond the settlement cycles. To enable delivery against the short positions, the sale of repoed stock has also been permitted. With the participants gradually putting in place internal systems to undertake short sales with the approval of the respective Board, it is expected that the liquidity in markets would increase.

The primary issuance framework required revamping in the light of RBI's withdrawal from the primary issuances of Central Government effective April 01, 2006. Along with the restructuring of the underwriting commitments of PDs to ensure 100% underwriting and permitting PDs to diversify their businesses, "WI" trading has been introduced to enable better distribution of auctioned stock and also more efficient price discovery. "WI" trading was initially permitted in reissued securities (May 2006) and the same has subsequently been extended to newly issued securities (Nov 2006) which would be operationalised after the necessary software modifications which is at an advanced stage.

The enactment of the Government Securities Act 2006 has enabled introduction of "STRIPS" in India. The RBI is taking steps for developing a market in STRIPS. The implementation of STRIPS would facilitate creation of a series of benchmark rates and enable evolution of a market structure for selling the securities in retail. Apart from expanding the investor base, introduction of STRIPS would also enable developing a proper yield curve. Based on the recommendations of the Working Group on STRIPS submitted in July 2004, an implementation team is working on the fine print for the introduction of STRIPS and is also looking at the international experience in this regard which has been varied. The RBI has consulted market participants on the operational issues such as the model, securities eligible for stripping, whether exclusivity should be granted to PDs etc. In regard to securities to be made eligible for stripping two pairs of coupon dates i.e., 02 January/02 July & 16 April/16 October have been identified with all securities having their coupon dates as any of the above being eligible for stripping. In future, to improve liquidity of STRIPS, securities both re-issues as well as fresh issues may have to be aligned with these dates. Simultaneously, the RBI is dealing with the issue of system changes.

The securitised debt market in India is also growing and increasingly banks will need to consider securitisation of their debt to meet growing credit requirements and manage capital efficiently. The RBI regulatory framework provides a sound basis for the growth of this market.

The approach to liberalisation of forex market in India has remained cautious with a clear emphasis on the need to safeguards against potential financial instability that could arise due to excessive speculation in the foreign exchange market. The reforms were carefully sequenced in respect to instruments and objectives. Although the access to forex markets by non-banks is predicated on the underlying commercial transactions, over a period considerable flexibility is available to cover these transactions on a dynamic basis for both trade and non-trade transactions. The impact of the reform initiatives is clearly discernible in terms of depth and efficiency of the market in all segments. Average daily gross turnover in the forex market has steadily increased to USD 28.6 billion as of January 31, 2007.

The RBI has proposed a further expansion of the access to the options market for corporates by allowing covered options. This will be part of the overall final derivatives policy. Similarly, we are examining the request of certain commodity companies to hedge their economic exposures in overseas exchanges which was also recommended by the Technical Group on Forex Markets.

Finally since this is a body of forex professionals I would like to stress the need to provide efficient and competitive service to individuals and small enterprises. With increasing globalisation the foreign exchange requirements of these categories of persons are also growing. With this objective, RBI has allowed entities which meet certain criteria to act as a limited authorised dealer (Category II) for certain non-trade current account transactions. Existing FFMCs, UCBs, and RRBs are also eligible for such licences. Individuals and small enterprises do not have adequate access to competitive and efficient service on foreign exchange. The exporters particularly smaller exporters and there are a large number of them do need better advice on hedging their currency exposures. Banks should consider devising products for the SME sector which will reduce transaction costs on foreign exchange transactions.

I wish the Conference all success in its deliberations.