Law
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Conference Material

India Habitat Centre
4-6th December 2017
New Delhi, India

NIPFP

Institute for
New Economic Thinking

Movement on the law for the Resolution Corporation

ajayshahblog.blogspot.in/2017/06/movement-on-law-for-resolution.html

by Suyash Rai.

Capitalism without bankruptcy is like Christianity without hell.
- Frank Borman

On June 14th, the Union Cabinet approved the proposal to introduce a Financial Resolution and Deposit Insurance Bill, 2017 ("the FRDI Bill"). This is an important step forward for a critical component of the overall strategy of India's financial sector reforms. Shaji Vikraman has insight on this in the *Indian Express*. In this article, I look deeper into the concept of the resolution corporation, why it matters, how we got to this milestone, and what comes next.

The slow unfolding of the banking crisis reminds us of the fragility of our financial system. The financial system, especially the banking system, is generally disaster-prone. On one hand, financial firms can make mistakes and experience losses. In addition, there is a link between problems of the economy and hardship in financial firms. When an economic downturn happens, the value of business activities declines, and this induces losses upon financial positions. We need to build a financial regulatory apparatus which will reduce financial fragility. This involves three main elements of machinery : micro-prudential regulation (which aims to push the failure probability of each financial firm to a desired value), systemic risk regulation (which aims to reduce the probability of a disruption in the overall financial system, and have tools to respond to such a disruption when it does arise) and resolution (a specialised bankruptcy process for most financial firms). At present, in India, we have weaknesses on all three elements.

Consequences of a weak resolution system

When micro-prudential regulation works well, the failure probability of financial firms is at a low level chosen by the relevant financial agency. The failure probability is not zero. Failure of inefficient firms is essential for `creative destruction'. The process of failure of inefficient firms, and the shift of capital and labour to efficient firms, is essential for productivity growth. The question is: How can we make the failure of financial firms orderly?

The failure of financial firms can often be quite disorderly. Unlike real sector firms, many financial firms manage a large amount money belonging to households and businesses, with only a small amount of capital brought in by their owners. Banks in India typically have leverage of 18$\times$ to 20$\times$, which means that their balance sheet size is 18 to 20 times the amount of equity capital. Such leverage is never seen with real sector firms. When the firm gets into trouble, there is clamour by the creditors who want to see a fair and efficient process through which they get some of their money back. Matters are more challenging with some financial firms which are so large and complex that their failure could induce instability in the financial system.

An orderly failure is one where a) the consumers either get their money back quickly or continue to get services without any significant inconvenience, and b) the stability of the financial system is not threatened. If we are not able to obtain orderly failures in the financial system, this has many adverse consequences:

- Consumers of failed financial firms suffer. As an example, in India, many cooperative banks fail every year. In spite of high entry barriers, larger institutions also fail (e.g. Global Trust Bank in 2004). Consumers lose money in these failures. These bad experiences make consumers wary of engagement with the financial system, and increase the share of gold and real estate in their portfolios.
- Financial stability is threatened, because even if one systemically important financial firm fails, the entire system could be destabilised by a messy, long-drawn bankruptcy process. This forces government to bail out such financial firms. So, a financial crisis ends up having a fiscal consequence.
- When faced with the possibility of harm to consumers, and threats to financial stability, governments get

cold feet in situations of firm distress. They are then prone to bail out financial firms using taxpayers' money. We in India are familiar with this story. Public sector banks are routinely recapitalised with public funds to ensure they do not fail. This is almost never a good use of public money.

- Regulators sometimes respond to these problems by setting up entry barriers, which harm competition and economic dynamism. They justify the every day harm to competition on the grounds that this averts harm to consumers, risks to financial stability and the fiscal cost of bailouts.
- Financial firms suffer from moral hazard, and take greater risks. At its worst, financial firms obtain supernormal profit from these two interlinked channels: the certainty of being bailed out and the lack of competition.

A system that ensures quick and orderly resolution of failed financial firms can help avoid these outcomes. The system should be such that government, financial firms and consumers believe that the failures will be orderly. The present system of resolution in India is inadequate.

First, it mostly empowers the respective regulators (eg. RBI for banks) to do the resolution. Since regulators give the licenses and are supposed to ensure safety and soundness of the firms they license, they tend to be tardy in acknowledging their mistakes. This regulatory forbearance leads to delays in recognition of failure, which increases the costs of resolution, and may lead to losses for consumers and increases risk to stability of the financial system. There is a conflict of interest between micro-prudential regulation (achieving a target failure probability for a financial firm) and resolution (gracefully closing down financial firms which are nearing failure).

Second, the present system gives very limited powers of resolution. The powers that are given are: forced mergers/amalgamation, and winding up. Some of the other powers, such as bail-in (discussed later), are not available.

Third, even these limited powers are not enjoyed over many of the financial firms. For example, regulators do not have resolution powers over public sector scheduled commercial banks and regional rural banks.

Fourth, the way the system is structured, a bankruptcy resolution can take years, sometimes even longer than a decade. This is partly because the regulators do not have powers to take timely resolution action.

The Financial Resolution and Deposit Insurance Bill

Indian policy thinking on this began in the RBI *Advisory group on reforms of deposit insurance* , 1999, chaired by Jagdish Capoor.

This slumbered until we got to the Financial Sector Legislative Reforms Commission, chaired by Justice BN Srikrishna, which worked from 2011 to 2013. In its full design of Indian financial regulation, it recommended a Resolution Corporation.

In 2014, a Working Group of Ministry of Finance and Reserve Bank of India, co-chaired by Shri Arvind Mayaram and Shri Anand Sinha, also recommended a resolution capability for financial firms.

In 2014, the Ministry of Finance constitued a Task Force for the Establishment of the Resolution Corporation, under the chairmanship of Shri M. Damodaran, to work out the plan for establishing the Resolution Corporation. This was part of the two-part creation of task forces for building the new institutions required in the FSLRC architecture, which came about as four task forces followed by one more.

The budget speeches of 2015-16 and 2017-18 announced a plan to draft and table a Bill on resolution of financial firms. In September, 2016, a draft of the Bill was placed in public domain for comments.

On June 14th, the Cabinet approved the proposal to introduce a Financial Resolution and Deposit Insurance Bill, 2017 ("the FRDI Bill") in Parliament. The FRDI Bill, when enacted, will create a framework to ensure that failure of financial firms is orderly. It will establish an independent Resolution Corporation tasked with resolving failed financial firms. The Corporation will also subsume the deposit insurance function presently performed by the Deposit Insurance and Credit Guarantee Corporation.

This Bill stands at the intersection of two long-term reform projects: 1) financial sector reforms, of which bankruptcy resolution of financial firms is an integral part; 2) bankruptcy reforms, of which financial firm resolution is an integral part. So, this Bill moves both these projects forward, and is an important building block for an efficient system of capital allocation in India.

FSLRC had envisioned a separation between the resolution corporation, which would apply for most financial firms, and the bankruptcy code, which would apply for the remaining financial firms and for all non-financial firms. The Bankruptcy Legislative Reforms Commission (BLRC), which drafted the Insolvency and Bankruptcy Code (IBC), worked with this scheme. IBC does not cover financial firms, unless the Central Government notifies certain financial firms to be covered under that law. Many types of financial firms, especially firms handling consumer funds and firms that are critical for financial stability, require a specialised resolution mechanism. For firms handling consumer funds (eg. banks, insurance companies), the process under IBC is not suitable, as a large number of small value consumers will find it difficult to invoke that process. The processes of IBC are designed for creditors who are firms, not individuals. For systemically important financial firms (eg. central counterparties, larger banks), a creditor-led resolution process under IBC is not suitable, because what is at stake is not just the interest of creditors but the stability and resilience of the financial system. Hence, for such financial firms a specialised resolution regime is required. The FRDI Bill will create such a specialised resolution regime.

What is resolution?

In the world of financial firms, resolution complements regulation. Regulators and the Corporation are expected to work in tandem, with the regulators focused on maintaining financial health and, when a firm gets into trouble, pushing for its recovery. The Resolution Corporation will take over and resolve a firm after recovery efforts have failed. Although the version of the Bill approved by the Cabinet is not yet in public domain, based on the version that was released for public consultations last year, the framework is divided into four stages.

