Chapter 5

Financial Intermediation

Financial markets form an important part of the Indian economy. Their performance in 2013-14 reflected the slowdown in the real economy with most intermediaries growing at a slower rate as compared to previous years. Moreover, there were growing concerns about asset quality in the banking sector. The Government of India along with relevant market regulators took cognizance of these growing challenges including financial inclusion and consumer protection and implemented a multitude of policy initiatives to reinvigorate financial markets. The passage of the PFRDA act and presentation of the FSLRC report in 2013-14 mark important milestones in moving towards the next generation of financial-sector reforms.

5.2 The financial system is an important growth fundamental for the Indian economy. At its heart is the working of organized financial trading. Governments and large firms raise resources directly from these markets. Some households invest directly in the markets. Financial intermediaries connect other households to the markets. Finance determines the allocative efficiency of how this investment is done. Measured steps have accordingly been taken for strengthening the financial system and adopting the best that the global financial system has to offer.

5.3 The speed of reforms in the financial sector has not kept pace with financial innovation.

5.4 In a fast changing world, financial policy has to catch up with the needs of future India that people are aspiring to build. The next wave of reforms will be through strengthening the institutional foundation—both laws and organizations—improving and polishing the financial processes; and by taking well-designed policy decisions that will enhance clarity, consistency, and transparency for a globalized India. This chapter highlights the recent developments in the Indian financial sector and the challenges and opportunities faced by the country in further building up a dynamic financial sector in sync with the global financial system.

(per cent)

	2012-13	2013-14
Bank credit	14.1	13.9
(a) Food credit	18.6	2.1
(b) Non-food credit	14.0	14.2
Aggregate deposits	14.2	14.1
(a) Demand deposits	5.9	7.8
(b) Time deposits	15.2	14.8
Investment	15.4	10.3
(a) Govt securities	15.5	10.4
(b) Other approved	-11.5	-33.6

Source: Reserve Bank of India (RBI).

Table 5.1 : Growth Rate of Credit, Deposits, and Investment

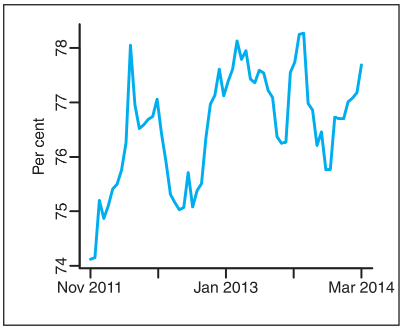
Bank credit

Aggregate deposits, bank credit, and investments

5.5 Growth rate of aggregate deposits marginally moderated to 14.1 per cent in 2013-14 from 14.2 per cent in the previous year

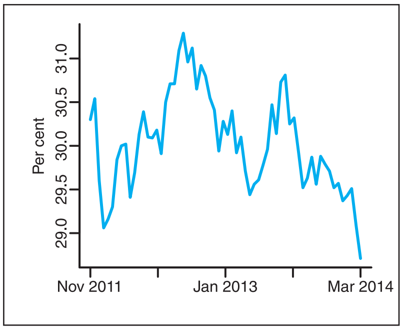
(Table 5.1). The acceleration is mostly on account of large accretion to non-resident Indian (NRI) deposits. Growth in bank credit increased to 13.9 per cent in 2013-14, as compared to 14.1 per cent in 2012-13. Non-food credit growth increased to 14.2 per cent from 14.0 per cent. The higher expansion in deposits relative to credit has caused slight moderation in the credit-deposit ratio to 77.8 per cent at end March 2014 from 77.9 per cent a year ago (Figure 5.1).

5.6 During financial year 2013-14, public-sector banks and foreign banks registered acceleration in bank credit, while there was a deceleration for private-sector banks. Commercial banks' investment in government and other approved securities was low at 26.9 per cent at end March 2014 compared to 28.0 per cent a year ago. Consequently, the investment-deposit ratio declined from 29.7 per cent at end March 2013 to 28.7 per cent at end March 2014 (Figure 5.2).



Source: RBI.

Figure 5.1 : Credit-Deposit Ratio



Source: RBI.

Figure 5.2 : Investment-Deposit Ratio

Interest rates of scheduled commercial banks

5.7 The Reserve Bank of India (RBI) continued with the policy of monetary easing during the first quarter of 2013-14 to support growth in the face of moderation of wholesale price index (WPI) inflation and reduced the repo rate by 25 basis points (bps) to 7.25 per cent on 3 May 2013. The RBI took exceptional monetary tightening measures during the second quarter of 2013-14, beginning with the measures announced on 15 July 2013 to deal with the excessively volatile forex market. Following stability in the foreign exchange market, the Reserve Bank initiated rollback of the exceptional measures in a calibrated manner since 20 September 2013. The process of realigning the interest rate corridor to normal monetary policy operations was completed with the marginal standing facility (MSF) rate reduced in three steps from 10.25 per cent to 8.75 per cent while contemporaneously, the repo rate was hiked in two steps of 25 bps each to 7.75 per cent with a view to containing inflation expectations. The policy rate was further increased by 25 bps to 8 per cent in January 2014, keeping in view the elevated level of inflation and inflation expectations.

(per cent)

	Mar'13	Mar'14
Median term deposit rate	7.42	7.74
Median base rate	10.20	10.25

Source: RBI.
Note: RRB is regional rural bank.

Table 5.2 : Deposit and Lending rates of SCBs (excl. RRBs)

Domestic term deposit and lending rates

5.8 Scheduled commercial banks (SCBs) responded to the policy measures by adjusting their deposit and lending rates (Table 5.2). The transmission of monetary easing during 2012-13 and Q1 2013-14 enabled the weighted average lending rate (WALR) on the outstanding rupee loans extended by banks to decline by 37 bps during 2012-13 and further by 7 bps in Q1 2013-14 whereas the median term deposit rate increased by 32 bps (Table 5.3).

(per cent)

	Mar '13	Mar '14
Outstanding Rupee loans	12.27	12.19
Fresh Rupee loan	11.53	11.64

Source: RBI.

