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Speech on "Funding Double Digit Growth for India – Repositioning the Financial Sector"

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This conference is being held at a time when the world is awaiting the final moments of Global Financial Crisis, Act 1, Scene II. We do not know in which way this drama will end – whether Financial Stability will prevail in Europe, whether the downgrading of the rating of the US economy and of the leading US Banks will result in dethroning of the dollar or whether this drama is yet to reveal itself fully to us. While all this is happening, while the developed economies of the world are sending out economic distress signals, the India story continues to attract interest. According to recent news reports, India is likely to overtake Japan as the third largest economy in the world in purchasing power parity terms. In spite of the current year deceleration in the growth rate, in spite of stories coming out of India of standstill in governance, in spite of confidence levels in India being currently rather low, the GDP growth is likely to be in excess of 7.5% during the current year. A study of how, in spite of the shocks India underwent during the global meltdown of 2008-09, the economy bounced back within a year is a fascinating one and proves the fundamental strengths of the Indian economy. At the height of the meltdown the foreign institutional investors withdrew $ 13.3 billion from the Indian markets, the Rupee crashed from a high of 40.36 to the dollar in March 2008 to Rs.51.23 in March 2009, export growth came to a standstill, GDP growth rate plummeted to 6.5% in 2008-09 from 9.7% in 2006-07 and the

Sensex, the barometer of India's feel-good factor, crashed from 21,000 plus to 8,000 plus. In spite of these tremors and shocks the fundamentals of the economy were such and the resilience of the Indian economy was such that India was back to the growth path in less than 12 months.

The economic success story of India stretches back to history. History reveals that from the first century A.D. to the end of the 16th century India was the world's largest economy, its share in world trade being higher than that of whole of Europe. It is from the beginning of the 17th century that India went into economic decline. Today the economy of India is the 11th largest in the world by nominal GDP. GDP growth rates have averaged over 7% during the last two decades, just falling short of double digit growth in the best years. According to the BRIC report published by Goldman Sachs, India will be the second largest economy after China in the next three decades. According to studies by Morgan Stanley, India's growth will start to outpace China's within 3-5 years and for the next 20 to 25 years India will grow faster than any other large nation. McKinsey & Co. has predicted that India's economy will grow five-fold in the next 20 years. India is today considered an attractive investment destination. India hardly used to get $ 2–3 billion as foreign direct investment when the process of liberalization started in the 1990s. The annual FDI figure touched a peak of $ 50 billion in the last few years.

This success saga was made possible by the speed and depth of reforms which were carried out in the 1990s. India dismantled its centrally controlled command economy and unleashed reforms in its industry policy, in its foreign investment policy, in its international trade policy and in its management of exchange rates. It carried out tax reforms, made major disinvestments in the public sector and carried out reforms to make private sector investment in infrastructure possible. It also carried out reforms in the financial sector – primarily in banking and to some extent in insurance – and also initiated reforms in its fiscal policy. There is no doubt in the mind of India watchers that these reforms triggered new investments, boosted growth, encouraged entrepreneurship and established India as a serious economic power.

The trouble with the reform story unfortunately is that after the successful sweeping reforms of the 1990s the reform process has slowed down. The first phase of reforms created certain amount of liberalization, linked India to the world and encouraged private initiatives. However, India needs to follow through with deeper and more wide ranging reforms which will bring the regulatory environment and the framework of the economy to a level which can cope with the challenges of growth. Unfortunately, this has not happened. Fiscal policy reforms have taken a u-turn and reforms in areas such as infrastructure, agriculture, land policy and labour in which the States have a say have failed to move forward significantly. There has been inability to put together a national consensus on reforms and the compulsions of coalition politics have derailed reforms to a great extent.

At the top of the pending reform agenda is the need for financial sector reforms. Financial sector reforms are important because of three imperatives. Firstly, if we want inclusive growth, if we want the total savings and investments in India to be far more than what they are now, we have to include more Indians in the growth process. This requires the financial sector to extend its reach. Secondly, in view of the current fragile global economic outlook India needs to reinforce its financial sector moorings and ensure that banks and other institutions do not suffer from the aftershocks of global tremors. Thirdly, there is an urgent need to channel most efficiently increasing amounts of domestic savings and global investment into the infrastructure sector and other productive sectors. The financial sector in India needs to be much more flexible and innovative in order to achieve these goals.

Let us first look at the global scenario.