First, when the financial firm is healthy, the respective regulators will monitor the firm and work to ensure it continues to stay healthy. At this stage, the Resolution Corporation will only get information indirectly through the regulators. Substantive powers to monitor the firm or to take any other action with respect to the firm will not be available to the Corporation.

Second, once the financial firm starts deteriorating, the respective regulator will attempt recovery. At this stage also, only the regulators will continue to have substantial powers over the firm.

Third, if the recovery efforts fail, and as the financial firm get close to failure, the Corporation will get substantial powers to instruct the firm to improve its resolvability and prevent actions that may erode the values of assets available for resolution. At this stage, the role of regulators is restricted.

Finally, when the firm fails, the Corporation will take charge and resolve it. Resolution typically means selling the failed financial firm, as a whole or in parts, to another financial firm via a competitive bidding process. However, resolution could also involve other instruments. For example, the firm could be "bailed-in", which means that the rights of and obligations to creditors may be written down to recapitalise the firm from within. Bail-in typically includes converting some junior debt into equity, but may also include writing down other types of claims. This is the opposite of a bail-out, wherein outside investors rescue a borrower by injecting money to help service a debt. Finally, liquidation may be a tool used for resolution.

There is a certain degree of tension and potential conflict between the Regulators and the Resolution Corporation. This is a healthy check-and-balance. Resolution works as a check on regulatory incompetence and forbearance. Both sides will need to be mature, respect the role of the other, and coordinate.

The idea of a specialised resolution regime for financial firms is well-accepted globally. The US has had a resolution system for banks for more than 80 years. The scope of this system was extended after the financial crisis of 2008. There have been more than 600 bank failures in US since the crisis. In this time, there has been not been even one bank run in the US, because depositors trust the resolution system to work. Why the crisis happened in the first place is another matter, which is beyond the scope of resolution. Resolution comes into play only after regulation fails, and the occurrence of crisis resulted from regulatory failure, among other factors.

Many other countries have put in place comprehensive resolution systems. These include: all European Union member states, Switzerland, Australia, Canada, Japan, Korea, Mexico, and Singapore. Many jurisdictions have ongoing or planned reforms to resolution regimes. These include: Australia, Brazil, Canada, China, Hong Kong, Indonesia, Korea, Russia, Saudi Arabia, Singapore, South Africa, Turkey.

Next steps

We are still a few years away from having a full-fledged resolution regime. Now that the Bill is going to the legislative branch, it remains to be seen what version of the Bill eventually gets enacted. If the essential features of a good resolution regime are diluted in the final version, the chances of success will be low.

Even after the Bill gets enacted, it would still take some time to build an independent and competent Resolution Corporation. Since this capability currently does not exist in the system, it will have to be cobbled together, and then strengthened over a period of time. Consider the example of human resource strategy. There are many models out there. While the Canadian authority works with fewer than 100 employees, the US authority has more than 10,000 employees. The Corporation could choose to run a tight ship, and rely on contractual work to scale up capacity in times of crisis, or it could choose to build a large organisation that is able to, on its own, deal with a crisis. Similarly, given the skill sets required to do this job, the Corporation will have to think innovatively about attracting top talent within the constraints of a government agency.

The Task Force on Establishment of the Resolution Corporation, led by M. Damodaran, has done considerable work that lays the groundwork for constructing the agency. The implementation of their project planning needs to commence immediately, so that the delay between enacting the law and enforcing it can be minimised.

It will also take our governance system some time to get used to this kind of a system of taking over and resolving a failed financial firm in a decisive and quick manner, as opposed to the present approach of allowing things to linger on. If things do go right, there are many potential benefits of this reform.

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Legislative strategy for setting up an independent debt management agency

ajayshahblog.blogspot.in/2016/10/legislative-strategy-for-setting-up.html

by Radhika Pandey and Ila Patnaik.

Every government requires an institutional arrangement for its borrowing and debt management. The borrowing of the government, i.e. the sale of bonds, is enabled by a capable bond market. To the extent that the bond market is liquid and has wide ranging participation, it becomes easier for the government to obtain low cost financing. Just as resource-raising of a private firm has an `investment banker' for advice and then execution, resource-raising for governments has a `public debt manager' for advice and issuance.

In India, RBI has traditionally been the public debt manager for the Government. RBI owns or controls bond market infrastructure (exchange, clearing house and depository), and also regulates the bond market.

Historically, RBI managed government debt on paper based ledgers. However, following a scam in the government securities market in 1992 and recommendations by an RBI Committee on Repurchase Agreements, RBI set up an electronic ledger for holding government securities. This ledger, the Securities General Ledger, was legally mandated to be the only depository for government securities through the Government Securities Act. The Act gave RBI exclusive powers to oversee, govern and regulate participation in the depository.

The RBI also set up a trading platform for government securities that was based on an order matching system known as NDS-OM and helped banks set up CCIL, a bank owned clearing and settlement system on which G-Secs could be settled.

In its role as overseer of the G-Sec market, RBI also acquired powers to regulate the G-Sec spot market through a carve-out created through a government notification under Securities Contracts Regulation Act. In 2006 it was given additional powers to regulate derivatives on government securities, through an amendment to the RBI Act by adding a chapter (Chapter III-D) giving it these powers. The amendment mandated that all derivatives transactions on G-secs will be legal only if they are undertaken by RBI regulated entities. The amendment gave powers to RBI to issue directions to agencies dealing in Government securities. These steps ensured that RBI had full supervisory powers over any entity that participated in either G-sec markets or in their derivatives.

In this period, RBI did not have a clear objective, as was emphasised by the preamble of the RBI Act which described the agency as a `temporary provision'. This arrangement came under question from two points of view. On one hand, securities markets underwent legal and institutional reform that improved their market infrastructure and regulatory capacity. In parallel, the objective of inflation targeting was gaining currency as the predominant objective of RBI. This repeatedly led to the proposal that the debt management work, which conflicts with monetary policy, be placed in an independent Public Debt Management Agency, and the bond market be merged into securities markets. In a recent paper we describe the legislative aspects of implementation of the PDMA. We work out the intricacies of a PDMA Act which establishes the PDMA as an agency, and merges the bond market with securities markets.

Existing thinking on the subject, such as the Financial Sector Legislative Reforms Commission, assumes a clean slate in which the PDMA is created as an agency and a unified financial market system is enacted at one go. We work out the complexities of amending existing laws, without the assumption of a clean slate. We also work out the issues of sequencing through which the existing institutional arrangements are transitioned into the new arrangements. In light of some recent developments towards setting up of a PDMA, this paper is useful as laying the groundwork for implementing the PDMA reform.

The establishment of PDMA would yield numerous gains for the Indian macroeconomic and financial system. It would free RBI of the conflict of interest of performing debt management work for the central and state governments. It would yield low cost financing for government debt. It would result in development of the bond market by harnessing the capabilities of the securities market infrastructure. Finally it would yield improvements in the government borrowing program by selling bonds to voluntary buyers in a deep and liquid government bond market.

Legislative strategy for setting up an independent debt management agency

No. 178
24-Oct-2016

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Legislative strategy for setting up an independent debt management agency

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Abstract

The Public Debt Management Agency (PDMA) is a body that issues public debt with the objective of keeping long term costs of government borrowing low. In India, the existing legal framework obliges the government to give the task of managing its debt to the RBI. Pursuant to its role as debt manager, RBI set up market infrastructure such as an exchange and a depository. Carve-outs were made in the regulation of securities, to allow the RBI to regulate the bond market. Over the last 20 years, the proposal to establish an independent PDMA has been repeatedly put forward. In this paper, we work out the legal strategy to set up a PDMA. We show the transition path for the roll out and for the movement of the functions, accounts, records and systems to the new agency in a phased manner.

Keywords: Public debt management, market infrastructure, market regulation, government securities

JEL classification codes: H63, H74, K10, L51

1 Introduction

Every government requires an institutional arrangement for its borrowing. The borrowing of the government, i.e. the sale of bonds, is enabled by a capable bond market. To the extent that the bond market is liquid and has wide ranging participation, it becomes easier for the government to obtain low cost financing. Just as resource-raising of a private firm has an 'investment banker' for advice and then execution, resource-raising for governments has a 'public debt manager' for advice and issuance.