Table 5.3 : Weighted Average Lending Rate (WALR)

5.9 Following the exceptional measures taken by the RBI in Q2 2013-14, both deposit and lending rates firmed up by September 2013. On balance, lending rates were largely sticky during the year whereas the median deposit rate of SCBs rose by 35 bps over the same period. The transmission of policy rate to deposit and lending rates of banks is relatively less pronounced as compared to money market rates reflecting the presence of structural rigidities in the credit market. The factors impeding the pace of smooth monetary policy transmission to the credit market include rigidities in repricing for fixed deposits, size of government borrowings, level of non-performing assets (NPAs), high inflation, and the significant presence of informal finance.

Interest rates on NRI deposits

5.10 There are two interest rate ceilings that are applicable for NRI accounts depending on the type of deposit. Interest rates on foreign currency non-resident (bank) (FCNR (B)) deposits are still regulated by the RBI. The rates for 1-3-year FCNR (B) deposits remained unchanged. The RBI increased interest rates on FCNR (B) deposits of 3-5-year maturity by 100 bps to 400 bps above the London Interbank Offered Rate (LIBOR) in August 2013 in light of prevailing exchange rate pressures. These moves were reversed in March 2014.

Sectoral deployment of credit

5.11 Disaggregated data on sectoral deployment of gross bank credit from 47 banks accounting for about 95 per cent of bank credit and non-food credit available in 2013-14, showed that among the major sectors, credit to agriculture, services, and the priority sector recorded higher growth as compared to 2012-13, while that to industry marginally declined as compared to 2012-13 (Table 5.4).

Table 5.4 : Growth of Sectoral Deployment of Gross Bank Credit

(per cent)

	2012-13	2013-14
Gross bank credit	13.6	14.0
Food credit	15.9	-3.6
Non-food credit	13.5	14.3
Agriculture & allied activities	7.9	13.5
Industry (micro, small, medium & large)	15.1	13.1
Services	12.6	16.1
Personal loans	14.7	15.5
Priority sector	8.4	22.0

Source: RBI.

Priority-sector lending

5.12 The outstanding priority-sector advances of public-sector banks showed (Table 5.5) a growth of 13.4 per cent at end March 2013 over end March 2012. Similarly the outstanding priority-sector advances of private-sector banks showed a growth of 14.3 per cent and foreign banks of 5.3 per cent during the same period. Table 5.6 shows growth of priority-sector lending (PSL) by sector.

Table 5.5 : Growth of Priority-sector Advances

(per cent)

	2011-12	2012-13
Public-sector banks	10.62	13.47
Private-sector banks	14.98	14.30
Foreign banks	20.71	5.33

Source: RBI.

Agricultural credit

5.13 The agriculture sector was disbursed ₹ 6,07,375.62 crore in 2012-13. Commercial banks, regional rural banks (RRBs), and cooperative banks extended credit to 152.77 lakh new farmers, increasing the total number of agriculture loan accounts financed as of March 2013 to 7.04 crore. As per the provisional figures available, as against the farm credit target of ₹ 7,00,000 crore for the year 2013-14, an amount of ₹ 7,30,766 crore was disbursed during the year. The majority of the credit was disbursed by SCBs but RRBs and commercial banks increased their share in disbursement in 2013-14 (Table 5.7).

Table 5.6 : Growth in Priority-sector Deployment of Credit by sector

(per cent)

	2012-13	2013-14
Agriculture & allied activities	7.9	13.5
Micro & smal enterprises	12.8	33.6
Other priority sector	3.1	18.1

Source: RBI.

Financial performance of banks

5.14 The Indian banking sector, which exhibited considerable resilience in the immediate aftermath of the global financial crisis, has been impacted by the global and domestic economic slowdown over the last two years. During 2012-13 there was a decline in the growth of profits of SCBs as credit off-take slowed down and interest rates softened. Asset quality deteriorated, particularly for public-sector banks. However, capital positions of Indian banks, including public-sector banks, remained strong and above the stipulated minimum.

(per cent)

	2012-13	2013-14
Cooperative banks	18.31	16.21
RRBs	10.48	11.31
Commercial banks	71.21	72.48

Source: **Indian Banks Association** (IBA), RBI, and National Bank for Agriculture and Rural Development (NABARD).

Table 5.7 : Agency-wise Credit Disbursed to Agriculture Sector

Table 5.8 : Working results of SCBs

(in ₹ crore)

Items	2011-12	2012-13
Income	741628	861398
Interest Income	655284	763612
Other Income	86344	97787
Expenditure	659969	770233
Interest Expended	430356	513803
Intermediation Cost (Operating Expenses)	137572	156585
Provisions and Contingencies	92042	99845
Operating Profit	173700	191010
Net Profit	81658	91165
Net Interest Income (Spread)	224928	249809
Total Assets	8320890	9573334
Net Income	311272	347595

Source: RBI

5.15 During 2012-13 the overall growth in balance sheet of banks moderated further. The growth in the consolidated balance sheet of SCBs in 2012-13 was 15.1 per cent, lower than the 15.8 per cent in the previous year (Table 5.8). The major source of this moderation was bank credit. The moderation in credit growth was partly reflective of the slowdown in real economic activity coupled with increasing risk aversion by banks. Although there was a moderation in the balance sheet of the banking sector, deposits - the largest component on the liabilities side—maintained their growth in 2012-13, primarily with the help of a revival in the growth of current and savings accounts (CASA). Consequently, the share of CASA was maintained at around 33 per cent. The credit-deposit ratio for all SCBs, on an outstanding basis, remained broadly unchanged at about 79 per cent.

There was a slowdown in credit growth.

5.16 The year 2012-13 was marked by a slowdown in the growth of credit to all productive sectors—agriculture, industry, and services. It was the sharpest for agriculture and allied activities. There was also a slowdown in the growth of credit to the infrastructure sector within industry. Further, a slowdown in credit to non-banking financial companies (NBFCs) was an important reason behind an overall slowdown in the growth of services-sector credit. Retail loans was the only segment that maintained its growth in 2012-13.

5.17 The growth in investments of banks increased to 17.0 per cent in 2012-13 from 16.1 per cent in 2011-12. During 2012-13, deceleration was witnessed in banks' investments in government securities (G-Secs) compared to the previous year. As against this, banks' investments in non-approved securities witnessed an almost five-fold increase.

5.18 In 2012-13, interest earnings were adversely affected with credit growth slowing down. This was also a period when interest rates, which had hardened during earlier years, started softening. Interest expended also grew at a slower pace during the year but its growth was higher than that of interest earned, thereby putting a downward pressure on the growth in both operating and net profits of banks.

