FSLRC: Big picture

Ila Patnaik

January 10, 2015

Numerous problems of the Indian financial system

- A limited modernisation of the financial system from 1992 onwards:
  1. Modern equity markets built: SEBI, NSE, NSDL, BSE.
  2. IRDA and entry of private insurance companies
  3. Significant reduction of capital controls.

Numerous problems of the Indian financial system

- A limited modernisation of the financial system from 1992 onwards:
    1. Modern equity markets built: SEBI, NSE, NSDL, BSE.
    2. IRDA and entry of private insurance companies
    3. Significant reduction of capital controls.
- Is the financial system serving the needs of households and firms?

Numerous problems of the Indian financial system

- A limited modernisation of the financial system from 1992 onwards:
  1. Modern equity markets built: SEBI, NSE, NSDL, BSE.
  2. IRDA and entry of private insurance companies
  3. Significant reduction of capital controls.
- Is the financial system serving the needs of households and firms?
- 50 percent households have access to finance • Ponzi schemes • Lack of financing for infrastructure investment • Financial savings of households has fallen.

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 finance)

2008 Raghuram Rajan (focused on domestic finance)

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

2010 Dhirendra Swarup (focused on consumer protection).

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 finance)

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 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 functioning of regulators. Better laws will set wheels in motion that will (in time) solve the problems.

Fundamental rethink of the laws is required

- The laws drafted from 1914 till 2012 have given us the maladies that we see around us.
- Nobody imagined that India would become a $2 trillion GDP with substantial *de facto* convertibility
- Looking forward: From 2013 to 2053, our nominal GDP will exceed that of the US today
- We need to build a financial system that will enable and support India's growth from 2014 to 2054.

FSLRC

- The 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.
- 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

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'

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*.

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*.

Accountability mechanisms

1. Clarity of purpose
2. Rule of law
3. Regulation-making process:
    3.1 Only one instrument: Regulation.
    3.2 Regulation-making initiated by the board only.
    3.3 What is the market failure? (Fits in objectives?)
    3.4 What is the proposed intervention? (Fits in powers?)
    3.5 Does the proposed intervention solve the envisioned market failure?
    3.6 What are the costs and benefits?
    3.7 Public consultation process
    3.8 Regulation issued by the board only.

9 components of the law

1. Consumer protection *Rights, powers, principles*

9 components of the law

1. Consumer protection *Rights, powers, principles*
2. Prudential regulation *Powers, principles*

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*

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*

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*

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*

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*

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 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. RBI:
    1.1 Monetary policy
    1.2 Implement consumer protection and prudential regulation for two sectors : banking and payments.
2. Unified Financial Authority:
    2.1 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.

Part II

Roadmap to implementation

Components

- Legislative process
- Adopt non-legislative recommendations on consumer protection, drafting of regulations and functioning of boards.
- Capacity building ahead of time:
  1. Staff
  2. IT systems
  3. Drafting of regulations
- Practical transition issues.

Three tracks of the implementation

- Legislative track.
- IFC as a strategy; numerous non-legislative questions.
- Institution building.

Thank you.