

A Noble - City of London Whitepaper

Life after the Great

Escape

How India needs to use the global credit crisis as a platform for reform

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- * The global crisis and India's response
- * The low hanging fruits of financial sector reform
- * Quantifying the benefits of reform

* * * * *

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A Noble - City of London Whitepaper

Life after the Great Escape : how India needs to use the global credit crisis as a platform for reform

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City of London, Mumbai



A new collaboration and partnership

The City of London has established a City Office in Mumbai. The City Office in Mumbai has been organising an exclusive series of roundtables on the Indian financial services sector since October 2007.

These bimonthly roundtables bring together corporate leaders and regulators from the Indian financial services sector and it provides a platform to explore the key issues and challenges facing this growing market.

At the last roundtable on 'Role of Risk Management & Global Financial Crisis' in April 2009 in Mumbai, there was a consensus across the roundtable participants that India should steer clear of a

As follow up to the roundtable response, we have collaborated with the Noble Group to develop a Whitepaper on "Life after the Great Escape: how India needs to use the global crisis as a platform for reform".

The Whitepaper aims to cover the following themes:

- The global financial crisis and the Indian policy responses to it
- Reiterate the need for financial liberalisation in India
- Highlight the cost of opportunities that India will lose, if it does not take the right measures at the right time

Moreover, based on discussions with market practitioners and using data available from official and proprietary sources, we have quantified the benefits to India of allowing foreign debt capital to enter more easily.

SOURCES INCLUDE:

1. Interviews with the industry experts from across the Indian financial services sector
2. Noble's proprietary research material
3. Material gathered from the City of London Roundtable
4. Using external databases
5. Telephone interviews with Indian banks conducting overseas business

There was a belief that India has an excellent chance to profit from global experience and build its financial sector from hindsight

'Schadenfreude' attitude and instead should direct its efforts to avoid mistakes in the future.

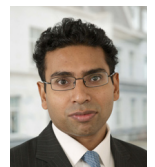
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METHODOLOGY

Using a mixture of primary and secondary sources (see below); we have identified a range of incremental reforms which, if implemented, can provide significant benefits to India.



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Executive Summary

India has warded off the worst effects of the financial crisis and achieved healthy growth of 6.7% in FY09. However, this is not, and should not be interpreted as, a case for reinforcing the *status quo*.

To return to the growth rates of two years ago, and indeed rise above them, India needs to implement meaningful reform.

Whilst the benefits of India's preference for restrictions on foreign capital flows generates a stability dividend which is evident in a crisis year such as FY09, the hidden cost that India pays for such capital restrictions, far outweighs the stability dividend. This is the thrust of not just this Whitepaper but also those of numerous reports commissioned by the Government over the past five years.

We find that Indian corporates borrow at a premium close to 200bps relative to their peers in other advanced and developing economies.

Opening up the Indian economy to foreign debt capital could reduce this premium and thereby boost corporate profits by 7% and GDP by 1.3%.

By easing restrictions on FIIs, India will not only increase FII debt inflows to \$13 bn p.a. (as opposed to the current figure of \$6bn p.a.), the country will also find that FIIs do not rush for the exits at the first sign of trouble.

Market practitioners highlight that there are at least five major "gaps" in the Indian financial landscape:

1. **Missing markets:** The lack of key market segments has been keenly felt by market participants. For example, malfunctioning of the corporate bond market severely affects loan pricing and availability of long term debt.
2. **Missing institutions:** Market depth has been affected by the regulatory restrictions placed on pension funds, insurance funds and foreign investors.
3. **Missing people:** Financial inclusion of the less privileged has emerged not only as a public policy goal on its own merit but also for its potential to contribute in creating deeper financial markets.
4. **Missing synergies:** A few areas where synergies have been elusive despite widespread recognition of the need to tap these synergies are the creation of 'universal banks' (institutions that offer a whole range of commercial and investment banking services under one roof) and improved regulatory co-ordination across various governmental and regulatory bodies.
5. **Missing governance:** Increased free float on the stock market through disinvestment of public sector companies will improve market oversight of public sector entities. Stricter deadlines within which listed entities have to publish their Annual Reports, more frequent publication of corporate Balance Sheets and a nationwide credit bureau are

some other governance gaps in the financial sector.

Where practitioners diverge is in their views on where India goes from here. We see three types of responses:

✓ **"We were right"**

this group feels vindicated and believes that India has followed the correct path in not integrating with the global financial system too quickly. Around **40%** of the practitioners we met fall in to this camp.

✓ **"Let's wait and watch"**

this group wants reform to continue but feels that the global financial sector is so destabilized that it is impossible for India to reform until the dust settles. **50%** of the practitioners we met hold this view.

✓ **"Let us forge ahead"**

this camp views the crisis as an opportunity for India to move forward and strengthen its financial sector. Only **10%** of practitioners seem to belong to this camp.

As highlighted above, we find the hidden costs to India of not reforming to be high. Hence we place ourselves in the "let's forge ahead" camp and highlight a range of incremental reforms which can deliver significant benefits.

THREE KEY AREAS TO FOCUS ON FOR FINANCIAL SECTOR REFORM

Restrictions on the movement of capital

At a time when Indian small and mid-sized companies are finding it difficult to access credit domestically,

we have restrictions in place on FII's entering the Indian debt market. Moreover, to complete the debt suffocation, the External Commercial Borrowings (ECB) route imposes a range of restrictions on Indian corporates seeking to borrow abroad.

A decision on moving to stage two of the RBI's Banking Roadmap, which would reform the banking sector (including providing greater access for foreign banks) seems another casualty of the credit crisis. Most market practitioners we met accepted the logic of "reciprocity", i.e., allowing more liberal entry to banks from countries where Indian banks have found easier entry.

We believe that the reciprocity argument is increasingly irrelevant in a globalised marketplace and a resignation to competitive protectionism would not serve India's interests.

Simpler but more effective governance is required

India ranks poorly on global governance indicators. This adds to the risk premia that India pays for capital. Creating stronger boards (with effective independent directors) and increasing the free float of public sector companies (through disinvestment) will help enhance the value of the public sector and improve stockmarket liquidity (an area where India lags other large markets).

Alongside auditors and regulators, independent directors are the third pillar that a capital market uses to safeguard investors. In India, however, promoters tend to exert enormous leverage on independent directors. We need a regime where

promoters are prohibited from interfering in the recruitment and tenure decisions of independent directors.

There is a need to encourage the concept of CEO and Board chair separation. Encouraging whistleblowing by enacting a law and ensuring a cult of risk governance would be the other important components of strengthening governance.

The Indian market makes it easy for Annual Reports to be published many months after the year ends. Since quarterly reports are unaudited, do not contain a cash flow statement and a balance sheet, and do not provide consolidated numbers, the Annual Report is keenly awaited as it is the only document that gives a full picture of a company's health.

We need the law to make it mandatory for Annual Reports to be published within four months of the year end (as is the case in other large markets).

Financial deepening

India's record in terms of financial inclusion is modest at best. Our claims of being less impacted by the global financial crisis seem to be offset by the fact that the vast majority of Indians have no involvement in the financial system, despite the priority sector lending obligations of public sector banks.

The drive for financial inclusion is presently focused on the liability side (deposit mobilization) and should in time accord a greater degree of stability to bank's funding sources. Indeed many Indian banks have made notable progress in advancing

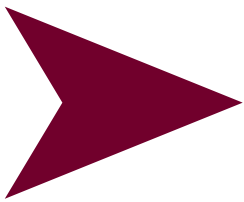
financial inclusion through use of technology and improvement in agency delivery mechanism. Further penetration of financial services, would need innovation on product design (e.g., microfinance) and delivery (e.g., use of mobile phones).

SUMMARY OF THE 'LOW HANGING FRUITS' OF FINANCIAL SECTOR REFORM

- India needs freer access to foreign debt capital and in particular needs to remove the existing restrictions on ECBs.
- Foreign participation in the debt market needs to be encouraged. Scrapping the withholding tax on bonds would help in this regard.
- India needs to revisit the logic of "reciprocity" used to block foreign banks from entering India.
- Increasing the free float of public sector units will not only increase liquidity, it will also provide more effective market oversight of public sector firms.
- We need:
 - a) tighter deadlines within which corporates have to publish their Annual Reports;
 - b) more frequent publication of consolidated results.
- We need to encourage the separation of the roles of the CEO and the Board chair and implement a Whistleblowing Act.
- The imperative of financial inclusion needs reemphasis post crisis not only on its own merit but also because it can help create deeper financial markets.

The global crisis and India's response

The crisis as it affected India



India went through the full range of responses to the financial crisis – **shock, denial, anger, despair, acceptance** and **resolution**.

As events unfolded last year, beginning with the failure of Bear Stearns (March 2008) through the events in September 2008 including collapse of Lehman Brothers, sale of Merrill Lynch to Bank of America, the switch to the 'bank holding company model by Goldman Sachs and Morgan Stanley, the takeover of Wachovia by CitiGroup - India like

the world went through the phase of **shock** and angst as once admired financial powerhouses were mortally wounded.