5.19 The two main indicators of profitability, return on assets (RoA) and return on equity (RoE) declined marginally during 2011-12 reflecting deceleration in net profit of banks. During 2012-13, the RoA and RoE were placed at 1.03 and 13.84 per cent respectively (Table 5.9). Reflecting a subdued performance of the secondary market and lower credit off-take, banks raised only about ₹ 300 crore through public issues in 2012-13. However banks' resource mobilization through private placement more than doubled to ₹ 26200 crore in 2012-13 as compared to the previous year.

(per cent)

	2011-12	2012-13
Return on assets	1.08	1.03
Return on equity	14.60	13.84

Source: RBI.

Table 5.9 : Return on Assets and Equity for SCBs

Capital adequacy ratio

5.20 The capital to risk weighted assets ratio (CRAR) (under Basel II) at the system-wide level declined to 13.88 per cent as at end March 2013, as compared to 14.24 per cent as at end March 2012. The decline in capital positions at aggregate level, however, was on account of deterioration in the capital positions of public-sector banks.

Non-performing assets of the banking sector

5.21 During 2012-13, the deteriorating asset quality of the banking sector emerged as a major concern, with gross NPAs of banks registering a sharp increase. The gross NPAs to gross advances ratio shot up to 3.6 per cent in 2012-13 from 3.1 per cent during the corresponding period of the previous year. The deterioration in asset quality was most perceptible for the State Bank of India (SBI) Group with its NPA ratio reaching a high of 5 per cent at end March 2013. With their gross non-performing assets (GNPA) ratio reaching about 3.6 per cent by end March 2013, the nationalized banks were positioned next to the SBI group.

Improving recovery in PSBs

Growth of NPAs is a cause for concern.

5.22 Because of the slowdown and high levels of leverage, some industry and infrastructure sectors, namely textiles, chemicals, iron and steel, food processing, construction, and telecommunication are experiencing a rise in NPAs. Overall NPAs of the banking sector increased from 2.36 per cent of total credit advanced in March 2011 to 3.90 per cent of total credit advanced in March 2014 (provisional). While there has been an across-the-board increase in NPAs, the increase has been particularly sharp for the infrastructure sector, with NPAs as a percentage of credit advanced increasing from 3.23 per cent in March 2011 to 8.22 per cent as in March 2014 (provisional).

5.23 GNPAs of public-sector banks (PSBs) have shown a rising trend, increasing by almost four times from March 2010 (₹ 59,972 crore) to March 2014 (₹ 2,04,249 crore) (provisional). As a percentage of credit advanced, NPAs were at 4.4 per cent in March 2014 (provisional) compared to 2.09 per cent in 2008-09.

Tackling NPAs

5.24 Asset quality in the banking system has deteriorated in the post-crisis years and among banks groups, PSBs had the highest level of stress in terms of NPAs and restructured advances. The RBI in its Financial Stability Report, December 2013 has indentified five sectors—infrastructure, iron and steel, textiles, aviation, and mining—as the stressed sectors. PSBs have high exposures to the 'industry' sector in general and to such 'stressed' sectors in particular. Increase in NPAs of banks is mainly accounted for by switchover to system-based identification of NPAs by PSBs, slowdown of economic growth, and aggressive lending by banks in the past, especially during good times.

5.25 Some recent initiatives taken by the government to address the rising NPAs include:

- Appointment of nodal officers in banks for recovery at their head offices/zonal offices/for each Debts Recovery Tribunal (DRT).
- Thrust on recovery of loss assets by banks and designating asset reconstruction companies (ARC) resolution agents of banks.
- Directing the state-level bankers' committees to be proactive in resolving issues with the state governments.
- Sanction of fresh loans on the basis of information sharing amongst banks.
- Conducting sector / activity-wise analysis of NPAs
- Close watch on NPAs by picking up early warning signals and ensuring timely corrective steps by banks including early detection of sign of distress, amendments in recovery laws, and strengthening of credit appraisal and post credit monitoring (Box 5.1).

Steps are being taken to improve asset quality.

Box 5.1 : Highlights of the RBI's Recent Guidelines on Early Warning System 30 January 2014

The RBI's recently released study 'Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalizing Distressed Assets in the Economy' has suggested various steps for quicker recognition and resolution of stressed assets. Banks will now be required to classify Special Mention Accounts (SMA) into three sub-categories:

1. **SMA-0**: Principal or interest not overdue but showing incipient signs of stress
2. **SMA-1**: Principal or interest overdue by 31-60 days
3. **SMA-2**: Principal or interest overdue by 61-90 days

The other main proposals in the framework are:

1. Centralized reporting and dissemination of information on large credit.
2. Early formation of a lenders' committee with timelines to agree to a plan for resolution.
3. Incentives for lenders to agree collectively and quickly to a plan. There is better regulatory treatment of stressed assets if a resolution plan is under way, or accelerated provisioning if no agreement can be reached.
4. Improvement in current restructuring process: independent evaluation of large value restructurings is mandated, with a focus on viable plans and a fair sharing of losses (and future possible upside) between promoters and creditors.
5. More expensive future borrowing for borrowers who do not cooperate with lenders in resolution.
6. More liberal regulatory treatment of asset sales:
   - Lenders can spread loss on sale of loan assets over two years, provided the loss is fully disclosed
   - Lenders can take-out financing/refinancing over longer periods, which will not be construed as restructuring
   - Leveraged buy-outs will be allowed for specialized entities for acquisition of 'stressed companies'
   - Steps to enable better functioning of ARCs mooted
   - Sector-specific companies and private equity (PE) firms will be encouraged to play an active role in the stressed assets market
   - Steps taken by the government and RBI so far have resulted in improvement in recoveries of NPA by PSBs. These have increased from ₹ 9726 crore as in March 2010 to ₹ 20,288 crore as in March 2013 and ₹ 27,623 crore as in March 2014 (provisional).

- Increased provision for restructured standard accounts to 2.75 per cent from 2.00 per cent
- Increased provision for new restructured standard accounts to 5 per cent up from 3.75 per cent w.e.f. 31 March 2015 spread over the four quarters of 2014-15

NON-BANKING FINANCIAL INSTITUTIONS

5.26 Non-banking financial institutions (NBFIs) is a heterogeneous group of institutions that caters to a wide range of financial requirements and can broadly be divided into financial institutions (FIs) and Non Bank Financial Companies (NBFCs).

