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New beginning in Financial System

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Abstract

India is on the cusp of fundamental reform of its financial system. The new draft Indian Financial Code (IFC) is a little-known but groundbreaking initiative to modernize Indian finance by transforming the laws, the regulatory architecture, and the working of regulators. There have been many efforts in India to rethink financial sector regulation to address persistent problems, such as a lack of financial inclusion, a glacial pace of innovation, the growth of an unregulated shadow financial system, numerous Ponzi schemes, high inflation, and the challenges of international financial integration. In some areas, progress was easy to achieve by removing restrictions imposed by the government. Yet, India's problems call for not just deregulation, but the construction of financial regulatory capacity. This is particularly difficult as it comes in a context where the Indian state has endemically low capacity. It replaces most existing Indian financial law. It outlines the powers of agencies that regulate the financial sector while recognizing that for those regulators to be effective, they must have clear objectives and be held accountable for achieving those objectives.

Keywords: *Regulators, Agencies, Accountable, Financial Integration*

Introduction

India embarked on substantial economic liberalization in 1991. In the field of finance, the major themes were the scaling back of capital controls and the fostering of a domestic financial system. This was part of a new framework of embracing globalization and of giving primacy to market-based mechanisms for resource allocation from 1991 to 2002, progress was made in four areas, reflecting the shortcomings that were then evident. First, capital controls were reduced substantially to give Indian firms access to foreign capital and to build nongovernment mechanisms for financing the current account deficit. Second, a new defined contribution pension system, the New Pension System, was set up so that the young population could achieve significant pension wealth in advance of demographic transition. Third, a new insurance regulator, the Insurance Regulation and Development Agency, was set up, and the public sector monopolies in the field of insurance were broken to increase access to insurance. Fourth and most important, there was a significant burst of activity in building the equity market because of the importance of equity as a mechanism for financing firms and the recognition of infirmities of the equity market. This involved establishing a new regulator, the Securities and Exchanges Board of India, and new infrastructure institutions, the National Stock Exchange and the National Securities Depository. In the coming forty years, India will need to build up the institutional machinery for markets as complex as the financial system seen in advanced economies today. The IFC puts India on that path.

By 2004, it was becoming increasingly clear that while some elements of modernization of the financial system had taken place from 1992 to 2004, financial economic policy needed to be rethought on a much larger scale to address the problems facing the system. As is the convention in India, the consensus undesired reforms was constructed through reports from four expert committees on:

International finance, led by Percy Misty in 2007
Domestic finance, led by Raghu ramRajan in 2008
Capital controls, led by U. K. Sinha in 2010
Consumer protection, led by Dhirendra Swarup in 2010

These four reports add up to an internally consistent and comprehensive framework for Indian financial reforms. The findings were widely discussed and debated in the public discourse (see table 1 for the main recommendations of these expert committees). The four reports diagnosed problems, proposed solutions, and reshaped the consensus.

Expert Committee Recommendations

Some parts of these reports were readily implementable, and have been gradually put into practice in the following years. However, the bulk of the work program envisaged by these four expert committees is incompatible with the present laws. More and deeper change was needed.

High-Powered Expert Committee on Making Mumbaian International Financial Center; Percy Mistry; 2007	The report outlined the prerequisites for making Mumbai an international financial center. According to the report, the quality and reputation of the regulatory regime is a key determinant of the market share of an IFC, in addition to the capabilities of the financial firms. It recommended increasing financial market integration, creating a bond-currency-derivatives nexus, and ensuring capital account convertibility and competition.
The Committee on Financial Sector Reforms; Raghuram Rajan; 2008	The committee was tasked with proposing the next phase of reforms for the Indian financial sector. The report focuses on how to increase financial inclusion by allowing players more freedom and strengthening the financial and regulatory infrastructure. It recommended leveling the playing field, broadening access to finance, and creating liquid and efficient markets.
Committee on Investor Awareness and Protection; DhirendraSwarup; 2010	The report outlines the need for regulation of the market for retail financial products in India and educating the consumers. The report points to the inadequate regulatory framework governing the sellers of financial products that induces problems like misspelling, the chief cause of which is rooted in the incentive structure that induces agents to favor their own interest rather than that of the customer. There port proposes a reconfiguration of incentive structure to minimize information asymmetry between consumer and seller.
Working Group on Foreign Investment in India; U. K. Sinha; 2010	The working group's primary focus was on rationalizing the instruments and arrangements through which India regulates capital flows. The regulatory regime governing foreign investments in India is characterized by a system of overlapping, sometimes contradictory and sometimes nonexistent, rules for different categories of players. This has created problems of regulatory arbitrage, lack of transparency, and onerous transaction costs.