Like many countries of the world, India too wished that the financial tsunami would not hit its shores at all. The strong growth performance in the first half of CY08, generated an illusion of India weathering the crisis very well. This was exemplified by the flourishing of the decoupling theory that had a wide following (see Table 1).

Table 1 India decoupled?

Quote	Date
"Our findings indicate that the impact of the North on the Emerging South countries has been declining over the past two decades implying that there is some partial support for the decoupling of business cycles of this group from the advanced countries in the North." <i>Akan C. and Kose, IMF Staff Papers</i>	Dec 07
"I urge to investors not to allow the worries of the western world to overwhelm them. The "fundamentals" of the Indian economy are strong." <i>P Chidambaram – National TV, (Source: Factiva)</i>	Jan 08
"India was better placed than China to withstand the worst effects of any economic downturn. The reason is that growth in India is driven by domestic consumption, so there is that larger decoupling issue that needs to be taken into account." <i>Kamal Nath, WEF Davos (Source: Factiva)</i>	Jan 08
"Recent data suggest decoupling is no myth. Indeed, it may yet save the world economy." <i>Article in The Economist,</i>	Mar 08
"The Indian banking system has the rule of <i>dharma</i> , which has taught the sector not to have greed." <i>Mr Ananthakrishna, Chairman and CEO of Karnataka Bank Ltd (Source: Business Line)</i>	Feb 09
"Compared to America, the Indian banking system is in a better position and more stable" <i>Douglas J. Young, Prof. Montana State UniversityUSA (Source: BusinessStandard)</i>	Jun 09

The surge in volatility in money markets in the wake of Lehman Brothers' collapse, the drying up of the external funding for Indian corporates, the sudden downward turn of macroeconomic indicators and the rapid deterioration of the investment climate all led to sharp criticism of the decoupling theory in September-October 2008 (see tables 2 to 4).

Table 2: How the liquidity crisis moved from the West to India

DATE 2008	TED Spread %	Call Money Rate in India %
8 Sept (Mon)	1.13	8.83
9 Sept	1.19	8.30
10 Sept	1.20	8.94
11 Sept	1.24	8.88
12 Sept	1.36	6.15
15 Sept (Mon)	1.79	9.84
16 Sept	2.04	10.59
17 Sept	3.03	13.07

Source: Patnaik, Aziz, Shah, Oct 20 2008

The Indian banking system had no direct exposure to sub-prime mortgage assets or to the failed institutions. It had very limited off-balance sheet activities or securitized assets. Despite that the prospects of economic growth falling off a cliff loomed large for India.

As India came to terms with how much it was integrated with the rest of the world, in spite of a formative financial system with limited external reach, "anger" kicked in and external factors were held responsible for the domestic situation.

This was followed by a period of gloom with 5-6 consecutive months of decline in exports, and industrial production accompanied by agricultural decline, a slowdown in quarterly GDP growth and reports of job losses.

As industrialists and investors gradually accepted the fact that India too was a victim of the global financial crisis, **despair** reigned in the months on either side of Christmas 2008.

As foreign investors pulled money out of the stock market, the Sensex fell by 52% between Jan 08 and Jan 09.

Table 3: Sources of funds for industry (\$ bn, share in %)

Sources	FY 08	FY 09
BANK CREDIT	93	86
	(57%)	(61%)
OTHER DOMESTIC	36	31
	(22%)	(22%)
FOREIGN SOURCES	34	24
	(21%)	(17%)
TOTAL	163	141
	(100%)	13.07

Source: RBI, Noble

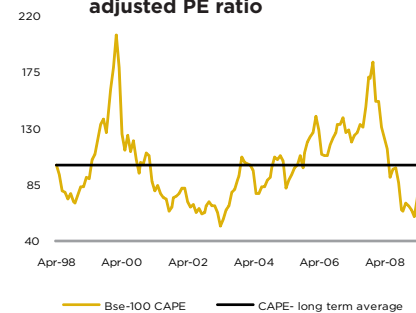
By Christmas 2008, based on the long term market valuation, indicators used by us - cyclically adjusted P/E (CAPE) and Tobin's q (which measures price: book value at replacement cost), the Indian market was close to its all time lows (see Figures 1 and 2).

Table 4: Sudden downturn in exports and industrial production

Date 08/09	Exports %	Imports %	IIP %
AUG	26.9	51.2	1.7
SEPT	10.4	43.3	6.0
OCT	-12.1	10.6	0.1
NOV	-9.9	6.1	2.5
DEC	-1.1	8.8	-0.3
JAN	-15.9	-18.2	1.0
FEB	-21.7	-23.3	-0.7
MAR	-33.0	-34.0	-0.8
APR	-33.2	-36.6	1.4

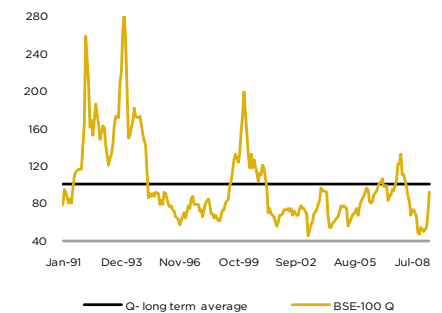
Source: RBI, Noble

Figure 1: The Indian stock market remained below its long term average as measured by the cyclically adjusted PE ratio



Source: Bloomberg Noble

Figure 2: At the height of the crisis, the stock market also plunged below its replacement value



Source: Bloomberg Noble

As usually happens in such circumstances, professional economists followed the herd and revised their economic growth forecasts for India downwards (see Table 5), somewhat oblivious to

Within days of Lehman Brothers going bankrupt, it became obvious that India was not decoupled from the world

the fact that the structural growth drivers of the Indian economy were intact.

Acceptance and Resolution

To its credit, in the midst of this madness, the RBI kept its cool under fire. Within days of Lehman Brothers going bankrupt, it became obvious that India was not decoupled from the world and the extraordinary developments in the world financial markets would have far-reaching consequences for India if not addressed urgently.

The strains in the credit market permeated into the Indian money and foreign exchange markets prompting authorities to take a series of conventional as well as unconventional measures.

The Reserve Bank of India undertook unprecedented monetary easing operations coupled with copious liquidity support in the domestic money and forex markets.

Notably, since mid-September, the RBI has reduced the policy rates,

Table 5: Median forecasts by professional forecasters of RBI

DATE	FY 09	FY 10
APR 08	8.1%	
JUL 08	7.9%	
OCT 08	7.7%	
JAN 09	6.8%	6.0%
APR 09	6.6%	5.7%
MAY 09*		6.4%

Source: RBI, Noble
 *Consensus forecasts from broker research as reported by Business Standard

viz., repo rate under the liquidity adjustment facility (LAF) from 9.0% to 4.75%, the reverse repo rate under the LAF from 6.0% to 3.25%.

The reserve ratios were also reduced with the cash reserve ratio being reduced from 9.0% to 5.0% whilst the statutory liquidity ratio was reduced from 25% to 24%.

Thus two and half years' of monetary tightening was undone in as many months (see Figure 3).

The Reserve Bank also injected potential liquidity of ~ \$88 bn (around 7% of GDP) into the Indian financial system and placed larger resources under banks' discretion (see Table 6).

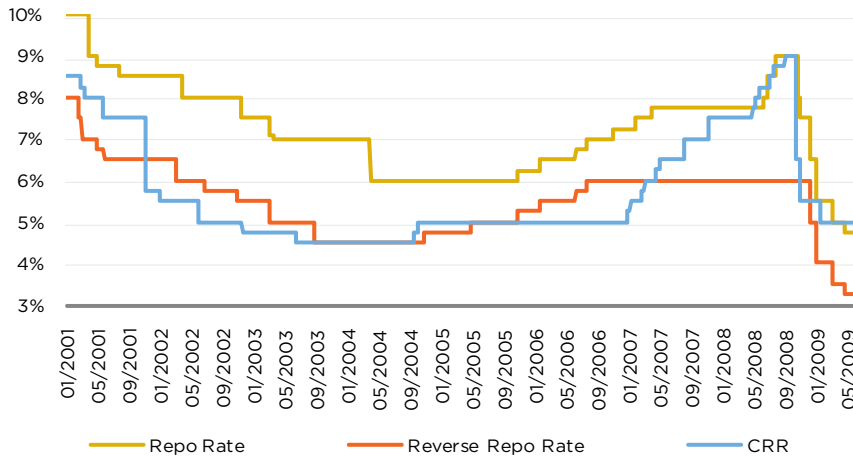
Table 6: Liquidity infusion by RBI (\$ bn)

Sources	Potential	Off-take
1. Reduction in reserves	33	33
2. Reverse sterilization	20	20
3. Term Repo Facility	13	0*
4. Export Credit	5	0*
5. Special Refinance	8	0*
6. Refinance Institutions	3	2
7. Facility for NBFCs	5	0*
Total	88	57

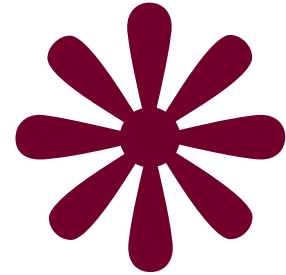
Source: RBI, Noble * nil/negligible
 Note: Uniform Rs.48/\$ applied for conversion.
 Data up to 16 April 2009.

