2012

Panel Discussion at the 2012 IOSCO Annual Conference

U K SINHA

SEBI

5/17/2012

The Opening up and Development of Capital Markets in Emerging Economies – The Indian Experience

About the Event

The 37th IOSCO Annual Conference is scheduled to be held at Beijing, during 13 – 17 May, 2012. During the course of the event, Chairman has been requested to participate in a Panel Discussion titled "Capital Markets Development and Regulatory Trends in Emerging Markets" on May 17, 2012.

The panel duration is of 2 hours (from 11:00 am to 1:00 pm) and, including the moderator, there would be six speakers. The panel discussion would broadly cover the following aspects -

- The opening up and development of capital markets in emerging economies;
- Development and regulation of corporate bond markets; and
- The building of international financial centers.

Other Panelists

The session would be chaired by Mr. Vedat Akgiray (Chair, IOSCO Emerging Markets Committee; Chairman, CMB Turkey). The other speakers in the session are –

- Mr. Tu Guangshao (Vice Mayor, Shanghai Municipal Government)
- Mr. Li Yang (Vice President, Chinese Academy of Social Sciences)
- Mr. Carlos Serrano (Vice President, CNBV Mexico)
- Mr. Zhang Yujun (President, Shanghai Stock Exchange)

Broad Structure of the Panel Discussion

The broad structure of the Panel Discussion would be as under –

- The session Chair would speak for about 5-10 minutes at the beginning and thereafter give the floor to the other Panelists.
- Each Panelist would then speak for around 15 minutes.
- Thereafter, the session Chair could raise some questions to the panelists.
- This would be followed by a Q/A session for the audience.

Talking Points

The Chairman's address may focus on the opening up and development of capital markets in India and the current regulatory trends. It may broadly cover the following aspects –

A. Indian securities market in 2012, Opening up of the Indian securities market and Development of the Indian securities market.
B. The global financial crisis and its impact on India. Based on the lessons learnt, various immediate as well as recent SEBI responses may be discussed here.
C. Mechanism in India for inter-regulatory co-ordination. The pointers here could be the multiplicity of regulators in India like SEBI, RBI, IRDA, etc. Reference may also be drawn to the FSDC and its working.

An Introduction to Indian Securities Market in 2012

1. India is home to the oldest stock exchange in Asia and the largest number of listed companies in the world. As at end-2011, India accounted for 2.95% of the total stock market capitalization of the world and 6.87% of the total stock market capitalization of the Asia-Pacific region *(Source: World Federation of Exchanges)*. The annual average growth in India's share in total stock market capitalization of the world during the decade 2002 - 11 was an impressive 17.87% (12.48% annual average growth in India's share in total stock market capitalization of the Asia-Pacific region). In 2011, National Stock Exchange of India Ltd. and BSE Ltd. ranked 3rd and 7th respectively in the world in terms of number of trades in equity shares. Thanks to the second position in the world in terms of number of contracts traded in stock index options and the third position in the world in terms of number of contracts traded in both single stock futures and stock index futures, National Stock Exchange of India Ltd., with 1,221 million contracts traded in 2011, ranked 3rd in the world among the equity derivatives exchanges *(Source: World Federation of Exchanges)*.

2. The just concluded Joint Fund-Bank Financial Sector Assessment Program (FSAP) of India has found substantially full compliance of the Indian securities market with the global standards and codes. India is now a Member of the Financial Stability Board (FSB) and the Financial Action Task Force (FATF).

Indian Experience

Securities and Exchange Board of India (SEBI)

3. Against this backdrop, we share with you the lessons from the Indian experience with the opening up and development of the securities market. So far, after the announcement of the New Economic Policy in July, 1991, two generations of economic reforms have been implemented in India and securities market figured prominently in both. One of the first steps announced in the Union Budget 1991 – 92 has been the establishment of Securities and Exchange Board of India (SEBI) as a statutory autonomous regulator in 1992 with the mandate *to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto.* Indian securities market underwent a paradigm shift from merit-based regulation to disclosure-based regulation. There have been major amendments to the Securities Laws subsequently, inter alia, to sufficiently empower SEBI, to provide for a Tribunal to hear appeals against SEBI's orders and to provide for a legal framework for the introduction of exchange-traded derivatives.

4. In this regard, it is worthwhile to note that the SEBI Act, 1992 has become the Model Act for the purpose of establishment of regulators in the other sectors of the Indian financial market, viz., insurance and pensions.

