Macroeconomic Headwinds: Roadblock or Checkpoint for Indian Economy in 2011?

Interview:

Mr. Sunil Singhaniya
Head - Equities, Reliance Mutual Fund
Message from the Convenor

Heartiest congratulations to all of you. With the release of the 4th issue of our magazine we are getting bigger and better, and it gives me immense pleasure and satisfaction to be convenor of the forum street. In-Fin-NITIE has given me an opportunity to work with students and advance forth with the common goal of learning and practising finance.

As always, In-Fin-NITIE brings interesting articles to you, along with something new: an interview from Mr Sunil Singhania, Head - Equities, Reliance Mutual Fund. The central focus of the articles in this issue is the "Macro Economic headwinds" and the "Road blocks for the Indian Economy", along with interesting articles focusing on a multitude of financial aspects.

I applaud the efforts of the of team Street for their unstinting efforts. I hope they strive to take the magazine to greater heights, and also hope that this issue will entertain you and keep you engrossed in the recent financial happenings around the world.

We look forward to your comments and wishes to bring out more interesting issues in the future.

Dr. M Venkateswarlu
Asst. Professor of Finance
NITIE, Mumbai
From the Editor’s Desk

The unveiling of the fourth edition of In-Fin-NITIE is not that of a mere printed book but of a generic reality. It is a mark that we leave on the pristine tradition of the gamut of initiatives taken up by Team Street. Our greatest victories lie even in our smallest achievements, our glory is found in every success. This issue is a window into our world, a reflection of our past and an echo into the future.

Indian Equity markets have seen withdrawal of FII money, and this is reflected in the fact that Indian indices are down by 13%-14% from the highs of 2011. IIP data has been dismal for a while now. Large part of these downsides are due to the macroeconomic data, which is creating the pressure.

Inflation has been creating turbulence in the Indian economy for a while now. RBI’s hawkish stance, and the warning about growth and inflation echoes the widespread skepticism. RBI has tried to fight inflation with limited resources that it can maneuver. In the recent mid quarter review, the eighth interest rate hike since March 2010 sends a strong signal that RBI sees inflation as the biggest hurdle for long term growth potential of the economy.

The fiscal deficit has been targeted at 4.6%, but it needs to be seen if a figure that looks great on paper becomes a reality, given the increasing subsidies bill. The Middle East strife has further exacerbated the situation by sky rocketing oil prices. Even if the short term vision of the Indian economy is slightly hazy, the long term outlook, inarguably, is still brighter.

In-Fin-NITIE, as usual, would like to move along with the students of NITIE, as we pursue success in the field of finance. We would like to hear from you regarding the magazine. Letters to the editor can be sent to street.nitie@gmail.com.

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India’s Widening Current Account Deficit

-Should we be worried?

On 16th Nov 2010, Economic Times reported “India’s Current Account Deficit may widen to a record: Goldman Sachs”.

India has a current account deficit of 4% of GDP and there is a possibility of it increasing to 4.3% of GDP in 2011-12. But, is Current Account Deficit always bad for the country’s growth?

CAD is one of the measures of the nature of a country’s foreign trade. It has three components: Balance of Trade Account, Trade in Service Account or the Invisible Account and Unilateral Transfers. Balance of Trade deals with the difference between export and import of merchandised goods. These are tangible in nature. E.g., food grains, textile, gems etc. Trade in Service records the monetary value of all the services. E.g., call centre services, tourism, education, expertise provided in sectors like film making etc.

Unilateral transfers are the money received in the form of gifts by foreign nationals. E.g., donations for philanthropic activities, remittances sent by NRIs etc. The major portion of CAD is covered by Balance of Trade Account. The surge in IT and ITES services, are also becoming increasingly visible in Balance of Payments.

![Graph showing India’s current account deficit over years](image)

India is a “twice deficit” economy. It has fiscal deficit and Current Account Deficit. The government needs domestic savings to manage fiscal deficit and foreign savings to manage CAD. During 1985 to 1990 fiscal deficit touched 9% of GDP and the government started borrowing from abroad to control it. This in turn increased the CAD which triggered the Balance of Payment Crisis (1991). To come out of it, the government had to take assistance from World Bank and Bank of England. Thus financing the deficit in one can result in deficit of the other. At the end of year 2010, Fiscal Deficit surged to 4% of GDP while CAD is 5.5% of GDP. Twin deficits, if not controlled, can be dangerous to the economy.

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Source: southasianinvestor.blogspot.com

How is Current Account Deficit calculated?

CAD is the net sum of monetary value of all exports minus imports. CAD is calculated using the prices currently prevailing in the market unlike GDP which is calculated with respect to the base year. Rise in price or quantity or both affect CAD. Oil imports consist of 35% of the import bills. In the year 2008-09, the increase in the world oil prices had increased India’s deficit to $10.7bn.

Changes in trade policy

Changes in trade policies from July 1991 onwards have included a significant scaling down of tariff barriers, and a partial dismantling of the system of import and export licences and simplification of procedures. There has been a consistent decline in tariff rates from 355% to as less as 25% in commodities. A duty rate of 20% is levied on equipment for power projects and there is no duty on equipment for fertiliser projects. The negative list, which consists of items that were restricted from importing, reduced from 70 to 3.

Today, India welcomes direct foreign investment in virtually every sector of the economy except those of strategic concern such as defence, railway transport and atomic energy. The cumulative FDI equity inflows in the country from 1991-2011 is $142934 million.
The Foreign Exchange Management Act (FEMA) provided for substantial relaxation of FDIIs in India. It increased Foreign Equity share to more than 51% for most of the industries. In infrastructure projects, the Foreign Equity share was as high as 79%.

The formation of Special Economic Zones encouraged exports. The first generation of new trade policy was successful in curbing the 1991 deficit crisis. Indian economy did not witness devaluation of Rupee after 1991. This was possible due to the strong forex reserves maintained by RBI.

While it may seem that monetary policy could come to rescue the nation reeling under CAD, however such policy actions have offsetting effects on the external balance. Suppose, for example, that monetary restraint lowers domestic demand, thus causing improvement in the current account by reducing income and the demand for imports. This latter effect is largely offset by the appreciation in the exchange rate that accompanies monetary restraint (higher interest rates, in this case, attract demand for domestic assets). Appreciation in the exchange rate would worsen the current account by switching expenditures from goods and services produced domestically to those produced abroad. The net effect of the offsetting factors on the current account is likely to be small.

After the global meltdown, the current account deficit has also started to widen as the economy recovered. Both oil and non-oil imports surged leading to widening of the current account deficit, but has increased since then to reach 3.9% in Q2 2010-11. RBI expects CAD at 3.5% of GDP in 2010-11 which is the highest CAD so far.

Current Scenario of CAD in INDIA (15.8 Billion USDs)

A) Strong domestic demand and constrained Exports:

Strong domestic demand, large infrastructure needs such as road and power equipment, and India's increasing reliance on commodity imports of oil and coal, will keep import demand robust in FY12. Also, there has been a reduction in import duties in 2006-2008. Export growth remains constrained by the weak external environment. The US and EU together account for more than 30% of India's merchandise exports and a larger proportion of India’s services exports. The EU is currently reeling under the turmoil due to sovereign debt crisis which has reduced their purchasing power, in turn decreasing the demand for Indian exports. This situation is unlikely to get better in the near future. Recently, net non-software trade in services has become strongly negative, as imports have exceeded exports by a wide margin. The deficit on goods and services has risen to 6.5% of GDP by end-June 2010.