Thus two and
a half years'
of monetary
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undone in as
many months.

Figure 3: Sharp reduction in policy rates in a short span



Source: Bloomberg Noble



These unprecedented monetary easing measures were supplemented by a few countercyclical prudential regulations.

In a significant move, the RBI relaxed the risk weights and provisioning norms for various sectors, besides easing loan restructuring norms.

Measures aimed at managing forex liquidity included an upward adjustment of the interest rate ceiling on foreign currency deposits by

Among the many unconventional measures taken by the RBI were a rupee-dollar swap facility for Indian banks to give them comfort in managing their short-term foreign funding requirements, an exclusive refinance window and a special purpose vehicle for supporting non-banking financial companies, and expanding the lendable resources available to apex finance institutions for refinancing credit extended to small industries, housing and exports.

Whilst the RBI was implementing these policy measures, the Finance Ministry very publicly and repeatedly exhorted the banks, particularly those in the public sector, to lend more and cut interest rates to stimulate credit demand.

The measures taken by the RBI have drawn a mixed response from the financial markets

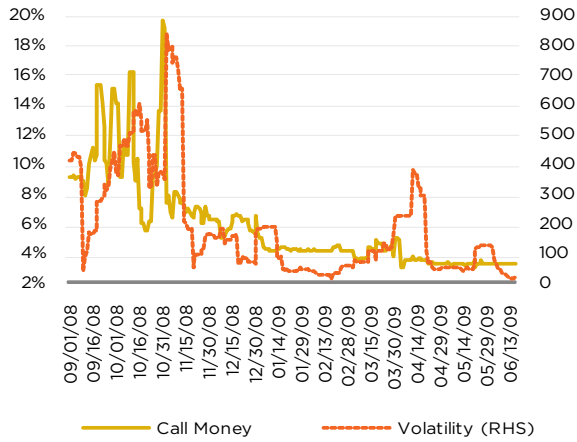
The measures taken by the RBI have drawn a mixed response from the financial markets.

While the RBI has been successful in bringing down the rates at the shorter end of the financial markets (viz., money, forex and bond market) it has not been successful in bringing about an equivalent impact on the Government securities spread (yield curve) and credit markets (see Figures 4-9).

non-resident Indians, substantially relaxing the External Commercial Borrowing (ECB) regime for corporates, and allowing non-banking financial companies and housing finance companies to access foreign borrowing.

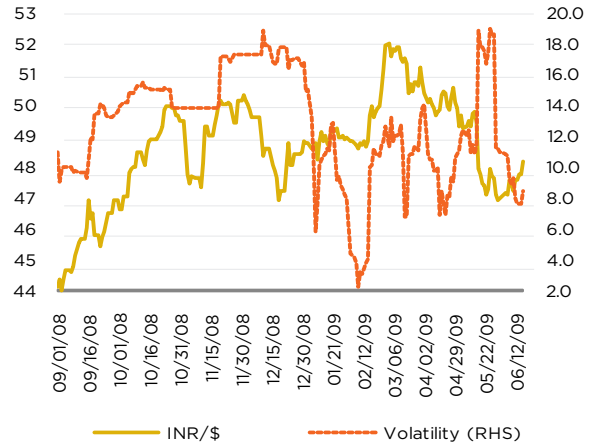
Volatility remains high in some segments of the financial markets (see Figures 5, 6 & 8).

Figure 4: Impact on Money Market (Very Significant)



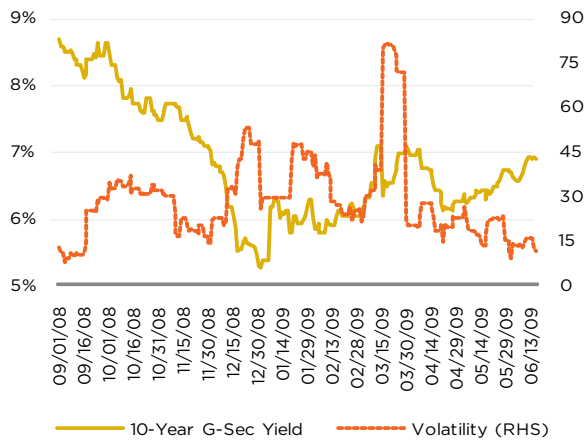
Source: Bloomberg Noble

Figure 5: Impact on the Forex Market (Modest)



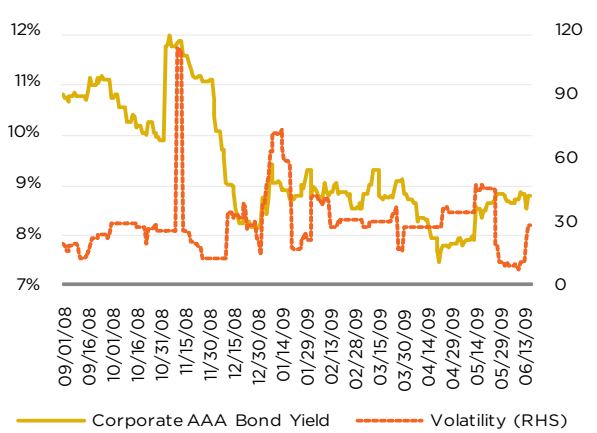
Source: Bloomberg Noble

Figure 6: Impact on Govt. Securities Market (Significant)



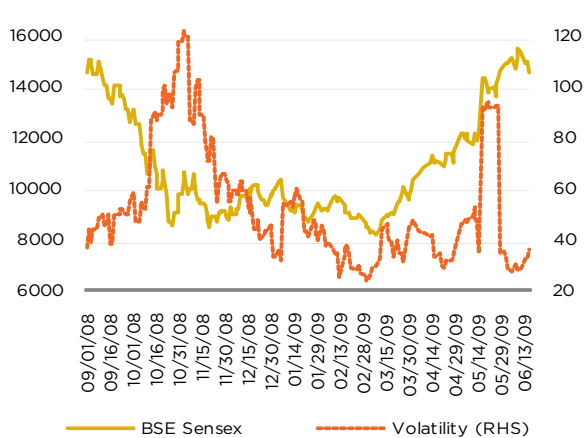
Source: Bloomberg Noble

Figure 7: Impact on Corporate Bond Market (Modest)



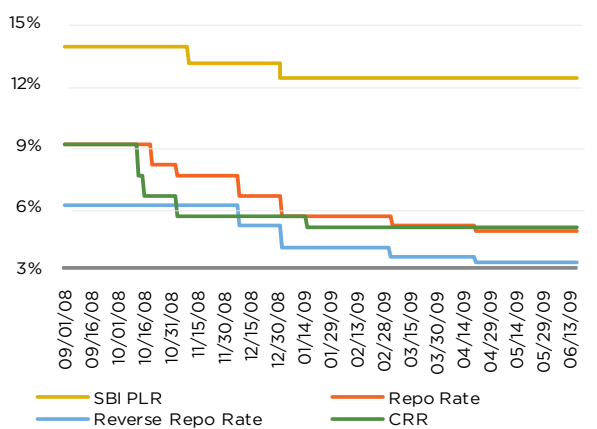
Source: Bloomberg Noble

Figure 8: Impact on Equity Market (Modest at Best)



Source: Bloomberg Noble

Figure 9: Impact on Credit Market (Modest)



Source: Bloomberg Noble

GOVT STIMULUS AND LARGESSE

The central government invoked the emergency provisions of the Fiscal Responsibility and Budget Management (FRBM) Act to seek relaxation from fiscal targets and launched two fiscal stimulus packages in December 2008 and January 2009.

These fiscal stimulus packages, together, amounting to about 3% of GDP, included additional public spending, 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 (see Table 7).

Moreover, to the extent that the crisis year coincided with that of a general election (which usually triggers)

Table 7: Major fiscal stimulus measures

Date	Measure taken
October 2008	Ad valorem rates of central excise duty on non-petroleum products reduced by 4%
November 2008	For promoting labour intensive exports, an interest subvention of 2% provided to textiles, gems & jewellery, marine products and SMEs. Allocation of an additional plan expenditure of Rs.200 bn for counter-cyclical stimulus. Additional allocation of Rs.14 bn to the textile sector. IIFCL authorised to raise Rs.100 bn through tax-free bonds to support infrastructure schemes under public private partnership.
December 2008	Second supplementary demand for grants provided for Rs.556 bn.
January 2009	Relaxation of the Debt Consolidation and Relief Facility (DCRF) for FY09 to enable States to borrow up to 3.5% of their gross State domestic product.
February 2009	General reduction in excise duty rates by 4% extended beyond FY09, in addition to a reduction in central excise duty (from 10% to 8% and service tax on taxable services from 12% to 10%.