Financial Regulatory Governance

Constructing effective financial law requires an understanding of market failures in finance that will shape appropriate interventions by the government and good public administration practices, which impact the working of government agencies. An essential feature of sound public administration is laws that embed effective accountability mechanisms. The pressure of accountability will impel the leaders of an agency to reshape their organization in ways that deliver performance. The four committee reports identified numerous shortcomings in the present arrangements, most of which can be identified as improperly drafted regulations. At first blush, it appears that these problems merely require writing better regulations. The deeper question that needs to be asked is why existing financial regulators have made faulty regulations. The proximate source of underperformance of government agencies is their poor organization and the low quality of their staffing. Their functioning is characterized by ineffective management structures and processes. These feedback loops are absent in India's government agencies. A lack of performance does not generate feedback loops that force the leadership to reinvent the agency.

The Nine Components of the Law

Within this framework of independent and accountable financial agencies, the draft IFC groups the substantive efforts the Indian government must undertake to address market failures in finance into nine categories:

1. Consumer protection
2. Micro-prudential regulation
3. Resolution
4. Systemic risk regulation
5. Capital controls
6. Monetary policy
7. Public debt management
8. Development and redistribution
9. Contracts, trading, and market abuse

Consumer Protection

The existing strategy on consumer protection in Indian finance emphasizes a disclosure-based approach. Firms are obliged to disclose a great deal of detail, and consumers are left to their own devices to avoid being mistreated. But this approach does not solve the problems of consumer protection in finance. Consumers of financial services are often more vulnerable than consumers of ordinary goods because of the complexity of the services, the longtime horizons in which consequences unfold, and cognitive biases. Hence, consumer protection in finance requires a special effort by the state.

This is a major gap in current Indian financial law and regulation that is imposing substantial costs upon the consumers of India. The overlaps and cracks in the regulatory apparatus, and the weak framework for consumer protection, have resulted in a procession of scandals such as Ponzi schemes. There is a recurrent threat that financial firms that achieve undue influence over their regulators will take unfair advantage of customers Regulators are empowered under the IFC to impose a range of requirements upon financial service providers, from disclosures to suitability and advice requirements to regulation of incentive structures. The legislation also embeds fairly intrusive powers for regulators, such as recommending modifications in the design of services and products. The choice and application of these powers will be informed by a set of principles that ensure that they are used where they are most required. The powers do not excessively restrict innovation, competition, or other balancing considerations. The local operations would be connected to a centralized and streamlined adjudication process, and a well-structured work flow would support the speedy and fair handling of cases. The analysis of patterns in the complaints of consumers at the Financial Redress Agency would feed back into improved regulations.

A New Agency Landscape

The division of the overall work of financial regulation across a set of regulatory agencies is also a focus of the IFC. Many structures can be envisioned for financial regulatory architecture. Parliament evaluates these various regulatory