In India, RBI has been the agent of the government doing debt management. RBI owns or controls bond market infrastructure (exchange, clearinghouse and depository), and regulates the bond market, as a consequence of this mandate. These arrangements were gradually put into place starting from the RBI Act, 1934, to the RBI Amendment Act, 2006. In this period, RBI did not have a clear objective, as was emphasised by the preamble of the RBI Act which described the agency as a 'temporary provision'.

This arrangement came under question from two points of view. On one hand, securities markets underwent legal and institutional reform that improved their market infrastructure and regulatory capacity. In parallel, the objective of inflation targeting was gaining currency as the predominant objective of RBI. This repeatedly led to the proposal that the debt management work, which conflicts with monetary policy, be placed in an independent Public Debt Management Agency[1], and the bond market be merged into securities markets.

This paper describes the legislative aspects of implementation of the PDMA. We work out the intricacies of a PDMA Act which establishes the PDMA as an agency, and merges the bond market with securities markets.

Existing thinking on the subject, such as the Financial Sector Legislative Reforms Commission, assumes a clean slate in which the PDMA is created as an agency and a unified financial market system is enacted at one go. We work out the complexities of amending existing law, without the assumption of a clean slate. We also work out the issues of sequencing through which the existing institutional arrangements are transitioned into the new arrangements.

At some point in the future, it is likely that India will execute the PDMA reform. When that discussion commences, this paper will be useful as laying the groundwork for implementing the PDMA reform.

The remainder of this paper is organised as follows. We start at Section 2 which sketches the concept of the PDMA. Section 3 shows the legal foundations of the existing arrangements on mandate, bond market infrastructure and bond market regulation. This helps give us a sense of what has to be changed. Section 4 summarises the evolution of policy thinking on this question in India from 1997 onwards, and briefly summarises the rationale provided by various elements of this process.

[1]On the question of conflict with monetary policy, the *RBI, Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework, January, 2014* expressed the concern that: "*Under the extant monetary policy framework, financing of large fiscal deficits through market borrowings has effectively resulted in the use of open market operations (OMO) primarily to smoothen G-sec yields rather than being employed as a pure monetary policy tool, contrary to cross-country practices which have increasingly favoured the separation of debt management operations from liquidity management (Table IV.11). In India, on the other hand, transmission has been impeded by: (a) not enforcing enough liquidity management discipline in the banking system; and (b) allowing excessive indirect monetisation of the fiscal deficit which also undermines the credibility of discretionary liquidity management operations.*" *(Para IV.32)*

Section 5 shows our proposed solution. We propose the FSLRC law, with small modifications, for the establishment of the PDMA as a financial agency. We show the legislative steps for merging bond market regulation and infrastructure into the mainstream financial markets. We work out the specific actions and their sequencing. Finally, Section 7 concludes.

The main paper is followed by a group of appendices with: an overview of the present state of Indian bond market infrastructure, international experience on bond market infrastructure and bond market regulation; the FSLRC draft law establishing PDMA as an agency; the amendments to existing law required for setting up PDMA, and the amendments required to merge the bond market into the mainstream financial market system.

2 The concept of the PDMA

At a conceptual level, consider the relationship between a private corporation and an investment banker. Capital raising is done by the corporation, through the following steps:

1. Corporations require the lowest cost of capital as this influences their ability to invest and their competitiveness.
2. The client, the corporation, chooses which investment banker is the best service provider suited to serve her needs.
3. The investment banker advises the corporation on the optimal methods of raising resources, which would yield the lowest cost financing for the corporation in the long run.
4. The corporation evaluates this advice and takes a final decision.
5. This decision goes back as an instruction to the investment banker.
6. The investment banker uses the best available market infrastructure through which securities are auctioned.
7. It is in the interests of the corporation to ensure trading of these securities using the best possible market infrastructure, so as to achieve high liquidity. This would yield a reduced liquidity premium, i.e. a lower cost of capital, and set the stage for future capital raising.

This identical arrangement is found, worldwide, with the problem of financing the deficit of a government:

1. Governments require the lowest cost of capital.
2. Government must choose an investment banker who is the best service provider. This agency is termed "the public debt manager".
3. The public debt manager must take a comprehensive view of all liabilities of the government. It must form a strategy and based on this, advise government on the optimal methods of raising resources, which would yield the lowest cost financing in the long run.
4. Government must evaluate this advice and take the final decisions about securities issuance, which would go back to the public debt manager as an instruction.
5. The public debt manager must use the best available market infrastructure through which the securities are auctioned.
6. It is in the interests of government to ensure that there is a sound bond market, which would yield a lower cost of capital.

This organisation, in the Indian parlance, is termed the 'Public Debt Management Agency' (PDMA). There is an extensive literature on the question of *whether* India requires a PDMA. Almost all the literature has argued in favour of construction of the PDMA. This paper is focused on a narrow question: working out the legislative and executive actions for the construction of the PDMA.

3 The existing arrangement

3.1 The debt management mandate

RBI is the agent of the government, performing debt management, through two elements of the *RBI Act*:

1. Section 17, in sub-section (11), clauses (e) and (f) establish the power of RBI to act as the manager of public debt and to issue and manage bonds and debentures. Of these, clause (e) was in the original 1934 Act, and the front-office function was added in 1949 in (f).
2. Section 21, in sub-section (2) obliges the government to give the public debt management mandate to Reserve Bank of India (RBI). This was in the original 1934 Act.
3. In 1951, Section 21A was introduced into the RBI Act. Subsection(1)(b) of Section 21A gave RBI the power to manage state debt by agreement between RBI and the respective state. This is a softer provision when compared with the treatment of debt of the Government of India, as the Constitution of India, Seventh Schedule, Article 246, gives states the power to choose their own debt management arrangement.

3.2 Bond market infrastructure

Bond market infrastructure is primarily the exchange, the clearinghouse and the depository. These arrangements were constructed in India flowing from the debt management mandate.

In the early decades, there were no computers. The only market infrastructure was paper-based tracking of ownership of government bonds, which would (in the modern parlance) be termed the depository function. This paper-based system was called the 'Securities General Ledger' (SGL), and was run by RBI. At first, SGL was an informal system without legal foundations. RBI built and operated the SGL as an instrument through which it performed its debt management mandate.

In 1992, the Harshad Mehta scandal involved manipulation of entries in the SGL.[2] This was the impetus for major changes to bond market infrastructure. RBI began improving operational controls and introducing computers in order to improve SGL, in response to the failures of 1991–1992. The *Report on Repurchase Agreements (Repo)* recommended that there were legal impediments in the way to electronic transfer of gilt securities which is not possible under the Public Debt Act, 1944. The *Report on Repurchase Agreements (Repo)* recommended the move towards a move towards a modern market infrastructure through the enactment of *Government Securities Act*.

[2] See, Samir K. Barua and Jayanth R. Varma, "Securities Scam: Genesis, Mechanics and Impact", in: *Vikalpa, IIM, Ahmedabad* 18.1 (1993), pp. 3–12; Debashis Basu and Sucheta Dalal, *The Scam (From Harshad Mehta to Ketan Parekh)*, Kensource Business Books, 2009.

The events of 1991–1992 also spurred improvements in bond market infrastructure going beyond the depository. In 1999 the *Report on Repurchase Agreements (Repo)* recommended that immediate steps should be taken to resolve the legal and procedural difficulties in the way to achieve a modern market infrastructure. It recommended the enactment of the Government Securities Act. By 2002, an exchange was informally built within RBI, named the 'Negotiated Dealing System' (NDS). At the same time RBI initiated the creation of an informal clearing corporation, the Clearing Corporation of India Ltd (CCIL), which was owned by banks.[3] This added up to a parallel exchange - clearinghouse - depository for the purpose of the bond market. The primary objective of developing this parallel market infrastructure was to allow electronic record keeping of government securities. See Appendix A for an overview of the present state of bond market infrastructure and the inherent complexities in the framework. In a parallel development in the securities markets the Depositories Act, 1996 was passed. This led to National Securities Depository Ltd., and Central Securities Depository Ltd. (NSDL and CDSL). In the Government Securities Act, 2006, which gave legal foundations to SGL, there was a carve out for SGL by including a provision that nothing in the Depositories Act, 1996, would apply to government securities.

3.3 Bond market regulation

At first, the bond market was unregulated. The first milestone towards the evolution of a framework of bond market regulation came about in 1944 with the enactment of the *Public Debt Act*. The Preamble of the Act read as follows:

> An Act to consolidate and amend the law relating to Government Securities and to the management by the Reserve Bank of India of the public debt of the Government.