Opening up of the Indian Securities Market

5. In India, financial sector reforms have taken both the forms: big bang reforms and gradual reforms. And, major reforms have been announced both during crisis times and normal times. The opening up of the Indian capital market is a case in point. A sharp decline in capital inflows through commercial borrowing and non-resident deposits, large borrowings from the IMF in July 1990 and January 1991 and a sharp reduction in forex reserves put India in a very precarious position in 1991. The Government of India started cautiously encouraging inflows of equity over debt, direct investment over portfolio investment and long term debt over short term debt. With this, India embarked on a gradual shift towards capital account convertibility.

6. In the Union Budget 1992 – 93, a proposal to *"allow reputable foreign investors, such as pension funds, to invest in our capital markets, with suitable mechanisms to ensure that this does not threaten loss of management control"* was announced. At first, the foreign institutional investors (FIIs) were allowed to

invest in all the securities traded in the primary and secondary markets and in the schemes floated by domestic mutual funds. There have been limits on the holding of a single FII and of all FIIs in the total issued capital of the company. There have also been prescriptions to ensure that the FIIs are broad-based and diversified.

7. In 2000, foreign corporate and high networth individuals have been allowed to invest as Sub-Accounts of the FIIs. Investments by the overseas corporate bodies (OCBs) through the portfolio route have been banned since November, 2001. Concerns related to some unregulated entities taking positions in the Indian securities market through the mechanism of offshore derivatives instruments (ODIs)/participatory notes (PNs) led to ban on issue of ODIs/PNs to any non-regulated entity and stipulations regarding KYC. The existing non-eligible ODIs/PNs were permitted to expire or to be wound down on maturity or within a period of 5 years, whichever is earlier.

8. There has been progressive liberalization on the restrictions on the investments by the FIIs. For instance, forward cover in respect of outstanding investments of the FIIs has been extended upto 100% of portfolio value. The FIIs were permitted to invest in dated Government Securities since April, 1998 and in Treasury Bills since May 1998. Similarly, the FIIs were permitted to trade in all exchange-traded derivative contracts upon their launch in India.

9. The aggregate limit on the holding of all FIIs was hiked from 24% to 30% (from April, 1997), from 30% to 40% (from March 2000), from 40% to 49% (from March 2001) and from 49% to the sectoral cap (from September 2001). There were simplification of documentation procedure for FII registration and reduction of registration fee for FIIs. The limits on the investment by the FIIs in debt securities have been increased substantially over the years. The restriction on the FIIs of 70:30 ratio of investment in equity and debt was done away with. The FIIs were permitted to offer domestic Government Securities as collateral for margins. An auction-based methodology for allocation of debt investment limits among the FIIs has been introduced.

10. The policy on protected cell company (PCC)/multiple share class vehicle (MCV) has been clearly spelt out. Recently, qualified foreign investors (QFIs) have been permitted to invest in the

Indian securities market (at first in the equity and debt schemes of the domestic mutual funds, next direct investment in equity and now in corporate bonds).

11. The data present impressive results on account of these policies. As on date, there are 1,767 foreign institutional investors who have got themselves registered with SEBI to invest in the Indian securities market. The FIIs made net investment in India of $ 30.25 billion during 2009 – 10, $ 32.23 billion during 2010 – 11 and $ 18.92 billion during 2011 – 12. As at end-March, 2011, the cumulative net investment by the FIIs stood at $ 140.48 billion, while the market value of the assets stood at $ 216.47 billion.

12. India's opening up of the securities market was not just restricted to the permission to the FIIs to invest in India. Foreign players have been allowed to enter and operate in the Indian securities market as almost every intermediary/participant. For instance, almost all the leading global players in the mutual fund industry, investment banking and stock broking have their operations in India. Indian companies have been permitted to raise funds abroad through the issue of Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs). Foreign companies can raise moneys from the Indian securities market by issuing and listing on our domestic bourses the Indian Depository Receipts (IDRs).

13. Indian stock exchanges were permitted to set up their trading terminals overseas, subject to the regulatory requirements of the host countries. There are many offshore venture capital funds which have registered with SEBI and invest in India. The domestic mutual funds were permitted to invest in foreign securities. There are also fund of funds investing overseas. Recently, the SEBI Board has approved the Regulations governing alternative investment funds (AIFs).