Source: RBI, Noble

profligacy by the incumbent Government, there was a default stimulus working alongside.

Components of this stimulus included massive upscaling of the rural employment guarantee programme, a farm loan waiver package (amounting to \$15 bn) and generous salary increases for Government staff.

In totality, these added a further stimulus equivalent to ~2% of GDP, to the budgetary stimulus.

The slew of measures taken to contain the slowdown in India were also marked by an unprecedented degree of co-ordination between monetary and fiscal authorities (see Table 8).

Table 8: Back to back measures taken by Government and RBI

Date	Government	RBI
Sept 16		✓
Sept 22	✓	
Oct 6	✓(SEBI)	✓
Oct 7	✓	✓
Oct 10		✓
Oct 14		✓
Oct 15	✓	✓
Oct 20		✓
Oct 22	✓	
Nov 1		✓
Nov 7		✓
Nov 15		✓
Nov 28		✓
Dec 6		✓
Dec 7	✓	
Jan 2	✓	✓

Source: RBI, Noble

Another characteristics of the crisis as it faced India has been that unlike the western world where the crisis moved in a sequence from the sub-prime credit sector to the financial sector to the real economy, in India the real sector has been affected separately by a 'perception

contagion' channel too with heightened risk perception among corporates.

Hence a crucial aspect of managing the crisis has been strong and frequent communication from policy authorities in India.

With the combination of fiscal and monetary policies, India has been fairly successful in warding off the worst effects of the financial crisis as well as achieve a healthy 6.7% growth in FY09 at a time when most developed countries have barely managed to register positive growth (see Figure 10).

India might have been lucky on certain aspects (e.g. election year coinciding with the crisis year) whilst the relatively uncomplicated financial system has shielded it from contamination.

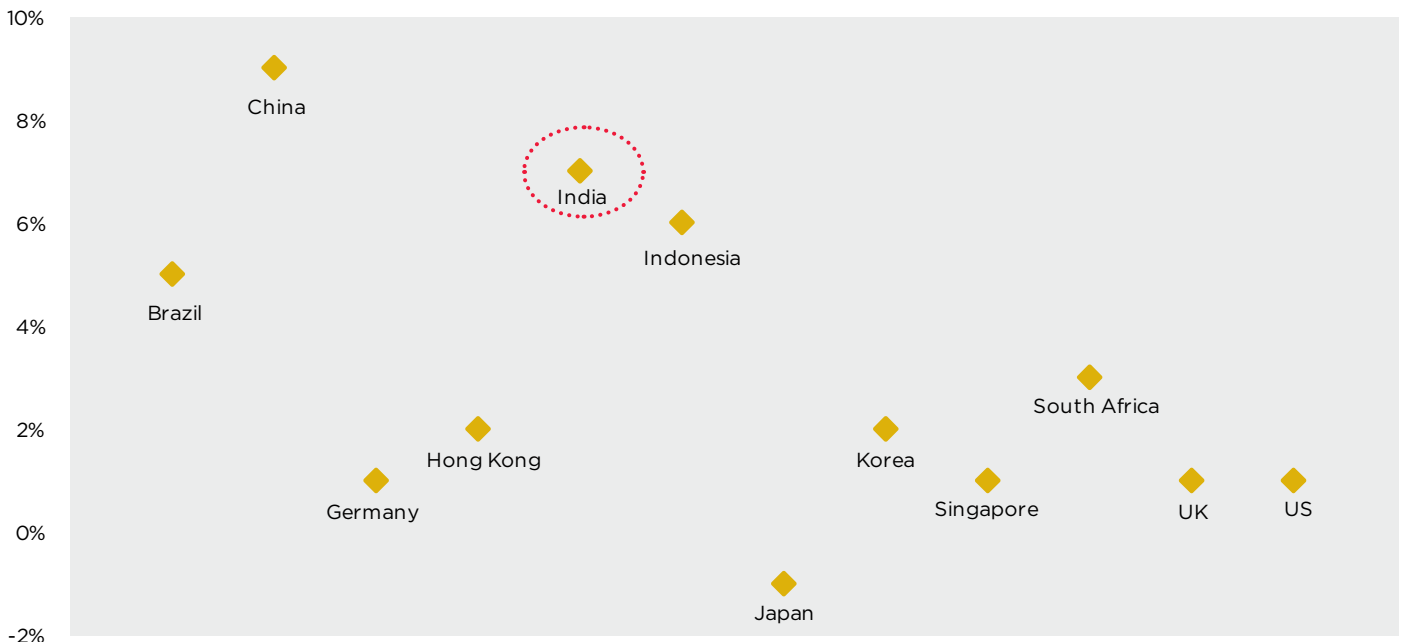
However, India needs to draw the correct lessons from the crisis

rather than conclude that closed unreformed financial markets are in essence good. The world today is a dramatically different place to what it was two years ago and unless India adapts to that, it might not be able to return to the growth rates of two years ago.

Hence a crucial aspect of managing the crisis has been strong and frequent communication from policy authorities in India

In the remaining chapters we highlight the need to guard against complacency and take definitive step toward economic reform to bring the economy back on higher growth path.

Figure 10: Strong growth in India in a crisis year



Source: IMF, Noble

Identifying the low hanging fruits of financial sector reform

Following the credit crisis, we have seen three types of responses from the Indian establishment.

✓ “We were right”

This group feels vindicated by the crisis and believes that India has followed the correct path in not integrating with the global financial system too quickly.

Around **40%** of market practitioners that we met fall in to this camp.

✓ “Let’s wait and watch”

This group wants reform to continue but feels that the global financial sector is so destabilized that it is impossible for India to reform until the dust settles.

Around **50%** of practitioners we met hold this view.

✓ “Let us forge ahead”

This camp views the crisis as an opportunity for India to move forward and strengthen its financial sector whilst the rest of the developed world tries to get its act together.

Only **10%** of practitioners seem to belong to this camp.

In this chapter, we explain why we would place ourselves in the “Let’s forge ahead” camp.

We find that the ‘low hanging fruit’ of incremental reform which can deliver significant benefits is ripe.

We also believe that the hidden cost to India of not reforming is very high.

THE UNFINISHED AGENDA OF ECONOMIC REFORM

The areas requiring reform encompass the financial as well as the real sector.

In the real sector, some oft repeated areas for reform include agriculture (Land Ceiling Act), labour (to impart greater flexibility), oil price deregulation (to remove subsidies), increasing FDI limits in key sectors (including retail), disinvestment of public sector units and providing autonomy to them, Government budgetary and tax reform (a return to Fiscal Responsibility and Budget Management Act, 2003 targets; the introduction of a uniform goods and services tax), etc.

While reform in the real sector is central and indeed will play a complementary role to the financial sector reform, the focus of this Whitepaper will be restricted to reform in the financial sector.

Various committees have, from time to time, deliberated on the areas of financial sector reform.

The “Committee on Financial Sector Reforms” chaired by Raghuram Rajan is the latest (September 2008) to set a reform agenda for the sector.

While it deals with a comprehensive range of issues ranging from monetary and regulatory policies to market microstructure, it has a preference for smaller steps (only a hundred that is!) in place of big bang reform.

Four other reports, viz.

“Report of the Committee on Fuller Capital Account Convertibility”
Chaired by S.S. Tarapore (July 2006),

“High Powered Expert Committee on Making Mumbai an International Financial Centre” Chaired by Percy S. Mistry (February 2007),

“Report of the Committee on Financial Inclusion” Chaired by C. Rangarajan (January 2008) and

“The Development of India’s Corporate Debt Market” jointly by City of London and ICMA Centre University of Reading (February 2008)

...have come into limelight for their far-reaching suggestions in the relevant areas.

A browse through the various recommendations of these committees and discussions with market practitioners would point to deficiencies in at least five major areas of the Indian financial landscape.

i) **Missing markets:** the lack of key market segments has been keenly felt by market participants. For example, acute malfunctioning of the corporate bond market severely affects loan pricing and availability of long term debt funding for Indian corporates. Absence of exchange traded currency and derivative markets (notably interest rate futures), regulatory and institutional constraints on the commodities market also deprives market participants and corporates of hedging instruments for risk management.

ii) **Missing institutions:** market depth have been affected by the regulatory restrictions placed on pension funds, insurance funds and foreign

investors. Similarly the emergence of an independent and transparent regulator for the commodities market is likely to help this market develop (just as SEBI helped the stock market develop).

iii) **Missing people:** financial inclusion of the less privileged has emerged not only as a public policy goal for its own merit but also for its potential contribution in creating deeper financial markets.