The recovery of the world economy from the global economic crisis of 2008-09 is beset with major uncertainties. At the present pace of output growth, it would take another four or five years before employment is back at pre-crisis levels in developed countries. Despite some progress in rebuilding balance sheets in the financial sector, the banking sectors of the major developed countries still look vulnerable to multiple risks from continued weak housing markets, sovereign debt stress, and continued overall economic weakness. The European debt crisis is putting a question mark on the stability of not only the banks but of Sovereign States as well. In addition, fiscal policies are shifting towards austerity in response to heightened concerns about the sustainability of public debt levels, but are weakening growth prospects in the short run.

All these factors constitute a threat to global financial stability and it is imperative that India's financial sector must, in spite of this negative outlook, continues to attract global investment and continues to create an enabling environment for greater savings and deployment of funds.

A study was done by the World Economic Forum (WEF) (2009) entitled the annual Financial Development Report (FDR) providing an index and ranking of fifty five of the world's leading financial systems. The study ranked these countries based on over 120 variables spanning international and business environments, financial stability, size and depth of capital markets, etc. In this study financial development is defined as "the factors, policies and institutions that lead to effective financial intermediation and markets and deep and broad access to capital and financial services". In this study India is ranked 38th, whereas Thailand is ranked 35th, Malaysia is ranked 23rd and South Africa is ranked 32nd.

A close study of the health, the stability, the depth, the resilience and the soundness of our financial markets and the financial sector as a whole shows up certain fundamental flaws. While we are in an age of internet banking and mobile phone banking, according to the Raghuram Rajan Committee (high powered committee set up by Government of India on financial reforms – report dated September 2008) the single most frequently used source of loans for the median Indian household is still the local money lender. While Indian capital markets are vibrant and are an attractive destination for global capital inflows, the majority of listed scrips are illiquid and the regulators have been unable to enforce the regulation that all listed scripts should have at least 25% non-promoter holding. While Indian bankers and other lending institutions have proved their mettle in difficult times and could cater to the credit needs of the Indian economy, the delivered cost of credit to most enterprises is much above comparable international standards and in spite of the recommendations of various committees, there is a lack of flexibility and innovation when it comes to financing of India's infrastructural needs. While there has been growth in financial products such as derivatives, futures and options, corporate bond markets are still in nascent stage. And to come to the regulatory and supervisory environment again to quote the Raghuram Rajan Report there are four problem areas which need immediate fixing:

First: the pace of change is slow and the process of regulatory approval for anything new is a difficult one. Inordinate delay in passing company bill, law on GST, Comprehensive amendment in Direct Taxes.

Second: Excessive regulatory micromanagement leads to counter productive interaction between the regulator and the regulated. Example GOI mandating age at which GM can be promoted in PSU Bank, Sebi mandating composition of sub-committees of Boards for regional Stock Exchanges, etc.

Third: Many areas of the financing sector have multiple regulators with jurisdiction overlaps, narrow sectoral attitudes and regulatory gaps because regulators tend to focus on their narrow area to the exclusion of other sectors. Company law requires [S.292A(5)] mandatory attendance by auditor at Audit Committee meeting. Clause 49 of listing agreement applicable to listed companies makes attendance of auditors optional. S.292A requires that at two thirds of the Directors on the Audit Committee shall be other than whole time directors whereas clause 49 requires that at least two thirds of directors on the Audit Committee shall be independent directors.

And lastly regulatory incentive leads sometimes to excessive caution.

Let us now get into the specific areas of the financial sector which need urgent attention.

FINANCING OF INFRASTRUCTURE

According to an expert committee set up by the Government of India on infrastructure financing chaired by Deepak Parekh, (Committee Report of May 2007) to sustain GDP growth at 9% per annum, India would have needed to invest US $ 475 billion in the infrastructure sector during the Eleventh Five Year Plan (ending in 2011-12) at 2007 prices, the major areas being power, roads, ports, telecom, urban infrastructure and oil and gas pipes If we update this figure for current price levels and if we also take into consideration the figures being considered as expenditure on infrastructure during the Twelfth Five Year Plan (starting from the year 2012-13) the total figure nears the $ 1.5 trillion mark. According to a McKinsey Report India's infrastructure spending has been consistently falling short of targets. The shortfall during the Eleventh five year plan is estimated up to 190 billion. It has been estimated that if the targeted level of 8% of GDP is to be spent on infrastructure during 2011-12, half of India's incremental savings will have to be intermediated into the infrastructure sector. Given the present condition of India's financial sector, this is an impossible task. A number of structural and regulatory barriers restrict the capability of the financial sector to intermediate the flow of foreign and domestic funds into infrastructure. Some of these are:

- Banks which have mobilized funds with a typical tenure of 3 to 5 years are constrained from lending to infrastructure which has normally a longer gestation period as this would result in asset-liability mismatch.
- Banks also have issues of prudential exposure limits which are limits on lending to single borrowers and specific industries and therefore cannot provide significant portion of funds for large infrastructure projects. The exposure of banks to sectors such as power, telecom, roads, ports, airport, etc are already very large and therefore significant amounts of further lending to infrastructure is constrained by the rate of growth of banks.
- Other long term saving mobilizers such as insurance companies, pension funds and provident funds have a number of regulatory constraints because of which they cannot be significant fund providers to the infrastructure sector. Though insurance companies have large long term funds at their disposal and are not faced with asset liability mismatch issues, a large portion of their funds are preempted by investment in Government securities by regulatory dictat and there are also IRDA guidelines on exposure norms.
- Infrastructure companies cannot also resort to large scale issuance of bonds because the corporate bond markets are shallow and secondary markets in bonds are practically non-existent.
- The constraints on supply of external commercial borrowings and the caps on total of such borrowings prevent reaching out to overseas funds in a significant way.

It is therefore clear that the financial sector would need to be reformed to rise above these constraints so that:

- Domestic financial savings can be channeled into specific categories of infrastructure investment according to appetite for risk, tenor and size of investment;
- Foreign financial savings can be specifically targeted — since domestic savings will be insufficient;
- Financial risk can be distributed more widely and efficiently to avoid concentration; and
- All the above can be achieved through a facilitating framework rather than regulatory dictat.

In order to achieve the above certain concrete steps will have to be taken.

Development of Corporate Debt Market

The creation of a deep and robust debt capital mechanism is the key to financing infrastructure companies by allowing them to raise long term debt. A well developed corporate bond market is also essential for financial system stability, efficiency and overall economic growth. However, this market is practically nonexistent in India. Most of the debt issues are quasi-governmental, or from public sector oil companies or Govt. sponsored institutions. Very few corporate bonds trade on a regular basis. A study of the World Bank Financial Structure database (May 2009) revealed that private bond capitalization in India was only 2.67% of GDP in 2007, whereas it was 58.81% in South Korea, 38.79% in Japan and 24.46% in China. Major policy changes are required to set this right and to create a robust debt market. Some of these are:

- Rationalize multiplicity of regulations and multiple regulators. Today a company seeking to raise bonds will come under the purview of Sebi, Company Law Board, Stock Exchanges and depending on the sector, Reserve Bank of India and National Housing Bank, all of whom have multiple and often conflicting requirements. This has to change.
- Regulatory asymmetry between loans and bonds should be removed in respect of rating requirements and mark to market requirements.
- Repo transactions on corporate bonds in interbank repo market should be allowed.
- Restrictions on a numbers participating in private placement markets should be done away with and private placements, as a corollary, should be confined to Qualified Institutional Buyers. Also an OTC market for trading in privately placed debt should be developed.
- Credit derivatives must be allowed to be developed for trading in them so that risk transfer mechanism comes into play.

Harnessing the Insurance Sector

The world over insurance company funds are used to build infrastructure. Unfortunately traditionally the insurance sector in India was dominated by a handful of public sector entities. Even with the coming in of the private sector in India, there is a need to change the regulations applicable to investments which can be made by insurance companies especially with regard with rating for bonds and inclusion of new instruments in permitted insurance category.

Facilitating Equity Flow into Infrastructure

- Liberalizing buyback regulations to allow vendors of major equipments to hold equity in initial stages and buying back such equity when projects get operational.
- Allowing Private Equity Funds as bidding partners in infrastructure projects.

Inducing Foreign Investments into Infrastructure

- Greater FII participation by liberalizing limits.
- Allow differential liberal treatment for infrastructure holding companies.
- Allow existing rupee loans for infrastructure to be refinanced through External Commercial Borrowings so that foreign lenders who may be averse to financing risky long gestation infrastructure projects at the early stage many come in later.

Other Steps

- Allowing greater exposure by NBFCs, underwriters and other financial intermediaries.
- Allow foreign borrowings by financial intermediaries for onlending to infrastructure.
- Allowing banks to raise long term bonds for infrastructure exempt from statutory reserve requirements.