Financial institutions

5.27 There were four FIs under the regulation and supervision of the RBI: Export-Import Bank of India (EXIM), National Bank for Agriculture and Rural Development (NABARD), National Housing Board (NHB), and Small Industries Development Bank of India (SIDBI). The total resources raised by FIs during 2012-13 were lower than in the previous year (Table 5.10). Both short-term and long-term resources raised declined, while those raised through foreign currency resources recorded a sharp increase. The rise in foreign currency borrowings was mainly with respect to EXIM as it more than doubled its external borrowings during the year.

(₹ crore)

	2011-12	2012-13
Resources raised		
Long term	96100	47000
Short term	105200	65900
Foreign currency	10400	20100
Total	211700	133000
Total oustanding	**201600**	**191300**

Source: Respective FIs.

Table 5.10 : Resource Mobilization by FIs

5.28 The funds raised by FIs from external sources increased by 73.4 per cent during 2012-13, while funds mobilized from internal sources decreased by 9.3 per cent. In case of deployment of funds, the growth of fresh deployments declined sharply to 13.6 per cent, whereas the funds used in other deployments surged significantly by 586.5 per cent (Table 5.11).

(per cent)

	2012-13
Sources of funds	**27.1**
Internal	-9.3
External	73.4
Others	225.4
Deployment of funds	**27.1**
Fresh deployment	-13.6
Repayment of past borrowing	17.6
Other deployments	586.5
Interest payments	26.2

Source: Respective FIs.

Table 5.11 : Variation in Pattern of Sources and Deployment of Funds of FIs

5.29 The financial performance of FIs improved during 2012-13 as both their operating and net profits increased. Increase in FIs' operating expenses during 2012-13 was mainly led by a higher wage bill. The RoA of all the FIs remained almost stable during 2012-13 with SIDBI and NHB having the highest RoAs. As compared to last year, net NPAs of FIs at aggregate level increased mainly on account of higher net NPAs in respect of EXIM, SIDBI, and NHB. NABARD had the fewest NPAs of the FIs and its NPA position improved further during the year. The CRAR of all the FIs was lower during 2012-13 than in the previous year. However, all the four FIs maintained a CRAR higher than the minimum stipulated norm of 9 per cent.

Non-banking financial companies

5.30 NBFCs as a whole accounted for 13.0 per cent of bank assets as on 31 March 2013. With the growing importance assigned to financial inclusion, NBFCs have been regarded as important financial intermediaries particularly for the small-scale and retail sectors. There are two broad categories of NBFCs based on whether they accept public deposits, namely deposit taking NBFCs (NBFC-D) and non-deposit taking NBFCs (NBFC-ND). The total number of NBFCs registered with the RBI declined from 12,385 as at the end of June 2012 to 12,225 as on 30 June 2013. The number of NBFC-Ds declined from 271 to 254 during the same period,

Box 5.2 : Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households

The RBI set up the Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households (CCFS) in September 2013 under the Chairmanship of Dr Nachiket Mor. The Committee's Report was released on 7 January 2014.

At its core, the Committee's recommendations are that in order to achieve the task of financial inclusion in a manner that enhances both financial inclusion and stability, there is need to move away from an exclusive focus on any one model to an approach where multiple models and partnerships are allowed to thrive, particularly between national full-service banks, regional banks of various types, NBFCs, and financial markets. The common theme of all the recommendations made by the Committee is that instead of focusing only on large generalist institutions, specialization and partnerships between specialists must be encouraged. Such an approach, in its view, would be far more effective at delivering high quality financial inclusion, without compromising financial stability or responsibility towards customers. Some of the key recommendations of the CCFS include:

1. **Universal Electronic Bank Account** for every resident to be made available at the time of issuing the Aadhaar number.
2. **Licensing**, with lowered entry barriers but otherwise equivalent treatment, more functionally focused banks, including payment banks, wholesale consumer banks, and wholesale investment banks.
3. **Developing risk-based supervision** processes for regional banks and strengthening existing ones before creating new regional banks.
4. **Reorienting the focus** of NABARD, SIDBI, and NHB to be market-makers and providers of risk-based credit enhancements.
5. **Consolidating NBFC definitions** into two categories: Core investment companies and other NBFCs. Restore permission of NBFCs-ND to act as business correspondents.
6. **On priority sector lending**, while the Committee acknowledged that the current focus of the policy, on small farmers, small businesses, and weaker sections, was well placed, it recommended an approach that incentivizes each provider to specialise in one or more sectors of the economy and regions of the country. Government subsidies to be channelled as direct benefit transfers (DBTs) rather than as subventions or waivers.
7. All financial firms regulated by the RBI be required to have an internal process to assess suitability of products prior to advising clients with regard to them.

Systemically important non-deposit taking NBFCs (NBFC-ND-SI) increased from 370 to 417 during the same period.

Financial inclusion

5.31 Financial inclusion is an important priority of the government. The objective of financial inclusion is to extend financial services to the large hitherto unserved population of the country to unlock its growth potential. To extend the reach of banking to those outside the formal banking system, various initiatives are undertaken by the Government of India (GoI) and RBI from time to time. PSBs opened 7840 branches in 2013-14 as compared to 4432 in 2012-13. They had a total of 96,853 automated teller machines (ATMs) by January 2014 as compared to 69,652 at the end of 2012-13. Boxes 5.2 and 5.3 highlight some of the key developments in this field.

Box 5.3 : New Banking Licenses in the Private Sector

The RBI released 'Guidelines for Licenses of New Banks in the Private Sector' on 22 February 2013, wherein applications for setting up new banks in the private sector were invited, for which 25 applications were received. A High Level Advisory Committee under the Chairmanship of Dr Bimal Jalan, former Governor RBI, was set up for screening these applications. The Committee submitted its Report along with its recommendations on 25 February 2014. Based on this, an internal scrutiny of the applications was done and the RBI, on 2 April 2014, granted 'in-principle' approval to two applicants, namely IDFC Limited and Bandhan Financial Services Private Limited, to set up banks under the Guidelines.