Over time, RBI demanded enhanced regulatory powers over the debt market. A large number of legal changes were undertaken in order to achieve this.

Section 16 of *Securities Contract (Regulation) Act* empowers the Central Government to prohibit securities contracts in certain cases. Through a notification dated 27th June 1969 issued by Government of India under section 16 of the *Securities Contract (Regulation) Act* all forward contracts in securities were banned.

In August 1999, the *Report on Repurchase Agreements (Repo)* recommended that to develop the repos in Government securities, it is necessary that the 1969 Notification be rescinded and the full powers over repos be vested with the RBI. Government of India rescinded the 1969 notification in 2000. Consequently, by a *2000 SCRA Notification*, the Central Government has delegated powers to Reserve Bank of India under section 16 of the *Securities Contract (Regulation) Act* for regulating contracts in government securities, money market securities, gold related securities and derivatives based on these securities.[4]

[3] NDS-OM is a screen based electronic anonymous order matching system for secondary market trading in Government securities owned by RBI. Presently the membership of the system is open to entities like Banks, Primary Dealers, Insurance Companies, Mutual Funds etc. i.e entities who maintain SGL accounts with RBI. https://rbi.org.in/scripts/FAQView.aspx?Id=86)

[4] The operative part of the *2000 SCRA Notification* states –

> Provided the powers exercisable by the Central Government under the said section 16 of the said Act, in relation to any contracts in Government securities, money market securities, gold related

The *Report on Repurchase Agreements (Repo)* further recommended that RBI should acquire regulatory powers under section 29A [5] of the *Securities Contract (Regulation) Act*. The Report recommended:

> "As expansion of the repo market with wider participation and variety of instruments would require RBI to have enhanced regulatory powers over the debt market there is need to amend Section 29A of SCR Act. to enable the Government to delegate regulatory powers for of trading in Government Securities and other debt instruments."

These developments marked the beginning of a shift of the regulatory powers over government securities to RBI. Later in 2006, the *RBI Act* was amended and a new chapter III D was added to vest RBI with overarching powers to regulate interest rate products and to give directions to all agencies dealing in 'securities', 'money market instruments', 'derivatives' and certain other instruments.[6]

RBI also derives regulatory powers through certain provisions of the *Government Securities Act*. Section 29 of the *Government Securities Act* gives powers to RBI to call for information, cause inspection and issue directions. Section 30 confers power on RBI to impose penalty on any person who contravenes any provision of the *Government Securities Act*, or contravenes any regulation, notification or direction issued under the GSA. Section 32 empowers the RBI to make regulations to carry out the purposes of the *Government Securities Act*.

As a consequence of the above changes, regulation of the bond market, like its market infrastructure, was separated from India's securities markets, where corporate bonds, shares and derivatives were transacted. This, as we shall discuss in the next section, had consequences for financial market development in India.

4 Towards an independent debt management agency

In the previous section, we have described India's journey to the present debt management arrangement. In parallel, there was a process of policy analysis, which analysed these arrangements and evaluated reforms. The areas of concern were (a) The success of reforms of

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> securities and in securities derived from these securities and in relation to ready forward contracts in bonds, debentures, debenture stock, securitised debt and and other debt securities shall also be exercisable by the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934).

[5] The Central Government may, by order published in the Official Gazette, direct that the powers (except the power under section 30) exercisable by it under any provision of this Act shall, in relation to such matters and subject to such conditions, if any, as may be specified in the order, be exercisable also by the Securities and Exchange Board of India or the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934).]

[6] The precise section that vests RBI with regulatory powers reads as follows–

> The Bank may, in public interest, or to regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products and give directions in that behalf to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time.

the mainstream financial markets; (b) The failure of bond market development; (c) The conflict of interest between monetary policy and debt management and (d) The need for an agency that would serve the interests of state governments.

The preceding sections have described the steps through which the mandate for RBI of debt management led to RBI's construction of bond market infrastructure and RBI's regulation of the bond market. In parallel, the mainstream financial markets of India were experiencing dramatic reforms. With extensive legislative activism including one Constitutional amendment, and the establishment of SEBI, NSE, BSE, NSDL, CDSL, NCDEX, MCX, etc., revolutionary gains were achieved in financial market infrastructure and in financial markets regulation. There was a contrast between the operational capabilities, regulatory sophistication and the end outcome (a deep and liquid market) of these markets when compared with the difficulties of the bond market. It became increasingly attractive to solve the problem of bond market development by merging bonds into the mainstream financial market system in terms of both market infrastructure and regulation.

From the viewpoint of debt management, there was a conflict of interest between RBI's objective as a central bank (to deliver a target rate of inflation) and RBI's objective as a debt manager (to deliver a low cost of borrowing). There was also a problem of fragmentation of the overall debt management problem between multiple agencies, which resulted in the lack of a single view and the lack of a debt management strategy.

These difficulties led to a large number of calls for the establishment of an independent PDMA.

RBI was the original proponent of debt management reform, having first recommended it almost two decades ago. The *RBI, Working Group on Separation of Debt Management from Monetary Management, (Chairman: V.Subrahmanyam), December, 1997* recommended that a company be established under the Indian Companies Act to take over the government's debt management function.

The *RBI, Report of The Committee on Capital Account Convertibility, (Chairman: S.S Tarapore), February, 1997* recommended that: "*... steps should be initiated to separate the debt management policy from monetary management and to this effect the Government should set up its own Office of Public Debt; RBI should totally eschew from participating in the primary market of Government borrowing.*"

Several subsequent reports and publications issued by the RBI have repeated the need for hiving out its public debt management function to a separate agency. For instance, the *RBI, Report of The Advisory Group on Transparency in Monetary and Financial Policies (Chairman: M.Narasimham, September, 2000* recommended that, "*The government should set up its own independent Debt Management Office to take over, ... , the present debt management functions discharged by the RBI*". The *RBI, Report of The Advisory Group on Transparency in Monetary and Financial Policies (Chairman: M.Narasimham, September, 2000*, stated that, "*There should be well calibrated legislative measures to separate debt management and monetary policy functions. The government should set up its own independent Debt Management Office to take over, in a phased manner, the present debt management functions discharged by the RBI. The Advisory Group recognises that separation of debt management and monetary policy is a necessary but not a sufficient condition for an effective monetary policy which would also require a reasonable degree of fiscal responsibility.*"

The RBI Annual Report for 2000-01, also recommended the separation of the functions of debt and monetary management in the medium-term, and the explicit removal of the debt management function from the RBI. The *RBI, Report of The Committee on Fuller Capital Account Convertibility, (Chairman: S.S Tarapore), July, 2006*, emphasised the separation of monetary and debt management functions of RBI.

The recommendation for a separate debt management function can similarly be found in several reports commissioned by the government. For instance, the *Ministry of Finance, Report of the Internal Expert Group on the Need for a Middle Office for Public Debt Management, (Chairman: Arvind Virmani), 2001* discussed the need for a comprehensive strategy for public debt management, with an integrated approach towards domestic and external public debt management. It recommended establishing a centralised middle office in the Department of Economic Affairs to develop a comprehensive risk management framework as the first stage of this process, and establishing an autonomous Public Debt Office as the second stage.

Ministry of Finance, Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre, (Chairman: Percy Mistry), February, 2007 and *Ministry of Finance, Internal Working Group on Debt Management, (Chairman: Jahangir Aziz), October, 2008*, similarly recommended setting up an independent debt management office. The *Planning Commission, Report of the Committee on Financial Sector Reforms, (Chairman: Raghuram Rajan), September, 2008* discussed the issue of financial repression and articulated need for a separate debt management agency as under:

> *T*his is also a good time to carefully think about changing the structure of public debt management, particularly in a way that minimizes financial repression and generates a vibrant government bond market.

In the present framework, as banking regulator RBI requires banks to hold a share of their deposits under SLR (the Statutory Liquidity Ratio)[7]. Emphasising on the need for minimising financial repression by creating a vibrant government bond market to ensure low cost financing of Government debt, the report stated:

> *T*he government will also need a vibrant government bond market to provide it low cost financing, as it relies less on forcing banks through statutory requirements to hold its debt. A deep government debt market across all maturities will provide the benchmarks that the private sector needs for pricing corporate debt, and various kinds of hedging instruments.

