Building a capable financial system: The Indian Financial Code

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Numerous problems of the Indian financial system

- A limited modernisation of the financial system from 1992 onwards:
  1. A big burst of activity on building the equity market. SEBI, NSE, NSDL, BSE.
  2. Entry of private banks and insurance companies, IRDA.
  3. NPS
  4. Significant reduction of capital controls.

Many problems remain

- Mis-selling of MFs and ULIPs
- Lack of financing for infrastructure investment
- Government borrows the bulk of household financial savings
- Regulatory turf battles
- Regulators often the barrier to progress
- Lack of rule of law
- Barriers to innovation and competition
- Most of India is cutoff from the formal financial system
- Firms and households face financing constraints
- Inflation crisis

The challenge and the opportunity

- Indian finance has been designed for a small third world country.
- India is now an emerging market; with a $2 trillion GDP where the demands being placed on the financial system are far beyond existing capabilities.
- We must establish a financial system that will serve India for the journey of GDP from $2 trillion to $20 trillion.
- Alongside this, we have an opportunity for a new large-scale export industry, i.e. financial services, that could be bigger than software exports.

A future for India in international financial centres

- The Indian workforce has scored success in software exports. This rides on skills in English and Mathematics.
- India has a great opportunity in international finance, as the skills required are: (a) Risk-taking; (b) English; (c) Mathematics and (d) Computer engineering. India has strong strengths in all four aspects.
- People of Indian origin dominate all global financial firms – even more than is the case with global computer firms.
- India can become a finance superpower, to compete with New York, London, Shanghai and Singapore.
- This requires a big shift away from socialist finance to modern finance.
- In 2004, the 'Percy Mistry Committee' was setup to plan how Bombay can become an International Financial Centre.

Committee process

By roughly 2004 it was becoming increasingly clear that the reforms process was stuck. This led to a committee process:

2007 Percy Mistry (focused on international financial centre)

2008 Raghuram Rajan (focused on domestic finance)

2010 U. K. Sinha (focused on capital controls)

2010 Dhirendra Swarup (focused on consumer protection).

- These reports add up to an internally consistent approach to financial sector reforms
- Some parts have been and are being implemented.
- The bulk of the work program requires modifying the laws.

The laws are the constraint

- We want the rule of law, so the laws matter!
- Piecemeal construction of laws, starting with the RBI Act of 1934
- Not designed in a coherent way
- Based on intellectual framework and requirements from a different age
- Most maladies are rooted in regulations and regulatory governance. Laws define the DNA of regulators. Better laws will set wheels in motion that will (in time) solve the problems.

FSLRC

- 2010 budget speech; implemented in 2011: Ministry of Finance setup FSLRC.
- An unprecedented project: To understand a sector, and to write a single conceptually consistent Code, that replaces roughly 50 existing laws.
- Chairman: Justice Srikrishna, and 7 members.
- Two years, 146 persons.
- A dedicated 35-person technical team
- Multi-disciplinary approach: Economics, Finance, Public Administration, Law.
- Consultation, cogitation, debate, international experience. Not a knee-jerk response.

The Indian Financial Code

- The Commission has delivered a draft ‘Indian Financial Code’ (IFC)
- 450 sections
- Replaces the bulk of existing Indian financial law.

Part I

Financial regulatory process

A unique arrangement

- Parliament delegates *the drafting of law* to regulators
- Regulators combine all three functions: legislative, executive and judicial.
- Both these are highly unusual arrangements!
- How can unelected officials be given the power to draft law?
- Regulatory independence??
- Combining all three violates ‘separation of powers’ doctrine.

FSLRC approach

1. Remove vague objectives and vague powers
   Do not write law which 'gives agency X the power to write regulations over sector Y'
2. The primary law must be specific about *objectives*, specify enumerated *powers* and establish elaborate *accountability mechanisms*.
3. Isolate the quasi-judicial function within the regulator.