“The RBI has liberalised the framework on an ad hoc basis and the liberalised framework continues to be a prisoner of the erstwhile strict control system.” Tarapore Committee Report (July 2006)

Finding appropriately skilled employees has also been an area of crying need highlighting the importance of education and training for the country’s young.

iv) **Missing synergies:** a few areas where synergies have been elusive despite widespread recognition of the need to tap these synergies are the creation of universal banks (institutions that offer a whole range of commercial and investment banking services under one roof), improved regulatory co-ordination across SEBI, the RBI, the Finance Ministry and the Ministry of Company Affairs, and in the emergence of oversight authority across market segments.

v) **Missing governance:** time and again aspects of governance have been emphasized for both the public and the private sector. Increased free float on the stock market through disinvestment of public sector companies would improve market oversight to Government owned entities.

Strict deadlines within which listed entities have to publish their Annual Report, more frequent publication of corporate Balance Sheets, parliamentary oversight over financial regulators, creation of an appellate authority and a nationwide credit bureau are some other governance gaps in the financial sector.

THREE KEY AREAS TO FOCUS ON FINANCIAL SECTOR REFORM

Whilst a comprehensive listing of all the areas of reform would be repetitive exercise, based on our discussions with market practitioners we would like to highlight a few key areas of where the need for reform is pressing and where relatively minor changes in regulations would generate very substantial benefits.

Restrictions on the movement of capital

At present there are several restrictions on the free flow of capital into the Indian economy. In the secondary capital market, FII flows are allowed relatively freely notwithstanding the call for restrictions on participatory notes (PNs) from important quarters, notably the Tarapore Committee. However, foreign money flows are restricted in the primary market and especially in the debt market.

Hence although foreign capital is highly visible wherever risk capital (including equity market, venture capital, private equity, etc.) is

required, their presence is low in the debt market. Such a laissez faire approach toward risk capital while ensuring tight leash over debt may be counter intuitive as the cost of equity is higher than the cost of debt in the long run.

For most Indian companies other than the bluest of blue chips we estimate the cost of equity to be at least 15%.

So by allowing Indian companies relative free access to foreign equity capital but restricted access to foreign debt capital, we are pushing the Indian corporate towards more expensive sources of capital.

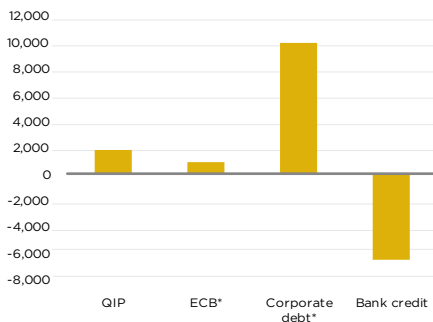
India is a capital scarce country and freer access to capital is a prerequisite for reaping the demographic dividend that should accrue to India.

However, a distinct regulatory preference for risk capital vis-à-vis debt capital is visible from the fact that nearly unlimited FII flows are allowed with huge cost for monetary policy operations (sterilization cost estimated at ~\$1 bn, p.a.) while foreign participation in debt market (both Government securities and corporate debt market) is severely restricted (in part because FIIs have to pay up to 20% tax on bond coupons).

The post March 2009 experience has demonstrated that while risk capital can return quickly following a crisis (see Figure 11), the lack of matching debt can severely throttle the availability of capital for all but the largest of companies.

Our discussions with a range of senior bankers also corroborated the mood of caution prevailing in the loan market with SMEs particularly being deprived of funding.

Figure 11: Return of risk appetite at the higher end of risk (\$m)



Source: RBI, SEBI, Business Standard, Noble
 * Data for April multiplied by 3 for arriving at q 1 data

Restrictions on foreign participation in the debt market therefore act as constraining factor akin to a supply bottleneck in the domestic manufacturing sector.

As lack of institutional participation is widely held responsible for lack of liquidity in the domestic debt market (which is overwhelmingly dominated by the public sector banks and LIC) foreign capital can play a significant catalytic role in debt market development akin to what it has done in the equity market.

Liberalised entry of foreign banks and flexibility of operations seems another casualty of the financial crisis.

On this issue, opinions diverged with the majority of the market practitioners we met accepting the logic of “reciprocity”, i.e., allowing more liberal entry to banks from countries where Indian banks have found easier entry and fewer restrictions.

However, most accepted the positive role that foreign banks have played in introducing technology, improved business process and infusing competition in the Indian banking sector.

We believe that the reciprocity argument is increasingly irrelevant in a globalised market place and a resignation to competitive protectionism would not serve India’s interest.

Telling America, for example, that “we won’t allow your banks to enter our country, if you don’t allow ours to enter yours” imposes a cost on India because it means that less capital flows into India and hence the cost of capital, particularly debt capital, stays higher than what it should be.

Moreover, given how strong Indian banks look vis-à-vis their foreign counterparts (see Table 9), given how far Indian banks have progressed technologically over the past decade and given that any foreign banks entering India will be subject to the same prudential regulations that an Indian bank would face, by blocking such entry we are fighting the regulatory battles of a bygone age when Indian banks did need protection from foreign competition.

Whilst most bankers we met agreed that India’s domestic debt market needs reform, some of them felt that the need for reform was less



Table 9: Banks - us and "US"

Indian Banks	ROE CY08	ROE 5-Yr Avg	ROA CY08	ROA 5-Yr Avg	US's biggest banks (by market cap)	ROE FY08	ROE 5-Yr Avg	ROA FY08	ROA 5-Yr Avg
SBI	16.8%	17.7%	1.0%	0.9%	Citigroup Inc.	-5.3%	4.7%	0.3%	0.3%
ICICI	11.6%	15.8%	1.1%	1.3%	Bank of America	7.4%	12.1%	0.8%	1.0%
PNB	18.0%	19.2%	1.2%	1.1%	Washington Mutual	-128.5%	11.0%	-4.2%	0.8%
Canera	15.0%	19.9%	0.9%	1.1%	BB&T Corporation	8.4%	13.8%	0.9%	1.4%
BOB	14.6%	14.4%	0.9%	0.9%	Regions Fin. Corp.	0.8%	-1.5%	0.2%	-0.2%
BOI	24.4%	18.9%	1.3%	0.9%	Fifth Third Bancorp.	-1.3%	6.9%	0.2%	0.6%
HDFC	17.7%	18.8%	0.7%	0.8%	Key Corp	-30.1%	7.0%	-2.0%	0.6%
IDBI	8.5%	11.7%	0.7%	0.8%	Comerica Incorporated	-2.0%	12.6%	0.1%	1.1%
UnBI	22.1%	19.8%	1.3%	1.0%	M&T Bank Corporation	3.5%	11.7%	0.4%	1.2%
CBI	11.3%	13.4%	0.5%	0.6%	CMarshall & Isley Corp.	-7.5%	1.1%	-0.6%	0.1%

Source: Reuters Knowledge, Bloomberg, RBI, Noble

Table 10: Governance Indicators - Rank

Item	Brazil	Russia	India	China
Corporate				
Ethics	55	90	57	40
Public Sector				
Ethics	51	79	58	40
Judicial/Legal				
Effectiveness	53	90	37	51
Corporate Governance	30	83	32	73

Source: World Bank, Noble
 Note: Ranking among 104 countries

Table 11: Lower free float leads to lower liquidity

Country	Free Float*	Avg daily volume to market cap**
CHINA	52%	0.64%
GERMANY	79%	0.54%
JAPAN	84%	0.53%
FRANCE	75%	0.40%
CANADA	91%	0.35%
US	95%	0.33%
UK	88%	0.31%
INDIA	50%	0.28%
BRAZIL	62%	0.17%

Source: Bloomberg, Noble
 * Avg free float of the constituents of the benchmark indices
 ** 6-month average daily volumes in the benchmark index constituents divided by total market cap of the index

urgent because Indian corporates could borrow from abroad using the ECB route. Leaving aside the point that in these credit starved times, very few Indian corporates will find willing foreign lenders, it is worth understanding just how limited the relevance of ECBs is.

Guidelines on ECBs place restrictions on nearly every aspect of fund raising. ECBs in the form of commercial loans, bonds, etc. are allowed with a minimum maturity of three years for which various conditions are prescribed. ECBs are allowed under two routes – the automatic route and the approval route - depending upon the sector and amount of capital to be raised.

‘Eligible borrowers’ and ‘recognized lenders’ are defined under the norms. There are strict end-use conditions for the debt raised with a list of impermissible activities.

Finally, and most importantly, the interest rates on ECBs are capped at six month LIBOR + 300 bps (for maturity between three to five years) and six month LIBOR + 500 bps (for maturity exceeding five years).

So in summary, Indian small and mid-sized companies are finding it difficult to access credit domestically.

At the same time, we impose restrictions on foreign institutions entering our debt market and finally to complete the debt suffocation, the ECB route imposes a range of restrictions on which corporates can borrow from abroad at what rate.

As mentioned in the Raghuram Rajan Committee Report, Indian companies and financial institutions should be allowed to invest abroad. This would also mitigate the difficulties of effectively managing the monetary policy under conditions of excessive capital inflow.