In conclusion, to keep India's growth momentums uninterrupted very large infusion of funds are needed for infrastructure. Many of these reform proposals for infrastructure financing have been on the drawing board for a very long time. There is a need to hasten the process of bringing these into play.

CAPITAL MARKETS

The second area which needs close scrutiny is the state of the capital markets. The purpose of efficient capital markets is to mobilize capital from those who have it and reach them to those who can utilize the capital in the best possible way. Capital markets in order to be efficient and fair to the investor must be transparent, must have robust systems and processes, must be well regulated and must be able to tap into the savings of investors both nationally and internationally to facilitate exchange of capital. These requirements presuppose, therefore, that settlement of transactions will happen in a seamless manner, price discovery will take place quickly and fairly and markets must be so regulated and protected that both the investor and the user of capital are safeguarded.

If we look at the scenario of capital markets in India we find that Indian households have traditionally preferred safety of bank deposits and Govt. Savings Schemes and much less than 10% of their investments in financial assets is in shares, debentures and mutual funds. The size of the mutual fund industry is estimated at $ 162 billion, revenue mobilization though primary markets in equity in 2010 was only $ 10 billion and in debt was much less. If we compare these figures to the amounts needed for investment in infrastructure plus amounts of new capital needed for projects in industry, mining and other corporate sectors it is obvious that Indian capital markets have a long way to go. Today only 1% of the Indian population participates in the capital market and of that only a fraction is active. If we consider that the current size of the Indian economy is $ 1 trillion, if we consider the fact that savings rate of Indian households is above 33%, if we are reasonably optimistic that the economy will grow for the next decade or so at an average rate of 8% plus this will add up to incremental savings of $ 5 trillion over the next decade. As a PWC study finds, the amount of savings of Indian households will exceed the amount of savings of US households by 2020. Even if 10% of the investments in financial assets are directed to financial assets, are our capital markets organized enough to handle such quantum of funds? Also the inflow of foreign funds into emerging markets will keep on increasing and India will be a major beneficiary and to facilitate such fund inflows Indian capital markets have to undergo a major transformation.

What are the major changes that are needed?

Firstly, abolish the duopoly of BSE – NSE and allow new stock exchanges and regional stock exchanges to flourish. India needs more and more distribution platforms for capital market offerings to attract more funds. While the Jalan Committee recommendations (Committee set up by the Govt. of India – report dated 2010) on ownership, management and regulation of stock exchanges are worth considering, for capital markets to grow and reach global scale, regional stock exchanges need to come out of the state of suspended animation they are in at present. Stock exchange shares should be allowed to be listed and one should have the regulatory mechanism for foreign stock exchanges to participate in the running of Indian Stock

Exchanges. This will be an essential step in deepening of capital markets and getting more players in.

Secondly, mutual fund regulations have to be revamped so that Asset Management Companies have greater flexibility in charging fees, mutual fund distribution is better regulated, the killed in the infancy step of allowing stock exchanges to distribute mutual fund products are revived, mutual funds are given freedom to design innovative and diversified products (such as real estate mutual funds, etc.).

Thirdly, pension funds should be allowed to invest a greater part of their corpus in equities either directly or through mutual funds.

Fourthly, the SME exchange which is yet to take off must be allowed to start activities so that large number of small and medium enterprises in India can raise much needed capital. The regulatory regime for this exchange and for the SME platform in other exchanges must be such that SME listed companies do not suffer from regulatory overload. Currency markets in India have not yet taken off and the present regulatory regime does not support a robust currency market including exchange rate derivatives. As India integrates into global markets, this becomes an important missing link.

BANKING

The next area of reform in India's financial sector is banking. In spite of the large reach of India's nationalized banks and their branch network, out of nearly 89.3 million farm households in India, 51.4% do not have any access to any credit either from any institutional or non-institutional sources. Only 37% of bank branches of Scheduled Commercial Banks are present in rural areas with only 40% of the population holding bank accounts. The success of chit funds and other dubious collective savings schemes in rural areas is partially ascribable to lack of the ability of the banking sector to reach out to all sections of society. Quick reforms are needed in the banking sector if the goal of financial inclusion is to be reached and to further strengthen India's banks.

Firstly, the much delayed issue of new banking licenses must be resolved. India badly needs more well organized banks with specialized focus and new banks should be allowed to start operations as fast as possible.

Secondly, governance reforms should be started immediately in the cooperative banking sector which is a hotbed for political interference and suffers from poor banking practices and therefore poses a systemic risk. Deposits held by Co-op banks in the country as on March 2010 were in excess of Rs.1,42,000 crores.