More recently, the *Ministry of Finance, Report of the Financial Sector Legislative Reforms Commission, (Chairman: B.N Srikrishna), March, 2013* recommended the creation of a specialised debt management agency and also provided a draft law which would govern its function. *RBI, Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework, January, 2014* also emphasised the need to separate debt management from monetary management.[8]

The recently released *MoF, Report of the Comptroller and Auditor General of India on Public Debt Management, Report No. 16 of 2016 (Performance Audit), July 2016* raised concerns about the

[7] Section 24, Banking Regulation Act

[8] The *RBI, Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework, January, 2014* presents an overview of debt management arrangements in some emerging market economies wherein the Central Bank is not responsible for debt management, though it may act as an agent for administering the debt management regulations.

state of the debt management framework in India and emphasised the need for a specialised debt management agency.

In parallel, a stream of expert committee reports (e.g. the Percy Mistry report, the Raghuram Rajan report, the Wajahat Habibullah report, the A. N. Padhi report, etc) argued in favour of 'convergence' of financial markets. In all countries, there are economies of scale and scope from unification of the regulation and of the market infrastructure of all financial markets[9]

This framework was adopted by FSLRC, which (a) Envisaged full unification of all financial market infrastructure, with regulation by the 'Unified Financial Authority', and (b) Establishment of the Public Debt Management Agency (PDMA). The legal framework proposed is a single law, the Indian Financial Code, proposed by FSLRC to replace all existing financial sector laws. This paper proposes a solution where the outcome of an PDMA is obtained under the present legal framework through a PDMA Law and a roll back of those laws and amendments such as the *Government Securities Act* or amendments to the *RBI Act* that were a consequence of its role as debt manager.

5 The solution

In this section, we work out the steps through which responsibility of debt management shifts from RBI to PDMA. This requires the construction of a new agency and a roll back of the amendments made consequential upon RBI's role as debt manager. We also propose a transition path for which some additional amendments may be required before the repeal of some sections of the law.

5.1 Agency construction

1. The first step is drafting a law that establishes the agency.

   The Financial Sector Legislative Reforms Commission (FSLRC) has provided a blue print of the law governing the establishment and functioning of an independent Public Debt Management Agency (PDMA).[10] The key features of the law are as under:

   Objective of the PDMA : The law provides an explicit objective to the PDMA. The objective is to minimise the cost of raising and servicing public debt, over the long-term and to keep public debt within an acceptable level of risk at all times.

   Functions of the PDMA : The law envisages the following functions to be performed by the PDMA:

   (a) issuance and management of government securities;

   (b) management of public debt, contingent liabilities and cash, of the Central Government.

[9] See Appendix B and C for international experience in market infrastructure, debt management and regulatory arrangements.

[10] See Appendix D. Henceforth, we will refer to this as the PDMA law.

The law lays down the detailed procedure which the PDMA must follow towards managing the debt of the Central Government. The law also lays down procedure for managing cash balances of the Central Government.

Power of Central Government to issue directions to PDMA : The law empowers the Central Government to issue directions to the PDMA on policy from time to time.

Payment of fees to PDMA : The Central Government must pay fees to the PDMA for the services rendered by the PDMA.

To be a stand-alone law governing all aspects of debt management, the FSLRC law on PDMA requires certain modifications. The law should require the PDMA to put in place a register recording the ownership of all securities, internal and external, issued by the PDMA. The register should, ideally also maintain a record of all the guarantees issued by the Government. This register becomes a key document to understand the magnitude of debt by the Government. This register is then linked to the register and an index of beneficial owners maintained under the Depositories Act, 1996:

> "The register and index of beneficial owners maintained by a depository under section 11 of the Depositories Act, 1996, shall be deemed to be the corresponding register and index for the purposes of this law."

This harnesses the legal and institutional foundations of the mainstream financial markets.

Another modification required in the law is to place an obligation on part of the RBI to provide all information and render all assistance that the PDMA may require in the initial stages.

> "Notwithstanding anything contained in any other law for the time being in force, the Reserve Bank shall provide all information and render all assistance as the Agency may require it to provide and render, so that the Agency is able to discharge its functions, with minimal interruption."

2. Consequential amendments to the *RBI Act*
   (a) Deletion of clauses: Currently, section 17(11)(e) and (f) of the *RBI Act* authorize the RBI to act as an agent for the central government for public debt management and issuance of bonds and debentures. These clauses can be deleted. However, in the transition the clauses will be used, and hence will need to be initially amended.
   (b) Deletion of section: Further, section 21(2) obligates the central government to entrust the debt management function to RBI. This section can be deleted. But again, for the purpose of transition, the clause will need to be amended so that Government can entrust this function to the RBI until the PDMA is set up.

5.2 Bond market infrastructure

Section 4 of the *Government Securities Act* empowers the RBI to open and maintain a Subsidiary General Ledger (SGL), constituents' subsidiary general ledger account and a bond ledger account. The provisions of the *Government Securities Act* also exclude the applicability of the Depositories Act to government securities. As part of the PDMA reform, the *Government Securities Act* will need to be repealed. However, in the transition this Act will be amended to allow the PDMA to transition and integrate the systems with securities market infrastructure.

There is no statutory backing for the exchange and clearing house that RBI has established (Negotiated Dealing System-Order Matching System (NDS-OM) and The Clearing Corporation of India Limited (CCIL)). Therefore no legislative changes are required in order to address them.

5.3 Regulation of the bond market

1. Deletion of Chapter IIID of *RBI Act*

   Chapter IIID of *RBI Act* comprises of sections 45U, Section 45V, 45W and 45X. These sections are proposed to be deleted, for the following reasons -

   - Section 45V provides that notwithstanding the *Securities Contract (Regulation) Act*, transactions in derivatives are valid only if one of the parties to such transactions is the RBI, a scheduled bank or an agency under the regulatory purview of RBI. In the proposed framework, all derivative transactions will be governed under *Securities Contract (Regulation) Act*.

   - Section 45W empowers the RBI to issue directions to all agencies dealing in government securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature. To harmonise the regulation of securities trading, the RBI will no longer have the power to issue directions in respect of these instruments, except as set out below:

     (a) RBI can continue issuing directions in respect of foreign exchange and currency spot, under FEMA.

     (b) RBI can continue undertaking its monetary policy functions, by regulating repo and reverse repo transactions that it enters into with other entities. Similarly, RBI can continue to regulate the inter-bank call and notice money market.

   - Section 45X obligates the agencies, referred to in Section 45W, to comply with the directions issued under Section 45W and to furnish information in this regard. This section will need to be consequentially deleted.

   - Section 45U which defines terms used in Chapter IIID will need to be consequentially deleted.

2. Repeal of *Government Securities Act*

   Currently, the *Government Securities Act* allows the RBI to regulate all aspects of government securities, including maintaining records of holders of government securities, transfer of title, nomination, etc. The *Government Securities Act* will require to be repealed to enable the PDMA to issue and manage government securities under the legal framework governing PDMA. To harmonise the regulatory framework governing government securities with all other securities, the provisions relating to transfer, nomination, evidence of title, etc. will be the same as are applicable to the securities of any other issuer. Accordingly, the corresponding provisions of the Companies Act, 2013 are replicated in the PDMA law as drafted by FSLRC.

3. Amendments to *Securities Contract (Regulation) Act*

   To allow Securities Exchange Board of India (SEBI) to regulate derivatives and repo and reverse repo transactions entered into by market participants, which are currently regulated by RBI, the definition of 'derivatives' in *Securities Contract (Regulation) Act* will need to be expanded to include the following transactions –

   (a) repo and reverse repo transactions entered into by market participants (RBI will continue to control repo and reverse repo transactions that it enters into with others); and

   (b) foreign exchange currency derivatives.

   Section 29A of the *Securities Contract (Regulation) Act* allows the central government to delegate its powers under the *Securities Contract (Regulation) Act* to SEBI and RBI. This section will need to be appropriately amended to restrict the power of delegation to SEBI only.

4. Consequential amendments to subordinate legislations

   All notifications including notifications issued by RBI under Chapter IIID of *RBI Act*, the *Government Securities Act* and *Securities Contract (Regulation) Act*, in respect of government securities, OTC Derivatives (OTC Derivatives) and Exchange Traded Currency Derivatives (ETCD), need to be reviewed and streamlined to give effect to the above-mentioned amendments.