B) Financing by short term capital:

During the July-September 2010, foreign institutional investors (FIIs) put in $18.8 billion, while it was only $7 billion in the same period last fiscal. However, foreign direct investment fell to $2.5 billion during the period under reference from $7.5 billion in the year 2009.

Moreover, Indias external debt rose by 12.8% to $295.8 billion in the first half of 2010-11. All this enlarges short-term debt and raises external vulnerability as the flows can dry once advanced economies start to pick-up. This is similar to the trends we saw before the 1990-91 crisis, though this time we also have equity flows compared to just debt flows then.

C) Macro-environment and Political Unrest:

Political unrest in macro-environment like the one currently in Egypt could have a twofold impact on our country. It will lead to rise in oil prices given that the Middle East and North Africa account for 60% of Indias oil imports. As protests in Egypt have further moved to parts of Middle East, oil prices have crossed more than $100/bbl from $97/bbl. Secondly, it will impact the remittances. Indian workers in the Middle East account for 50% of Indias total private transfers.

Impact of CAD

There are four key implications of high CAD:

1) CAD is the gap between the domestic savings and the investments rate:

The investment-to-GDP ratio was slightly lower in FY10, from 34.9% in FY09. So the wider CAD suggests that the gross domestic savings declined further from 32.5% of GDP in FY09, largely due to government dis-savings.

2) It signifies strengthening of domestic demand. Since India is a supply-constrained economy, greater import absorption is a key valve for meeting excess demand. This when juxtaposed with high inflation and firm asset prices, could pose a serious threat.

3) It demonstrates that capital flows are much more important for India to fund its deficit. Therefore, despite the talk of capital controls, policies should remain geared towards encouraging, rather than discouraging, net capital inflows.

4) Finally, rupee appreciation over the last few months, despite a widening CAD, suggests that positive sentiment due to strong capital inflows has rubbed off.

Controlling the rising Current Account Deficit

Higher trade deficit and less support from net invisibles led to a higher current account deficit. Some of the ways of reducing current account deficit are:

1) Slowdown consumer spending:

The government will have to go for deflationary fiscal policy by raising interest rates and taxes. This would no doubt reduce consumer spending but would also see crowding out of investment by the private players.
It will cause rise in unemployment and decrease in earnings, thus reducing Purchasing power of people which in turn would reduce demand for imports. Hence it is not an efficient policy.

2) Devaluation:

Devaluation of Rupee by RBI will encourage exports and reduce imports. This is a bad idea as it would pump up money supply in an already inflationary economy. Sterilisation of Forex intervention is difficult under the present levels of government borrowing.

Also, here we are assuming that imports and exports will respond significantly to the change in the exchange rate. If both happen, the current account deficit will come down. India exports agricultural product's in large numbers. However, price elasticity of such products exports is very low in the US and European Market. The volume of Indian exports is hugely dependent on the volume of world trade and world GDP. The overwhelming determinant of export growth is going to be the pace of recovery in US and Europe.

3) Boost Productivity:

Government could try to increase supply side productivity. This would require protectionist policy which would provide protection to domestic industries. The government has introduced tariff barriers and import license fee to discourage import. To boost production, the government has introduced supply side policies like better education and training, privatisation and investment in transport and infrastructure. The “golden quadrilateral” project that connected all the four metros provided opportunity for business across the country. But this is a long term solution and has no immediate effect on reducing CAD.

4) Promoting investor friendly environment (FDI and FII's):

FDIs provide short term money while FDIs hold money for considerable amount of time. FDIs bring with them technology, equity and newer markets. Before 1991, FDI investments were up to 40% only and now it is increased to 100% in all the sectors except in few like the multi brand retail and print media.

Capital flows in India is via FIs and ECBs (External Commercial Borrowings) are short term, market sensitive and fluctuate very often. The year 2008 saw FIs pull out when the Sensex dipped to below 12000 points. Thus relying completely on capital flows can be dangerous. Fortunately India's good Forex reserves and strong FDIs have helped reduce deficit and sustain through the world crisis.

Is Current Account Deficit (CAD) always bad for the country?

The United States reported a current account deficit equivalent to 127 billion USD in the third quarter 2010 and China reported current account surplus of 102 billion USDs in the same period. Does this mean China is better off than US?

Under the Britton Woods Agreement, the Chinese enjoyed fixed exchange rate policy till 2005 and after 2005 the Chinese government did not allow Renminbi to appreciate leading to high current account surplus. The Chinese government forces its people to save rather than to invest. The Chinese government buys US bonds from the savings. Thus the US banks have surplus cash which is then made available at cheaper rates to Americans. Americans invest and enjoy returns.

Deficit being good or bad depends on the external economic conditions. Deficit reflect underlying economic trends that may be desirable or undesirable at a particular point of time. Research suggests that an overvalued real exchange rate, inadequate foreign exchange reserves, excessively fast domestic credit growth, unfavourable terms of trade shocks, low growth in partner countries, and higher interest rates in industrial countries influence the occurrence of reversals in their current account.

Moreover, the current account can be viewed in terms of the timing of trade. A country may import goods today (running a current account deficit) and, in return, export goods in the future (running a current account surplus then).

Thus excess or deficit of money does not indicate if the country is doing well or not. It is the way the money is utilised and invested which is the better indicator of the welfare of the countrymen.

Is India’s current account deficit of $18 billion a cause of worry? India’s economic strength was witnessed during the recession period from 2008-09. When most of the developed economies like the US and Europe were struggling to survive, India reported GDP growth of 7%. Some countries such as Australia has had a persistent current account deficit, yet has experienced economic growth for the past 18 years (1991-2009).

With changes in trade policy and increasing FDIs we see entrees in the stream of JVs like the Retail major Walmart tying up with Bharti, and UK’s Tesco tying up with Star Bazaar (100% subsidiary of Tata Trent). Such ventures would expose the Indian partners to technical expertise and technology.

The current situation of deficit can be handled and is really not a cause of worry. The RBI can bring the situation in control by altering the exchange rates and pulling FDIs into the country. But in order to ensure prosperity, the Trade policies should be structured to help India move up the Value Chain. It should move from a mere assembly unit to designing and manufacturing of engines. The government should boost research and development, encourage creativity in the field of entertainment and indulge in activities that would increase worthiness of the product. It has to create and develop unique products and services that can enforce demand in the international market. This would boost export revenues and thus decrease deficit. This is a long term strategy that would make way for India becoming a superpower in future.

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> Pugal T. A., International Economics
Lazy Banking
- High cost of funds likely to impact credit growth

India performed tremendously well during the global financial crisis manifested by its growing exports and domestic demand. But there are still some pain points in the economy. According to the latest data released by RBI, bank credit for the fortnight ended 1st Jan ’10, grew by 13.7% on an annual basis versus higher growth rate at 23.8% in ’09. With inflation as the sword of Damocles hanging over the government’s head RBI has increased key rates about 7 times in less than a year. 2010 wasn’t too good for the banking industry in terms of loan disburse. It remained subdued for most of the period, even as growth in credit fell to single digit at the end of October 2009. If India wants to continue being defined as the 2nd fastest growing economy in the world then it certainly can’t afford sluggish credit growth.

Interest rates can be thought of as honey. A small dose with your morning tea satisfies your taste buds much like today’s ordinary citizen happy to park his money in the banks. However too much of it is feared to cause sickness similar to what is dreaded by corporate and retail investors if credit keeps heading north.