14. In its efforts at opening up the Indian securities market, SEBI has immensely benefited from its IOSCO Membership. SEBI has been a Member of the International Organization of Securities Commissions (IOSCO) since 1989. Our first election as the Chairman of the Asia-Pacific Regional Committee of the IOSCO was for a two-years term ending in 1993. Subsequently, SEBI has signed the IOSCO MMoU and also entered into bilateral Memoranda of Understanding (MoUs) for co-operation and information sharing with overseas regulatory bodies.

Development of the Indian Securities Market

15. There are, as mentioned in the beginning, many instances of major securities market reforms being initiated after stock market misbehavior or crisis in the real and/or financial sector. Though the Union Budget 1991 – 92 announced a proposal to set up a central depository, it was not until 1996 that the proposal became a reality. The problems associated with forged share certificates, bad deliveries, voluminous numbers of transfer deeds, all in the booming primary and secondary securities market of the mid-1990s, put the establishment of the depositories and dematerialization on a fast track.

16. Similarly, the opaqueness of the trading rings which led to the securities market misbehavior in 1992 ushered in reforms like the introduction of fully automated screen-based trading system and the regulation of transactions between clients and brokers. The lessons from the securities market misbehavior in 2002 resulted in the ban on all deferral products, introduction of rolling settlement and launch of derivatives and a little later the corporatization and demutualization of all the stock exchanges in the country. Among the reforms introduced in the aftermath of the global financial crisis 2007 – 09 and the Satyam episode are the prescription of uniform margining norms for all categories of investors, launch of exchange-traded currency derivatives, disclosure norms on pledged shares and the requirement of a valid peer review certificate for statutory auditors.

17. There are, as mentioned in the beginning, several instances of major reforms being initiated during normal times. India is, perhaps, the first major jurisdiction to have regulations governing credit rating agencies (CRAs) (in July 1999). A number of products and processes have been introduced during normal times in the Indian securities market for the benefit of the investors and issuers. Among the products are fund of funds, gold exchange traded funds (India is the largest consumer of gold in the world), infrastructure development funds and derivative contracts on foreign stock indices. Among the processes are ASBA, qualified institutions' placement, fast track issuances, securities trading through wireless technology (internet trading and mobile trading), straight through processing (STP), direct market access (DMA), smart order routing and uniform KYC requirements for investors in the Indian securities market.

18. A notable feature of the Indian securities market today is its robust risk management mechanism, the outcome of continuous improvements brought out during both crisis and normal

times. To preempt market failure, stock exchanges developed comprehensive risk management system encompassing capital adequacy norms of trading and clearing members, adequate margin requirements, limits on exposure and turnover, on-line position monitoring and automatic disablement, etc. They also administer an efficient market surveillance system to curb excessive volatility and to detect and to prevent price manipulation. The fact that an anonymous electronic order-book does not allow members to assess credit risk of the counterparty necessitated some innovation in this area. This brought in the concept of novation whereby a clearing corporation/house assumes counterparty risk of each member and guarantees financial settlement. The market has now full confidence that the settlement of trades would take place as scheduled irrespective of any default by isolated members. The robustness of the risk management systems has been tested during the global financial crisis 2007 – 09 and the Indian stock exchanges have not experienced a settlement default for close to a decade now. In addition, there are the investor protection fund and investor services fund at the stock exchanges and the Investor Protection and Education Fund (IPEF) with SEBI. The amount of guarantee is much higher than that provided by the Deposit Insurance and Credit Guarantee Corporation.

19. In addition, the capital adequacy norms for the other market intermediaries were also reviewed in view of the changing complexities and the evolving dynamics. In the last SEBI Board Meeting, for instance, we decided to prescribe the minimum networth of a stock exchange to be Rs. 100 crore, of a clearing corporation to be Rs. 300 crore and of a depository to be Rs. 100 crore. India recognizes the stock exchanges, clearing corporations and depositories as market infrastructure institutions and has clear prescriptions regarding their ownership and governance norms.

20. SEBI follows an elaborate process with regard to introducing a new policy/initiative or amending an existing one. The proposal is at first discussed in a SEBI-constituted expert committee on the functional area (like the Primary Market Advisory Committee, Secondary Market Advisory Committee, SEBI Committee on Disclosures and Accounting Standards). There are 10 such Committees in existence as on date (Some of these are standing Committees, while the others are task-specific). The proposal along with the recommendations of the expert committee is then hosted in the SEBI website for public comments. Wide publicity is given to the proposal being open for public comments by means of press releases and bringing up the same during the course of Chairman's/Member's Speeches and interactions with the market constituents. The public

comments on the proposal are taken to the expert committee and the proposal incorporating the accepted public suggestions are taken to the Board of Members of SEBI for approval. After the approval, the new regulation or the amendment is notified in the Official Gazette of India. The same is then laid before each House of the Parliament of India and are subject to any modification/annulment as agreed by the both Houses.