   One such notification which will require to be repealed is the *2000 SCRA Notification* issued by the Ministry of Finance delegating the powers of the Central Government under *Securities Contract (Regulation) Act* to RBI in relation to (a) government securities, gold related securities and securities derived from these securities and (b) ready forward contracts in bonds, debentures, securitised debt and other debt securities.

The proposed amendments are described in Appendix E and F.

5.4 Sequencing

The global best practises on transition path show that that transition towards a full-fledged debt management agency is achieved over a period of three years. This includes physical installation of agency to gradual transfer of functions to finally, introduction of integrated and autonomous information systems.

Amendments to the *RBI Act* to facilitate the transition

Currently, section 17(11)(e) and (f) of the *RBI Act* authorizes the RBI to act as an agent for the central government for public debt management and issuance of bonds and debentures. This will continue in the interim. Section 17(11)(e) and (f) will need to be amended to allow the RBI to act as an agent of the Central Government to manage public debt, only if the

Central Government issues a notification under section 21(2) of the *RBI Act* entrusting the debt management function to the RBI. The clauses will be deleted only when the PDMA fully takes over the function of the debt manager.

Further, section 21(2) obligates the central government to entrust the debt management function to RBI. To allow the PDMA to carry on its functions as an investment banker for and issuer of, government securities, section 21(2) will need to be amended to allow the Central Government to issue a notification in the official gazette, entrusting the RBI *or* the PDMA with the management of public debt and with the issuance of any new loans, for the Central Government. The section will be deleted only when the PDMA is fully functional.

Stage 0

1. The PDMA Bill would need to be passed by the Parliament. The law needs to have an enabling provision that the law shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint and different dates may be appointed for different provisions of this law.

Stage 1

1. In this stage, the provisions of the PDMA law dealing with establishment, governance and funding of the PDMA, would need to be notified. At this stage, the PDMA wound not undertake the functions mandated under the PDMA law. The PDMA should be able to enter into contracts, recruit employees, evaluate and replicate the IT systems used by the RBI for public debt management or build new systems and infrastructure, and build capacity for discharging its functions. RBI and the PDMA would need to coordinate with each other for transitioning –

   (a) the existing systems and software used by RBI for public debt management;

   (b) records (such as the securities general ledger) maintained by RBI.

   To allow this, the provision of the PDMA law imposing an obligation upon RBI to co-operate with the PDMA for the transition, will need to be notified.

2. In the transition, the Central Government should have the ability to delegate its public debt management function to the RBI or PDMA, through an executive notification. Currently, the *RBI Act* obligates the Central Government to delegate its public debt management function to the RBI only. To allow the Central Government to delegate the debt management function to PDMA, the provisions of the *RBI Act* which impose this obligation on the Central Government, will need to be amended.

3. The Central Government will need to issue a notification under the amended provision (referred to in item 2) entrusting the public debt management function to RBI. This will ensure that RBI continues to manage the public debt and issue government securities, until Stage 2.

Between Stage 1 and Stage 2

1. PDMA will acquire office space, recruit employees, do procurement for infrastructure, build capacity (eg. prepare operations manuals and internal process manuals, build record keeping and IT capacity), take over or replicate the software and systems used and records maintained, by the RBI in connection with its debt management function.

2. SEBI will prepare and keep ready substitutes for circulars, notifications and directions issued by RBI in respect of government securities.

Stage 2

1. PDMA will begin the public debt issuance and management functions (a) using existing RBI systems; and (b) under the current regulatory framework. To allow this, the following two steps will require to be taken -
   (a) The Central Government will issue a notification entrusting the public debt management function to PDMA (under the amended provision of the *RBI Act* referred to in item 2 of Stage 1).
   (b) All references to RBI in the *Government Securities Act* will be replaced with references to PDMA. Currently, *Government Securities Act* allows the RBI to issue directions and generally control the government securities markets. To allow PDMA to issue government securities and manage public debt under the current regulatory framework, the PDMA will step into the shoes of RBI in the *Government Securities Act*.
2. Chapter IIID of the *RBI Act* will require to be deleted. Currently, Chapter IIID of the *RBI Act* empowers the RBI to (a) regulate OTC Derivatives; and (b) issue directions to all agencies dealing in government securities, money market instruments, foreign exchange, derivatives and other instruments as the RBI may specify. As a result of the deletion of this chapter, government securities and other instruments, will, like all other securities, be regulated under the *Securities Contract (Regulation) Act*.
3. The Central Government will need to issue a notification delegating its powers under the *Securities Contract (Regulation) Act* to SEBI, in respect of (a) government securities; and (b) derivatives, both exchange traded and OTC.

   The steps enumerated in items 2 and 3, will ensure that there is a consolidated statutory and regulatory framework for all securities.
4. SEBI will need to issue its own set of notifications prepared and kept ready before Stage 2. These notifications will replace the directions issued by RBI in respect of government securities and derivatives.

Between Stage 2 and Stage 3

1. PDMA will need to replace all circulars, notifications and directions issued by RBI under the *Government Securities Act*, and issue its own directions transitioning market participants to the PDMA framework and systems. For example (a) government securities held in the constituents' subsidiary general ledger account will need to be transferred to the demat accounts of the holders, maintained with depositories; (b) the issuance and trading of government securities will need to be integrated with existing issuance and trading platforms available for other securities.[11]
2. PDMA will develop capacity for undertaking the cash management and contingent liability management and other functions, as envisaged in the PDMA law.

[11] The existing market infrastructure for Government securities such as NDS-OM and SGL should follow due process of law and be governed and recognised under *Securities Contract (Regulation) Act* and *Depositories Act* respectively.

Stage 3

1. The *Government Securities Act* will be repealed, and the entire public debt management function will move to the new PDMA framework and systems. All securities issued under the *Government Securities Act* will now be covered under the PDMA law.
2. All provisions of the law on Public Debt Management, other than the provisions which are notified in Stage 1, will be notified.
3. Section 17(11)(e), Section 17(11)(f) and Section 21(2) of the *RBI Act* will need to be deleted.

6 State debt

RBI Act provides that the states may enter into an agreement with RBI to manage public debt of states. Public debt of states is part of the State List. However under Article 252 (1) of the Constitution, if two or more States (say, State A and State B) find it desirable that any of the matters under the State list should be regulated in State A and State B, by the Parliament, then:

1. State A and State B may authorise the Parliament to pass a law on such subject. Such a resolution must be passed by the legislatures of State A and State B.
2. The Parliament may pass a law regulating such subject in State A and State B.

All the states except the state of Jammu and Kashmir have passed the *Government Securities Act* in pursuance of clause (1) of Article 252.[12]

Once an independent debt management agency is set up, states must be given the option to delegate the issue and management of State Government securities PDMA. If a State Government opts to delegate the issue and management of State Government securities to PDMA, then the following steps are required:

- It will require to opt itself out of the GSA framework, i.e. the GSA will be repealed to the extent of the securities issued by that State Government.
- For the repeal of *Government Securities Act* with respect to the securities of any State Government, in pursuance to Article 252 (2) of the Constitution of India, atleast two States must pass a resolution authorising the Parliament to repeal the *Government Securities Act*.
- The repealing legislation may, then, be adopted by other States desiring to opt out of the GSA.
- Consequently the provisions of the PDMA law would apply to state government debt.

[12]The Statement of Objects and Reasons to the *Government Securities Act* states as under: And whereas in pursuance of clause (1) of Article 252 of the Constitution, resolutions have been passed by the Houses of the Legislatures of all the Sates, except the State of Jammu and Kashmir, to the effect that the matters aforesaid should be regulated in those States by Parliament by law;

Pursuant to the aforesaid statement, section 1 (4) of the *Government Securities Act* provides that the provisions of GSA will apply to all the States, except the State of Jammu and Kashmir, unless this State also adopts the provisions of the *Government Securities Act* by similarly passing a resolution under Article 252(1) of the Constitution of India.

Sections 17(11)(e) and 17(11)(f) of the *RBI Act* will cease to apply to state debt. Section 21(A)(1)(b) of the *RBI Act* will also have to be deleted.