Bank earnings come primarily from transactions and loan disburse (credit). To cater to loan demands banks issue credit at a higher rate than the investments it attracts via different interest bearing funds (fixed deposits, certificates of deposits, etc). This creates a cycle of healthy investment growth with easy liquidity in the market. It was exactly this strong capitalization that saw the Indian banks through recession. Rakesh Mohan ex-deputy governor of RBI once described the sluggish non food credit growth of 14.5% during 1998-2002 as a period of “lazy banking”. Nearly a decade later the same words don’t seem out of line. With rising inflation and volatile interest rates (India has always been at the forefront in terms of volatility in interest rates. (See exhibit 1)), banks today are caught up in the rat race. Each bank is increasing the deposit rates to repel customers from investing in other banks. Consequently the rising cost of funds (fixed deposit rates have increased nearly 250 basis points since September 2010) is likely to squeeze net interest margins (NIM).

Although economic growth momentum that is voiced vociferously by all major institutes and analysts at 8.2-9% is expected to set a stable foundation, there could be a twofold burden on banks as:

- **CRR**: Even though CRR which is an expense item for banks has decreased from its high of 9% in 2008 to the current 6%, it is still higher than 5% on a Y-O-Y basis. If it is increased further then interest margins for banks would be further squeezed.

- **Interest expense**: Earlier banks use to pay interest on the minimum amount in an account between the 10th and last day of the month. However post 1st April 2010 banks were asked to determine interest on a daily basis and consequently give interest on an average amount i.e. banks will have to shell out nearly 7000cr to its savings bank account holders.

![Figure 1: Rates over the years](image)

In January Credit grew from 14.9% to 23 %, with country’s foreign banks responsible for the biggest jump of 13.1% from 6.1%. Credit off take to commercial real estate sector grew at the highest rate from 12.7% to 19.9% in January 2011 on a Y-O-Y basis. Deposits grew by 14.3%. Above mentioned statistics show that there exists a gap between the loan demand and available deposit. Loan periods are getting longer and deposits have shorter maturities. Banks are simply not getting enough money from depositors. This is despite the fact: central bank is infusing liquidity in the system with the buyback of bonds (RBI brought back sovereign bonds worth more than Rs.8500cr last year with further promise to buyback nearly Rs.10000cr worth of bonds).
Loans in the first half of 2010 grew at 5.5%. If the onetime 3G telecom spectrum proceeds are excluded, then the picture looks bleaker with growth rate just hitting 2.4%. India’s industrial output grew at 1.6% in December; the lowest in nearly 20 months. While individual sectors like automobiles and real estate have grown, major contributors to India’s industrial production indices like cement and coal, mining have mellowed down from their robust growths in 2008-09. Companies spending on capacity expansions also decreased 31% in 2010 from 2009. With lacklustre industrial performance, flagging loan disbursals, costlier commodity prices the domestic purchasing demand could be damaged in the near future. (A vicious cycle could be formed see figure 2). Investor confidence may take a further beating as rates rise. The sensitivity index has already shed 15% since the start of the year; the worst performance across the entire Asia-pacific region.

According to a December 2010 RBI report Infrastructure, basic metal and metal products and engineering industries accounted for two-third of the annual incremental credit off-take. Credit flow to the industry sector grew 27.4 per cent as of December 2010, against 15.7 per cent in the year-ago period. Indeed Infrastructure was specifically addressed in this year’s budget with such provisions as increasing the tax exemption in infra bonds, increasing FIIF infusion to $25 billion et al. Further, the government’s decision to infuse capital into some banks would increase their limit for infrastructure lending. Thus, notwithstanding the central banks tightening of monetary policies, infrastructure could well be bank’s knight in shining armour.

Among various indicators of financial stability, banks’ non-performing loan assumes critical importance since it reflects on the asset quality, credit risk and efficiency in the allocation of resources to productive sectors.

During the last decade, the PESTLE (political, economic, social, technological, legal and environmental) framework has undergone significant changes, largely, due to rise of emerging economies, including India, recession, Basel 3 reforms, increase in the pace of globalisation, etc. Moreover, Government intervention in the credit market has eased considerably. Overall, these developments have led to structural change in the financial sector, which has created conducive yet ambiguous environment for market mechanism, in general, and economic factors, in particular, for playing a critical role in influencing the portfolios of banks and financial institutions.

For banks to maintain a growth rate of 20-22% as envisaged by RBI for year 2011, not only do the deposit costs need to come down but the slippage ratio (=fresh accumulation of Nonperforming assets/ total standard assets at the beginning of the year) should also be decreased. Recent news highlight the fact that decrease in NPA has helped banks like SBI, Bank of India and HSBC post positive results. Other areas where banks profitability can be increased are treasury and CASA deposits. But because of ambiguous external market scenario treasury income cannot be forecasted successfully which leaves us with current account saving account deposits (CASA). CASA is closely linked to NIM. By increasing low cost CASA deposits NIM can be increased.

Because foreign rates are at historical low levels and domestic rates are high Banks could also look at raising cheaper funds abroad. Some have already moved in that direction with IDBI planning to raise USD1 billion by September 2011 as also Indian Overseas Bank, which plans to raise a similar amount, half before end-March. Banks can also get a boost from non interest income such as trade, forex, advisory as well as loan refinancing. Indian banks need to shrug off its complacency. It cannot rest on the laurels it won during the recessionary period. The biggest challenge before Indian banks now is mobilization of deposits. RBI may have to refrain from raising the cash reserve ratio, and focus only on raising interest rates as part of its tighter money policy.

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> www.economicstimes.com
> www.livemint.com

ANSWERS TO CROSS-FIRE, JANUARY 2011

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The winner of Cross-Fire & Fin-Toonz are
Prateek Bhatnagar & Darshan Mehta of MDI, Gurgaon.
They win a cash prize of Rs. 1000

CONGRATULATIONS !!
After realizing the long term implications of the convergence of accounting standards that is taking place around the world, the Institute of chartered accountants of India (ICAI) has decided to work in sync with the international financial reporting standards (IFRS). The likely date for the first phase of the three phase implementation is 1st April 2011 but may be delayed according to latest newspaper reports. Along with India, countries such as Argentina, Canada, Indonesia, Mexico and republic of Korea are also expected to initiate the convergence process around the same time. Currently there are 105 countries that require or permit the use of IFRS. Let us have a look at the key benefits and challenges this move poses to the future of our economy.

Several firms have already started aligning themselves according to the new standards. Firms like Wipro, Mahindra and Mahindra, Tata Motors, Dr. Reddy’s etc have started moving towards the global accounting standards. One reason behind this early implementation is the compulsion of IFRS for the firms to get into European market which for many Indian companies is a significant market. Apart from these Indian MNCs most of the Indian firms have chosen to wait and watch. The larger firms are taking this as an opportunity for unifying projects and streamlining their processes.

This convergence will bring a lot of changes in the financial statements of various companies. For example the convergence will boost up the net asset of Coal Indian because of the removal of some overburden reserves which were there in the traditional accounting. Also companies which are planning to go for IPOs will have to understand the new rules properly for valuation purposes. All those companies which are going for IPO prior to April 1 and are planning to implement IFRS after April 1 will have modify their draft red herring prospectus according to the new standards.

For investors and analysts, comparing companies across boundaries and carrying out valuation would become easier and more accurate. For better analysis investors used to convert financial statements from one form to the other. This move would save a lot of their time and cost.

This implementation will also have a huge impact on the future of Indian chartered accountants. With the knowledge of IFRS they will now be more globally acceptable. Thus the Indian accounting industry is set to grow exponentially.