21. SEBI keeps surveying continuously the global developments to learn from the global experiences. For instance, prescription of the corporate governance norms for listed companies (Recommendations of both Kumar Mangalam Birla Committee and N R Narayana Murthy Committee, the Clause 49 and the subsequent amendments to it have to be viewed as implementation of the lessons from Enron-like episodes and the enactment in the US of the SOX Act).

22. The events related to the recent global financial crisis had highlighted, inter-alia, how the regulatory mechanism needs to be more effective and how the regulators have to be on top of new developments in products, in trading practices and in risk management. It is also important for the regulators to have, at regular intervals, an assessment of the impact they are creating in meeting the mandate given to them by the legislation. It appears prudent to do so as a pro-active measure once in a while by the regulator rather than do it when something wrong has happened. The regulators world over are equipping themselves to meet these new challenges (For instance, the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 in the US). In this context, SEBI has initiated a few steps - most prominent amongst them being the constitution of the International Advisory Board (IAB). Additionally, SEBI is in the process of engaging an outside independent agency to study and make appropriate recommendations in the areas of a) Organizational structure, b) Human resources, c) Technological resources, d) Sharing of regulation and oversight with SROs, and e) Co-operation with external agencies, so as to meet the emerging challenges and priorities.

23. While some of the developmental and regulatory initiatives of SEBI have been path-breaking, SEBI provided for a phased implementation of these initiatives so as to allow for a smooth transition to the new regime. For instance, in the example cited above of minimum networth of a stock exchange and a clearing corporation, we have provided for three years for an existing stock exchange or an existing clearing corporation has been given three years to build up the

prescribed networth. This approach has been followed even in the introduction of dematerialization, the introduction of rolling settlement and the launch of equity derivatives (options followed by futures, index products followed by single stock products) and currency derivatives (INR-USD pair followed by other currency pairs; futures followed by options).

24. India has harnessed the information technology and communication technology prowess to the optimum. For instance, India is the first jurisdiction to tap satellite technology for setting up trading terminals across the length and breadth of the country. This has also made possible the adoption of VaR based margining and SPAN module for computation of margins (portfolio approach to risk and intra-day computations). At the same time, we have put in place sufficient checks and balances to ensure protection of the interests of investors. For instance, guidelines on algorithmic trading and BCP/DR

25. Thinking out of the box has helped us at times in having some of the global firsts. For instance, tapping satellite technology for setting up trading terminals (NSEIL is one of the largest VSAT-based exchanges in the world), T+2 rolling settlement (the first major jurisdiction to have T+2), dematerialization (as against immobilization), mandatory IPO grading, single KYC for the securities market, etc.

26. India's unique demographic factors has also weighed significantly. We are one of the youngest countries in the world. There is very low level of per capita income, disparity among the regions, lack of infrastructure, high quality of education and healthcare, high levels of literacy, low level of participation in the securities market. The future seems to offer significant opportunities. For instance, the recent shift to defined-contribution pension scheme and the recently announced tax incentives for direct investment in equity (earlier available for investment through mutual funds) are expected to boost the retail participation in the Indian securities market. SEBI has plans to reach out to them via local offices and massive investor awareness campaigns.

27. Capacity building (Certifications made mandatory to operate in the Indian securities market), establishment of NISM, the facility to be developed not only for India but for the Asia-Pacific, Africa Rim.

28. Greater Scrutiny of the Regulator in a Democratic Country: The Hon'ble SAT, the Hon'ble Supreme Court, the Parliament of India and its various Standing Committees and the Fourth Estate