Accountability mechanisms

1. Clarity of purpose
2. Rule of law
3. Regulation-making process:
    1. Only one instrument: Regulation.
    2. Regulation-making initiated by the board only.
    3. What is the market failure? (Fits in objectives?)
    4. What is the proposed intervention? (Fits in powers?)
    5. Does the proposed intervention solve the envisioned market failure?
    6. What are the costs and benefits?
    7. Public consultation process
    8. Regulation issued by the board only.
4. Judicial review
5. Reporting

9 components of the law

1. Consumer protection *Rights, powers, principles*
2. Prudential regulation *Powers, principles*
3. Resolution *Cover entire financial system; orchestrate work with prudential regulation*
4. Systemic risk regulation *The woods and not the trees*
5. Capital controls *Rule of law, only control access / lack of access*
6. Monetary policy *Clarity of objective, Monetary policy committee*
7. Public debt management *Investment banker and cash manager for MoF*
8. Development *Redistribution by MoF, market infrastructure and processes by regulators*
9. Foundations of contracts; securities. *Framework for 'Infrastructure Institutions'*.

Political functions versus technical functions

- When Parliament sets up an agency, there should be clarity of purpose
- Consumer protection, prudential regulation, resolution, monetary policy: All well specified problems that can be contracted out.
- Political functions should not be contracted out:
  1. Unelected officials making decisions on political questions
  2. Loss of accountability.
- Hence, MoF should play the lead role in explicitly political problems:
  - Redistribution through finance
  - Capital controls
  - Crisis management.

New financial architecture

1. **Reserve Bank of India**:
   1. Monetary policy
   2. Implement consumer protection and prudential regulation for two sectors : banking and payments.
2. **Unified Financial Authority**:
   1. Implement consumer protection and prudential regulation for everything in finance other than banking and payments.
3. **Resolution Corporation**: Cover the full financial system
4. **Public Debt Management Agency**
5. **Financial Redress Agency**: One stop shop for aggrieved consumers
6. **Financial Sector Appellate Tribunal**: Appeal orders and regulations across the financial system
7. **Financial Stability and Development Council**: Data, research, coordinate work on systemic risk and development.

Status of implementation

- Aspects of IFC that can be voluntarily adopted by regulators: FSDC decision to implement these. Summarised in a *Handbook of governance-enhancing features of IFC*.
- Institution building ahead of time through task forces:
  1. Resolution corporation (RC)
  2. Public debt management agency (PDMA) : task force and executive order
  3. Financial sector appellate tribunal
  4. Financial data management centre (FDMC).
- Process of consultation is underway for taking feedback from all quarters about the draft IFC, based on which Ministry of Finance will take a view about modifications required.

Next steps

- Legislative process for the IFC.
- Project management, to reshape existing financial agencies into a new agency architecture, and to enforce the new law.
- From past experience, it takes some time for the enforcement capacity to emerge, for every new law. How can this time be made as short as possible?

Pending Bill

THE TRIBUNALS, APPELLATE TRIBUNALS AND OTHER AUTHORITIES (CONDITIONS OF SERVICE) BILL, 2014 This bill has the following features:

1. Standardising allowances and leaves as per a schedule
2. Creates different dates of retirement for chairman depending on where he came from
3. Creates a requirement for the chairman to get leave approved from the concerned Minister

Problems

1. Half-hearted attempt at greater accountability.
2. No linkage of pay and leave with High Court Judges, which provides better parity with Judiciary.
3. Non-amendment of Bill periodically could leave pay and allowances frozen.
4. It provides superintendence of leave with the Minister in charge, this creates:
    1. perception that executive is infringing in the judiciary
    2. routine administrative task antagonistic to the stature of a Minister's position.
5. There is a need to standardise the pay and leave of judicial officers in tribunals but parity should be achieved with judiciary.
6. Bill does not address bigger need for bringing transparency, accountability and efficiency in tribunals.

Solution

1. FSLRC tries to solve the problem of judicial delays and accountability through the following steps:
    1. Creating an executive registry inside the tribunal
    2. Making the registry responsible for computerisation, record-keeping and efficient functioning of non-judidicial functions
    3. Requiring annual reports and detailed functioning statistics

Thank you.