Impact on various stakeholders:

With India trying to be more global in its approach, such a move will position our economy better in the global context. It would be much easier to compare organizations across various domains internationally, making the entire system more transparent and reliable; thereby instilling confidence into the system.

It will become much easier for industries to attract huge foreign capital at a lower cost of capital. Benchmarking of data across international boundaries will be possible. IFRS will eliminate barriers to listing abroad as it is more globally acceptable. Cross border mergers and acquisitions will also get a boost because of the increased convergence among international organizations. On the whole, corporations looking to expand globally are inclined to benefit from this move.
Implementation methodology:

Phase 1:
Following companies will implement IFRS -
1. Opening balance sheet as on 1 April 2011
2. 50 companies that are part of nifty
3. 30 companies that are part of Sensex
4. Companies listed outside India
5. Companies having net worth greater than INR 1,000 crore

Phase 2:
Following companies will implement IFRS -
1. Opening balance sheet as on 1 April 2011
2. Companies having net worth greater than INR 500 crore

Phase 3:
Following companies will implement IFRS -
1. Opening balance sheet as on 1 April 2014
2. All other listed companies

Issues:
Currently the differences between Indian GAAP and IFRS are under-estimated. Convergence with IFRS will lead to the entire set of financial statements undergoing a huge change. It would be a big challenge to bring about awareness of IFRS among financial statement users.

IFRS uses fair value of most of the items that are present on the balance sheet. Arrival at the fair value is a task in itself requiring a deep valuation analysis to be carried out. Fair values of several financial instruments such as derivatives would result in increased volatility on the income statement.

Another important question is of meeting the April 1 deadline. There are a lot of issues that has to be dealt with and a lot of changes that have to be made for this convergence. The attempt is to convert top 200 – 300 companies which are already global and to show the ways to others for the next stage. A major issue of tax related to new accounting practices is also a topic of debate.

Suggestions like implementing IFRS only for financial accounting and later implementing it for tax purposes are being made by experts. Even though the implementation of IFRS will become mandatory in India but still there is no clarity about its impact on taxation policies. Thus companies might be required to maintain separate documents for both IFRS and taxation purposes.

Currently the training facilities and accounting courses on IFRS in India are very limited and hence successful implementation might require expert help. Companies would require dedicated internal staff for this activity henceforth. Several companies will also have to change their existing systems and IT processes.

Implications of a delay:
One question that is clicking everyone’s mind is that can India delay IFRS convergence when we are going to have a new direct tax law coming into effect from April 1, 2011. There are a lot of segments of the opinion that the delay would not let India be a part of the global debate. Another important point in this context is India has already promised to the G20 about this and so going back will again create problems for us. Again debatable issues like agricultural accounting, foreign currency transactions, pension accounting etc cannot be taken into account from Indian perspective unless and until India won’t go for this convergence.

Conclusion:
The institute of chartered accountants of India (ICAI) has laid down the strategy for convergence with IFRS for public interest entities and SME’s, along with the role ICAI, Government, reporting entities and its expectations from IASB. This convergence is certainly not an overnight exercise and will involve a lot of effort on the part of organizations in the short run but this should not deter them from implementing it as it has long term healthy implications on our economy.

Reference:
> Concept Paper on ‘Convergence with IFRS in India’ by the Institute of chartered accountants of India (ICAI).

ANSWERS TO FIN- QUIZZITIVE, JANUARY 2011

1. Vineet Rai - In addition to founding Aavishkaar, Vineet is the Co-founder and Director of Intellecap
2. MMB Legal and Tatva on Ikyra acquiring Magna for $22 million
3. Pegasus International holdings
4. The Dutch 'dubbelje' with its 14mm diameter is the smallest sized coin currently in use anywhere in the world. The Phillips engineers in charge of setting the technical specifications for the Compact Disc (CD) gave this disc a very Dutch touch: the size of the center hole of a CD equals the size of the dubbelje, and the Dutch dubbelje is the only coin in the world that passes through a CD center hole. The happened purely by chance as one of the engineers happen to have the dime in his pocket
5. Subaru
6. Red Book or the Budget Report
7. Dead cat bounce

The winner of the quiz is Chetan Singhal of NITIE, Mumbai. He wins a cash prize of Rs. 1000
Street Talk:  
Mr. Sunil Singhaniya  
Head - Equities, Reliance Mutual Fund  

A CA rank holder, with a few years of experience, Sunil Singhaniya began his investment career with Motisons Securities as ‘The President’. He set up the business and later moved to Advani Share Brokers, handling institutional research and sales. He thereafter completed his CFA and moved to Reliance in 2003 as fund manager.

When he moved to the funds business, Reliance Mutual Fund had been handling less than Rs 100 crore in equity assets. Today, with Rs 17,700 crore in equity assets, Singhaniya is a part of one of the largest equity fund players in the business.

We would like to thank Mr. Sunil Singhaniya for taking out time from his busy schedule and sharing his thoughts with us.

Q. This is the eighth hike that the Reserve Bank has taken since March 2010. Where do you see the interest rates cycle and inflation?

A. Inflation continues to be a worry. However, our view is that we have seen the worst and from here on we will see a very gradual but sure fall in inflation rates. Of course the price trend in oil will be a key determinant. Also as far as RBI is concerned, there also our view is that we are nearing the interest rate hike cycle.

Q. There has been quite some pressure on the Indian equity markets in last quarter. What are your expectations from the market in 2011?

A. We continue to be positive on Indian equities on a medium and long term basis. The economy should grow at a compounded 8% on an average over the next few years and that, along with the basic strong fundamental traits like demographics, increasing spread of wealth and opportunities and consumption, should see the Indian markets deliver steady and decent returns for longer periods of time.

Q. How does price-to-earnings (PE) ratios of Sensex and Nifty look?

A. India is a growth market and it is unfair to compare Indian P/E ratios with countries like Brazil or Russia which are predominantly commodity or oil plays. Also a faster growth rate leads to a higher multiple. Having said that, after the recent correction, Indian equities are trading at less than 13 times FY12 earnings and less than 13 times FY13 earnings which is lower than the last 10 years average. This provides long term investors with decent upside possibilities.

Q. How do you think the turbulence in global platform is going to affect the Indian markets and the economy as a whole?

A. In the near term all markets tend to be correlated. However the recent global events have further reinforced the advantages of a predominantly domestic economy and that is where India scores over most of the other economies. Over a period of time, once stability returns, the attractiveness of India will surely enhance.

Q. With the volatility in crude oil prices and given the fact that India has a huge import bill, how much does it concern you?

A. As mentioned earlier, oil remains a key determinant as it impacts our trade deficit, current account deficit, subsidy burden and thus fiscal deficit. Thus oil price moving up sharply surely has the potential of causing slowdown in the Indian economy.

Q. Which themes are you betting on this year? Are there any sectors that have been laggards and are expected to bounce?

A. Consumption, financial and infrastructure will be the key themes.

Q. What are you underweight on?

A. With oil prices shooting up and difficulty in passing on the prices to the customer would mean that government oil companies will suffer.

Q. Which are the key factors in your opinion that are likely to decide the trend of markets this year?

A. Presently the Middle East scenario becomes a major monitorable as oil is so important for the Indian economy. Other local factors like reforms, infrastructure spending by government, crackdown on corruption would be few other important factors to track and impact markets.

