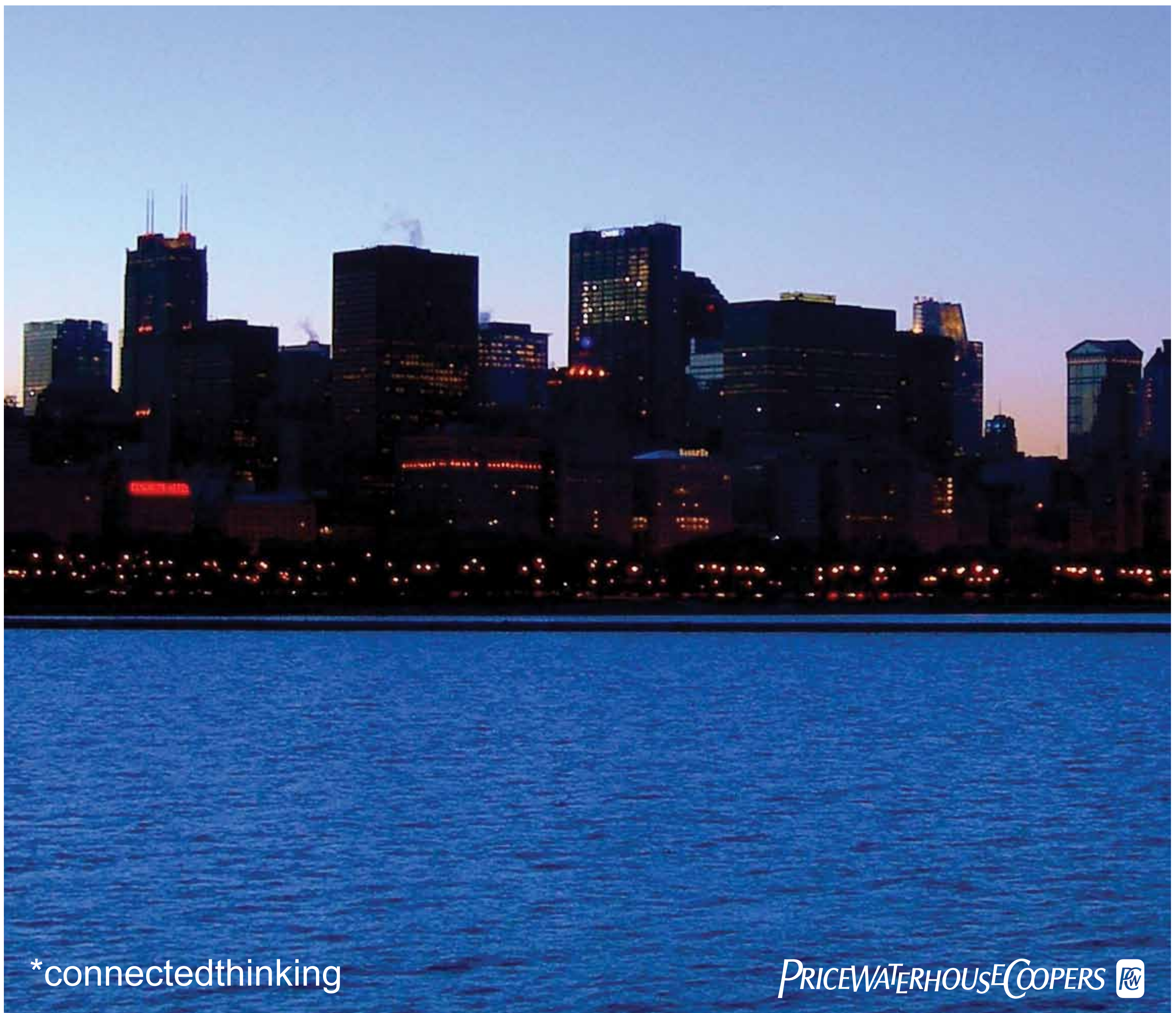
ASSOCHAM

The Indian capital market: Growth with governance*



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Preface

Indian Capital Markets have shown tremendous growth in the post Liberalization era. It remains one of the most resilient globally and poised to be one of the Top destinations for domestic and global businesses to expand and invest into. As global economy moves for imminent recovery, India has shown extraordinary strength to bounce back with greater stability and sustainability. **Raising capital is a strategic priority** across India and role of Capital Markets has assumed far greater importance and urgency. The Debt market still needs to be developed to invite capital inflows needed for massive infrastructure development. The frontiers of global markets are not only increasing but also moving towards process of convergence. FIIs inflows into the Indian equity markets have touched US$ 17 billion during 2009 and the steep rise in number of retail investors has brought into focus further issues of corporate governance and investors protection more prominently. The efforts of the Regulators and the Government to protect the interests of investors in securities and to promote the development of, and to regulate the securities market towards enlightened Governance, has bee lauded by all stake holders. There is huge potential for the capital markets growth as at present just 2% of the population, account for retail investors and the lowest strata of the pyramid still remains untapped. The real inclusive growth also needs penetration of capital market to the last mile.

The National Conference on **"Capital Market – Growth with Governance"** aims to assemble investors, practitioners, policy makers and other stake holders of the Indian capital market Eco-system to provide them an excellent platform to share views, experiences and research results on every aspect of Indian capital market such as Governance in Security Market, Investors protection; Vulnerability of Capital Market to FII Inflows, PSU Divestment, Role of Pension Fund, and Need for SME Exchanges.

I not only wish the conference a great success but also assume that ASSOCHAM shall continue to organize such programs for larger public benefits with great degree of excellence. ASSOCHAM extends earnest thanks to PricewaterhouseCoopers as our knowledge partner in this conference and also thanks to industry partners, Ministry of Corporate Affairs, SEBI, RBI, Conference Sponsors, Magazine Partner and Electronic Media & Online Media Partners for supporting this initiative.

D. S. Rawat
Secretary General
ASSOCHAM

We are pleased to present the PricewaterhouseCoopers-ASSOCHAM joint thought leadership study on Indian Capital Markets- Growth with Governance. The Indian economy has undergone significant change in the last two decades. From the closed economy of the 1980s, the 1990s was a decade of liberalization of the economy and in the 2000s, the economy witnessed unprecedented growth.

The growth in the economy was duly supplemented by a significant increase in the capital markets activity. There were significant changes to the legal framework, with Securities Exchange Board of India (SEBI) being entrusted with the regulatory power to govern the capital markets to ensure compliance. There was also technological advancement in the capital markets with the introduction of terminal based trading replacing the open outcry system and launch of the integrated market surveillance system, to monitor market malpractices, by the regulator.

The Corporate Governance framework was also strengthened through a series of amendments to the existing governance structure, by introduction of Clause 49 to the Listings Agreement and setting up of committees like the Naresh Chandra Committee Report on Corporate Audit and Governance. So far India has risen up to the challenge of a growing economy by ensuring that the requisite infrastructure is put in place to ensure market best practices and restore investor confidence.

The story of growth is incomplete without the presence of governance. The strong fundamentals of an economy are based on the virtues of good governance and ethical practices. This thought leadership study makes an attempt to chart the course of the Indian capital markets through the last two decades of growth with governance.

Bharti Gupta Ramola
Leader, Transactions
PricewaterhouseCoopers

01 Executive summary

Much has happened in the Indian capital market in the last 17 years. With its foundations laid in socialist based economy of four decades, with strict government control over private sector participation, foreign trade and foreign direct investment, India opened its gates to the outside world in the early 1990s. Since then its economy and financial markets underwent radical changes, largely in response to the economic crisis of the late 1980s. The government control on foreign trade and investment were loosened and the barriers to entry in the days of the license raj were relaxed.

The emergence of Securities and Exchange Board of India (SEBI) as the supreme capital market regulator showed India's commitment to come across as a strong economic force, through establishing market best practices of enhanced corporate disclosure and increased investor protection.

The establishment of National Stock Exchange (NSE), a state-of-the art exchange, with sophisticated technology to improve trading practices and reduce unethical dealings, supported by a strong legal framework and technological base to strengthen the governance structure, has been the highlight of the Indian capital market in the last decade. The opening up of the economy has increased the flow of Foreign Direct Investment (FDI) and has put India on the global map, as a new-age economic force to reckon with.

The increased level of sophistication in the market has been duly supported by increasingly complex instruments like derivatives and other structured products. While, the recent global meltdown has made us aware of the perils of sophisticated markets, the learning has been to follow a path of caution while maintaining a steady pace.

Several steps have been taken by the regulator to enhance the level of corporate governance and reporting requirements of the Indian stock market. Significant legislation has taken place in this area to curb market malpractices. The large scams and frauds have taught us that growth without a robust governance structure falls short of global expectations. The regulators have been active in responding to such events and in certain cases have undertaken proactive measures to stop such events from recurring.

This paper attempts to discuss the journey of the Indian capital market from the pre-reform era to the current era of liberalisation and enhanced governance.

02

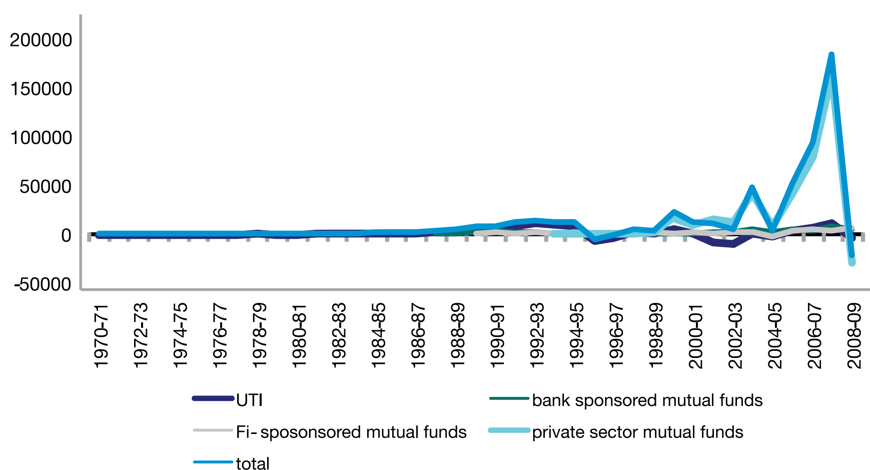
Capital markets – Pre-reform

The depleting foreign currency reserves in 1991 forced India to start the process of economic liberalisation. The reforms were accomplished by allowing increasing competition and greater foreign participation to provide fillip to the troubled economy.