7 Conclusion

The Indian macroeconomic and financial system has undergone enormous changes from the 1930s. RBI has gone from an agency that was a 'temporary provision' to having clarity of purpose in the form of an inflation target. The mainstream financial system has achieved high capabilities with legal foundations for the securities markets, regulation by SEBI, and securities infrastructure in the form of exchanges, clearinghouses and depositories.

From 1997 onwards, there have been calls for the establishment of a independent Public Debt Management Agency (PDMA). This would yield numerous gains: It would free RBI of the conflict of interest of performing debt management work for the central and state governments; it would improve debt management services obtained by the central and state governments; it would ignite bond market development by harnessing the capabilities of the mainstream financial markets of India; it would yield improvements in government borrowing by selling bonds to voluntary buyers in a deep and liquid government bond market.

FSLRC has a comprehensive solution with a draft law which builds on a clean slate. A new agency, the PDMA, is created, and there is a unified treatment of financial markets. The contribution of this paper lies in working out the legislative strategy for the PDMA reform in isolation. This involves using the FSLRC draft for the PDMA as an agency, with small changes, amendments to existing law that merge the bond market into the mainstream financial market system, and a careful construction of a steps through which the changes are put into place without causing any disruption. This analysis would be useful when, at a future date, the PDMA reform is executed.

A Present state of bond market infrastructure

The key features of the present state of bond market infrastructure are discussed below.

Restricted membership of the SGL account : Each entity eligible for dealing in Government securities is required to open a SGL account and a current account with the back office of RBI. In exercise of powers under Section 4 of the *Government Securities Act*, the RBI specifies the conditions for opening and maintaining the SGL account. The RBI lays down a list of entities who are eligible to open and maintain SGL accounts.[13] The list primarily includes banks, Primary Dealers, Financial Institutions, Insurance companies, Mutual Funds,Provident and Pension Funds, NSDL and CDSL. Entities other than these cannot directly deal in Government securities. This explains the concentrated ownership of Government securities. Further, operational aspects such as transfer of Government securities from one SGL account to another is subject to RBI approval. There are complexities involved in the transfer of securities to SGL account holders' own demat account with depositories.[14]

Complexities involved in opening and maintaining CSGL account]: The entities who are not eligible to open and maintain SGL account with RBI can open and maintain Constituents Subsidiary General Ledger (CSGL) account with RBI on behalf of these entities. These entities open and maintain Gilt Account Holders (GAH) accounts with their CSGL account holders. The RBI specifies the eligibility criteria for opening and maintaining CSGL accounts. Further, the RBI lays down operational guidelines to be complied with by the CSGL account holders. As an example, no constituent is entitled to open more than one gilt account without the prior written permission of the RBI.[15]

Non-applicability of the *Depositories Act* to government securities: The depository framework for government securities is carved out from the legislative framework governing depositories for securities market. The RBI's depository arrangements for government securities are not regulated by the *Depositories Act*. The NSE's and BSE's depository arrangements for government securities are regulated by the *Depositories Act*. However, section 31 of the *Government Securities Act* provides that nothing in the *Depositories Act* shall apply to government securities covered by the *Government Securities Act*, unless an agreement to the contrary is executed between a depository under the *Depositories Act*, and the Government or the RBI.

Exchange for auction and trading of Government securities : In 2002 the RBI set up the Negotiated Dealing System (NDS) and the NDS-OM as a platform for auction and trading of Government securities.[16] The *RBI Act* and the *Government Securities Act* do not prescribe how to conduct primary and secondary trading in Government securities. Terms and conditions for issue of Government securities are laid out in *Revised General Notification for issue of Government of India Dated Securities*. The features of issuance

[13] Reserve Bank of India, *Subsidiary General Ledger Account: Eligibility Criteria and Operational Guidelines*, Dec. 4, 2009.

[14] Very recently some steps have been announced by RBI to ensure seamless transfer to securities from SGL to demat form.

[15] See, Reserve Bank of India, Department of Government and Bank Accounts, *Amendment to Constituents' Subsidiary General Ledger Account: Eligibility Criteria and Operational Guidelines (Guidelines) Notification No. 183 dated Sept 05, 2011*, May 22, 2012.

[16] Prior to 2002, trading in Government securities used to place through telephones. For more details on the operational aspects of NDS, See https://rbi.org.in/scripts/PublicationsView.aspx?id=12288

procedure are codified in *Revised General Notification for issue of Government of India Dated Securities*. The Notification prescribes who is eligible to invest in government securities, types of securities, types of auctions, mode of payment, and form in which securities may be held.[17]. The *Securities Contract (Regulation) Act* confers powers on the government of India to regulate and supervise all stock exchanges. However NDS-OM is not set up under the *Securities Contract (Regulation) Act*.

Restrictive membership of NDS-OM : The RBI prescribes the routes to access the order-matching segment of NDS for trading in government securities. Direct access is provided only to SGL account holders including banks, primary dealers, mutual funds, insurance companies, financial institutions etc.

In summary, the exchange and depository infrastructure is owned and controlled by RBI.[18] The *Planning Commission, Report of the Committee on Financial Sector Reforms, (Chairman: Raghuram Rajan), September, 2008*, *Ministry of Finance, Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre, (Chairman: Percy Mistry), February, 2007* and *Ministry of Finance, Report of the Financial Sector Legislative Reforms Commission, (Chairman: B.N Srikrishna), March, 2013* focussed on financial sector reform and have all supported PDMA using the securities market infrastructure on the grounds that wider participation in the bond market would enable the development of deep and liquid bond markets in India. From the point of view of the PDMA, it will need a bond market to sell government securities as the present arrangement of RBI as the banking regulator requiring banks to hold government securities under their Statutory Liquidity Ratio (SLR), is also being slowly phased out. Therefore, it should have the choice to use whichever exchange or depository that allows it to best meet its objectives. International best practices support the use of the securities market infrastructure.

B International experience on bond market infrastructure

Table 1 presents an overview of the Government bond market infrastructure in similarly placed economies. The first column presents an overview of the trading infrastructure, the second column provides information on depository arrangements and the third column describes the framework for settlement of bond market transactions. The first column shows that in most of the countries the bonds are traded on the platform provided by the stock exchange. Government bond issuance and trading is part of the unified framework of securities trading. Malaysia is the only country other than India where trading of bonds takes place on a platform owned by the Central Bank.

As far as the infrastructure of depository is concerned, the Central Bank is the responsible authority in Japan, Indonesia and Nepal. In all the other countries, the depository infrastructure for Government bonds is part of the unified infrastructure for other securities.

The settlement of government securities is overseen by the securities market regulator with a few exceptions. As an example, in Malaysia, the settlement of the primary and secondary

[17] Ministry of Finance, *Internal Working Group on Debt Management*, tech. rep., 2008.

[18] The existing bond market infrastructure should follow due process of law and be governed by *Securities Contract (Regulation) Act* and *Depositories Act*.

Table 1: Bond market infrastructure in similarly placed economies

Country	Trading infrastructure	Depository	Settlement of securities transactions
Japan	PTS (Proprietary trading system), multiple platforms	Bank of Japan	BoJ-NET (Bank of Japan-Financial network)
India	NDS-OM	SGL (Subsidiary General Ledger,)	CCIL (Clearing corporation of India)
South Korea	KRX (Korea-Exchange) trading system	Korea Securities Depository	Korea Securities Depository is under supervision of MoSF, FSC and FSS
Indonesia	FITS (Fixed income trading system) by Stock Exchange	Central bank	SSSS (Scripless Security Settlement System) run by Bank Indonesia
Israel	TACT (Tel-Aviv Continuous Trading) run by stock exchange (Tel Aviv)	TASE clearing house	TASE clearing house
Viet Nam	EBTS run by HNX	Vietnam Securities Depository	Vietnam Securities Depository
Malaysia	Fully Automated System for Issuing (FAST) run by Central Bank	Bursa Malaysia Depository	STSS (Scripless Securities Trading and Settlement) Bank by the Central Bank
Taiwan	EBTS run by TPEX	TDCC (Taiwan Depository and Clearing Corporation)	CGSSS (Central Government Securities Settlement System)
Nepal	NATS (NEPSE automated trading system) run by NEPSE (Nepal Stock Exchange)	NRB (Nepal Rastra Bank)	CDS and Clearing Limited
Thailand	Stock Exchange of Thailand	Thailand Clearing House	Thailand Clearing House Thailand Securities Depository
South Africa	OTC and the Johannesburg Stock Exchange	Central securities depository	Strate

Table 2: Institutional arrangements for debt management and bond market regulation: Advanced economies

Country	Regulator-bond market	Public debt management
Australia	Australian Securities and Investment Commission (ASIC)	Australian Office of Financial Management
France	Autorite Des Marches Financiers (AMF)	Agence France Tresor
Canada	Investment Industry Regulatory Organization of Canada (IIROC)	Canadian Ministry of Finance
Italy	CONSOB	Italian Treasury-Public Debt Directorate
Japan	Financial Services Agency	Ministry of Finance and Bank of Japan
U.S.A	Securities and Exchange Commission (SEC)	The Office of Debt Management, US Treasury
Germany	Federal Financial Supervisory Authority (BaFin)	German Federal Republic Finance Agency (Gmbh)
UK	Financial Conduct Authority (FCA)	UK DMO (Executive agency of HM treasury)

market transactions in government securities and unlisted corporate debt securities take place through the Scripless Securities Trading System (SSTS), which is part of the Real Time Electronic Transfer of Funds and Securities (RENTAS) system.