Q. Can a finance student make a career in the field of Asset Management?

A. Surely. There are various avenues for finance students. Fund management, financial analysis, wealth management, sell-side analysts, are a few career options.
Unleashing the BCD Nexus in India
- Repairing the broken Monetary Transmission Mechanism

In India, it is frequently observed that every time a change in policy rate is announced by the central bank, it is not the markets but the RBI governor or the Finance Minister who has to prod the banks to change their borrowing and lending rates. In most advanced economies, the market rates automatically move in synchronization with policy rates. The reason for this discrepancy is that the monetary transmission mechanism in India is weak and enfeebled. Amongst others, one of the major reasons for this is the lack of a well-developed and fully functional BCD Nexus. This article introduces the concept of BCD Nexus and looks at why it is critical for repairing the monetary transmission mechanism.

The monetary transmission mechanism is the process through which any changes in the short term interest rate made by the central bank of the country propagate into changes in the interest rates across the economy, thereby affecting the output and inflation. The changes in policy rates first impacts the financial and assets markets which in turn induces changes in the spending behavior of the consumers which ends up impacting the GDP and inflation. The degree of development of monetary transmission mechanism decides how efficiently the impact of change in policy rate is carried across the yield curve to impact all the market interest rates and thus its strength can have a direct impact on the way monetary policy is conducted in a country. Its effectiveness largely decides the amount of the control that the Central Bank exercises on the economy of a country.

Monetary Transmission Mechanism in India

In India, the monetary policy transmission is largely dysfunctional because the interest rate pass-through from policy rate to deposit and lending rates is not only incomplete but also suffers from huge lags as well.

The cost of working with the weak mechanism is very high for an economy. With a weak monetary transmission, if a certain reduction in inflation is called for, RBI needs to make savage changes in the short term rate every time it intends to make even a miniscule impact. Central banks in mature market economies on the other hand are able to control inflation through small changes in the interest rate. The lending rates behave rigidly and don't move in line with the policy rate changes made by RBI, rendering the monetary tools ineffective.

It has been empirically established that the monetary transmission mechanism of India is weak when compared to developed economies. The extent of Monetary Policy Transmission effectiveness can be judged by the calculation of Interest Rate Pass Through. It is the degree and speed with which the variations in monetary policy are passed on to the interest rate spectrum of the economy. Estimates suggest that, during the period of September 1998-March 2004, the interest rate pass-through in India was 0.61 and 0.42 for lending and deposit rates, respectively (source: RBI report), i.e., a reduction of 100 basis points (bps) in the Policy Rate led to a reduction of almost 40 bps in the banks’ deposit rates and 60 bps in their prime lending rate. Thus, the interest rate pass-through in India is incomplete. In contrast, the interest rate pass through in many other developed economies like US and UK is close to 1.

<table>
<thead>
<tr>
<th>Table 1: Interest Rate Pass Through</th>
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<tr>
<td><strong>Deposit Rate</strong></td>
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<tr>
<td>UK</td>
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<td>Canada</td>
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<td>Thailand</td>
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The relative downward inflexibility in the commercial interest rate structure can be attributed to a number of factors namely administered savings rates, lack of floating rate products and absence of BCD Nexus.

Though the above mentioned factors do play a part, albeit a small one, in weakening the interest rate structure, it is the lack of BCD Nexus which has proved to be a major obstacle in repairing the monetary transmission mechanism. The idea of BCD Nexus and its relation with the monetary transmission mechanism is discussed in the subsequent sections.
Understanding the BCD Nexus

The Bond-Currency-Derivatives (BCD) Nexus is a complex system of integrated markets through which small changes in the policy rate propagate to influence rates across the economy. It transmits the impact of a change in the policy rate into changes in interest rates for all maturities and all credit qualities.

For the monetary policy transmission to work, any change in the short term rate must be transmitted across yield curve by arbitrageurs. And it must translate into all credit curves as well. Bank lending rates must move parallel to the corporate bond market rates. Derivatives on the yield curve are vital to getting a yield curve that is free of arbitrage.

BCD Nexus and Monetary Transmission in India

Since the BCD nexus is not well developed in India, the interest rate pass through is not complete as the long term interest rates remain largely unaffected by changes in policy rate. The mechanism to carry the impact of short term half of the yield curve to the long term half is broken. For an effective pass through, a well developed bond and derivatives market is needed where the speculators and arbitrageurs can carry the impact of policy rate changes across the entire yield curve by trading in both the spot as well as the derivatives market. Lack of a well developed Corporate Bonds market in India has ensured that banks remain the only source of borrowed funds for the corporate. Since the banks face no competition as source of funds, they feel no obligation to change their rates even when policy rate changes are announced. A well developed corporate bond market would present a viable alternate source of funding for the corporate that currently just rely on the bank lending for their funding. This competitive funding channel would force the banks to align their lending rates with the market rates thus enabling a complete pass through of the interest rates, thereby strengthening the monetary transmission mechanism.

Current State of BCD Markets in India

The capital markets in India are heavily inclined towards equities with equities market occupying around 74% of the annual trading volume in the capital markets. This lack of interest in debt securities has seriously impaired the BCD Nexus. Within the debt market segment also, the market is heavily skewed towards government securities.
Though India’s equity market is among the most liquid markets in the world, its debt market is very small when compared with the debt markets of other economies.

The above data clearly shows that the corporate bond market in India is less than 1% of the corporate debt market in US. Also, in developed economies like US, corporate tend to use both equity and debt markets for their funding requirements and the borrowing structure is not skewed as it is in India.

Similar to an underdeveloped corporate bond market in India, the derivatives market is almost non-existent. The regulators have always been skeptical about the use of derivative instruments and this has been severely constraining the development of India’s financial markets. The first launch of Interest Rate futures was rolled back due to illiquidity in market. The trading in interest rate futures was sabotaged by RBI, which banned bank participation in this market. RBI which till last year looked pretty committed towards the launch of credit derivatives market decided to block the launch in India post the financial crisis. Internationally, banks can protect themselves from the credit risk through the mechanism of credit derivatives. However, banks and financial institutions have not started using credit derivatives in India in a formal way and post-RBI decision it might now take a very long time before credit derivatives become a reality in India. Also, there have been many regulatory restrictions like preventing FIs from participating on the market, requiring ‘hedging’ transactions only, forcing tiny position limits which have constrained the market development.

**Building the BCD Nexus**

There is an immediate need to develop the BCD Nexus in India to address the problems arising out of weak monetary transmission mechanism. Here some recommendations are suggested that need to be taken to develop the BCD markets in India.

The Bond market has been plagued by lack of participation and skewed nature owing to prohibition on short-selling. A two-way market movement needs to be promoted which would require permitting participants to freely undertake short-selling. To expand the investor base, enthusiastic participation from the retail investors and FI need to be stimulated. The introduction of Separate Trading of Registered Interest and Principal of Securities (STRIPS) in G-secs should be hastened. In the corporate bond segment, there is an urgent need to address the issues of lack of a Central Counter Party based settlement mechanism and high stamp duty.

In the Derivatives market segment, the regulators need to change their skeptical approach towards these instruments. The interest rate futures market lacks liquidity mainly because banks are allowed to use them only for hedging exposures and not trading. There is a need to allow banks to take trading positions subject to regulations including capital requirements. Also, RBI envisages only ‘hedging’ and not ‘trading’ transactions in Credit Derivatives. This would be detrimental, since hedgers as well as speculators are needed for market to be fully functional and hence market players performing all the three roles of hedging, speculation and arbitrage should not only be allowed but also encouraged.

There is a need to encourage participation of the domestic institutional investors also. The investment guidelines of both the Insurance as well as Pension funds need to be relaxed to allow them to play in the corporate bond as well as derivatives markets and provide them liquidity and depth.