Table 5.12 : Resource Mobilizsation through Primary Market

(₹ crore)

	2012-13	2013-14
Debt	16982	42383
Equity	15473	13269
IPOs	6528	1236
Number of IPOs	33	38
Mean IPO size	198	33
Private placement	361462	276054
Euro issues (ADR/GDR)	NA	NA
Total	**393917**	**331728**

Source: Securities and Exchange Board of India (SEBI).

Financial Markets

Market performance and outlook

5.32 During 2013-14, resource mobilization through the primary market witnessed a downward movement over the previous year (Table 5.12). The cumulative amount mobilized through equity public issues declined by 14.2 per cent. During 2013-14, 38 initial public offerings (IPO) listed at the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) with a mean IPO size of ₹ 33 crore went down by 83.33 per cent compared to 2012-13. The public issue of corporate debt increased in 2013-14 by 149 per cent whereas private placement fell by 23.5 per cent during the same period

Resource mobilization by mutual funds

5.33 During 2013-14, mutual funds (MF) mobilized ₹ 53,783 crore from the market as compared to ₹ 76,539 crore in 2012-13, a drop of 23.1 per cent (Table 5.13). The market value of asset under management (AUM) stood at ₹ 8,25,240 crore as on 31 March 2014 compared to ₹ 7,01,443 crore as on 31 March 2013, an increase of 17.6 per cent.

(₹ crore)

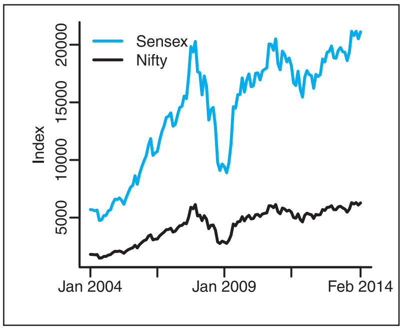
Sector	2012-13	2013-14
UTI	4629	401
Public	6808	4543
Private	65102	48838
Total	**76539**	**53783**

Source: SEBI

Table 5.13 : Trends in Resource Mobilization by Mutual Funds

Secondary markets

5.34 Indian benchmark indices BSE Sensex and NSE Nifty gained 18.8 and 18.0 per cent in fiscal year 2013-14 (Figure 5.3). Among the select world indices (Table 5.14), the SPX index registered the highest percentage change of 29.6 per cent during the calendar year 2013. Sensex and Nifty meanwhile observed a percentage change of 9.0 and 6.8 per cent respectively for the same period.



Source: NSE and BSE.

Figure 5.3 : Closing Values of NSE and BSE

5.35 At the end of March 2014, 1710 foreign institutional investors (FIIs) were registered with the Securities and Exchange Board of India (SEBI), with the number of registered sub-accounts increasing to 6344. The total net foreign institutional investment (FII) flows during 2013-14 stood at US $ 8.9 billion (Figure 5.4). Market turnover in the cash segment of the equity market at the BSE and NSE stood at ₹ 5,21,664 crore and ₹ 28,08,489 crore respectively in 2013-14 as compared to ₹ 5,48,774 crore and ₹ 27,08,279 crore respectively in 2012-13. In the equities derivatives segment, all three stock exchanges, NSE,BSE, and Multi-commodity Exchange Stock Exchange (MCX-SX), registered a marked increase in turnover. In the currency derivatives space, the number of contracts and turnover fell at NSE and MCX-SX in 2013-14 (Tables 5.15, 5.16). The fall in currency derivatives trading is due to forex volatility and the liquidity tightening measures taken by the RBI.

Index	% change in '13 over '12
S&P BSE SENSEX	9.0
NSE CNX NIFTY	6.8
S&P 500	29.6
DAX	25.5
FTSE 100	14.4
NIKKEI 225	56.7
HANG SENG	2.9
Brazil Ibovespa	-15.5
Kospi	0.7
Dow Jones Indus. Avg.	26.5
Straits Times STI	0.0
Shanghai SE	-6.7
CAC 40	18.0

Source: Bloomberg.

Table 5.14 : Performance of Major Markets in the World (%)

(₹ crore)

	Cash	Equity
2012-13	3257086	38704572
2013-14	3341338	47575571

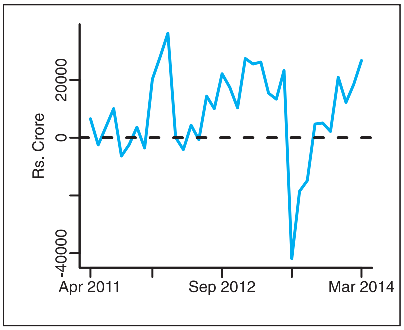
Source: BSE, NSE and MCX-SX.

Table 5.15 : Market turnover

Table 5.16 : Trends in Currency Derivatives

Exchanges	No. of contracts	Trading value (₹ crore)	Average daily trading value (₹ crore)
NSE			
2012-13	959243448	5274465	21706
2013-14	660192530	4012513	16445
MCX-SX			
2012-13	597310766	3303179	13593
2013-14	398584890	2422410	9928
USE			
2012-13	23766846	132861	547
2013-14	47479296	301620	1236
BSE			
2012-13	NA	NA	NA
2013-14	39157195	244312	3016

Source: NSE, MCX-SX, USE and BSE.



Source: SEBI

Figure 5.4 : Net FII Investment

Primary market initiatives

5.36 This subsection highlights the regulatory changes over the last financial year that seek to increase access to and efficiency of the financial system.

Steps to develop corporate bond market

5.37 Various policy reform measures were implemented in consultation with all market regulators and the Ministry of Corporate affairs (MCA) to improve the regulatory regime and stimulate the growth of the corporate bond market:

- Strengthening of the legal framework for regulation of corporate debt by amendments in rules/regulations formulated by the MCA, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFESI) Act, and Income Tax Act.
- Relaxation of investment guidelines for pension funds, provident funds, insurance funds, etc. to enable the inclusion of a long-term and stable class of investors.
- Introduction of new products or removal of legal or regulatory constraints for nascent products such as covered bonds, municipal bonds, credit default swaps, credit enhancements, and securitization receipts.
- Amendment in definition of deposit in Companies (Acceptance of Deposits) Rules 1975.
- Development of securitized debt market by ensuring clarity in taxation policy for securitized debt.
- Rationalization of withholding tax (WHT) on FIIs for G-Secs and corporate bonds.
- Relaxation of investment norms of insurance / pension funds to encourage such funds to increase their participation in corporate bonds.
- Encouragement of public issuance of corporate bonds for raising Tier II capital by banks, especially since banks are viewed as more reliable by public investors.
- Insurance companies allowed to participate in the repo market to increase liquidity. The RBI also reduced the

minimum haircut requirement in corporate debt repo. Repo in corporate debt shall also be permitted on commercial papers, certificates of deposit, and non-convertible debentures of less than one year of original maturity.