Although many of the Indian acquisitions of FY 06-07 appear on hindsight to have been made at bull market valuations, it would be a double fault to miss the current opportunity of inorganic growth in overseas markets at a time when asset prices in Europe and the US are still at attractive levels.

Simpler but more effective governance is required

India ranks poorly on global governance indicators (see Table 10). This clearly adds to the emerging market risk premia that India pays for capital.

Creating stronger corporate boards (with effective independent directors), greater autonomy for public sector functioning and delinking of multiple layers of governmental oversight (e.g., the Reserve Bank, Central Vigilance Commission and the Ministry of Finance for the public sector banks) would go a long way in enhancing the value of the public sector.

Government and promoter control have been a major restraining factor in the availability of free float in the Indian market and this has made India one of the least liquid amongst the world’s top 10 stock markets (see Table 11).

Public sector disinvestment and increased participation of financial institutions (as opposed to the promoters’ friends and family) on the boards of companies could aid various other governance initiatives.

The role of Auditors and Boards needs reinvigoration. Auditors should be changed periodically taking a cue from public sector banks (changed every three years). Alongside auditors and regulators, independent directors are the third pillar that a modern capital market

uses to safeguard investors. In India, however, promoters tend to exert enormous leverage on independent directors both through their social relationships (they are often part of the same family or social circle) and through their financial relationship (the promoter for all intents and purposes pays these directors).

Hence, the chances of them blowing the whistle on the promoter are fairly remote. We need a regime where promoters are prohibited from interfering in the recruitment of independent directors and prevented from setting their pay and tenure.

In the interest of investors, regulation should mandate that the only sitting executive on the Board is the CEO.

There is a need to encourage the concept of separation of CEO and Chairman of the Board which is well accepted in Europe and US companies are steadily moving in that direction. This would bring a better balance in the Boardroom.

Encouraging whistleblowing by enacting a law and ensuring a cult of risk governance would be the other important components of strengthening corporate governance.

In contrast to other large capital markets, the Indian market makes it all too easy for Annual Reports to be published many months after the financial year has ended.

Since quarterly reports are unaudited, do not contain a cash flow statement and a balance sheet, and do not provide consolidated numbers, the Annual Report is keenly awaited as it is the only document that gives a full picture of a company's financial health. Companies with weak cash flows delay Annual Reports for sometimes 6, even 12 months after the year end

by which time the market's focus has moved on to the other things. In larger markets, the law says that the annual report has to emerge within four months following the year end.

The Indian market needs better quarterly reporting and more timely annual reports at the year-end.

Financial deepening

Apart from institutional health, the financial crisis may adversely impact the momentum gained in the area of financial inclusion in India. India's rather modest record in this regard post independence (see Table 12) points to the need for renewed vigour in this regard.

India's claims of being less impacted by the global financial crisis fall apart when one realizes that the vast majority of Indians have no involvement in the financial system.

It is almost like a country without roads feeling pleased about the fact that it has fewer car accidents than Europe or America.

The drive for financial inclusion is presently focused on the liability side (deposit mobilization) and should in time accord a greater degree of stability to bank's funding sources.

Our banks' analyst Aditi Thapliyal, highlighted in November 2008 how many Indian banks are exposed to an asset-liability mismatch due to most of their liabilities being short dated corporate deposits (see Tables 13 and 14).

Indeed many Indian banks have made notable progress in advancing financial inclusion through use of technology and improvement in agency delivery mechanism. Further penetration of financial services, would need innovation on the product design (e.g.,

Table 12: Financial Inclusion - Factsheet

Item	With Access
Households with any form of bank account	36%
Farmer households with any sources of credit	49%
Farmer households with formal sources of credit	27%
Households preferring to keep savings at home	36%
Households with life insurance	24%
Households with equity investments	0.7%

Source: Planning Commission, NSSO, CSO, MAX-NCEAR Survey, SEBI, Noble.

Table 13: Duration Gap for Indian Banks

Bank	Asset Duration	Liability Duration	Duration Gap
Karnataka	3.7	1.3	2.4
Federal	3.1	1.2	1.9
Yes	2.0	0.5	1.4
ICICI	2.7	1.3	1.4
South Indian	2.6	1.4	1.2
Axis	3.7	2.6	1.1
BOB	3.0	2.0	1.0
PNB	3.3	2.7	0.6
ING Vysya	2.1	1.5	0.6
SBI	3.4	3.3	0.1

Source: Company Filings, Noble. As on March 2008. Note: all figures mentioned here in years unless otherwise mentioned.

Table 14: Asset Liability Mismatch quantified

Bank	Mismatch (Rs. bn)	Mismatch/Market Cap
Karnataka	-53	540%
Federal	-89	410%
Yes	-58	391%
ICICI	-56	283%
South Indian	-13	168%
Axis	-616	143%
BOB	-131	100%
PNB	-577	81%
ING Vysya	-151	77%
SBI	-27	30%

Source: Company Filings, Balance sheet data as on FY08, market cap as on 31st Oct.

microfinance) and delivery (e.g., use of mobile phones) side so that the less privileged are able to enjoy the benefits of the credit and insurance markets.

SUMMARY OF THE ‘LOW HANGING FRUIT’

- India needs freer access to foreign debt capital and in particular needs to remove the existing restrictions on ECBs.
- There is a need to rebalance policy priorities to allow foreign participation in debt market. Scrapping the withholding tax (up to 20% on bond coupons) would be a constructive measure.

- To improve financial disclosure norms, there is a need to place more strict deadlines within which listed entities have to publish their Annual Report together with more frequent publication of corporate Balance Sheets and cash flow statements as opposed to the current practice of once a year publication of such critical financial information.
- The imperative of financial inclusion needs reemphasis post crisis not only on its own merit but also for its potential contribution in creating deeper financial markets.

India needs freer access to foreign debt capital and in particular needs to remove the existing restrictions on ECBs

- India needs to revisit the logic of “reciprocity” in allowing foreign banks in a globalised environment as a resignation to competitive protectionism would not serve India’s interest.
- Two-way capital flows should be encouraged by allowing Indian institutions to invest and acquire overseas firms.
- Increasing the free float of listed public sector units will not only increase market liquidity it will, provided the Government has the appetite for this, lead to more effective market oversight of public sector units.

CONCLUSION

Pundits have been writing about the need for financial sector reform in India for over two decades now.

Whilst some of these reforms have taken place (e.g., allowing FII’s to participate in the stock market on a level footing with domestic investors), other glaring anomalies exist (e.g., the restrictions placed on FII’s in the debt market).

Whilst these are not causes which trigger mass dissent or protest, the cost imposed by these restrictions is more substantial than that generated by almost any other issue which has been in the public limelight in recent years.

We now turn to the subject of quantifying the hidden cost of not reforming India’s financial services sector.

Quantifying the benefits of reform

SETTING THE PACE OF THE DEBATE - THE IMPOSSIBLE TRINITY

Open economy macroeconomics presents some hard policy choices to the authorities running developing countries.

Capital inflow far in excess of current account deficit forces central banks to accumulate foreign exchange to avoid appreciation of the currency (which would reduce export competitiveness).

On the other hand, excessive liquidity created in the domestic market (as central banks can only partially sterilize the enormous capital flows from abroad) pushes interest rates down until such rates are equalized to the level of the capital exporting countries.

Thus allowing more capital flows loosens developing economies' central banks' grip over monetary policy in setting exchange rates and interest rates suitable for their export competitiveness and inflation control.

In other words policy makers in developing countries cannot have the best of all worlds, i.e., open capital flow, independent monetary policy and fixed exchange rates – known as impossible trinity in economic theory.

Various countries have chosen their own path to resolve this trilemma. India's present disposition seems to have made a choice of restricting capital flow (particularly debt

capital flows in order to retain the flexibility of managing the exchange rate and the freedom to pursue a deflationary policy for management of inflationary expectations.

In this chapter, we would argue whilst the stability dividend of such a policy is all too evident in a crisis year (as outlined in Chapter I), the hidden cost that India pays on a continuous basis by far outweighs the stability dividend reaped on a crisis year.

We attempt to arrive at some preliminary estimates of the lost opportunity for Indian corporates, and contend that the stability risks of opening up to foreign capital flows are currently being overplayed.

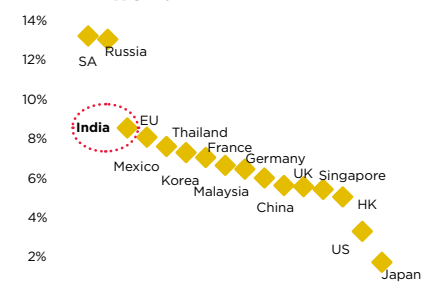
CAPITAL CONTROLS MAKE INDIA A HIGH COST ECONOMY

Excluding countries in Latin America and Africa, India has one of the highest costs of capital for its corporate sector (see Figure 12).