The capital markets reforms in 1991 were preceded by a regime which ensured almost complete control of the state over the financial markets. Initial Public Offerings (IPO) were controlled through the Capital Issues Control Act. The Controller of Capital Issues (CCI) controlled the price and quantity of IPO and trading practices were short of transparency. The banking sector too was significantly controlled. There were few private banks and those faced challenges on their expansion plans. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. After the nationalisation of large banks in 1969 and 1980, the government-owned banks dominated the banking sector. The Reserve Bank of India (RBI) controlled the interest rates and the financial sector was replete with entry barriers, significantly restricting opportunities for the establishment of new banks, insurance companies, mutual funds and pension funds.

The Unit Trust of India (UTI) created in 1964 was the only mutual fund and it enjoyed complete monopoly of the mutual fund business up until 1988. The resource mobilisation by mutual funds demonstrates UTI's dominance in the early 1990s.

The early 1990s therefore, was a time when the primary role of the financial system in India was to channel resources from the excess to the deficit. The role of technology was limited and customer relationship and service was not a priority. Risk management procedures and prudential norms were weak, affecting asset portfolio and profitability.



Stock exchange

The Bombay Stock Exchange (BSE), the oldest and the largest stock exchange in India, traded for two hours in a day with an open outcry system. The exchange was managed in the interests of individual members, a majority of whom had inherited their seats. A large proportion of stocks listed on the exchange were not actively traded. There was minimum supervision from the exchanges and speculation was rampant. There were regional exchanges which were unconnected and engaged in open outcry sysem of trading. Each exchange had a board representative nominated from the Capital Markets division of the Minstry of Finance, the then regulator of the capital markets.

03

Capital markets reforms

The capital market reforms were based on improving two fundamental aspects. First, the improvement in the legal reporting framework and second the improvement in the technology framework.

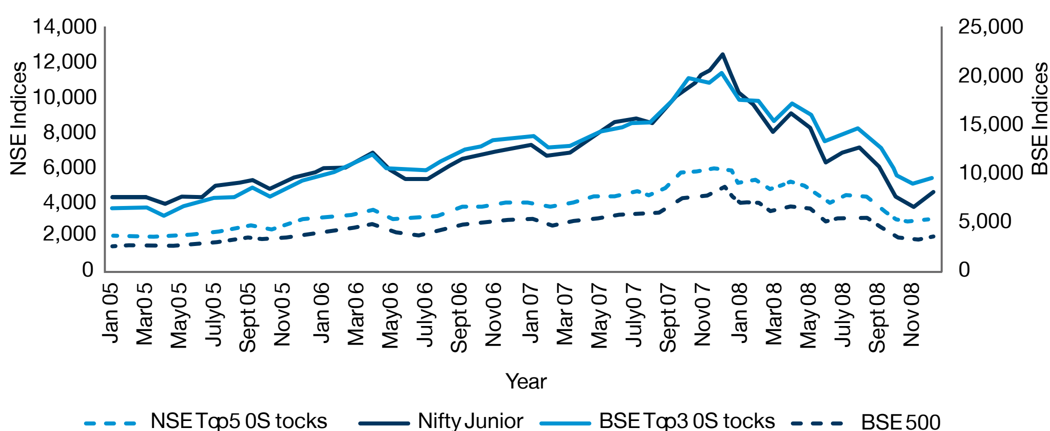
Legal framework

There have been significant reforms in the regulation of the securities market since 1992 in conjunction with the overall economic and financial reforms. A key element of the reform strategy was building a strong independent market regulator. The SEBI Act, which came into force in early 1992, established SEBI as an autonomous body. The apex capital market regulator was empowered to regulate the stock exchanges, brokers, merchant bankers and market intermediaries. The Act provided SEBI the necessary powers to ensure investor protection and orderly development of the capital markets.

The introduction of free pricing in the primary capital market has significantly de-regulated the pricing control instituted by the erstwhile CCI regime. While, the issuers of securities can now raise capital without seeking consent from any authority relating to the pricing, however the issuers are required to meet the SEBI guidelines for Disclosure and Investor Protection, which, in general, cover the eligibility norms for making issues of capital (both public and rights) at par and at a premium by various types of companies.

The freeing of the pricing of issues led to an unprecedented upsurge of activity in the primary capital market as the corporate mobilised huge resources. However, it did expose the inadequacies of the regulations. In order to address these inadequacies, SEBI strengthened the norms for public issues in April 1996. The graph below shows the BSE index movement from 1990 to 2006.

Movement of indices of NSE and BSE



Source: Bloomberg

The disclosure standards were enhanced to improve transparency and uphold the objective of investor protection. The issuers are now required to disclose information on various aspects, such as, the track record of profitability, risk factors, etc. Issuers now also have the option of raising resources through fixed price floatations or the book building process.

Clearing houses have been established by the stock exchanges and all transactions are mandatorily settled through these clearing houses and not directly between the members, as was practiced earlier.

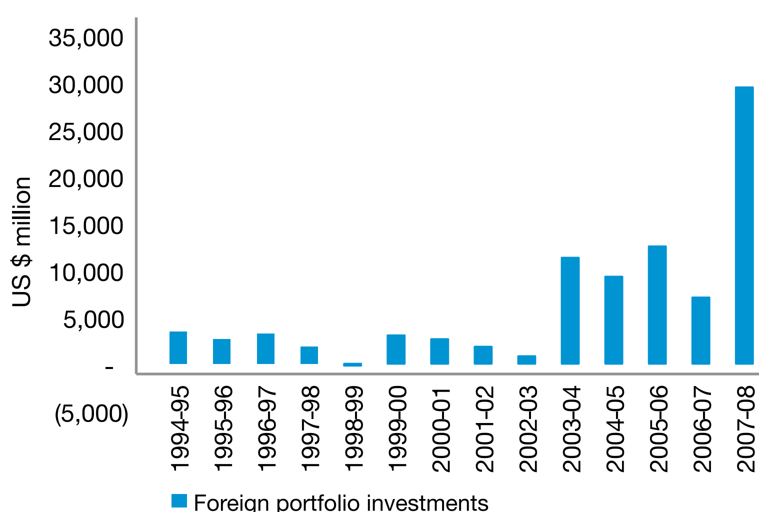
The practice of holding securities in physical form has been replaced with dematerialised securities and now the transfer is done through electronic book keeping, thereby eliminating the disadvantages of holding securities in physical form. There are two depositories operating in the country.

The margin system, limits on intra-day, trade and settlement guarantee fund are some of the measures that have been undertaken to ensure the safety of the market. The trading and settlement cycles have been significantly reduced. The cycles were initially shortened from 14 days to 7 days. The settlement cycles were further shortened to T+3 for all securities in 2002. The settlement cycle is now T+2.

Listed companies are required to furnish unaudited financial results to the stock exchanges and also publish the same on a quarterly basis. To enhance the level of disclosure by the listed companies, SEBI decided to amend the Listing Agreement to incorporate the segment reporting, accounting for taxes on income, consolidated financial results, consolidated financial statements, related party disclosures and compliance with accounting standards.

The last few years have seen significant interaction with the international capital markets. A major step towards that was the inclusion of Foreign Institutional Investors (FIIs) such as mutual funds, pension funds and country funds to operate in the Indian markets. As a quid pro quo, Indian firms have also raised capital in international markets through issuance of Global Depository Receipts (GDRs), American Depository Receipts (ADRs), Euro Convertible Bonds (ECBs), etc.

Foreign Portfolio Investments



Source: RBI

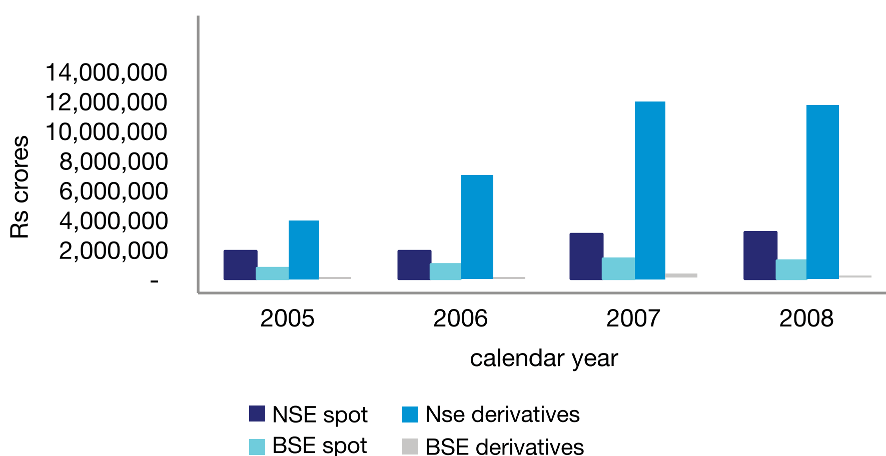
The SEBI's regulatory realm stretches beyond the stock exchanges to merchant bankers, registrars, share transfer agents, underwriters, mutual funds and various other advisors and market intermediaries. There have been efforts made to increase transparency in the takeover process and interests of minority shareholders.