- Insurance companies and mutual funds allowed to participate as market makers in credit default swap (CDS) market to improve trading in this product.
- Setting up of central counter party (CCP) and creation of trade guarantee fund for trading in corporate bonds in stock exchanges.
- New trading platform and risk management system for corporate bonds including a centralized database on outstanding amount, settlement value, and traded volume to eliminate fragmentation of information.

The data on corporate bonds for private placement and public issuance is given in Table 5.17 and 5.18.

Table 5.17 : Private Placement of Corporate Bonds

	2012-13	2013-14	2014-15*
Listed only on NSE			
No. of issues	1295	837	94
Amount (₹ crore)	206187.25	140713.04	9122.8
Listed only on BSE			
No. of issues	1094	997	194
Amount (₹ crore)	72473.84	78805.14	10651.75
Listed on NSE & BSE			
No. of issues	100	90	12
Amount (₹ crore)	82800.91	56536	3800
Total			
No. of issues	2489	1924	300
Amount (₹ crore)	361462	276054.18	23574.55

Source: NSE and BSE
*In April 2014

Table 5.18 : Particulars on Public Issues

	Issues	Amt. Raised (₹ crore)
2010-11	10	9451.17
2011-12	20	35610
2012-13	20	16982
2013-14	35	42382.97
2014-15	1	264.7

Source: SEBI.

Increasing minimum public shareholding for listed companies

5.38 The Securities Contracts (Regulation) Rules (SCRR) 1957 provide for non-promoter, public shareholding for all listed companies to be 25 per cent (except for government-owned public-sector enterprises where the threshold is 10 per cent). SEBI has introduced the following methods for achieving the minimum public shareholding (MPS) requirement in terms of Rules 19(2) (b) and 19A of the SCRR.

- Issuance of shares to public through prospectus.
- Offer for sale (OFS) of shares held by promoters to public through prospectus and sale of shares held by promoters through the secondary market by OFS through the stock exchange. This is coupled with a new Institutional Placement Programme (IPP).
- Rights issues to public shareholders, with promoters/promoter group shareholders foregoing their rights entitlement. The same norms apply to bonus issues.

5.39 Orders were issued to non-compliant private companies and public-sector undertakings (PSU) and ₹ 18,799 crore was raised through companies meeting their MPS.

Secondary market initiatives

5.40 It was a busy year in the secondary markets as many market segments were liberalized and new products like interest rate futures were launched. Other schemes and reforms include:

Small and Medium Enterprise (SME) segment

5.41 A framework to permit small and medium enterprises, including start-up companies, to list on the SME exchange without being required to make an IPO, was announced in the Union Budget 2013-14. The issue however will be restricted to informed investors. This will be in addition to the existing SME platform on which listing can be done through an IPO and with wider investor participation. This move was made to increase SME access to capital markets.

Reduction and harmonization of securities transaction tax (STT)

5.42 The STT has been reduced for equity futures from 0.017 per cent to 0.01 per cent in 2013-14. At the same time the commodities transaction tax (CTT) rate on non-agricultural commodities futures contracts has been harmonized at the same rate as on equity futures.

External market initiatives

Foreign Portfolio Investor (FPI)

5.43 Following the K. M. Chandrasekhar Committee recommendations, SEBI has notified new FPI regulations on 7 January 2014 to put in place a framework for registration and procedures with regard to foreign investors who propose to make portfolio investment in India. The RBI followed up these recommendations with announcement of FPI norms with SEBI on 25 March 2014.

5.44 The portfolio investor registered in accordance with SEBI guidelines shall be called registered foreign portfolio investor (RFPI). The existing portfolio investor class, namely FII and qualified foreign investor (QFI) registered with SEBI shall be subsumed under RFPI. An RFPI may purchase and sell shares and convertible debentures of an Indian company through a registered broker on recognized stock exchanges in India as well as purchase shares and convertible debentures which are offered to public in terms of relevant SEBI guidelines/ regulations. An RFPI shall be eligible to invest in government securities and corporate debt and all exchange-traded derivative contracts on the stock exchanges subject to limits prescribed by the RBI and SEBI. This move is expected to streamline the foreign investment process in India for all FPIs.

Registered foreign portfolio investor regime will ease foreign portfolio investment.

Review of ADR/GDR scheme

5.45 A committee was set up to review the American Depository Receipt (ADR)/Global Depository Receipt (GDR) scheme of 1993 keeping in view the new company law and the recent legislations in the financial markets; the needs of the Indian companies and foreign investors; and the need for simplification and legal clarity of the Scheme. The Committee submitted its report on 27 November 2013. The government has accepted the report and the new scheme suggested by the Committee would be notified at a later stage after the necessary tax-related amendments are made.

IFC offshore bond programme

5.46 International Finance Corporation [IFC(W)], a member of the World Bank Group, launched a US$1 billion offshore bond programme—the largest of its kind in the offshore rupee market—to strengthen India's capital markets. Under the programme, the IFC will issue rupee-linked bonds and use the proceeds to finance private-sector investment in the country. The IFC's offshore bond programme will help bring depth and diversity to the offshore rupee market and pave the way for an alternative source of funding for Indian companies.

Enhancement of FII debt limits

FII limits were enhanced to US$ 81 billion.

5.47 The GoI in consultation with the RBI has progressively enhanced the limits for FII investments in the domestic debt (G-Sec as well as corporate debt) market keeping in view India's evolving macroeconomic scenario. The FII debt limits have now been enhanced to US$ 81 billion (corporate bond US$ 51 billion and G-Secs US$ 30 billion) from the earlier US$ 66 billion.

Financial Sector Legislative Reforms Commission

The FSLRC report marks an important milestone in financial reforms.