29. <u>Mechanism for Inter-regulatory Coordination in India</u>

- High Level Coordination Committee on Financial Markets (HLCCFM) was constituted vide a Demi-Official (DO) letter dated May 24, 1992 written by the then Secretary, Department of Economic Affairs, Ministry of Finance, Dr. Montek Singh Ahluwalia, to the then Governor, of the Reserve Bank of India (RBI), Mr. S Venkitaramanan. HLCCFM was envisaged as the forum to deal with inter-regulatory issues arising in the Indian financial and capital markets, as India had been following a multi-regulatory regime in the financial sector. It functioned under the Chairmanship of Governor, RBI, with Chairman, Securities and Exchange Board of India (SEBI) Secretary (Economic Affairs, Ministry of Finance), Chairman, Insurance Regulatory and Development Authority (IRDA) and Chairman Pension Fund Regulatory and Development Authority (PFRDA) as the Members.
- However, HLCCFM was an informal body and, hence, had its own limitations. In the absence of formal instruments, clear specifications as to its functions/powers and an empowered secretariat to service the HLCCFM, its effectiveness had been limited. The markets that are regulated by Member Organizations of the HLCCFM had undergone rapid transformation since 1992. As a result, financial markets in India have become more complex and have been increasingly integrated with the global financial markets. In such a scenario, if the regulators do not take an integrated and holistic view, the outcomes may be sub-optimal.
- Various Governmental Committees, as mentioned below, had recommended a holistic approach to regulation:
    - RBI's Advisory Group on Securities Market Regulation (RBI-AGSMR; 2001);
    - High Level Expert Committee on Making Mumbai an International Financial Centre (MIFC; 2007);
    - Committee on Financial Sector Reforms (CFSR; 2008); and
    - Committee on Financial Sector Assessment (CFSA; 2009).
- The CFSR had touched upon the need to have a regulatory mechanism for ensuring and safeguarding financial stability. The CFSR suggested the creation of a statutory body called

Financial Sector Oversight Agency (FSOA) to perform the macro-prudential supervision of the economy, to monitor the functioning of large, systemically important, financial conglomerates and to address and diffuse inter-regulatory conflicts. The CFSR envisioned a council approach with all the Chiefs of the Regulatory Bodies as Members and the Finance Secretary as a Permanent Invitee.

- The High Level Expert Committee MIFC had underlined the need for macroeconomic stability for a credible international financial centre to function in the country. The report of the Committee on Financial Sector Assessment (CFSA) which was a joint effort of the RBI and the Ministry of Finance, Government of India, says stability assessment and stress testing of the financial institutions need to be conducted on a more systemic basis, to capture the second round and contagion risks. For this purpose, the CFSA had recommended setting up of an inter-disciplinary Financial Stability Unit. Accordingly various regulators had set up their own Financial Stability Units. RBI set up the FSU on July 17, 2009, while SEBI established the same in September, 2011. The CFSA also emphasized that in the interest of financial stability, there is a need for strengthening inter-regulatory co-operation and information-sharing arrangements among the regulators, both within and across borders. The CFSA had identified that there was no legislation in India specifically providing for regulation of financial conglomerates and holding companies.
- The financial crisis of 2008-09 has fundamentally changed the structure of banking and financial markets the world over. Accordingly, it was announced on February 26, 2010 in the Union Budget 2010 – 11 that: *"With a view to strengthen and institutionalize the mechanism for maintaining financial stability, Government has decided to setup an apex-level* ***Financial Stability and Development Council (FSDC)****. Without prejudice to the autonomy of regulators, this Council would monitor macro prudential supervision of the economy, including the functioning of large financial conglomerates, and address inter-regulatory coordination issues. It will also focus on financial literacy and financial inclusion."*
- In the context of regulatory jurisdiction of SEBI and IRDA over ULIPs, the Standing Committee on Finance, in its Report of April 2010, had stated *"the Committee also desire that the proposed Financial Stability and Development Council should be constituted early to address interalia such inter-regulatory issues."*
- The Hon'ble Finance Minister, Government of India held a meeting with the Regulators and the Officials of the Ministry of Finance on the creation of **Financial Stability and**

Development Council (FSDC) on October 12, 2010. A Discussion Paper had been circulated by the Ministry of Finance to all the proposed Member Organizations. It was agreed in the meeting that with a view to strengthen and institutionalize the mechanism for maintaining financial Stability, Government of India would set up the apex Council.