Derivative market

One of the most noteworthy achievements of the Indian capital markets over the past 17 years has been the development of the derivative market. It has significantly enhanced the sophistication and maturity of the market. In India, derivative trading began in June 2000, with trading in stock index futures. By the fourth quarter of 2001, each of India's two largest exchanges had four equity-derivative products: futures and options for single stocks, and futures and options for their respective stock indices. The NSE has become the largest exchange in single stock futures in the world, and by June 2007, it ranked fourth globally in trading index futures, a sign of an evolving and maturing market.

Market liquidity too has increased greatly since 1992. This was primarily attributed to settlement rules (discussed below) and the introduction of derivatives trading. The move from fixed period to rolling settlements, shortened settlement periods, and a dramatic increase in derivatives trading contributed to steadily increasing market liquidity.

Derivatives market turnover



Source: BSE and NSE

Technology framework

The advent of technology to the markets has been largely attributed to the National Stock Exchange (NSE). NSE introduced the screen based trading and settlement system, supported by a state-of-the –art technology platform. To fulfill the commitment to adopt global best practices and bring about more transparency to the capital markets functioning, SEBI also assumed the responsibility of monitoring the markets and stock exchanges. A significant step towards that initiative was the launch of the Integrated Market Surveillance System (IMSS) in 2006.

The IMSS equipped the regulator to identify doubtful market activity. The IMSS's primary objective is to monitor the market activities across various stock exchanges and market segments including both equities and derivatives. IMSS collects and analyses data not only from the stock exchanges but also from National Securities Depository, Limited. (NSDL), Central Depository Services (India) Limited. (CDSL), clearinghouses, and clearing corporations.

The RBI introduced the electronic funds transfer system, "The Reserve Bank of India National Electronic Funds Transfer System" (referred to as "NEFT System" or "System"). The objective of the system is two-fold. First, is to establish an electronic funds transfer system to facilitate an efficient, reliable, secure and economical system to funds transfer and clearing in the banking sector throughout India. Second, is to relieve the stress on the paper based funds transfer and clearing system.

04

Global financial crisis: India and international perspective

The crisis which originated in the United States (US) housing mortgage market in 2007 transformed into a full fledged global financial crisis, considered to be the worst ever since the Great Depression. The financial landscape changed drastically with the collapse of Lehman Brothers in 2008. Irrespective of the degree of globalisation of a country and soundness of economic fundamentals, the crisis spread across the world in varying degrees of penetration. The international transmission of liquidity shocks was fast and unprecedented. The falling asset prices and valuation uncertainty affected market liquidity, the failure of leading global institutions and the deleveraging process tightened the market for funding liquidity. While the global financial markets have started showing signs of stabilisation, credit flow in the advanced markets is yet to recover.

Despite the decoupling theory, the emerging economies too faced problems and were affected during the crisis. Decoupling theory basically states that when the growth of the developed economies goes downwards, the emerging economies would remain unaffected due to their foreign exchange reserves, corporate balance sheets and the banking system. In the peak of the global economic crisis however, the decoupling theory did not make sense as emerging economies, including India, faced capital flow reversals, sharp widening of spreads on sovereign and corporate debt and abrupt currency depreciations.

Even though the Indian banking system had no direct exposure to the subprime crisis and had very limited off balance sheet activities and securitised assets, limited dependence on external demand as exports account for less than 15 % of the GDP and growth is predominantly driven by domestic consumption and investment, the financial crisis did affect the Indian economy. The seemingly 9 % GDP growth rate fell down to 6 %. This was primarily because of India's integration into the world economy, India's two-way trade (merchandise exports plus imports), as a proportion of GDP grew from 21.2% in 1997-98, the year of the Asian crisis, to 34.7 % in 2007-08 and the increase in the Indian corporates' access to external funding. In the five-year period from 2003 to 2008, the share of investment in India's GDP rose by 11 percentage points. Corporate savings financed roughly half of this, but a significant portion of the balance financing came from external sources. While funds were available domestically, they were expensive relative to foreign funding. On the other hand, in a global market awash with liquidity and on the promise of India's growth potential, foreign investors were willing to take risks, and provide funds at a lower cost. In 2007 - 08, India received capital inflows amounting to over 9 % of GDP as against a current account deficit in the balance of payments of just 1.5 % of GDP. These capital flows, in excess of the current account deficit, proove the importance of external financing and the depth of India's financial integration.

Key indicators of the global nature of the Indian economy (as a % of GDP)

Year	Goods Trade	Services Trade	Gross Current Account	Gross Capital Account	Gross Current & Capital Account
1	2	3	4	5	6
1970s	10.0	1.3	12.7	4.2	16.9
1980s	12.7	2.5	17.2	5.4	22.6
1990s	18.8	4.1	26.7	15.1	41.8
2000s					
(2000–09)	29.3	9.7	45.0	32.7	77.7
2008–09	40.2	13.2	60.5	51.0	111.5

Impact of the crisis on the Indian economy

India’s financial markets were impacted significantly by the crisis; India’s dramatic growth was fuelled by significant foreign capital flows; Indian banks and corporate found their overseas financing drying up, forcing the corporate to shift their credit demand to the domestic banking sector. Also, in their frantic search for substitute financing, corporates withdrew their investments from the domestic money market mutual funds, putting redemption pressure on the mutual funds and non- banking financial institutions. This substitution of overseas financing by domestic financing brought both money markets and credit markets under pressure. The foreign exchange market came under pressure because of reversal of capital flows as part of the global deleveraging process.

Apart from the financial market effect, the slump in exports also added to the trouble. The United States, European Union and the Middle East, which account for three quarters of India's goods and services trade, were in a synchronised down turn.

The Indian economy witnessed moderation in growth in the second half of 2008–09 in comparison with the robust growth performance in the preceding five years. The deceleration in growth was particularly noticeable in terms of negative growth in industrial output in Q4 of 2008–09 - a decline for the first time since the mid-1990s (Table 1). This was on account of erosion of external demand which affected industrial performance; a reflection of increasing globalisation of the Indian industry.

The transmission of external demand shocks was swift and severe on export growth, which declined from a peak of about 40 % in Q2 of 2008–09 to - 15 % in Q3 and further to - 22 % in Q4; a contraction for the first time since 2001–02. Concurrently, domestic aggregate demand also moderated resulting from sharp deceleration in the growth of private consumption demand. In order to respond to the slowing demand, fiscal stimulus measures were undertaken by the government which included both tax cuts and increase in expenditure. This raised the fiscal deficit of the Central Government by 3.5 % of GDP in 2008–09. Consequently, the growth in government final consumption expenditure registered a sharp increase in Q3 and Q4 of 2008–09. For example, if we see the GDP growth rates in the Indian economy (Figure 1) the economy which was projected to grow at 9% fell to 6%. Even though 6% is better that what developed economies grew at in the recessionary period, it was simply not good enough for an emerging economy like India because of the smaller base at which we operate on. Even if we look at the Balance of Payments scenario (Figure 2) there was a significant deterioration in the situation in 2009.

Figure 1: India - GDP Growth rate

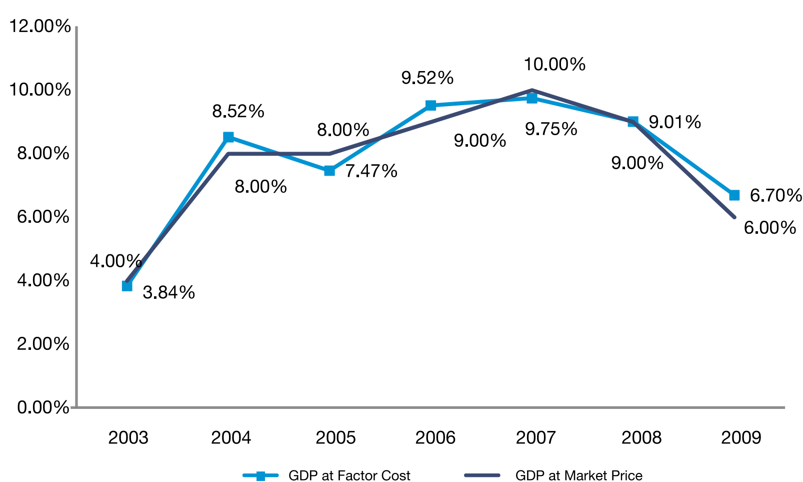
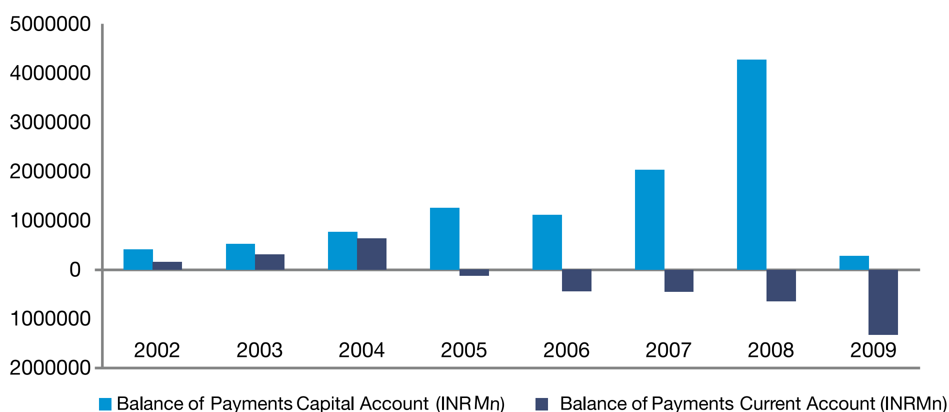