5.48 With a view to revamping financial-sector laws to bring them in tune with current requirements, the GoI set up the Financial Sector Legislative Reforms Commission (FSLRC) on 24 March 2011. The Commission submitted its Report on 22 March 2013. The FSLRC has given wide-ranging recommendations on the institutional, legal, and regulatory framework, and operational changes in the Indian financial sector. Broadly, the recommendations of the Commission can be divided into two parts, legislative and non-legislative aspects.

5.49 The legislative aspects of the recommendations relate to revamping the legislative framework of the financial-sector regulatory architecture through a non-sectoral, principle-based approach and by restructuring existing regulatory agencies and creating new agencies wherever needed. The Commission has recommended a seven-agency structure for the financial sector. The non-legislative aspects of the FSLRC recommendations are broadly in the nature of governance-enhancing principles for enhanced consumer protection, greater transparency in the functioning of financial-sector regulators in terms of their reporting system, greater clarity on their interface with the regulated entities, and greater transparency in the regulation making process by means of mandatory public consultations, incorporation of cost-benefit analysis, etc. The recommendations of the FSLRC were also discussed in fair detail in the Financial Stability and Development Council (FSDC) meetings. In the eighth FSDC meeting held on 24 October 2013, the Council decided that Regulators would voluntarily adopt governance-enhancing recommendations that do not require legislative changes within a reasonably proximate timeframe. It was also decided to set up task forces with a project approach to lay the roadmap for the establishment of new agencies like the Resolution Corporation (RC), Public Debt Management Agency (PDMA), Financial Sector Appellate Tribunal (FSAT), and Financial Data Management Centre (FDMC).

5.50 With a view to facilitating the task of regulators and helping develop a uniform rationale-based understanding about the non-legislative governance-enhancing principles, a detailed 'Guidance Handbook' was prepared which essentially includes governance-enhancing provisions/recommendations, their rationale, suitable examples of global good governance practices, and guidance on implementation.

5.51 These recommendations encompass issues relating to consumer protection, consumer protection for retail customers, timeline for regulations on consumer protection, requirements for framing regulations, notices to regulated entities, transparency, transparency in Board meetings, reporting, approvals, investigation, adjudication, imposition of penalty, and capacity building. For ensuring coordination between the regulators so as to ensure cohesion at opertional level, the non-legislative aspects of the FSLRC recommendations were also discussed in the Inter Regulatory Technical Group housed in the RBI.

The FSLRC report emphasizes financial consumer protection.

5.52 Going forward, the government intends to concretize the institutional structures through task forces on RC, PDMA, FSAT, and FDMC and by examining legislative aspects of the FSLRC recommendations, fine-tuning the draft IFC managing technical programmes for capacity building and by strengthening the Management Information System (MIS).

Financial Stability and Development Council Secretariat

5.53 With a view to strengthening and institutionalizing the mechanism for maintaining financial stability, enhancing inter-regulatory coordination, and promoting financial-sector development, the government has set up an apex-level Financial Stability and Development Council (FSDC) in December 2010. The Council is chaired by the Finance Minister and has heads of financial-sector regulatory authorities, the Finance Secretary and/or Secretary, Department of Economic Affairs, Secretary, Department of Financial Services, and the Chief Economic Adviser as members. The Council monitors macro-prudential supervision of the economy, including functioning of large financial conglomerates, and addresses inter-regulatory coordination and financial-sector development issues. It also focuses on financial literacy and financial inclusion.

The FSDC reviewed key financial stability issues.

5.54 The council met three times in 2013-14 and has already met twice in 2014-15. During these meetings, the Council reviewed the position of asset quality and capital adequacy of the banking system

Box 5.4: Financial Stability Board

The Financial Stability Board (FSB) was established in 2009 under the aegis of the G20 bringing together the national authorities, standard-setting bodies, and international financial institutions to address vulnerabilities and to develop and implement strong regulatory, supervisory, and other policies in the interest of financial stability. India is an active Member of the FSB. The FSDC Secretariat in the Department of Economic Affairs coordinates with the various financial-sector regulators and other relevant agencies to represent India's views with the FSB. As a member of the FSB, Basel Committee on Banking Supervision (BCBS), and International Monetary Fund (IMF), India actively participates in post-crisis reforms of the international regulatory and supervisory framework under the aegis of the G20. India remains committed to adoption of international standards and best practices, in a phased manner and calibrated to local conditions, wherever necessary.

in the country, National Strategy for Financial Education, recommendations of the FSLRC, impact of tapering off of the quantitative easing in the US and preventive measures to be taken, steps to be taken by regulators/government to facilitate the 'Corporate Distress Resolution Mechanism' as laid out in the Companies Act 2013, Assessment on External Sector Vulnerabilities, Issuance of Basel III Compliant Capital Instruments by Banks, etc. (see Box 5.4).

Global competition for key markets

5.55 A major development in recent years has been a new era of international competition. The two biggest markets in India are the rupee and Nifty. In both these markets, active trading has developed at overseas venues. Foreign customers have the choice of sending an order to India or elsewhere; households and firms in India are gradually finding ways of harnessing overseas choices. India has lost competitiveness in key markets.

5.56 Table 5.19 shows the structure of the global market for the rupee. Daily activity in the rupee adds up to $50.58 billion. The overseas market has developed into a significant competitor. Table 5.20 shows the structure of the global market for Nifty. More than half of the open position is now overseas.

5.57 Ten years ago, the global market was practically absent in both these fields. The rise in market share of the overseas market is a major external impulse upon the Indian financial system. Global competition generates pressure on private players to become more efficient, which is a positive development. However, the outlook for onshore trading is hampered by policy problems. The outcome of this global competition hinges on six factors:

1. There are capital control frictions against foreign investors;
2. Often there are technical mistakes in rules on position limits and margins;
3. There is adverse tax treatment of non-resident participants;
4. Markets in India are not open at all hours;
5. There are bureaucratic and procedural overheads; and
6. The domestic market is less well developed than some competing markets.

