India needs greater financial supervision: IMF

India needs to improve its financial system supervision and crisis preparedness while at the same time liberalising some sectors to reduce distortions and risks created by heavy state involvement in banking, the International Monetary Fund said on Tuesday.

The IMF's Financial System Stability Assessment Update said India had improved its supervision and regulations in the 20 years since it started liberalising its economy and that its financial system fared well in the global financial crisis.

"Despite these recent successes, India's financial sector still confronts longstanding impediments to its ability to support growth as well as new challenges to stability," said the 116-page study.

These challenges were mostly medium- to longer-term, while stress tests of banks and other indicators showed that the financial system vulnerabilities were manageable in the near term, it said.

But the large role of the state - which owns big financial institutions, directs credit to priority sectors, and controls the range of permitted activities and the availability of foreign capital - "contributes to a build-up of fiscal contingent liabilities and creates a risk of capital misallocation that may constrain economic growth," it said.

The financial sector's capacity to support sustainable economic growth would be boosted by "gradually reducing mandatory holdings of government securities by financial institutions, and allowing greater access to private - domestic and foreign - sources of capital," the Fund suggested.

India should also allow "more room for private initiative and competition" in micro finance and other efforts to reach poor borrowers, who are under served by existing financial institutions, the study said.

One problem the study noted in particular was an inherent risk of the Reserve Bank of India facing "conflicting goals," because some RBI officers are directors on the boards of public banks that are also supervised by the RBI.

"Using the banking system rather than government programs in meeting the needs of priority sectors - agriculture, small and micro credit, education, health - and underserved areas may conflict with RBI's supervisory role," the Fund said.

RBI, in its supervisory role, would benefit from more attention to crisis preparedness, and stronger resolution powers and contingency planning for the insurance sector and the payment system, it said.

Despite an oversight regime that largely met international standards, "a common issue across the sectors is the lack of de jure independence, which can be rendered more challenging by the intricate relationship with state-owned supervised entities and their business decisions," the IMF noted.

The study is based on data and conditions as of February 2012, the Fund said. Such periodic studies are mandatory assessments of countries' financial systems to ensure they're in compliance with international standards.

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