Figure 2: Indian BOP scenario



Key macro economic indicators – India

Indicators	2008–09: Q1–Q4				2009–10: Q1–Q2	
	Q1	Q2	Q3	Q4	Q1	Q2
Real GDP Growth (Y-o-Y) (%)	7.8	7.7	5.8	5.8	6.1	–
Industry	5.1	4.8	1.6	–0.5	4.2	–
Services	10.0	9.8	9.5	8.4	7.7	–
Inflation (Y-o-Y) (%)						
WPI	12.0	12.1	5.9	0.8	–1.1	–0.2
CPI-Industrial Workers	7.7	9.8	9.7	8.0	9.3	11.8
Money and Credit Growth						
(Y-o-Y) (%)						
Broad Money (M3)	21.5	19.5	19.9	18.6	20.2	19.7
Banks Credit	24.5	23.5	22.7	16.4	15.1	14.1
Interest Rates (%)						
Overnight (call) money	6.8	9.5	7.8	4.2	3.2	3.2
10-year g-sec	8.4	8.5	5.9	6.6	6.8	7.1
Foreign Trade						
Export Growth (%)	37.6	39.5	–15.0	–22.3	–30.0	–21.0
Import Growth (%)	31.6	60.5	2.1	–29.1	–35.0	–33.6
Balance of Payments						
(US $ billion)						
Trade Deficit (–)	–31.4	–38.7	–34.7	–14.6	–26.0	–
Current Account Deficit (–)	–9.0	–12.5	–13.0	4.7	–5.8	–
Net Capital Flows	11.1	7.6	–4.3	–5.3	6.7	–
Reserve Outstanding	312.1	286.3	256.0	252.0	265.1	281.3

Components of aggregate demand in India (%)

Item	2008–09				2009–10
	Q1	Q2	Q3	Q4	Q1
Growth rates (Year-on-Year)					
Private Final Consumption Expenditure	4.5	2.1	2.3	2.7	1.6
Government Final Consumption Expenditure	–0.2	2.2	56.6	21.5	10.2
Gross Fixed Capital Formation	9.2	12.5	5.1	6.4	4.2
Change in Stocks	6.0	5.6	1.4	–0.9	3.2
Exports	25.6	24.3	7.1	–0.8	–10.9
Less Imports	27.4	35.3	21.7	–5.7	–21.2
Relative shares					
Private Final Consumption Expenditure	58.0	55.5	57.4	51.4	55.6
Government Final Consumption Expenditure	9.6	8.3	12.5	13.4	9.9
Gross Fixed Capital Formation	32.2	34.5	30.9	31.6	31.6
Change in Stocks	3.2	3.2	2.9	2.9	3.1
Net Exports	–1.3	–10.5	–8.5	–2.9	1.6

Source: Central Statistical Organisation.

Reserve Bank policy

In the economic turmoil which hit the world, the Reserve Bank's policy response was aimed at containing the external problems, to keep the domestic money and credit markets functioning normally and to manage the liquidity stress

- To maintain a comfortable liquidity rupee position
- Augment foreign exchange liquidity
- To keep credit delivery on track

This was a change in policy as it marked a reversal of the Reserve Bank's policy stance from monetary tightening in response to heightened inflationary pressures of the previous period to monetary easing in response to easing inflationary pressures and moderation in growth in the current cycle. The policy included conventional and unconventional measures. On the conventional side, RBI reduced the policy interest rates aggressively and rapidly, reduced the quantum of bank reserves reserved by the central bank and expanded and liberalised the refinance facilities for export credit. Measures aimed at managing foreign exchange liquidity included an upward adjustment of the interest rate ceiling on the foreign currency deposits by non-resident Indians, substantially relaxing the external commercial borrowings (ECB) regime for corporate, and allowing non-banking financial companies and housing finance companies access to foreign borrowing.

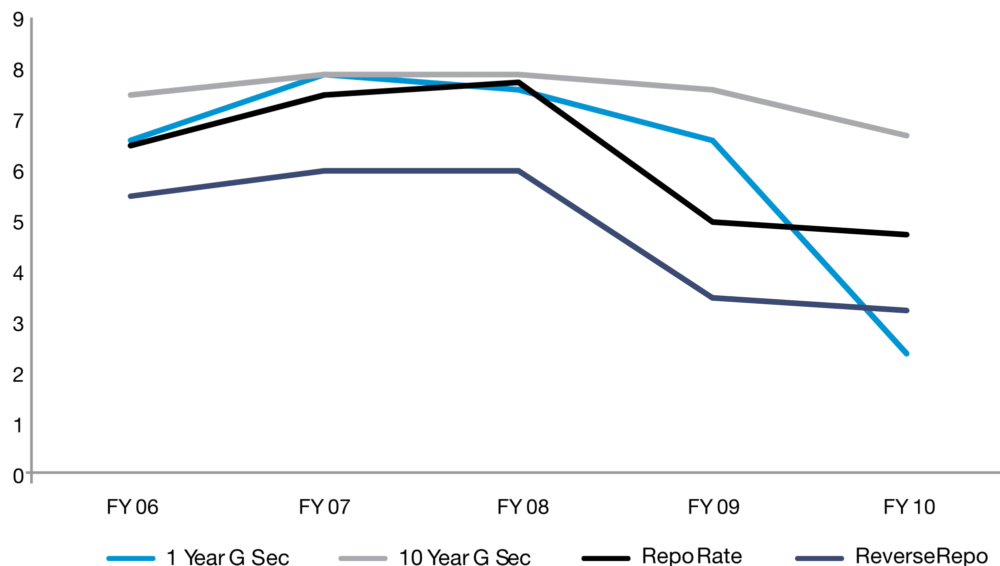
Government’s stimulus plan

The government’s fiscal stimulus packages, amounting to about 3 per cent of the GDP, included additional public spending, particularly capital expenditure, government guaranteed funds for infrastructure spending, cuts in indirect taxes, expanded guarantee cover for credit to micro and small enterprises, and additional support to exporters. These stimulus packages came on top of an already announced expanded safety-net for the rural poor, a farm loan waiver package.

The entire fiscal stimulus in India was aimed at addressing the deficiency in aggregate demand rather than extending support to the financial sector. While this meant a deviation from the planned fiscal consolidation path as committed under the Fiscal Responsibility and Budget Management (FRBM) Act, without the stimulus the deceleration in GDP growth during 2008–09 would have been much sharper.

The measures put in place since mid-September 2008 have ensured that the Indian financial markets continue to function in an orderly manner. The cumulative amount of primary liquidity potentially available to the financial system through these measures is over USD 75 billion or 7 % of GDP. This sizeable easing has ensured a comfortable liquidity position starting mid November 2008 as evidenced by a number of indicators including the weighted average call money rate, the overnight money market rate and the yield on the 10 year benchmark government security. Taking the signal from the policy rate cut, many of the big banks have also reduced their benchmark prime lending rates.

Figure 3: Interest rates year end (%) * average from April to November



In the current scenario, India clocked a higher than expected GDP growth rate of 7.9% in the second quarter of 2009-10, and the economy is forecasted to grow at 6% plus in this fiscal.

The rebound was suitably aided by the monetary stimulus, where the central bank has cut the key policy rates by a cumulative 4.25%, apart from other measures. It was also attributed to various reasons including India's high domestic savings rate, the large domestic market and India Inc.'s cautious response to the liquidity crisis, i.e. judicious use of key resources like cash and management bandwidth with appropriate focus on cost rationalisation. This has obviously not gone unnoticed with the global investors, and as soon as the global markets started rallying earlier this year, strong FII inflows returned to the Indian markets. Initial Public Offers (IPO's) too are back in favour after a wash out for most of 2008 and the first quarter of 2009.

Figure 4 : Net FII investment position in India

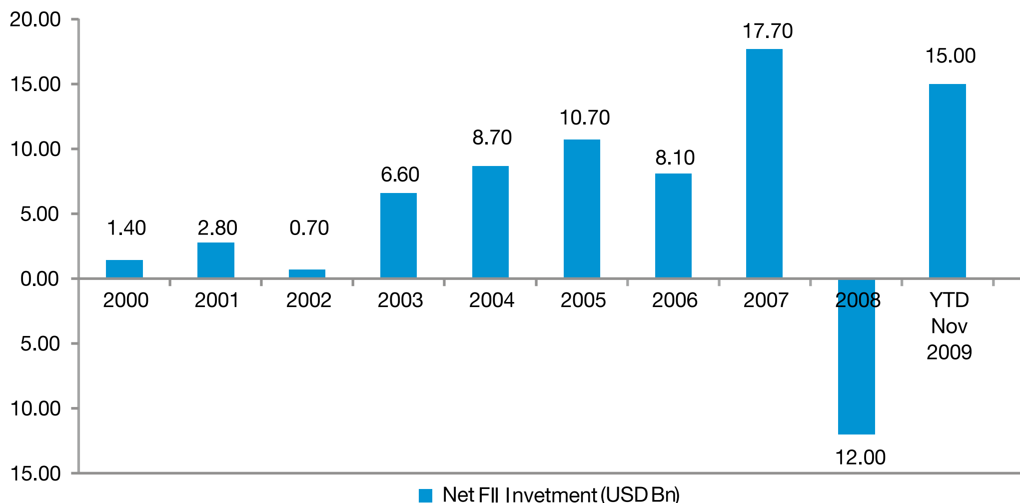
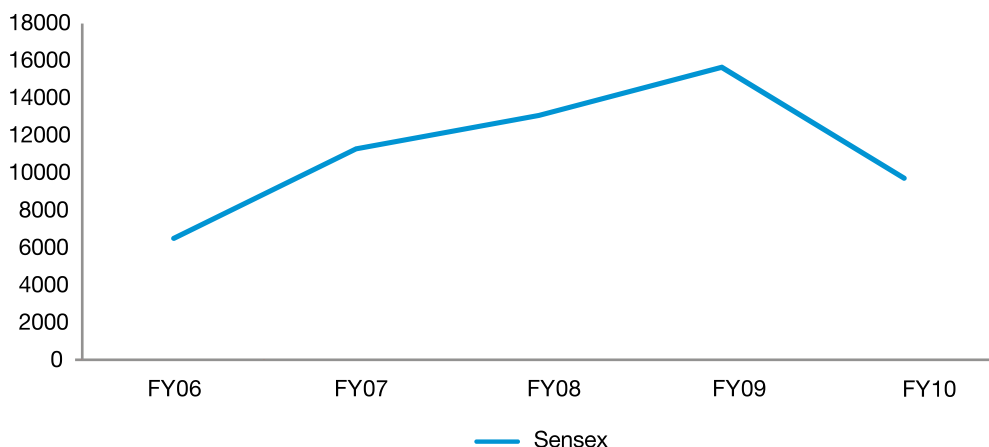