(Billion US$ of open interest)

	Exchange-traded	OTC
Onshore	10.6	20.9
Offshore	1.4	17.6

Source: Bank of International Settlements (BIS)

Table 5.19 : The Global Market for the Rupee

(Billion US$ of open interest)

	Exchange-traded	OTC
Onshore	22.1	6.9
Offshore	0.0	22.8

Source: NSE and SGX

Table 5.20 : The Global Market for Nifty

Insurance and pensions

Insurance

5.58 A healthy and developing insurance sector is of vital importance to every modern economy. It encourages the savings habit, provides a safety net to rural and urban enterprises and individuals, and generates long-term funds for infrastructure development. Development of insurance is therefore, necessary to support continued economic growth. Social security and pension reforms also benefit from a mature insurance industry. Since its opening up in 2000, the number of participants in the insurance industry has gone up from 7 insurers (including the Life Insurance Corporation of India [LIC]), 4 public-sector general insurers, 1 specialized insurer, and the General Insurance Corporation (GIC) as the national re-insurer in 2000 to 53 insurers as on 31 March 2014 operating in the life, non-life, and re-insurance segments.

Life insurance

5.59 During 2013-14 life insurers underwrote first-year premium of ₹ 1,19,641 crore as against ₹ 1,07,361 crore during 2012-13, registering a growth of 11.44 per cent. The premium underwritten by the private sector declined by 4.01 per cent, whereas that underwritten by the LIC registered a growth of 17.64 per cent.

Non-life insurance

5.60 During 2013-14, non-life insurers including standalone health insurers and specialized insurers (Export Credit Guarantee Scheme [ECGC] and Agriculture insurance company [AIC]) underwrote premium worth ₹ 77,583 crore as against ₹ 69,089 crore during 2012-13, registering a growth of 12.23 per cent. (Table 5.21)

(per cent)

	2102-13	2013-14
Private insurers	25.26	15.37
Public insurers	14.60	9.86

Source: Insurance Regulatory and Development Authority (IRDA).

Table 5.21 : Growth of Premium Underwritten by Public and Private Insurers

Micro insurance

5.61 Micro insurance regulations issued by the Insurance Regulatory and Development Authority (IRDA) have provided the necessary impetus for promoting insurance to the needy sector. There were 17,052 micro insurance agents operating in the micro insurance sector as of end 2012-13, a 35 per cent increase as compared to 2011-12. In micro insurance-life, the individual new business premium in the year was ₹ 109.68 crore under 50.36 lakh policies, which is marginally lower than ₹ 115.68 crore raised under 46.20 lakh policies in 2011-12. The group business amounted to ₹ 218.03 crore premium under 139.81 lakh lives in 2012-13.

Insurance penetration and density

5.62 Insurance penetration is defined as the ratio of premium underwritten in a given year to the GDP. Likewise, insurance density is defined as the ratio of premium underwritten in a given year to the total population. Insurance penetration has grown from 2.3 per cent (life 1.8 per cent and non-life 0.7 per cent) in 2000 to 3.96 per cent (life 3.17 per cent and non-life 0.78 per cent) in 2012.

Pension sector

5.63 The New Pension System (NPS) now called National Pension System was introduced by replacing the existing defined benefit pension system for the new recruits joining government service on or after January 2004. Till 7 May 2014 a total of 67.41 lakh subscriptions have been enrolled under the NPS with a corpus of ₹ 51,147 crore. From May 2009, the NPS was opened up for all citizens in India to join on a voluntary basis. The Swavalamban Scheme for workers in the unorganized sector launched in 2010, initially for three years for the beneficiaries who enrolled themselves in 2010-11, has now been extended to five years for the beneficiaries enrolled in 2010-11, 2011-12, and 2012-13 and thus the benefits of co-contribution under the Scheme would be available till 2016-17. A customized version of the core NPS model, known as the NPS Corporate Sector Model was also introduced from December 2011 to enable organized-sector entities to move their existing and prospective employees to the NPS under its Corporate Model. All the public-sector banks, which also act as points of presence for the NPS, have been asked to provide a link on their websites to enable individual subscribers to open online NPS Accounts.

66 lakh subscribers have enrolled under the NPS.

5.64 The Pension Fund Regulatory and Development Authority (PFRDA) Act 2013 has been made effective from 1 February 2014, after it was passed by Parliament in September 2013. The PFRDA Act 2013 seeks to vest the PFRDA with statutory status in order to allow it to perform its regulatory and developmental roles effectively and to extend the social security cover to hitherto uncovered working population through the NPS.

Challenges and Outlook

- Financial markets continue to suffer from illiquidity;
- A major objective should be to develop the bond-currency derivative (BCD) nexus to equity market quality levels;
- There are concerns about balance sheet quality with banks and a subset of non-financial firms;
- Most households are as yet cut off from large parts of the financial system. Bank-centric notions of financial inclusion have limited value;
- The next wave of infrastructure financing will require a capable bond market; and
- The FSLRC has proposed the draft IFC which addresses the problems of Indian finance and sets the course for a modern financial system.

Developing the BCD nexus is a priority.

The Road Ahead

Indian Financial Code (IFC)

5.65 The *Report of the Financial Sector Legislative Reforms Commission,* was submitted to the government on 22 March 2013. The report contained the FSLRC Draft Indian Financial Code. The Commission distilled the consensus of a decade of expert committee reports into a draft IFC, which replaces most existing Indian financial law. It sought to address present weaknesses of the Indian financial system, and meet the requirements of the Indian economy over the coming 30 years.

5.66 The IFC articulates clear objectives for financial regulation, where government intervention is required. These are: consumer protection, micro-prudential regulation, resolution, systemic risk reduction, market abuse in organized financial trading, consumer redress, debt management, capital controls, and monetary policy. In each area, precise objectives are stated and precise powers given to financial agencies.

5.67 The IFC lays great emphasis on the formal process through which the legislative, executive, and judicial functions take place in financial regulators. The principles of rule of law and accountability, are utilized to create a better environment of checks and balances around regulators.

5.68 The present financial regulatory architecture has come about through numerous episodes in the past decades, without a coherent design. The FSLRC has designed a modified financial regulatory architecture, which would increase accountability by achieving clarity of purpose for each organization and avoid conflicts of interest. The modified arrangements also facilitate achieving economies of scope and scale, of related activities, for the private sector and for the government.

5.69 The FSDC decided that while the draft IFC is a bill that requires Parliamentary action, a number of changes proposed by the FSLRC can be implemented voluntarily, without any legislative changes. To provide examples of best practices, and to guide regulators on compliance with the measures recommended by the FSLRC, the Ministry of Finance has published a *Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code*.