While this may be a result of high inflation that warrants a higher nominal rate to keep the real interest rate positive, it is pertinent to note that a number of countries of the world, including China, run a negative interest rate (see Figure 13) as a matter of policy choice.

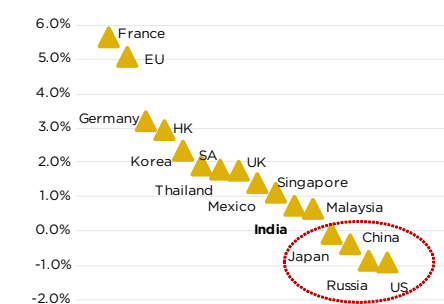
The moot point, however is that Indian corporates pay a high premium for their capital compared to their international peers,

Figure 12: India has one of the highest nominal lending rates in the world



Source: The World Factbook, CIA - US, Noble

Figure 13: A number of economies are running negative real interest rates



Source: The World Factbook, CIA - US, Noble

explaining rush of Indian corporates to chase money abroad for interest arbitrage, as reflected in the sharp increase in external commercial borrowing (ECBs).

Besides the decline in interest rates, timely availability of credit to corporates would enhance supply response to some critical sectors of the economy including infrastructure

ESTIMATION OF HIGHER CAPITAL COST TO CORPORATE ON PROFITABILITY

The cost to companies for not allowing higher debt flow has been estimated by us under a ceteris paribus assumption, i.e. assuming only a reduced cost of funds for the corporate but leaving the total volume of debt unchanged (a less restrictive assumption if two way capital flows are allowed). The estimation is done in two stages.

Firstly, we created a sample of 4,091 listed and unlisted companies extracted from the CMIE Prowess database for which data was consistently available from FY03.

Secondly, in order to assess the economy-wide impact of reduced interest cost, this sample of companies are then “blown up” in proportion to the total credit and corporate securities outstanding in the economy.

Further, two scenarios (of 1% and 2% reduction in interest rates as a result of capital inflow) are examined, separately for the sample of companies and the entire economy, to find out the impact on the profitability of Indian companies of higher capital inflows.

We find that if capital flows reduce borrowing rates for corporates by 200 bps, corporate profits would rise by 7% and GDP would be boosted by 1.3% (see Table 9).

We may also note that besides the decline in interest rates, timely availability of credit to corporates would enhance supply response to some critical sectors of the economy including infrastructure.

As India’s inflation is often characterized by supply bottlenecks, this would lead to lowering of inflation.

Table 9: The cost of not allowing freer foreign debt flow is significant to the corporates and the economy

	FY08
A. Data pertaining to 4,091 companies (CMIE)	
Interest cost (Rs. bn)	603
Expenses (Rs. bn)	26,685
Borrowing (Rs. bn)	8,921
Profit after tax (Rs. bn)	2,488
Average Lending rate	6.8%
B. Estimated difference made by higher foreign debt flow to the sample of 4,091 cos.	
Scenario I (lending rate reduced by 1%)	
Increase in profit (Rs. bn)	89
Increase in profit in %	4%
Scenario II (lending rate reduced by 2%)	
Increase in profit (Rs. bn)	178
Increase in profit in %	7%
C. Estimated difference made by higher foreign debt flow to all Indian companies	
Scenario I (lending rate reduced by 1%)	
Increase in profit of all companies (Rs. bn)	296
Increase in profit as % of GDP	0.6%
Scenario II (lending rate reduced by 2%)	
Increase in profit of all companies (Rs. bn)	592
Increase in profit as % of GDP	1.3%
<i>Memo item</i>	
GDP at current market price (Rs. bn)	47,234

Source: CMIE (Centre for Monitoring Indian Economy) for panel-A data pertaining to 4,091 listed and unlisted companies for which data was consistently available, RBI, SEBI, Bloomberg, Noble

Note: The total borrowing for the economy has been arrived by adding credit data for FY08 (Source RBI) with the sum of five year (FY03-FY05) flow data of debt issuances in the primary issues (public+rights) and private placement market (Source SEBI), assuming a average maturity period of five years. This resulted in a multiplicative factor of 3.3 to the sample of companies taken by us from CMIE in panel-A.

By inference this would also take off some of the pressure on monetary policy to maintain higher interest rates in order to maintain a stable real interest rate in the medium to long run.

ESTIMATION OF THE MAGNITUDE OF DEBT CAPITAL FLOW UNDER FREER REGIME

We now turn to an estimation of debt capital flows that could potentially have accrued to Indian economy in case of a freer debt inflow regime.

Here, a priori we assume that India's attractiveness as an investment destination remains same for both equity and debt capital.

Hence we measure the debt capital flow that would come to India in case debt is allowed to come as freely as that of equity.

Here again our findings are quite stark. Even while we assume that debt capital would be as volatile as equity, i.e. even after allowing for huge capital outflows in 2008, India on an average stands to gain ~ \$13 bn inflow under freer regime.

Purportedly, this amount would be much higher going forward (see Table 10).

Besides, in the absence of highly developed secondary market for corporate debt, the minimum lock in period of corporate debentures ensures a far greater stability to the debt flows.

WHY NOW AND NOT LATER

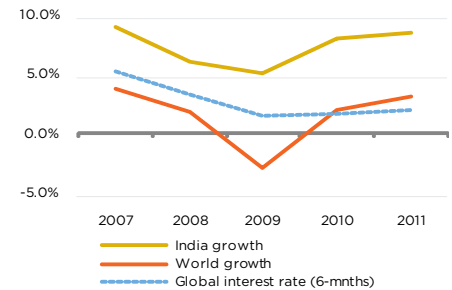
While the logic of freer capital flows has been spelt out above, we would like to stress that the crisis need not holdup India in its road to reform.

Indeed the time just seems ripe for big ticket reform in allowing greater access to foreign debt capital together with development of the corporate debt market.

Global inflationary conditions are likely to remain benign while India growth story plays out in the years ahead (see Figure 14).

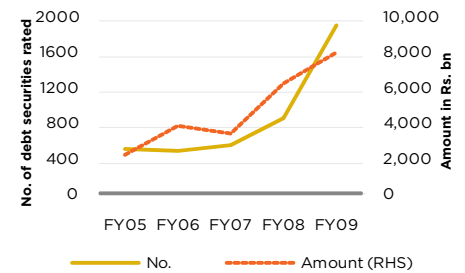
Meanwhile there have been signs of increasing depth of the domestic corporate debt market with sharp growth in high quality paper being floated in the market (see Figures 15 and 16).

Figure 14: India story would play out in benign global condition



Source: Global Development Finance, World Bank, Noble

Figure 15: Sharp increase in rating of corporate debt securities (<1yr maturity)



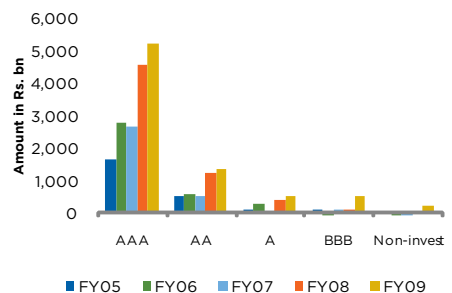
Source: SEBI, Noble

Table 10: India can easily attract a much greater amount of debt capital under a freer regime (Amount in \$ bn)

	Average for CY 01-08
Net portfolio equity flows to developing world (A)	51
Net debt flow to the developing worlds (B)	171
Net FII equity investment in India	5
Net FII debt investments and ECB flows into India (D)	6
India's share in developing country equity inflows (E=C/A)	7.7%
India's share in developing country debt inflows (F=D/B)	1%
Estimated debt flow if debt share is increased to equity level ((ExB) - D)	13

Source: Global Development Finance, World Bank, RBI, SEBI, Bloomberg, Noble

Figure 16: Investment grade securities dominate Indian Corporate Bond mkt



Source: SEBI, Noble

FEAR OR GREED - WHAT SHOULD MOTIVATE ECONOMIC POLICY?

Finally, some of the market practitioners we met expressed concerns regarding the destabilizing impact of foreign capital flows, i.e., foreign capital will run for the door at the slightest sign of trouble, leaving us high and dry.

Some of these fears appear to be exaggerated. Proof of this can be found in the equity market where the quantum of FII capital pulled out of India was de minimis compared to the quantum of FIIs holding in the Indian stock market (see Figure 17).

Moreover, just like others, FIIs also rebalanced their portfolios to increase their debt exposure. So the data does not lend support to the notion of foreigners being fair weather friends.

A careful evaluation of India’s external sector points to many hidden strengths despite the recent woes of exporters and the current account deficit.

Some key elements include the high surplus on the invisible account driven by India’s famous IT services exports, high remittances from Indians abroad, steady growth in FDI as the world sets up shop in India and relatively low external debt

service obligations. On many critical parameters India’s external situations compares favourably with other emerging markets (see Table 11).

Finally to set the record straight on foreign banks, we have a rather long quote from the recently published Development Finance Report from World Bank.