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**BEST ENTRY FOR FIN-TOONZ, JANUARY 2011**

**Toon 1: Rocketing India**
Chat Box 1: (Pranab Mukherjee) See what magnificent schemes I have in store this budget for people.
Chat Box 2: (Mannohan Singh) Ever heard of FRBM? I only want policies that shoot serse to newer highs.

**Toon 2: The Big Q**
Chat Box 1: (Dollar) My dear euro, you have always helped me. Your countries have bought my bonds to keep me alive. Help me again.
Chat Box 2: (Euro) This time I am sick too my friend, I will have to save myself first so that I can save you next.
Chat Box 3: (Yen) Damn be Euro and Yen. I’ll depreciate myself in order to survive and then I’ll see who saves whom. Ha Ha Ha

**Toon 3: Done Undone**
Chat Box 3: (People) In a few days, food will be costlier than gold if food inflation persists.
Chat Box 2: (Govt.) Reduce this RBI, you are my sole hope or else people will definitely not spare me.
Chat Box 1: (RBI) I have done everything I could. The best what we can do now is to watch from a height and wait.
Inflation repercussion on growth - Post meltdown

"As inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery." - Keynes

Inflation vs. Growth

Since the time these two terms ‘Inflation’ and ‘Growth’ have been coined, economists have been arguing about their relationship. Some claim these to be indirectly associated; others advocate their direct relationship, while few even suggest lack of relationship. However, they all agree upon the necessity of little inflation for growth of the economy. Looking back in the 1960’s during the times of high growth but low inflation, when inflation was treated positively, Philips curve shows inflation and growth being positively related in short-run. In the longer term also, their positive correlation was advocated by the economists. However with changing times, experiences of high inflation were inherently unstable. Countries were not able to withstand high inflation, thereby pursuing inflation control thorough monetary as well as fiscal policies.

However, post financial crisis with the economy back on track, demand has fuelled up causing inflation in major developing economies. Along with rising demand, following government policies meant for revival of the economy have also causing inflationary pressure:

- Stimulus packages worth Rs. 2.48Tn.
- Monetary policy action by the central bank, cutting its lending rate to 6% from the pre-crisis 9%.
- Pared the cash reserve ratio (CRR), infusing Rs. 1.6Tn of liquidity into the system.

Excess liquidity bought by the stimulus packages has caused inflation the economy. The money supply has further increased with cheap money finding its way into Indian markets because of lower interest rates.

Recent Inflation Worries

There are several reasons why we should worry about the spike in the inflation rate. Inflation is a tax on the poor and long-term lenders, eroding their already miniscule earnings to even smaller value. In 2011, inflation has eroded Indian stock market by around 8%, while Long bond yields have risen by more than 20%, causing drop in foreign investments coming to India.

High inflation has been part of Indian Economy since a long time. Past six months have noticed even higher inflation rates than today. So why is there such hoopla all around for inflation?

Answer to this lies in the alarming levels of economic indicators for last Nov’10 quarter, for which high persistent inflation is responsible. With Index of Industrial production at 2.7%, the latest since the Indian economy recovery from the economic downturn of 2009. Some analysts blamed the incompetency of IIP index and base effect for such low figures. However, year-on-year growth of three month average of IIP index showed downward shifts. So, will RBI keep a check on the poor IIP growth rate or containing the growing inflation, the dilemma will remain forever.
What other economic indicators are saying?

Economic indicators like growth in railway freight and sales of commercial vehicles, which indicate goods movement within the country, have also not shown significant growth. Cement dispatches dropped in November showing sluggish growth in infrastructure sector. Since, Non-oil imports (3/4th of which are industrial inputs) are down from their highs in July. Indian economy showed great resilience during the economic slowdown and acted as growth engine for the global economy. Though we recovered faster from the crisis, inflation also caught us sooner than others. Along with eroding the income of people and depleting yields of long term bonds, inflation is posing serious threats to the growth story of India.

Take a look at the Indian markets, MSCI India index has been showing downward trend since Dec’ 10, while the MSCI world index has been showing upward trend. This clearly shows heavy selling in the Indian markets by foreign investors, most of which are investing their money back in the US markets. During past quarter, US growth has been higher than expected levels. At times when investments by foreign investors are necessary, foreign investor’s exit from Indian markets can dent India’s growth story. Take a look at the Indian markets, MSCI India Index has been showing downward trend since Dec’ 10, while the MSCI world index has been showing upward trend.

India already has a burgeoning fiscal deficit; add to that the rising inflation which further deteriorates the situation. With soaring food and oil prices, subsidy bill of the government is bound to rise leading to even higher fiscal deficit. Unlike the telecom auction last year where government had significant windfall income, in 2011 there would be rarely any chances of such income. Taking a look at the forecasts of real GDP growth by World Bank for 2011, Indian economy will grow at 8.5% compared to 9.2% for 2010. Prime concerns sighted for Indian growth story has been inflation, which can reach as high as 8.5%.

Steps taken by the RBI

RBI’s prime motive has been to siphon excess money from the system to check rising prices as food inflation neared the decade’s high of 20%. To no surprise, RBI has already signaled an increase in interest rates asserting its determination to restrain inflation. The repo, which is the rate at which it lends to banks, is now at 6.75%. And the reverse repo, which is the rate at which it borrows from banks, stands at 5.75%. The rate hikes would help prevent rising food prices from spilling over into general inflation.

Why it is getting difficult to tame inflation?

With RBI committed to tame the inflation even at the cost of growth, inflation has remained at much higher levels when compared to its target value. Even the monetary and fiscal policies, the two major weapons in the hands of RBI to contain inflation are proving useless. It becomes necessary to understand the real drivers of inflation in India today.

Dec’ 10 Wholesale Price Index has remained at 114.1, however WPI for food items for same period has been at 185.9. Food has been the major culprit for inflation in recent times, primarily due to supply side constraint. 2010 witnessed the worst drought in three decades worldwide, along with heavy rainfall in last two months causing price spike. Ahead, accelerating commodity prices abroad are further repercussion to core inflation. Domestic prices of auto and consumer durables have already seen a rise primarily due to rising input prices. Public spending continues to be expansionary which is fuelling further inflation. Moreover, some of these investments may get diverted towards productive investments in agriculture to signal strong determination to tackle food prices.

Tackling inflation caused by supply side constraint with monetary policy seems to be useless. Only sustained long term investments through fiscal measures in addressing supply concerns can bring inflation to reasonable levels. With inflation projections being revised upward while growth forecasts are being revised down, taming inflation is definitely going to be a hard nut to crack for India.

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New banking licenses  
- Boon or bane for the existing industry

With the nation at the crossroads of different yet-to-be-addressed priorities, India is poised at a critical juncture with some serious alternatives to be reflected upon. And one of them and quite distinctly prominent enough is the state of the banking landscape in the country. If the policy manifesto of inclusive growth is to be seriously pursued, the banking sector needs to undergo some major transformations and a step in this direction was indicated by the Finance Minister in his budget speech last year.

“We need to ensure that the banking system grows in size and sophistication to meet the needs of a modern economy. Besides, there is a need to extend the geographic coverage of banks and improve access to banking services” quoted Mr. Pranab Mukherjee in his budget speech for 2010-11. This was further shown a direction in the Annual Policy Statement of the RBI Governor by putting forth the proposal to approve additional banking licenses to private sector players and also consider NBFC’s for the same.