Figure 5 : Equity market scenario: Sensex as on 30 November, 2009



The index of industrial production recorded a 10.4% in August 2009 year-on-year gain over its value in August 2008, as compared to a 6.8% year-on-year gain in July. The services segment has also shown over 8% growth vis-à-vis the previous quarter, and there is similar good news in the construction and mining segments. The government's stimulus package also helped raise sentiments and in spite of a not too great monsoon year, the Indian economy seems set to record one of the higher growth rates internationally.

Capital account convertibility: Is India ready

Capital account convertibility (CAC) is a monetary policy that centres around the ability to conduct transactions of local financial assets into foreign financial assets freely and at market determined exchange rates.

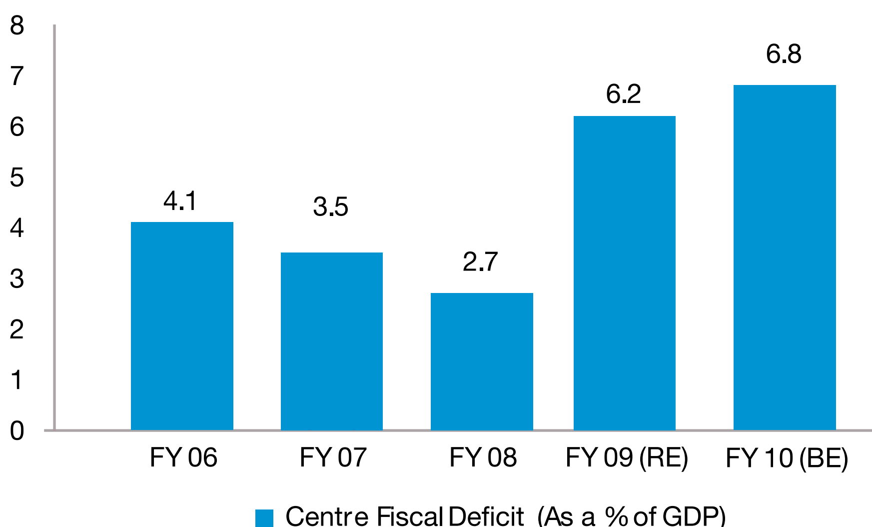
CAC as a theory was coined by the Tarapore Committee in 1997, in an effort to find fiscal and economic policies that would enable developing third world countries' transition to globalised market economies.

India currently has current account convertibility, i.e. foreign exchange is easily available for import and export of goods and services. India also has partial capital account convertibility i.e. an Indian individual or institution can invest in foreign assets up to USD 25,000 and there are some caps on the foreign direct investment in India.

The First Tarapore Committee was set up by the RBI in 1997 to study the implications of executing FCAC in India. It recommended that the before CAC is implemented, the fiscal deficit needs to be reduced to 3.5% of the GDP, inflation rates need to be controlled between 3-5%, the non-performing assets (NPAs) need to be brought down to 5%, Cash Reserve Ratio (CRR) needs to be reduced to 3%, and a monetary exchange rate band of plus- minus 5% should be instituted. However, most of the pre-conditions weren't entirely fulfilled and the idea lost steam in view of the Asian Crisis as well.

Over a period of time, with the improvement in India's economic fundamentals and the importance of a flat world and financial liberalisation policies, the implementation of CAC has again become a debatable issue. However there are major risks which have to be factored in. Going back to the Tarapore Committee, the CRR currently stands at 5%, Inflation is expected to hit 6.5% to 7% by March 2010 and FY 09 fiscal deficit as a % of GDP is expected to be around 6.2% (Figure 6).

Figure 6 : Centre Fiscal Deficit as a % of GDP



There are benefits to fuller capital account convertibility for financial institutions, including increased diversification, greater access to capital, and a broader range of risk management tools. However, policymakers, financial institutions, and their clients typically face additional challenges with fuller capital account convertibility. At about USD 104 billion, total foreign bank claims on India are comparable to those on China and Russia. In contrast, Indian banks' claims on other countries are four times less than this total. With fuller capital account convertibility, new risks will arise as cross-border transactions increase. Such activities will not only involve different currencies and span many countries but also include on-balance sheet lending and funding, as well as off-balance sheet derivatives and other complex financial transactions.

Risks on the road to implementation of fuller capital account convertibility (FCAC)

Market risks such as interest rates and foreign exchange risks become more complex as financial institutions and corporate gain access to new securities and markets, and foreign participation changes the dynamics of domestic markets. For instance, changes in foreign interest rates will affect the interest sensitive assets and liabilities of banks. Foreign participation can also be a channel through which volatility can spill-over from foreign to domestic markets.

Credit risk will include new dimensions with cross-border transactions. For instance, transfer risk will arise when the currency of obligation becomes unavailable to borrowers. Settlement risk (or Herstatt risk) is typical in foreign exchange operations because several hours can elapse between payments in different currencies due to time zone differences. Cross-border transactions also introduce domestic market participants to country risk (the risk associated with the economic, social, and political environment of the borrower's country, including sovereign risk).

With FCAC, liquidity risk will include the risk from positions in foreign currency denominated assets and liabilities. Potentially large and uneven flows of funds, in different currencies, will expose the banks to greater fluctuations in their liquidity position and complicate their asset-liability management as banks can find it difficult to fund an increase in assets or accommodate a decrease in liabilities at a reasonable price and in a timely manner.

Risk in derivatives transactions becomes more important with capital account convertibility as such instruments are the main tool for hedging. Risks in derivatives transactions include both market and credit risks. For instance, OTC derivatives transactions include counterparty credit risk. In particular, counterparties that have liability positions in OTC derivatives may not be able to meet their obligations, and collateral may not be sufficient to cover that risk. Collecting and analysing information on all these risks will become more challenging with FCAC because the number of foreign counterparts will increase and their nature too will change.

Operational risk may increase with FCAC. For instance, legal risks stemming from the difference between domestic and foreign legal rights and obligations and their enforcements becomes important with fuller capital account convertibility. Differences in bankruptcy codes can complicate the assessment of recovery values. Similarly, differences in the legal treatment of secured transactions for repos can lead to unanticipated losses in the current scenario where not only is there instability in the international arena, but India's domestic economy too is going through ups and downs.

Capital account convertibility can actually destabilise the economy through massive capital flight from a country. Not only are there dangerous consequences associated with capital outflow, excessive capital inflow can cause currency appreciation and worsening of the Balance of Trade. Furthermore, there are overseas credit risks and fears of speculation. In addition, it is believed that CAC increases short term Foreign Institutional Investment more than long term Foreign Direct Investment, thus leading to volatility in the system.

The rising prices and the appreciation of the rupee are adversely affecting India's exports and the Balance of Trade. Moreover, the fiscal deficit has been highly underestimated by ignoring the deficits of individual states and through issuance of oil bonds to the public sector oil companies, making severe losses due to the heavy subsidies on oil.

As recognised in the recent Tarapore Committee Report, the ability of financial institutions to identify, measure, and manage risk will also depend on the availability of instruments to manage risk, the liquidity of financial markets and the quality of market infrastructure, and level of market discipline. However, key segments of the Indian capital markets remain underdeveloped. The term money market is limited and although there is a domestic yield curve for government securities with maturities up to 30 years, its depth and liquidity are limited. The corporate bond market is relatively small and illiquid, and the market for securitised assets has fallen short of expectations. The OTC derivatives market is growing rapidly but its prudential and regulatory framework has just been laid out.

India would need to work on sustaining its economic fundamentals over a period of time with a strong banking system before going ahead with the implementation of Capital Account Convertibility.

Concerns on innovative financial products

The global financial crisis across the world pointed out many realities which global investors, regulators and countries chose to ignore over a period of time. India's financial markets were impacted significantly by the crisis. Worldwide, major global financial institutions had to be rescued by fire sales, the financial landscape changed significantly with the collapse of Lehman Brothers. In fact the famous investor Warren Buffet labelled these products as weapons of mass destruction (WMD).

Regulators and market participants have been warning for years about the dangers of the unchecked growth of the credit default swap market and about the difficulty of assessing who could be at risk for derivative market failures.

Globally, the market saw failures to the extent of government takeover of US mortgage giants Fannie Mae and Freddie Mac, the collapse of Icelandic bank Lands banki and, most notably, the bankruptcy of Lehman Brothers and Bear Stearns. AIG was pushed to the brink of bankruptcy last fall when a credit downgrade allowed swap counterparties to demand billions of dollars of collateral AIG didn't have. Policymakers however, chose to rescue AIG.