- The objective behind the setting up of the FSDC is to promote collective responsibility as well as to leverage the expertise of the financial sector regulators. An eminent international authority on modern-day central banking, Professor Charles Albert Eric Goodhart, has also recognized the need for an oversight, coordinating committee in a large developed country with a number of regulatory/supervisory bodies with focused specialized purposes and the need for that committee to be chaired by the Finance Minister of the country during crisis times.
- Vide Notification dated 30th December, 2010, the Financial Stability and Development Council (FSDC) has been set up by the Government of India to institutionalize and strengthen the mechanism for maintaining financial stability, financial sector development, inter-regulatory coordination, financial literacy, financial inclusion, macro-prudential supervision and coordinating interface with financial sector bodies like the Financial Stability Board (FSB) and the Financial Action Task Force (FATF). The Chairman of the FSDC is the Finance Minister of India and its members include the heads of the financial sector regulatory authorities (RBI, SEBI, IRDA and PFRDA), Finance Secretary and/or Secretary, Department of Economic Affairs (DEA), Secretary, Department of Financial Services and the Chief Economic Adviser. A Secretariat has been set up in the Department of Economic Affairs to assist the FSDC.
- So far, the FSDC has met four times.
- The FSDC is to be assisted by a Sub-Committee to be chaired by the Governor, RBI. So far, the FSDC Sub-Committee has met six times.
- The Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 has, inter alia, established, the **Financial Stability Oversight Council (FSOC)** to provide, for the first time, comprehensive monitoring to ensure the stability of the US financial system. The FSOC is charged with identifying threats to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States financial system. The FSOC is chaired by the Secretary of the Treasury and brings together the expertise of the federal financial regulators, an insurance expert appointed by the US President and the state regulators.

- The FSDC and the FSDC Sub-Committee provide an extremely useful forum to bring together all financial sector policymakers – regulators and the Government – on a single platform. It provides a formal platform for deliberating on issues which could probably pose threats to the country's financial stability and arriving at responses to eliminating/mitigating those threats. As risks to financial stability can arise from any segment of the economy/financial system, this forum enables risks to be viewed from a holistic perspective.
- The Sub Committee of FSDC meets at least quarterly and dwells on issues in the following three segments:
    - Risks to financial stability;
    - Inter-regulatory coordination; and
    - Financial inclusion and financial literacy.
- Beginning with the Financial Stability Report (FSR) of December 2011, the FSR is deliberated in the Meeting of the Sub Committee prior to its publication and the views and suggestions of the Sub Committee Members are suitably incorporated.
- Since its formation, the Sub Committee of the FSDC has deliberated upon a large number of issues, including the following:
    - Development of the corporate bond market;
    - Introduction of Infrastructure Debt Funds;
    - The extant monitoring framework for financial conglomerates and on ways to improve the mechanism, e.g., through creation of domestic supervisory colleges;
    - Subjecting government sponsored NBFCs to the Reserve Bank's prudential framework for NBFCs;
    - Putting in place safeguards for the risks arising out of issuance of FCCBs;
    - Putting in place a regulatory framework for wealth management services, including investment advisory services;
    - Putting in place a crisis management framework which can deal with crisis like situations, as and when they emerge;
    - Putting in place a robust resolution mechanism for financial institutions in the country;
    - Steps to be taken to foster greater financial inclusion in the country; and
    - Putting in place a national strategy for financial literacy

- Under the aegis of the FSDC Sub-Committee, the following two Technical Groups have been formed:
    - Technical Group on Financial Inclusion and Financial Literacy; and
    - Inter-Regulatory Technical Group.
- There are proposals currently under the consideration of the FSDC Sub-Committee to set up the following:
    - Inter-Regulatory Forum for Monitoring of Indian Financial Conglomerates; and
    - Crisis Management Group
- Vide Securities and Insurance Laws (Amendment and Validation) Act, 2010, Chapter IIIE has been inserted in the RBI Act, 1934 to provide for a **Joint Committee** to deal with any difference of opinion related to hybrid/composite instruments.

Lessons from the Global Financial Crisis and India's Regulatory response

I. Advent of the Crisis

- **Reining in of inflation** by the mid-1980s; reaffirmed commitment of central bankers around the world to lower inflation.

- **High rates of economic growth:** technological innovations, growing globalization and free trade, rise of China, India, Brazil, Russia, South Korea, South Africa and other emerging economies capable of producing ever-cheaper goods, decline of organized labor keeping the wage growth in line with productivity.
- **Less volatility in the ordinary business cycle** of the advanced industrial nations: fewer ill effects of the recessions and longer lasting expansions (For instance, in the US, the stock market crash of 1987 did not cause a recession, while the 1990 – 91 recession lasted only eight months).
- Even when thousands of dot-coms went bust in the US, no banking crisis materialized as much of the funding was on account of equity share capital. But with interest rates at historic lows after the Federal Reserve aggressively countered the fallout of the tech bust, a housing bubble began to inflate, first in the US and then in many other countries. The **problems of easy money, easy credit** (in the US, for instance, the spread between the yield on high risk

junk bonds and low-risk Treasury Bills shrank to historic lows of less than 2.5%) **and lax regulation and supervision** in the US, the UK, Ireland, Spain, Iceland, Estonia, Latvia, Dubai, Australia, New Zealand and even China and Singapore.