Rationale for more Banks

Some of the barometers of the economic growth of a nation are the stability and soundness of its financial system. But these two alone do not guarantee inclusive growth. The banking system needs to broaden and deepen its reach so as to provide a wider distribution and access to financial services for both consumers and producers. The poor, which are the major stakeholders in the issue of inclusive growth, should be given more and more opportunities to partake in the normal functions rendered by the financial system i.e. accumulate their savings, make investments, avail credit and also ensure themselves against exigencies.

Status Quo of the Banking Sector

Presently, India has 27 public sector banks, seven new private sector banks, 15 old private sector banks, 31 foreign banks, 86 regional rural banks, 4 local area banks, 1,721 urban cooperative banks, 31 state cooperative banks, and 371 district central co-operative banks. The average population coverage by a branch of a commercial bank has improved from 12300 on June 30, 2005 to 9400 as on June 30, 2010 in the urban areas and from 17200 on June 30, 2005 to 15900 as on June 30, 2010 and the All India weighted average during the same period improved from 15,500 to 13,400. According to a report by ICRA, public sector banks hold over 75% of the total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5%, respectively.

<table>
<thead>
<tr>
<th>Region Covered</th>
<th>As on June 30, 2005</th>
<th>As on June 30, 2010</th>
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<tbody>
<tr>
<td>Urban Areas</td>
<td>12,300</td>
<td>9,400</td>
</tr>
<tr>
<td>Semi-urban and Rural Areas</td>
<td>17,200</td>
<td>15,900</td>
</tr>
<tr>
<td>All India Weighted Average</td>
<td>15,500</td>
<td>13,400</td>
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</table>

Population coverage by a commercial bank branch


Though there has been no doubt that the Indian financial system has made huge strides in improving its geographical reach and financial viability alongside competitiveness, a vast segment of the populace is yet to reap its advantages and it is to this end that the RBI is considering the provision of licenses to a limited number of new banks as well as bring the Non-Banking Financial Companies into its fold.

New Licenses: The Way Ahead?

The subject of allowing the setting-up of new banks (including the local area banks), conversion of NBFC’s into banks and whether or not to involve the large business and industrial houses in the same, has been debated upon by a number of opinion-makers.

The different scenarios and their impact can be discussed under the following heads:

1. Minimum capital requirements and promoters’ contribution

The 2001 guidelines for licensing of new banks envisaged a minimum capital of Rs. 200 crores to be increased to Rs. 300 crores over three years from commencement of business. Given the time lapse since then and the inflation in between, there is a case to have a minimum capital requirement in excess of Rs. 300 crores.

Having a high capital requirement in excess of Rs. 300 crores, would attract only serious contenders and will result in optimum utilization of capital from the beginning.
New Banking Licenses

But it might also attract non-serious entities with inadequate financial backing and more frequent cases of bank running out of money. Also, ensuring fit and proper shareholding and directors of large number of small banks is quite onerous.

Having a high capital requirement (Rs.1000 crores) would evince interest from serious parties with backing but the promoters are highly unlikely to be seriously committed to the cause of financial inclusion.

2. Promoters’ shareholding

The current approach in this regard is requiring promoters to bring in a minimum of 40 percent of capital with lock-in clause for 5 years and the threshold for other significant shareholders to be restricted to maximum of 10 percent with the requirement to seek acknowledgement from Reserve Bank of India on reaching 5 percent threshold and above. Promoters too would have to dilute to the extent required in a time bound manner say, 5 years after the lock in period.

The requirement of dilution would ensure that only promoters not hungry for control would seek the licenses and the bank would run professionally in the long run. The bank would be run professionally in the long run in the absence of any significant influence.

But this could also act as a deterrent for serious promoters and the bank might lack vision and direction. Also, in the absence of a promoter it would be difficult to fix responsibility and accountability for the affairs of the bank.

3. Foreign shareholding in the new banks

The aggregate of non-resident investment (including the FDI, FII and NRI) could be capped at a suitable level below 50% and locked in for initial 10 years. This would enable foreign capital to be used in promotion of domestic banks and allow greater foreign technical collaboration. The downstream investment of banks for monitoring indirect foreign investment would not be an issue.

But this might pose a problem when the banks would require raising further capital from the domestic sources. Foreign capital willing to invest in banking or promote banks in India will be constrained.

4. Eligible Promoters: Industrial Houses?

The 2001 licensing guidelines prohibited promotion of new banks by industrial houses. However, individual companies, directly or indirectly connected with large industrial houses were permitted to acquire by way of strategic investment shares not exceeding 10 percent of the paid-up capital of the bank, subject to RBI’s prior approval.

Allowing the participation of industrial houses could have both merits and demerits. The industrial and business houses, with their presence in almost all financial services sectors, are already competing with banks on both the assets and liability sides. Their equity is widely held and they have a long history of nurturing and building new businesses.

But an affiliation to these houses would tend to undermine the independence and neutrality of banks as arbiters of the allocation of credit to the real sectors of economy. Conflicts of interest, concentration of economic power, likely political affiliations along with governance and safety net issues are the main concerns.

5. NBFC’s

The NBFCs are mostly private sector institutions, which have carved their niche in the Indian financial system. The 2001 guidelines on entry of new banks in the private sector permitted NBFCs with a good track record for conversion into a bank, provided it satisfied the specific criteria relating to minimum net worth, not promoted by a large industrial house, AAA (or its equivalent) credit rating in the previous year, capital adequacy of not less than 12 percent and net NPA ratio of not more than 5 percent.

If conversion of NBFC’s to banks were to be permitted, some sectoral credit issues, such as infrastructure and microfinance, could be better catered to by NBFC’s specializing in these sectors. The NBFC model particularly those in lending activities has been successful in expanding the reach of financial system and thus by converting to banks, this model could be scaled up to better leverage the benefits and achieve the objective of financial inclusion.

But since the NBFC model and the bank model are entirely different, NBFCs may not fulfill the ‘well established and well regulated’ criteria and hence the ‘track record’ of an NBFC cannot be taken as an automatic eligibility criterion for conversion into banks. The initial capital requirement for NBFCs is a miniscule 2 crore and the due diligence and ‘fit & proper’ assessment exercise of promoters/directors is minimal both in terms of scope and rigour, as compared to banks. Moreover, the NBFC’s continued dependence on wholesale deposits and short term borrowings to sustain even their existing business operations would raise financial stability issues.

Conclusion

Besides the above mentioned factors, several other issues like the business model for the banks need to be addressed if the new licenses idea is to be a resounding success. Perhaps the RBI and the Government can draw lessons from the recent downturn and the fate of similar schemes in other nations to successfully see through this endeavor and achieve a long-overdue growth which is inclusive.

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**Something Wacky**

Human tendency is to find a reason for everything that happens around them and correlate these events. In the world of finance where there are so many numbers flying around, there are many more opportunities for such correlations. Team Street collects some of the wackiest correlations that have been made in history.

**Butter production in Bangladesh**

Would you believe that in the 10 years between 1993 and 1993 you could have used the production of butter in Bangladesh to predict how well the S&P 500 index would perform? On average, David Leinweber found, when butter production was up 1%, the S&P 500 was up 2% the next year. Conversely, if butter production was down 10%, you could predict the S&P 500 would be down 20%.

**Super Bowl Winners**

Whenever a National Football League (NFL) team wins Super Bowl, the stock market in US shoots up. An NFL win has about an 80% correlation to stock market success, according to a February, 2008, Wall Street Journal article. In 2002, when an NFL team lost to an AFL team, the stock market dipped sharply. So does that mean next time when an American Football League (AFL) team wins, its bad news for markets? We leave that to you to ponder over.