India too has a INR 60,000 crore loan securitisation market, in which mutual funds (MFs) have emerged as the biggest investors over the past 5 years. Thirty six odd mutual funds are estimated to have an exposure of INR 42,000 crore to all securitised products which is 8-10 per cent of the assets under management of the industry. But if you look at the share of securitised product in debt schemes, the exposure represents 25-30 per cent. Asset Backed Securities (ABS) are totally illiquid; unlike the global markets, there is no secondary market for these securities. In India, delinquencies in retail portfolios of banks have still not reached panic levels. Nonetheless, they are inching up slowly but surely. Add that to the sudden drying up of liquidity and the domestic mutual fund industry emerges as India's weakest link in the securitisation food chain. The bigger fear is that this exposure could have a cascading effect on the entire banking sector, with the risk getting transferred to many of the parent companies of these MFs. The dominance of mutual funds in securitisation coincided with private sector banks slipping into overdrive to hawk retail loans.

Dangers with securitised products

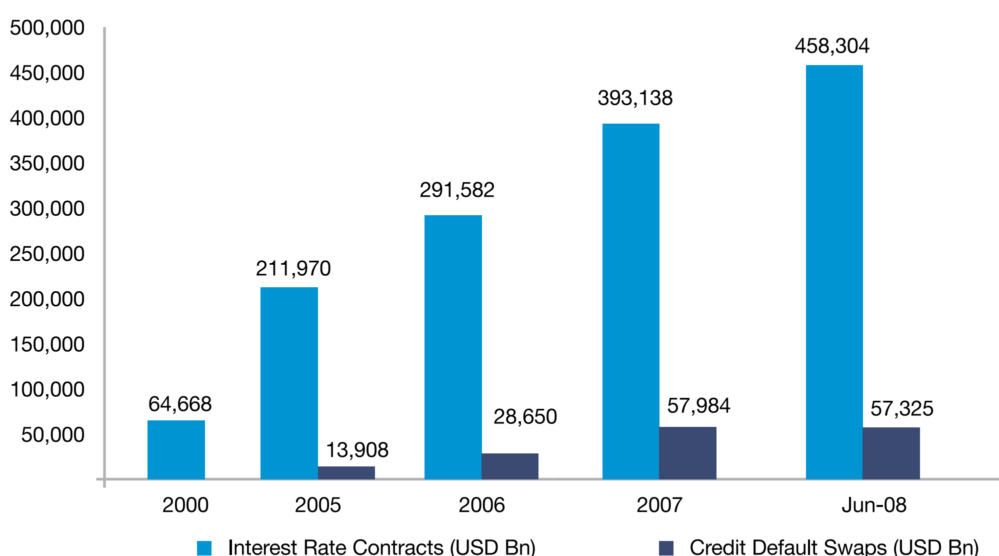
- High-risk, high-return products originated by private sector banks, Non-banking Financial Companies (NBFC's) and companies; the mutual funds that pick them up have no control over their credit quality
- Highly illiquid with no secondary market; Mutual funds have no option but to hold the ABS or Mortgage Backed Securities (MBS) till maturity
- Not very transparent products; disclosures are on a monthly basis to rating agencies (in contrast to corporate debentures or bonds, in which information is always available about the company on a stock exchange on a daily basis).Globally, despite agencies rating them highly, a sudden chain of defaults in the underlying assets (mortgages) brought down the big institutions.
- ABS or MBS exposure can lead to asset-liability mismatches if there are heavy redemptions in a scheme with very large exposures to such products

Innovative financial products have played a key role in the development of the current financial crisis, and have also compounded the difficulty of resolving it. This is because the difficulty of valuing such products has, in many cases, caused markets for them to cease functioning. This has led to great uncertainty regarding the financial position of institutions holding these products, which has, in turn, frozen the process of trying to separate "good assets" from "bad assets," an important step in restoring the normal functioning of credit markets.

Categories of innovative products

Derivative products, i.e., products whose value is a function of the value of other underlying financial products such as stocks, bonds, or loans, are a key category of innovative products. The overall over-the-counter market for derivative products has expanded dramatically over the past decade, rising from USD 90 trillion in 1998 to nearly USD 700 trillion by June of last year (in notional amounts) (Bank for International Settlements 2008). Major types of derivative instruments include those related to foreign exchange.

Figure 7 : Notional amount outstanding of over the counter derivatives



Among derivatives, credit default swaps (CDS) have been the greatest source of systemic risk. A credit default swap is a financial contract in which the protection buyer (risk shedder) pays a fixed periodic fee in return for a contingent payment by the protection seller (risk taker). The contingent payment is triggered by a credit event of the entity that the contract refers to. Credit events, which are specified in CDS contracts, may include bankruptcy, default, or restructuring. On a gross notional basis, CDS grew from negligible amounts in 1998 to USD 58 trillion by December 2007 (about 10% of the total), although they fell substantially last year to USD 32 trillion (The Depository Trust and Clearing Corporation 2009). The gross notional value is the total value of potential payouts specified in the contract

Asset Backed Securities: The main source of instability and uncertainty for financial markets has been the valuation of ABS, especially mortgage backed securities. Traditional ABS is backed by the credit obligations of individuals, such as residential mortgage loans, auto loans, and credit card balances. Collateralised Debt Obligations (CDO's) are similar in structure, but typically are backed by investment-grade corporate loans and/or bonds. These include collateralised loan obligations, which are based on loans, and collateralised bond obligations, which are based on bonds. The bulk of securitised assets were originated in the US (about USD 9.6 trillion out of a total of USD 12 trillion at the end of 2008). Agency MBS, i.e., those originated by Freddie Mac, Fannie Mae, and Ginnie Mae, made up just over half of that total (USD 5.0 trillion). Assets originating in Europe totaled USD 2.4 trillion, the bulk of which were residential mortgage backed securities.

The main victim of CDS during the crisis was the insurer American International Group (AIG), which suffered total losses of USD 99 billion in 2008 and had to be effectively nationalised by the US government. AIG's decline was triggered by losses on its portfolio of mortgage-backed securities held by its financial products subsidiary, which resulted in a reduction of AIG's capital reserves. This decline in capital reserves, in turn, led Standard & Poor's and Moody's Investors Service to downgrade AIG from an AAA to an A rating. These downgrades then triggered collateralisation requirements under AIG's CDS contracts, which were estimated to total USD 450 billion. The amount of collateral that AIG had to produce was about USD 100 billion, which it simply did not have. In other words, AIG's whole model was based on the company preserving its AAA rating.

These products led to the worsening of the crisis as the markets for various kinds of asset-backed securities products froze up due to the difficulty of valuing such products. The lack of a functioning market for these assets resulted in the market uncertainty about the financial position of many financial institutions, and complicated attempts to aid those institutions. This undermined the banks' originate- to-distribute model, which has made it much more difficult for them to increase lending, as it means they have been unable to move existing loans off their balance sheets. For example, mutual funds stopped buying CDOs after some money-market fund values dropped below par due to losses incurred on those CDOs. The direct impact on financial institutions in Asia of the losses arising from asset-backed securities was limited due to their relatively small holdings of these assets. US and European bank losses arising from holdings of such assets amounted to about USD 910 billion as of June 2009 (Reuters 2009). Accounting for losses from other financial institutions, the total is likely to have reached about USD 1.1 trillion. However, losses by Asian institutions due to such holdings were much smaller, accounting for only about 3% of this total. Nevertheless, the magnitude of the losses has been significant for some institutions, primarily Japanese banks. Most of the impacts on Asia have been indirect, arising either from a liquidity crunch due to a shortage of US dollars in specific countries, or from the deterioration in economic conditions arising from the sharp decline in export demand across the region.

Hedge funds

Hedge funds typically invest in a broad range of investments, including equities, debt, and commodities; invest in many international markets; and make both long and short investments. They also generally adopt various sophisticated investment strategies using structured products. Hedge funds typically have absolute-return investment targets and fee structures highly geared to those returns, and, most relevantly for financial stability issues, employ leverage to enhance those returns.

Available data on hedge fund assets show that they rapidly rose from about USD 324 billion in 1999 to USD 2.2 trillion in 2007, an annual average growth rate of 23%. In 2008, the total number of hedge funds fell 9% to about 10,000 (International Financial Services London 2009). The level of assets, however, collapsed to only USD 1.5 trillion by the end of 2008, reflecting declines in both market value and redemptions. Moreover, the level could have been even lower, as some hedge funds adopted "lock-up" provisions that temporarily prevented redemptions by their investors.

Perhaps the most counterintuitive finding about hedge funds is that their overall average leverage ratio is not very high, hitting a near-term high of about 190% in 2007, and falling to about 120% in 2008 (McGuire and Tsatsaronis 2008). In contrast, regulated commercial and investment banking institutions had, in some cases, far higher leverage ratios of about 20 times or more. These included Citigroup (19.2 times), Goldman Sachs (28 times) and Morgan Stanley (33 times) (Wall Street Journal 2008).

Prior to the current global financial crisis, concerns about systemic risk arising from highly leveraged investors centered on two categories—direct losses of core institutions on counterparty exposures to such investors, and indirect losses on banks' trading positions caused by forced liquidation of hedge funds. In fact, hedge funds were not a major contributing factor to the start of the current crisis. Of greater significance were the direct losses experienced by the internal funds of investment banks and the warehoused assets of banks. Indirect losses attributable to hedge funds started to become an important issue in 2008, when hedge funds became large-scale forced sellers to meet redemption demands by investors in response to the overall decline in financial markets. Thus, the current crisis differs from that of the Long Term Capital Management (LTCM) crisis of 1998, when both direct and indirect losses arising from LTCM's failure were seen as having systemic risk implications. This suggests that regulation of hedge funds and private equity funds is not an urgent issue, although issues of monitoring and regulation need to be considered carefully.