- **New structures of incentives and compensations** that channeled greed in new and dangerous directions: rewards to bankers and traders in terms of bonuses tied to short-term profits, giving an incentive to take excessive risks and leverage, interest-only mortgages, negative amortization loans, teaser rates and option adjustable-rate mortgages, esoteric derivative securities based on mortgages, auto loans, student loans and even credit card debt (securitization) sold to credulous investors around the world, who were incapable of assessing the risk inherent in the original loans, insurance in the form of CDSs, rating agencies (Fitch, Moody's, Standard & Poor's), lured by hefty fees, helping turn toxic loans into gold-plated securities that generated risk-free returns, all resulting in an opaque, impenetrable and complex financial system.
- **Lax underwriting standards:** financial innovations rendered irrelevant the question whether lenders bothers to assess the risk/creditworthiness of the applicants, banks had kept some of the toxic assets on their own balance sheets or else stowed them in structured investment vehicles and conduits that did not show up on official balance sheets until the crisis forced them to acknowledge their losses. The lack of knowledge to the market participants as to who were holding toxic assets or how much causing panic and inability/unwillingness to assess counterparty risk.
- **Greater role of the shadow banking sector:** Shadow banks like non-bank mortgage lenders, conduits, structured investment vehicles, monocline insurers, money market funds, hedge funds, investment banks, etc. who borrowed from the depositors (purchasers of CPs) on a short term basis and invest the money into illiquid, risky, long-term securities. When panic struck the financial system, the depositors demanded their money back or refused to renew the loans, forcing the shadow banking system to liquidate these complex, difficult-to-value securities at fire-sale prices.
- **Failure of regulators and supervisors** who, on the pretext of free-market fundamentalism, allowed financial institutions to circumvent everything from capital adequacy requirements to accounting regulations.

- **Failure of corporate governance** on account of conflicts of interest prevalent among the boards of directors charged with minding the store.

II. Repercussions

Devastating toll on global output and welfare:

	Actuals						Projections		
	1994 – 2003	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2017**
World	3.4	5.4	2.8	-0.6	5.3	3.9	3.5	4.1	4.7
- Advanced Economies	2.8	2.8	0.0	-3.6	3.2	1.6	1.4	2.0	2.7
- Emerging and Developing Economies	4.4	8.7	6.0	2.8	7.5	6.2	5.7	6.0	6.3
Asia-Pacific	NA	7.6	5.1	3.6	8.3	5.9	6.0	6.5	NA
- Industrial Asia	NA	2.4	-0.2	-4.1	3.7	-0.2	2.2	2.0	NA
- Emerging Asia	NA	9.5	6.8	5.8	9.8	7.4	6.9	7.5	NA
- India	6.0	10.0	6.2	6.6	10.6	7.2	6.9	7.3	8.1

Source: IMF

III. Impact of the Crisis on India: Finance, Trade and Confidence Channels

- **Growth in India's GDP:** 6.8% in 2008 – 09 compared to an average of 9.5% per annum during 2005 – 08 (decline of global trade by 11% in 2009 compared to an average growth of 8.6% per annum during 2004 – 07).
- **Growth in India's Exports:** Decline of 2.2% in 2009 – 10 and growth of 12.2% in 2008 – 09 compared to an average of 25.0% per annum during 2005 – 08.
- **Current Account and the Capital Account:** Net capital flows during the crisis years significantly short of the current account deficit putting significant downward pressure on the Indian Rupee.
- **The exchange rate** depreciated from Rs. 39.37 per US Dollar in January 2008 to Rs. 51.23 per US Dollar in March 2009. Again, the exchange rate depreciated from Rs. 43.95 per US Dollar in July 2011 to Rs. 53.58 per US Dollar in December 2011.

- **Sudden stop and then the reversal of capital flows** consequent upon the global deleveraging process; impact felt by the forex markets and the stock market.
- **Significant pressure on the domestic credit market** as drying up of external sources of funding made the India Inc. turn to domestic sources of credit.
- **Lack of confidence** as one institution after the other, one developed country/region after the other started experiencing the problems.
- **India's deep trade integration** with the rest of the world: India's two-way trade (merchandise exports and merchandise imports) as a percentage of GDP more than doubled during the decade that preceded the crisis: 19.6% in 1998 – 99 (the year of the Asian crisis) to 40.7% in 2008 – 09.
- **India's deep financial integration** with the rest of the world: India's ratio of total external transactions (gross current account flows and gross capital account flows) to GDP more than doubled from 44% in 1998 – 99 to 112% in 2008 – 09.