**Women’s Hemlines**

This theory presented by George Taylor says that the hemlines of women wear gives an indicator of the direction in which the stock market moves. The shorter the skirt, the stronger the economy will be. In hindsight, hemlines explain some of the major stock market movements: when skirts get shorter, it’s time to buy and when skirts get longer, it’s time to sell.

These are some of the theories that have gained popularity in media. We wish there be huge butter production in Bangladesh, NFL team wins Super Bowl and the women hemlines rise further. But we are sure Buffets of the world don’t use these rules to invest in the market.

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**Street Gyan**

**What is Spread Trading?**

A spread is defined as the sale of one or more futures contracts and the purchase of one or more offsetting futures contracts. A spread tracks the difference between the prices of whatever it is you are long and whatever it is you are short. Therefore the risk changes from that of price fluctuation to that of the difference between the two sides of the spread.

The spreader is a trader who positions himself between the speculator and the hedger. Rather than take the risk of excessive price fluctuation, he assumes the risk in the difference between two different trading months of the same futures, the difference between two related futures contracts in different markets, between an equity and an index, or between two equities.

For example, a spreader might take the risk of the difference in price between August Soy Meal and December Soy Meal (see picture below), or the difference in price between December Kansas City wheat and December Chicago wheat, or between the strongest stock in a sector and the weakest stock in that sector.

![Graph showing spread trading example](image)

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Example: Long August Soy Meal (SM7Q) and Short December Soy Meal (SM7J)

A spread trader can just as easily trade the difference between MICROSOFT and IBM (see below). Or he can trade the difference between two Exchange Traded Funds.

![Graph showing another spread trading example](image)

Example: Long Microsoft (MSFT) and Short IBM (IBM)
1. "It was an accident" is what he termed his invention as. His invention was the result of his spare time efforts. Once invented, it was so successful that it sold around 1.5 million dollars worth the product within a year of being invented. What am I talking about and who was the inventor?

2. Banks today have various branches and are connected by a secure and robust communications infrastructure. This enables them to share financial information, customer's information and loads of other things. By what name is a bank known owing to this feature?

3. In March 31, 1913, the great financier J P Morgan passed away. This prompted this kid to immediately take out the money he had in this bank. This was because he saw that his father’s bank shares had fallen in value after his death was announced. He had a green leather book which was a ledger that he meticulously filled till his 21st birthday. Identify the person.

4. When the eager minister asked how the French state could be of service to the merchants and help promote their commerce, Z came into existence. X is one of the most popular books of 19th century. It was written by Y. X popularized the term Z further. Identify X, Y and Z.

5. Who is the person and identify the connection with him and gambling

6. X was a famous almanac during the colonial times of America and was written by a prolific inventor Y. He adopted a pseudonym Z for writing the almanac from the 17th century author of another popular London almanac. A few years ago a famous sidekick A of a famous investor B released his collection of speeches in tribute to X. Identify X, Y, Z, A and B.

7. This economist was the first to use this term. It was first used in reference to the Japanese crisis of 1993 but rose in popularity during the recent crisis of 2008. What’s the good word?

8. If Lee Iacocca was the first to do this and Steve Jobs the most famous to do this, then what did they do?

9. X started in 1986 while Y started in 1989. Just before a major scam, X had reached 4000 while Y was hovering around 200. After that, X underwent through a series of disasters and booms which saw a great deal of fluctuation while Y created history with each passing year. Y also suffered major criticisms and blows but held on steadily. It is rumoured that Y is the only phenomenon that can bring even X to a standstill. Currently both are almost on equal terms, with X occasionally bettering Y. Identify X and Y.

10. What is your Amuda number?

Mail in your answers to: street.nitie@gmail.com with the subject ‘Fin-Quizzitive’ before April 15, 2011. Winner to get a cash prize of Rs. 1000/-
**CROSS-FIRE**

**Across**
2 "From the Brink of Bankruptcy" is based on this company's story. (3 Words)
3 The sum-of-the-years' ________ is an accelerated depreciation method.
8 The less popular of the two methods allowed for preparing the statement of cash flows is the ________ method.
10 This Journal is considered world's first business publication. (2 Words)
12 He won 1977 Nobel Memorial Prize in Economics for research on international trade and international capital movements along with James Mead. (2 Words)
15 First proponent of the "drain theory" in the 1860s. (3 Words)
16 ________ analysis of an income statement shows each amount as a percentage of net sales.

**Down**
1 Founder of this wealth management company is the winner of Nobel Prize and Grammy Award. Name the Company. (3 Words)
4 The ________ ratio is the annual cash dividend per share of common stock divided by the earnings per share for the year.
5 He was the man behind the merger of Edison's GE and Thomson Houston Electric Company to form GE. (2 Words)
6 If a corporation has cumulative preferred stock, the preferred stock’s ________ must be subtracted from the corporation’s net income in the calculation of earnings per share.
7 A Slang term used for the stock markets in U.K. (2 Words)
9 The cost of an asset minus the estimated salvage value is the asset's ________ cost.
11 He is the classical economist known for his Iron Law of Wages. (2 Words)
13 This principle is achieved by depreciating an asset over its useful life.
14 The alternate term for the 'book value' of an asset is ________ value.

Mail in your answers of ‘Cro$$-Fire to’ : street.nitie@gmail.com with the subject ‘Cro$$-Fire’ before April 15, 2011. Winner to get a cash prize of Rs. 1000/-

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# NATIONAL INSTITUTE OF INDUSTRIAL ENGINEERING

P.O. NITIE, VIHAR LAKE, MUMBAI – 400 087.

**MANAGEMENT DEVELOPMENT PROGRAMMES**

(April to July-2011)

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**Fee (inclusive of service tax)**

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**UNIT BASED PROGRAMMES**

NITIE conducts tailor-made training programmes known as "Unit Based Programmes" (UBPs). UBPs are run exclusively for any organization on any management areas aimed to fit company’s specific needs and held at NITIE or at a location convenient to the organization.

**CONSULTANCY**

NITIE offers professional consultancy services in various facets of Supply Chain Management, Operations Research, Information Systems, Marketing Personnel and other management and productivity related fields.

**For further information please contact:**

**Assistant Registrar (Programme)**

**NITIE**

Vihar Lake, Mumbai 400 087

Tel. No. (022) 28573371, Fax : (022) 28574033, E-mail: program@nitie.edu / nitie1963@gmail.com
About NITIE

The National Institute of Industrial Engineering (NITIE), Mumbai is a centre of excellence recognized by the Government of India. It was set up in 1963, in collaboration with the International Labour Organization (ILO). Since its inception, NITIE has been providing solutions to complex problems of the industry and business. NITIE today, is constantly ranked among the top 10 business schools in the country and its Post-Graduate Programmes are among the best in the country. Throughout the years, NITIE and its alumni have carved a niche for themselves in the industry.

The Team that is - Street

Street is a student-run Finance Interest Group at NITIE that assists budding managers in assimilating classroom as well as practical learning; thus nurturing them to evolve as better equipped financial managers. Having completed 6 years of existence, Street has grown from being an informal, in-house discussion forum to a truly national b-school society. In the year 2010-11, Street organized a wide variety of activities ranging from workshops to lecture series to inter b-school competitions. We also aim to strengthen the brand ‘Street’ by fostering partnerships with the alumni, academia and the corporate world.

CONTACT- street.nitie@gmail.com
Street, The Finance Forum

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MUMBAI 400 087