05 The Indian debt market

In many countries, debt market (both sovereign and corporate) is larger than equity markets. In fact, in matured economies, the debt market is three times the size of the equity market. However, in India like in emerging economies, the equity market has been more active, developed and has been the centre of attention be it in media or otherwise. Nevertheless, the Indian debt market has transformed itself into a much more vibrant trading field for debt instruments from the elementary market about a decade ago. Further, the corporate debt market in developed economies like US is almost 20% of their total debt market. In contrast, the corporate bond market (i.e. private corporate sector raising debt through public issuance in capital market), is only an insignificant part of the Indian debt market. Amongst the most important reforms is the development and deepening of the non-public debt capital market (DCM), where growth has been lack lustre in contrast to a soaring equity market.

The stock of listed non-public-sector debt in India is currently estimated at about USD 21 billion, or about 2% of GDP, just a fraction of the public-sector debt outstanding (around 35% of GDP), or the equity market capitalisation (now close to 100% of GDP). To strengthen the Indian financial systems it is now pertinent to develop the environment for corporate debt market in India.

The limitations of public finances as well as the systemic risk awareness of the banking systems in developing countries have led to a growing interest in developing bond markets. It is believed that well run and liquid corporate bond markets can play a critical role in supporting economic development in developing countries, both at the macroeconomic and microeconomic levels. Though the corporate debt market in India has been in existence since the Independence in 1947, it was only after 1985-86, following some debt market reforms that the state owned public enterprises (PSUs) began issuing PSU bonds. However, in the absence of a well functioning secondary market, such debt instruments remained highly illiquid and unpopular among the investing population at large.

Recent developments in the corporate debt market in India

In the recent past, the corporate debt market has seen a high growth of innovative asset-backed securities. The servicing of debt and related obligations for such instruments is backed by some sort of financial assets and/or credit support from a third party. Over the years greater innovation has been witnessed in the corporate bond issuances, like floating rate instruments, zero coupon bonds, convertible bonds, callable (put-able) bonds and step-redemption bonds.

These innovative issues have provided a gamut of securities that caters to a wider segment of investors in terms of maintaining a desirable risk-return balance. Over the last five years, corporate issuers have shown a distinct preference for private placements over public issues. This has further cramped the liquidity in the market. The dominance of private placement in total issuances is attributable to a number of factors.

- Lengthy issuance procedure for public issues, in particular, the information disclosure requirements
- Costs of a public issue are considerably higher than those for a private placement
- The quantum of money raised through private placements is typically larger than those that can be garnered through a public issue. Also, a corporate can expect to raise debt from the market at finer rates than the prime-lending rate of banks and financial institutions only with an AAA rated paper. This limits the number of entities that would find it profitable to enter the market directly.

Importance of the development of the corporate debt market

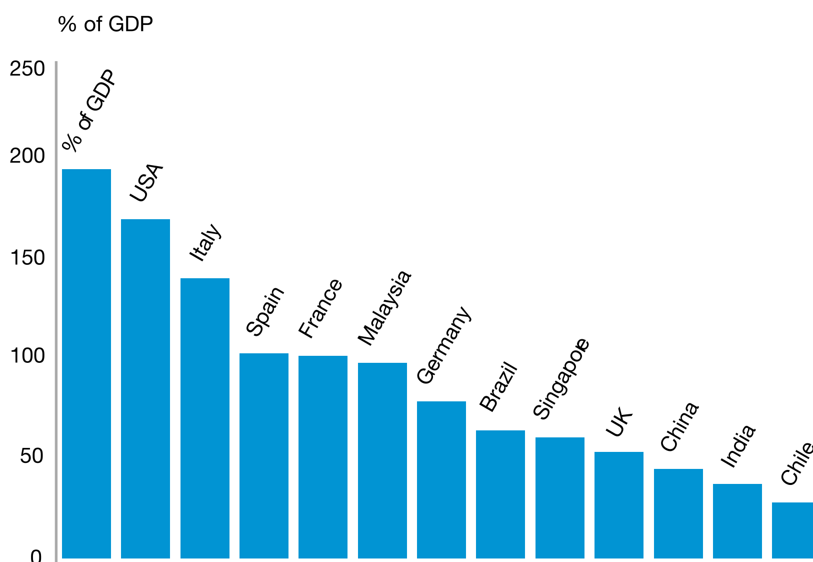
The economic advantages of having a viable private DCM can be grouped into three broad categories.

Diversification: It gives providers of capital access to a broader set of diversification opportunities. In India today, household wealth is parked in bank deposits, real estate and gold, with very limited stock ownership. More active insurance and pension markets, for example, would allow families to spread investment risks more broadly. In turn, these institutional investors would contribute to enhancing credit price disclosure as they allocate resources into interest-bearing securities.

Efficiency in managing cost of capital: Access to a functioning DCM, and the multiple financing options that come with it, endows borrowers with greater efficiency in managing the cost of capital. Historical and cross-sectional experience teaches that problems in the banking sector can interrupt the flow of funds from savers to investors for a dangerously long period of time. Indeed, one of the lessons from the 1997 Asian financial crisis has been the importance of having non-bank funding channels open. In the wake of this crisis, a number of countries in the region, including Korea, Malaysia, Singapore and Hong Kong, have made progress in building their own corporate debt markets.

Financial stability: On-the-ground estimates indicate that the total stock of non-equity claims on India's corporate sector could be somewhere in the region of 10% of GDP. With listed securities worth just USD 21 billion, this means that roughly 80% of the market is in the form of private placements. These liabilities are negotiated and priced on the principles of relationship lending, issued with virtually no public disclosure, and are typically held to maturity by banks. This brings us to a third set of reasons why developing a debt capital market is in India's interest. The current system of financing has already, and will increasingly, become less adequate for an economy as large and as ambitious as India's. Spreading credit risk from banks balance sheets more broadly through the financial system would lower the risks to financial stability. And a deeper, more responsive interest rate market would allow the central bank greater degrees of freedom in the conduct of monetary policy. This will be particularly important as India gradually opens up its capital markets to the rest of the world.

Figure 8: India's DCM is small by international comparison



Source: BIS, Goldman Sachs, Data as of December 2006

Indeed, one of the lessons from the 1997 Asian financial crisis has been the importance of having non-bank funding channels open. One of the causes of the Asian financial crisis was over-dependence of the Asian corporations on short-term foreign funds and mismatch of currencies. Before the crisis, Asian banks were dependent on short-term foreign currency funds (similar to external commercial borrowings in India) and corporations were dependent on short-term funds from such banks. Such dependence on short-term foreign currency funds was the reason for the rapid outflow of capital from Asian countries as soon as confidence in these countries started to fade. If bond markets had been more developed in Asia and if domestic bond markets denominated in their own currencies, had worked efficiently, the impact of the crisis would have been softened or entirely prevented. The development of local currency bond markets has been seen as a way to avoid crisis, with these markets helping to reduce potential currency and maturity mismatches in the financial system. The Tarapore Committee also recommends the development of an active debt market as a prerequisite for capital account convertibility.

Apart from its fundamental role of achieving allocative efficiency, a well-developed government bond market strengthens the monetary policy implementation framework by equipping a central bank with market-based indirect instruments.

Further, a vibrant corporate debt market would allow corporates to get a standardised rate and fees instead of individually negotiating these with a syndicate of banks for loan finance. But corporates don't have a choice of issuing significant amount of bonds in India. Sooner than later, banks may find that their entire appetite for lending is soaked up by top tier corporates.

Lastly, due to the lack of adequate infrastructure for bonds where they can sell/ securitise the loans, banks may find their ability to lend to smaller corporates impaired. Once large and well-run enterprises develop a preference for financing through bond markets, commercial banks will get the message and divert more of their resources to financing SME business.

The Indian Government itself estimates that the country needs to invest USD 475 billion in infrastructure over the next five years. The Ministry of Finance anticipates that 70% of this will come from the government and public sector units (PSUs), including public financial institutions, while multilateral agencies are expected to fund a further 10%. The government expects the private sector to raise about 20% of the total, or USD 95 billion, primarily through a public private partnership (PPP) model. This is where the corporate debt market comes into play, for infrastructure could be both the catalyst for growth of the DCM and one of its largest beneficiaries. The debt market makes a natural home for infrastructure financing, by matching long-term projects with long-term investors, drawing on institutional investors pricing expertise and improving transparency around projects and pricing. Moreover, infrastructure debt should find natural buyers in the pensions and insurance funds that are seeking long duration and implicit inflation links.

Focus on eliminating the short-comings and plugging the gaps

India's DCM development efforts can concentrate on two major areas:

Technical issues: Technical reforms can be undertaken fairly quickly and easily. Indian authorities have already made some progress in this area, with several additional announcements expected in the coming months.

Political issues: These would be more challenging issues that will rub up against political constraints. Progress in these areas will be slow, with the full slate unlikely to be completed for nearly a decade.

Political commitment will be essential, though admittedly difficult, in the current climate and it would help to have one regulatory agency step forward as the debt markets champion, working in consultation with industry participants.

If India can deepen and strengthen its debt capital market, the results could be significant. Drawing on the cross sectional experience of G7 countries since the 1970s, its estimated that the overall capitalisation of the Indian debt market (including public-sector debt) could grow nearly four-fold over the next decade. This would bring it from roughly USD 400 billion, or around 45% of GDP, in 2006, to USD 1.5 trillion, or about 55% of GDP, by 2016. The following issues should be kept in consideration to encourage the debt market in India

Cost of issuance: Cost of issuance in terms of rating, listing, disclosure and marketing requirements makes the public issue of bond expensive, making private placement a preferred alternative for most issuers. If the corporate bond market is to develop, a great deal of attention will have to be given to minimise the issuance cost and the time taken to make public issue. There is a need to rationalise and reduce the stamp duty.