IV. SEBI's immediate policy responses to the global crisis

In the aftermath of the crisis, SEBI took various measures, prominent amongst which are enumerated below -

- Introduction of Index Options with Longer Tenure on January 11, 2008.
- Requirement of a volatility index by stock exchanges was introduced on January 15, 2008.
- Enhancement of investment limits of FIIs in debt securities to $ 5 billion on January 31, 2008.
- Permitting Direct Market Access (DMA) for institutional clients through the broker's infrastructure without manual intervention by the broker on April 03, 2008.
- The derivatives segments of stock exchanges were permitted to construct a bond index (both GoI and corporate) and disseminate the same.
- Both short selling by institutional investors and securities lending and borrowing for all market participants were operationalized with effect from April 21, 2008.
- With effect from April 21, 2008, all institutional trades in the cash segment were also subject to payment of margins as applicable to transactions of other investors.

- On May 05, 2008, cross margining across cash and derivatives segments was extended to those institutional clients having positions in the cash segment alongwith corresponding off-setting positions in the stock futures market.
- With effect from the close of market-hours on October 07, 2008, SEBI decided to remove the ban on issue of Offshore Derivative Instruments (ODIs) with derivatives tradable on any recognised stock exchange in India as underlying and also to remove the cap on the total value of outstanding ODIs.
- On October 16, 2008, the restriction regarding allocation of investments by a foreign institutional investor between equity and debt was done away with.
- On February 06, 2009, SEBI decided to allocate $ 8 billion to the FIIs/sub-accounts in an open bidding platform provided by the stock exchanges, with the minimum bid amount of Rs 250 crore and the minimum tick size of Rs. 100 crore.
- On October 18, 2008, the permitted discretion in the Valuation of Debt Securities by Domestic Mutual Funds was revised to -150 basis points to + 500 basis points and -100 basis points to +400 basis points respectively for rated instruments with duration upto 2 years and rated instruments with duration over 2 years.
- In order to ensure market safety and to safeguard the interests of investors, with effect from October 22, 2008, the exposure margin for Exchange Traded Equity Derivatives was revised to the higher of 10% or 1.5 times the standard deviation (of daily logarithmic returns of the stock price).
- It was decided on October 24, 2008 that in respect of purchase of units in income/debt oriented schemes (other than liquid fund schemes) with amount equal to or more than Rs. one crore, irrespective of the time of receipt of application, the closing net asset value of the day on which the funds were available for utilization would be applicable.
- In order to further strengthen the framework for close ended schemes of SEBI-registered mutual funds, it was decided not to permit early exit in any scheme of a mutual fund in the nature of a close ended scheme and to make it obligatory on the part of the asset management company to list all the close ended schemes to be launched on or after December 12, 2008.
- On January 19, 2009, it was mandated that with effect from February 01, 2009, liquid fund schemes and plans should make investment in/purchase debt and money market securities

with maturity upto 182 days only and that with effect from May 01, 2009, liquid fund schemes and plans should make investment in/purchase debt and money market securities with maturity of upto 91 days only.

- Launch of exchange traded interest rate futures on August 31, 2009
- Introduction of systems audit of mutual funds in November 2009
- Settlement of corporate bond trades between specified entities mandated through Clearing Corporations in October 2009
- Stock exchanges permitted to set trading hours between 9 am to 5 pm in October 2009
- Internal audit for credit rating agencies on half yearly basis mandated in January 2010
- Additional transparency and disclosure norms mandated for credit rating agencies in May 2010
- Revising in July 2010 the exposure margin for exchange traded equity derivatives to be the higher of 5% or 1.5 times the standard deviation (of daily logarithmic returns of the stock price) of the notional value of the gross open position in single stock futures and gross short open position in stock options in a particular underlying.
- Introduction of call auction in pre-open session on a pilot basis by BSE Ltd. and NSEIL in July 2010 for the scrips forming part of Sensex and Nifty.
- Allocation of increased limits of FII investments in government securities and corporate debt of $ 5 billion each through bidding process and first come first served process in December 2010
- Standardization of Rating Symbols and Definitions
- Futures on 91-day Government of India Treasury Bill
- Liquidity Enhancement Schemes (LES) for Illiquid Securities in Equity Derivatives Segment
- Precautions regarding flow of third party funds/unidentified money into the Indian securities market.

****