Architectures and hands out the work associated with laws to a suitable group of statutory agencies. At present, Indian law features close connections between a particular agency (for example, the Securities and Exchange Board of India) and the work that it does (in this case, securities regulation). The IFC does away with such integration because changes in work allocation should not require changes to the underlying laws. Under the IFC, from the outset, and over coming decades, decisions about the legal framework governing financial matters would be kept separate from decisions about financial regulatory architecture. This would yield greater legal certainty, while facilitating rational choices about financial regulatory architecture that are motivated by considerations about public administration and public economics. Going forward, these problems will be exacerbated through technological and financial innovation. Financial firms will harness innovation to conduct activities in unregulated areas. And when there are overlaps, financial firms will forum-shop, searching for the most lenient regulator and portraying their activities as taking place within the favored jurisdiction. At present, many activities that naturally sit together in one financial firm are forcibly spread across multiple financial firms to suit the contours of the Indian financial regulatory architecture. The financial regulatory architecture should be conducive to greater economies of scale and scope in financial firms. In addition, when the true activities of a financial firm are split up across many entities, each of which is overseen by a different supervisor, no one supervisor has a full picture of the risks that are present. Only technical objectives can be contracted out to independent regulators that can then be held accountable for objectively defined outcomes; an independent agency cannot be expected to pursue the political objectives of the administration. The financial regulatory architecture should also enable a comprehensive view of complex multiproduct firms and a full understanding of the risks that they take. Finally, the IFC also considers transition issues, breaking up the desired into a set of small and implementable measures. Based on these considerations, the IFC envisages a financial regulatory architecture made up of seven agencies. First, the Reserve Bank of India will continue to exist, but its functions will be slightly modified. It will conduct monetary policy, regulate and supervise banking by enforcing the proposed consumer protection and micro-prudential laws, and regulate and supervise payment systems by enforcing these two laws. This proposed financial regulatory architecture is a modest change from present practice that will serve India well in coming years.

From Ideas to Action

The draft Indian Financial Code is currently being debated in the public domain. If the political leadership supports the draft, the law may be enacted by the new parliament created after the elections of May 2014.In the meantime, regulators have chosen to voluntarily adopt principles contained in the IFC, such as those related to the rule of law, accountability, improved regulation-making processes, and improved consumer protection regulations. The Ministry of Finance has released a guidance handbook on actions that will be taken by all existing agencies to enhance governance, drawing on ideas from the IFC that are compatible with existing laws. In addition, the government is likely to embark on the process of building institutional capacity by setting up the bodies that have to be initiated from scratch and so need longer transition periods. The government should also undertake widespread consultations on the draft law and present the law for a vote in parliament. Building state capacity to implement the changes proposed by the Financial Sector Legislative Reforms Commission is going to be a huge challenge. Not only will it require new institutions to be set up, but it will also require a change in the way regulators and the government function and interact with firms and consumers. This will necessitate large-scale training of the staff of the regulatory agencies as well as of the Ministry of Finance. The judiciary will be faced with the challenge of learning and interpreting the new law. This body of jurisprudence will continually interpret the IFC in a dynamic environment with changing products and processes. The full adoption of the draft IFC will have a profound impact on India, contributing to a financial system that allocates resources well, achieves higher growth, and reduces risk. This is an important milestone in the development of state capacity in India.

Modernizing Indian Finance

• Existing laws in India are rooted in the notion that the state is benevolent and feature few checks and balances. The draft IFC steps away from this idea of power without accountability.
• Financial law should reflect an understanding of market failures in finance. It should acknowledge that bureaucrats and politicians serve their own interests, not

necessarily those of the general public. Objectives for financial regulators and mechanisms governing their functions should be clearly specified, and laws should hold leaders of government agencies accountable for performance.

Preparing for the Law

• The administration that takes power in India following the country's mid- 2014 general election should prioritize enacting the IFC. Ideally, parliament will enact the law between 2015 and 2017.
• To pave the way for the law, regulators should voluntarily adopt IFC principles that are consistent with existing laws, such as those related to the rule of law, accountability, regulation-making processes, and consumer protection regulations.

Conclusion

India's financial system has long been inadequate. With an economy worth $2 trillion, the country's financial flaws are increasingly serious and outright dangerous. But fundamental change is under way. The government-backed Financial Sector Legislative Reforms Commission drafted the Indian Financial Code (IFC), a single unified law that replaces most existing financial law in India and is an important milestone in the development of state capacity. Now the government must work to adopt and implement the full code.

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