Market making: Market making should be encouraged for promoting the corporate debt market. This requires incentivising large financial intermediaries like primary dealers to take up this job. One way is to encourage the investment bankers involved in the placement of the bonds.

Listing norms: For already listed entities, there listing norms could be simpler; they should be allowed an abridged version of disclosure. However, companies which are not listed and which are opting for the private placement mode should be subjected to stringent disclosure norms.

The practice of suspension of trading/delisting of securities in case of non-compliance with listing norms by an issuer needs to be replaced by heavy penalties on the promoters and directors of the erring company.

Developing a trade reporting system: A mechanism that captures all the information relating to trades in corporate bonds, disseminate the same and keeps a data base of trade history needs to be developed. Various regulators should direct the regulated entities to report all the transactions done by them to the trade reporting system.

Trading, clearing and settlement mechanism: A robust trading platform would go a long way in enabling efficient price discovery in corporate bonds and also help in creating depth and vibrancy to the market. An efficient clearing and settlement system would further the development of corporate bond markets by reducing the counter party risk and settlement risk. As the corporate bond market develops and expands, diversifying and expanding investor interest will need institutional measures for credit enhancement. We are fortunate in India to have built first-rate credit rating institutions.

Specialised debt funds for infrastructure financing: As recommended by the High Level Expert Committee on Corporate Bonds and Securitisation, there is a case for creation of specialised Debt Funds to cater to the needs of the infrastructure sector.

Developing a market for debt securitisation: Apart from reducing the stamp duty on debt assignments, pass through certificates and security receipts, the government should also endeavour to resolve the uncertainty in taxation issues pertaining to securitised paper.

Despite some recent successes, the reform effort in India's DCM has not yet reached critical mass. If the authorities can streamline the issuance process and make the public markets attractive to issuers; if they can strengthen the trading platform and settlement and clearing systems; and if they can follow through on plans to allow securitisation, then the resulting momentum should help to push through the harder and politicised reforms.

06 Corporate Governance structure

Corporate Governance has been a much debated issue in the western world. In India the Corporate Governance Code has been largely modeled on the lines of the Cadbury Committee (1992) in the United Kingdom. The gaining prominence of Corporate Governance in India has been primarily attributed to the three large scams, the Harshad Mehta scam, the Ketan Mehta scam and the more recent Satyam Computers Limited fraud involving Ramalinga Raju. There have been smaller incidents like the C.R. Bhansali case and the UTI scam, which have further augmented the cause for a strong governance framework.

The World Bank's corporate governance assessment for India has shown that over the last few years, a series of legal and regulatory reforms have transformed the governance framework and significantly improved the level of responsibility and accountability of insiders, board and transparency. A giant step towards the endeavour was the Kumarmangalam Birla Committee Report, which led to the inclusion of Clause 49 in the listing agreement, in the year 2000. The second committee on Corporate Governance was under the Chairmanship of N.R. Narayana Murthy, formed in late 2002. Based on the recommendations of the second committee, SEBI issued a circular in 2003 revising Clause 49 of the listing agreement. The recommendations of the Committee included revisions to the independence of the chairman and proportion of independent directors.

Clause 49 prescribed formation of an audit committee and a shareholder grievance committee with independent directors representing two-thirds of the membership of the audit committee, and with at least one committee member possessing an expert knowledge in the field of finance and audit. Clause 49 also enhanced the disclosure requirements, including disclosure of compensation to non-executive directors.

SEBI has introduced the concept of IPO grading, done by a credit rating agency registered with SEBI, for all primary market issuers, who file their draft Red Herring Prospectus, on or after 1 May, 2007. The grading is performed after due consideration to governance structure and financial strength.

The Ministry of Corporate Affairs (MCA) has issued two press releases on January 10, 2010 and January 22, 2010. The latter specifies the roadmap recommended by the Core Group set up by the MCA for Convergence of Indian Accounting Standards with IFRS. The highlights of the roadmap include:

- Two sets of accounting standards (existing Indian Accounting Standards and Indian accounting standards converged with International Financial Reporting Standards (IFRS)).
- Indian accounting standards converged with IFRS would apply to specified class of companies in three phases.
- Existing Accounting Standards to apply to other companies (including Small and Medium Companies).
- Roadmap for Banking and Insurance companies to be announced by 28 February, 2010.
- Draft Companies (Amendment) Bill will be prepared by February 2010.
- Convergence of Accounting Standards to be completed by ICAI by 31 March, 2010 and NACAS to submit its recommendations to the Ministry by 30 April, 2010.

The amendment to Clause 49 was supplemented by efforts made by the Department of Company Affairs (DCA) and the Ministry of Finance (MoF) in enhancing the governance structure. The steps included the formation of the Naresh Chandra Committee on Corporate Audit and Governance in 2002, and the Expert Committee on Corporate Law (J. J. Irani Committee) in late 2004. The clear mandate was to provide more powers to the independent directors and audit committees. The Naresh Chandra Committee proposed similar governance requirements like the Sarbanes Oxley Act, 2002 passed by the US Congress.

Auditor independence

The Naresh Chandra Committee Report incorporated in Clause 49 also regulates the independence of auditors' process. The trend has been that most large companies use international auditing firms to audit their IFRS or US GAAP set of financial statements. However, there are a sizable number of Indian business houses which engage local accounting firms to audit their financial statements. With the inclusion of IFRS in the Indian statutory reporting framework, the auditing profession is likely to undergo a significant unlearning and relearning process to meet the challenges of the high quality financial reporting norms.

07 Conclusion

The Indian capital market has undergone significant change in the last two decades. It has become efficient through use of modern day technology and proactive legislation. It has attracted significant global interest and has managed to establish confidence of both global and local investors. However, as the economy grows, so does its requirements. Change is a constant and therefore the Indian capital markets also need to continue to evolve to ensure that it meets the challenges of the current day. Corporate governance is a key focus area and capital markets needs to ensure introduction of swift legislative changes to ensure confidence in the market. As the global financial crisis begins to recede and normalcy returns in the market, India needs to set forth infrastructure to provide the necessary boost to the corporate debt market and introduce innovative financial products, while ensuring the best interests of the investors in mind.

Notes

About Assocham

The Knowledge Architect Of Corporate India

Evolution of Value Creator

ASSOCHAM initiated its endeavour of value creation for Indian industry in 1920. Having in its fold more than 300 Chambers and Trade Associations, and serving more than 3 lakh members from all over India. It has witnessed upswings as well as upheavals of Indian Economy, and contributed significantly by playing a catalytic role in shaping up the Trade, Commerce and Industrial environment of the country.

Vision

Empower Indian enterprise by inculcating knowledge that will be the catalyst of growth in the barrier less technology driven global market and help them upscale, align and emerge as formidable player in respective business segments.

Mission

As a representative organ of Corporate India, ASSOCHAM articulates the genuine, legitimate needs and interests of its members. Its mission is to impact the policy and legislative environment so as to foster balanced economic, industrial and social development. We believe education, IT, BT, Health, Corporate Social responsibility and environment to be the critical success factors.

Members - Our Strength

ASSOCHAM represents the interests of more than 3,00,000 direct and indirect members. Through its heterogeneous membership, ASSOCHAM combines the entrepreneurial spirit and business acumen of owners with management skills and expertise of professionals to set itself apart as a Chamber with a difference. Currently, ASSOCHAM has 100 National Committees covering the entire gamut of economic activity in India with pointed focus on Growth, Youth, Health and Earth and It has been especially acknowledged as a significant voice of Indian industry in the field of Information Technology, Biotechnology, Telecom, Banking & Finance, Company Law, Corporate Finance, Economic and International Affairs, Tourism, Civil Aviation, Corporate Governance, Infrastructure, Energy & Power, Education, Legal Reforms, Real Estate & Rural Development etc.

Insight into 'New Business Models'

ASSOCHAM has been a significant contributory factor in the emergence of new-age Indian Corporates, characterized by a new mindset and global ambition for dominating the international business. The Chamber has addressed itself to the key areas like India as Investment Destination, Achieving International Competitiveness, Promoting International Trade, Corporate Strategies for Enhancing Shareholders & Stakeholders Value, Government Policies in sustaining India's Development, Infrastructure Development for enhancing India's Competitiveness, Building Indian MNCs, Role of Financial Sector the Catalyst for India's Transformation.

ASSOCHAM derives its strengths from the following Promoter Chambers: Bombay Chamber of Commerce & Industry, Mumbai; Cochin Chamber of Commerce & Industry, Cochin; Indian Merchant's Chamber, Mumbai; The Madras Chamber of Commerce and Industry, Chennai; PHD Chamber of Commerce and Industry, New Delhi and has over 3 Lakh members.

Together, we can make a significant difference to the burden that our nation carries and bring in a bright, new tomorrow for our nation.

About PricewaterhouseCoopers

PricewaterhouseCoopers Pvt. Ltd. (www.pwc.com/india) provides industry - focused tax and advisory services to build public trust and enhance value for its clients and their stakeholders. PwC professionals work collaboratively using connected thinking to develop fresh perspectives and practical advice.

Complementing our depth of industry expertise and breadth of skills is our sound knowledge of the local business environment in India. PricewaterhouseCoopers is committed to working with our clients to deliver the solutions that help them take on the challenges of the ever-changing business environment.

PwC has offices in Ahmedabad, Bangalore, Bhubaneshwar, Chennai, Delhi NCR, Hyderabad, Kolkata, Mumbai and Pune.

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