“The participation of foreign banks in developing countries’ financial systems has increased rapidly in recent years.

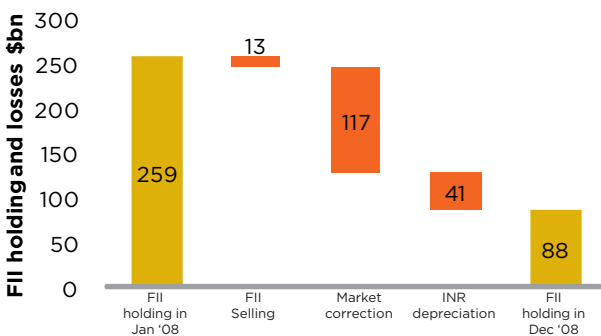
At the end of 2007, the 910 foreign banks with a presence in developing countries controlled combined assets in excess of \$1.2 trillion and accounted for more than 39% of total domestic banking assets.

Although it is far too soon to come to a reliable conclusion on the impact of foreign bank ownership on developing countries’ experience during the financial crisis, preliminary evidence does not support the view that foreign banks’ subsidiaries bear an inordinate responsibility for observed contractions in domestic credit.

Evidence gathered for three Latin American countries in which foreign banks have a prominent role suggests that foreign bank subsidiaries and domestic banks responded similarly to the global financial crisis.

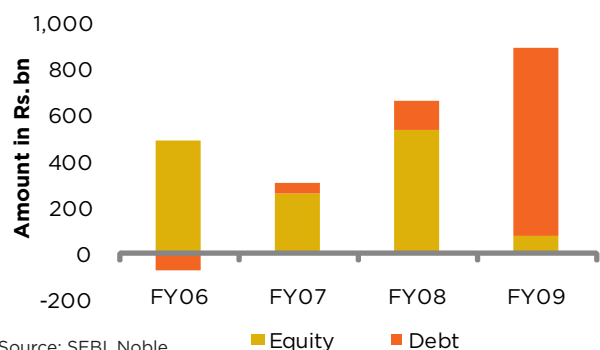
Foreign banks accounted for 23% of total bank lending during 2006–08 in Brazil, 24% in Colombia, and 50% in Peru.

Figure 17: FIIs are not from Mars ...



Source: Bloomberg, Noble

Figure 18: ...and behave like everyone else on Earth



Source: SEBI, Noble

In Brazil, the slowdown in domestic credit creation was modest, and credit creation by domestic banks shrank more from the peak than that of foreign banks.

In Colombia, the rate of growth in bank lending has been decelerating since 2007, but there is no evidence of a sharper decline in the wake of the financial crisis – if anything, domestic banks reduced credit creation more than did foreign banks.

In Peru, the pace of lending by domestic and foreign banks has remained roughly stable since early 2008.”

World Bank Development Finance Report (June 2009).

In summary, by allowing foreign capital, particularly foreign debt capital, to enter India more freely, India would:

- lower the cost of borrowing for its corporates by 200 bps, thereby boosting corporate profitability by 7% and GDP by 1.3%.
- reduce supply bottlenecks and thereby ease the pressure on monetary policy to dampen inflationary expectations.
- attract foreign capital of \$13 bn p.a. (as opposed to the current figure of \$6 bn p.a.).



Table 11: India's external position is relatively strong at present

Indian Banks	FY03	FY04	FY05	FY06	FY07	FY08	Top 20 debtor countries	External debt (\$bn)	External debt to GNP	Debt service ratio	Forex reserves to total debt	concession-al reserves to total debt	Short-term to total debt
Current Account							China	323	12%	3%	335%	11%	54%
Exports/GDP	11%	11%	12%	13%	14%	14%	Russia	251	26%	14%	121%	1%	16%
Imports/GDP	13%	13%	17%	19%	21%	21%	Turkey	208	52%	33%	30%	2%	20%
Trade Balance/GDP	-2%	2%	-5%	-6%	-7%	-8%	Brazil	194	19%	37%	44%	1%	11%
Invisibles (net)/GDP	3%	5%	4%	5%	6%	6%	India	170	18%	5%	117%	23%	16%
Current Receipts/GDP	19%	20%	22%	24%	26%	26%	Mexico	161	20%	19%	48%	1%	5%
Current Payments/GDP	18%	18%	22%	25%	28%	27%	Indonesia	131	38%	17%	33%	27%	25%
Current Account Balance / GDP	1%	2%	0%	-1%	-1%	-2%	Poland	126	39%	25%	39%	1%	17%
Capital Account							Argentina	122	59%	32%	26%	1%	29%
Foreign Investments to India (net)/GDP	1%	3%	2%	3%	3%	5%	Hungary	108	103%	33%	20%	1%	14%
Capital Flows (net)/GDP	2%	3%	4%	3%	5%	9%	Kazakhstan	74	103%	34%	26%	1%	17%
Capital inflows/GDP	9%	13%	14%	18%	25%	37%	Philippines	60	47%	20%	38%	21%	8%
Capital outflows/GDP	7%	10%	10%	15%	20%	27%	Thailand	55	27%	9%	121%	12%	32%
Foreign Investment to India (net)/GDP	11%	24%	18%	20%	23%	39%	Romania	55	47%	18%	55%	2%	32%
External Debt							Malaysia	53	36%	4%	158%	8%	31%
Debt-GDP Ratio	20%	18%	19%	17%	18%	19%	Ukraine	50	48%	18%	45%	4%	45%
Debt-service Ratio	16%	16%	6%	10%	5%	5%	Chile	48	38%	20%	40%	1%	20%
Liability-service Ratio	16%	19%	7%	11%	6%	7%	Venezuela	45	25%	13%	82%	0%	27%
Import Cover of Reserves (months)	14%	17%	14%	12%	13%	15%	Colombia	40	27%	31%	39%	3%	12%

Source: RBI, Noble

About Noble

Noble is an independent Anglo-Indian investment bank, dedicated to helping small and mid-cap companies grow.

Noble is a UK-headquartered research driven equity investment bank that specialises in UK and Indian mid and small capitalisation companies.

In the UK, Noble is a full service investment bank and asset manager, providing a full range of services to fast growth companies, institutions and investment vehicles.

Noble publishes high quality fundamental research on more than 180 companies across 12 sectors in India and the UK.

In India, Noble launched its equities business in September 2008 as an

investment adviser to institutional investors.

In April 2009, Noble announced a strategic alliance in India with UBS relating to mid and small cap Indian equities.

Founded in 1980, Noble is almost entirely owned by its management and employees with more than 110 employees spread across offices in Mumbai, London and Edinburgh.

Noble is proud to be the exclusive UK member of Global M&A, the leading global partnership of independent corporate finance

houses which services the growing market for international mid-market M&A activity.

Noble has four operating companies:

- Noble & Company Ltd.
- Noble Fund Managers Ltd.
- Clear Capital Ltd.
- Noble Corporate Management Ltd.

which are authorised and regulated by the Financial Services Authority.

City of London Corporation

The City of London is exceptional in many ways...

... not least in that it has a dedicated local authority committed to enhancing its status on the world stage.

The smooth running of the City's business relies on the web of high quality services that the City of London Corporation provides.

Older than Parliament itself, the City of London Corporation has centuries of proven success in protecting the City's interests, whether it be policing and cleaning its streets or in identifying international opportunities for economic growth.

It is also able to promote the City in a unique and powerful way through the Lord Mayor of London, a respected ambassador for financial services who takes the City's credentials to a remarkably wide and influential audience.

Alongside its promotion of the business community, the City of London Corporation has a host of responsibilities which extend far beyond the City boundaries.

It runs the internationally renowned Barbican Arts Centre; it is the port health authority for the whole of the

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The City of London Corporation, however, never loses sight of its primary role – the sustained and expert promotion of the 'City', a byword for strength and stability, innovation and flexibility – and it seeks to perpetuate the City's position as a global business leader into the new century.

City Office in Mumbai

The City of London has long recognised the critical importance of India to the UK-based financial services industry, and is committed to making the best possible use of existing cultural, linguistic, political and trade relationships.

In order to strengthen direct links with India, one of the world's largest and most vibrant emerging markets, the City of London has established the City Office in Mumbai since 2007.

The City Office in Mumbai works to further strengthen trading and investment links in both directions between India and the UK through the provision of world class financial services and products.

Guidance to the City Office in India is provided by the City of London India Advisory Council.

The Council is chaired by: Mrs Naina Lal Kidwai (Group General Manager and Country Head HSBC).

Other members of the Council are:

Mr Mukesh Ambani (Chairman of Reliance),
Ms Zia Mody (Senior Partner of AZB & Partners),
Mr Nasser Munjee (Chairman of Development Credit Bank),
Mr Deepak Parekh (Chairman of the HDFC Group),
Dr Ajay Shah (Senior Fellow, NIPFP) and
Mr Jairaj Purandare (Executive Director, PWC).

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