Thirdly, to bring down the cost of banking for the poorer sections of society banks should be allowed to use more liberally the correspondent system and should be able to use existing network like telephone kiosks. Elements of the rural banking model from Bangladesh may be incorporated to improve the last mile linkage to rural consumers and to bring down cost of delivery. Spreads are too high. Deposits @ 9%. Average lending @ 14%.

Fourthly, there should be reforms in the governance of public sector banks. Underperforming banks should be allowed to be taken over, mergers among banks should be allowed in case of need, Boards of public sector banks should have greater say in appointments and compensations for senior level management and oversight by Govt. and regulation should be balanced with shareholder say in management.

Also, the present ambivalence about Non Banking Finance Companies and Micro Finance Institutions must go. These need to be well regulated, adequately capitalized and technically well equipped but they should be given greater regulatory flexibility to expand operations. Entry of more private sector well governed deposit taking companies in the system will increase channelisation of savings for productive purposes.

FINANCIAL SECTOR REFORMS – THE WAY AHEAD

One inescapable conclusion is that if financial sector reforms have to be successful the regulatory architecture has to be redefined. The current system involves half a dozen apex regulatory agencies (such as SEBI, IRDA, PFRDA, EPFO, RBI, FMC) apart from several ministries in the Central Govt. that retain regulatory power. This structure leads to major regulatory overlaps, regulatory gaps, tussles for territory and regulatory arbitrage. This complex structure also leads to delay in introducing new regulations, delay in creation of new markets, delay in design of new products and delay in entry of new participants as consensus is difficult to achieve. India needs to move toward greater convergence of financial market regulations and reduction in number of regulators. While the recent establishment of a Commission for Legislative Reforms in Financing Sector by the Central Govt. is a most welcome step, it must be remembered that there are several legislature proposals for financial sector reform which have been before the Govt. and Parliament for several years. Making further reform proposals without first achieving consensus may not serve the purpose.

Secondly, lack of competition in parts of the financial services industry, the pervasiveness of public ownership and overcompartmentalisation of sub sectors have resulted in sub optional performance by existing market players. Competition needs to be across larger, more capable players rather than among a plethora of small, weak, undercapitalized players that cannot capture economies of scales or make the kind of investments in people, training, technology and research into product development that supports innovation. The Indian financial sector needs a wave of consolidation — through acquisitions and mergers among private and publicly owned institutions — for its financial firms to be strong enough to compete with each other and with foreign firms. Entry barriers and protectionism need to be removed. This will strengthen our institutions and give depth to our markets.

Friends, as we sit here today, the B20 which is the business group of the G20 nations is planning a meeting in the framework of the G20 Summit. The B20 Summit will be held at Cannes from 1st to 3rd November 2011. One of the working groups of the B20 is a working group on financial regulations. This working group has made major recommendations for the B20 which include :

- Reforms of financial regulations to reinforce financial stability such as improving prudential standards, corporate governance, risk management and supervision of firms by regulators. The working group feels that for these reforms to be effective yet not hamper the prospects of growth, regulators must assess their impact on crucial drivers of economic growth such as availability of capital to SMES, availability of long term financing, etc. and should adapt the requirements of financial sector reforms to mitigate their negative impact, if any, on growth.

- The Financial Stability Board mandated by G20 should report on the pace of reforms on a country by country basis every six months. Financial regulatory rules and principle must be implemented in a comprehensive and globally harmonious manner wherever such financial regulations have a cross-border significance. The role of the Financial Stability Board will be to study the impact of regulatory reforms and report under/over implementation.

- Governments and regulators and international bodies should create the right environment to allow financial services firms to innovate within a proper risk framework to meet the needs of their customers.

If we analyse these recommendations of the working group on financial regulations, it is obvious that a global consensus is emerging on reforms in the financial sector and in future financial sector reforms will happen within a global framework. India as a major investment destination and as one of the largest economies in the world cannot stay away from this trend.

In conclusion, an observation from the Raghuram Rajan Committee needs careful consideration — “There is so much to be gained from reforming the financial sector. The financial sector has built capabilities such that, with appropriate policy changes, it can grow tremendously, both domestically and internationally. It can generate millions of well paying jobs and more important, have an enormous multiplier effect on inclusion and economic growth. Given the right environment, financial sector reforms can add between a percentage point and two to the economic growth rate".