In summary, an overview of bond market infrastructure arrangements in other economies suggest that:

1. Government bond issuance and trading is part of the unified framework of securities trading.
2. The depository infrastructure for Government bonds is part of the depository infrastructure for the financial market with a few exceptions.
3. The settlement of government securities is overseen by the securities market regulator.

India is the only country where all the three elements of bond market infrastructure are owned, controlled and managed by the Central Bank.

C International experience on market regulation

Table 2 and Table 3 present an overview of institutional arrangements governing debt management and regulation of debt market. A key finding emanating from the Tables is that the agency responsible for management of debt, including issuance of Government securities is distinct from the agency regulating bond market. The location of debt management agency varies. In some countries there are specialised agencies responsible for issuance and management of public debt such in Germany. In some others, the responsibility for management of debt is vested in an Executive Agency of the Ministry of Finance such as in U.K and Australia. In some other countries, the responsibility of debt management is vested in a Department within the Ministry of Finance such as in Brazil, France and Argentina. In India and China, the public debt is managed by the Central Bank.

Table 3: Institutional arrangements for debt management and bond market regulation: Emerging economies

Country	Regulator-bond market	Public debt management
Argentina	Comision Nacional de Valores (CNV)	Ministry of Economy and Public Finances
Saudi Arabia	Capital Markets Authority (CMA)	**Central Bank**
South Africa	Financial Services Board (FSB)	National Treasury
India	**Central Bank**	**Central Bank**
China	China Securities Regulatory Commission (CSRC) and **Central Bank**	**Central Bank** (Internal debt), Ministry of Finance (External debt)
Mexico	National Banking and Securities Commission (CNBV)	Mexican Ministry of Finance and Public Credit
Russia	Federal Financial Markets Service (FFMS)	**Central Bank**
Brazil	Brazilian Securities and Exchange Commission	Public debt Undersecretariat
Indonesia	Financial Services Authority (FSA)	Directorate of Government Securities Management, Ministry of Finance
Turkey	Capital Markets Board (CMB)	Undersecretary of Treasury
South Korea	Financial Supervisory Service (FSS) under Financial Services Commission (FSC)	Ministry of Strategy and Finance, Government Bond Policy Division

The unified regulator of financial market serves as the regulator of Government bond market. We do not see examples of countries where the regulator of Government bond market is distinct from the overall securities market regulator. Even in countries where the Central Bank manages public debt, the regulation of Government bond market is not solely vested with the Central Bank. India stands out as the only example where the Central Bank is the issuer and manager of Government debt as well as the regulator of Government debt.

D Law establishing PDMA as a financial agency

PART XV

Public Debt Management Agency

CHAPTER 83

Objective and functions of the Debt Agency

Objective.

352. (*1*) The objective of the Debt Agency is to, –

(*a*) minimise the cost of raising and servicing public debt, over the long-term; and

(*b*) keep public debt within an acceptable level of risk at all times.

(*2*) The Debt Agency will carry out its objectives under the general superintendence of the Central Government.

Functions.

353. (*1*) The Central Government must entrust the Debt Agency with, and the Debt Agency must undertake the, –

(*a*) issuance and management of government securities; and

(*b*) management of public debt, contingent liabilities and cash, of the Central Government.

(*2*) The Debt Agency may perform such other functions as may be authorised under this Part.

CHAPTER 84

Management of public debt and contingent liabilities

Management of public debt.

354. (*1*) The Debt Agency must manage the public debt through, –

(*a*) the formulation of a medium term public debt plan and an annual public debt plan; and

(*b*) the implementation of the medium term public debt plan and the annual public debt plan, as approved by the Central Government.

(*2*) The Debt Agency must, at the end of every three calendar years, submit a draft of a medium term public debt plan to the Central Government.

(*3*) The Central Government must approve the draft medium term public debt plan with or without modifications, and communicate the same to the Debt Agency, as soon as may be practicable, after the date on which it is received from the Debt Agency.

(*4*) The Central Government may at any time, in consultation with the Debt Agency modify the medium term public debt plan.

(*5*) The Debt Agency must implement, to the best of its abilities, the medium term public debt plan as approved and modified by the Central Government from time to time.

(*6*) The Debt Agency must, at the end of each calendar year, submit a draft of an annual public debt plan to the Central Government.

(*7*) The draft annual public debt plan must take into account, –

(*a*) the medium term public debt plan;

(*b*) the public debt at the relevant time, including inherent risks of the Central Government;

(*c*) the forecasts of revenue and expenditure of the Central Government;

(*d*) the prevailing and evolving market conditions for government securities;

(*e*) aspects of efficiency of public debt, including the cost, risk and phasing of borrowing and repayments; and

(*f*) such other factors as the Debt Agency may consider appropriate.

(*8*) The Central Government must approve the draft annual public debt plan, with or without modifications, and communicate the same to the Debt Agency, as soon as may be practicable, after it is received from the Debt Agency.

(*9*) The Central Government may, in consultation with the Debt Agency, modify the annual public debt plan at any time.

(*10*) The Debt Agency must implement, to the best of its abilities, the annual public debt plan as approved and modified by the Central Government from time to time.

(*11*) The Debt Agency must, in consultation with the Central Government, prepare an issuance schedule, at such times as the Debt Agency may determine to be practicable and necessary.

(*12*) The Debt Agency must publish, –

(*a*) the medium term public debt plan and the annual public debt plan, within ninety days from the date on which it is approved by the Central Government; and

(*b*) such other information as may be prescribed.

(*13*) The Central Government must, by notification, prescribe, –

(*a*) the information which must be published under section (*12*); and

(*b*) the intervals at which the information under section (*12*) must be published.

(*14*) In this section, –

(*a*) "medium term public debt plan" means a plan to achieve the desired composition of public debt for the immediately following three financial years.

(*b*) "composition of public debt" includes the amount, structure, maturity, currency, indexing and mode of issuance, of public debt.

(*c*) "annual public debt plan" means the annual plan for, –

(*i*) advising on the composition of public debt for the immediately following financial year; and

(*ii*) operationalising, in the immediately following financial year, the strategies mentioned in the medium term debt plan.

(*d*) "issuance schedule" means a calendar of the Central Government for issuance of government securities.

Management of contingent liabilities.

355. (*1*) The Debt Agency must manage the contingent liabilities of the Central Government through, –

(*a*) the development, maintenance and management of a database of contingent liabilities;

(*b*) the management and monitoring of contingent liabilities;

(*c*) undertaking credit risk assessments in relation to contingent liabilities; and

(*d*) advising the Central Government on the pricing and issuance of contingent liabilities; and

(*2*) The Debt Agency must at the end of every financial year, assess the risks associated with the contingent liabilities of the Central Government, in accordance with international methodologies and practice.

(*3*) The Debt Agency must publish information relating to contingent liabilities of the Central Government in the prescribed manner.

(*4*) In this section, "contingent liabilities" means the explicit contingent liabilities of the Central Government.

Liability for financial obligations.

356. The Central Government is liable to meet the obligations arising from the public debt issued by the Debt Agency.

CHAPTER 85

Government securities

Issue of government securities.

357. (*1*) The Debt Agency must issue government securities in accordance with the provisions of this Part.

(*2*) The terms and conditions of government securities will be such as may be prescribed.

(*3*) The Debt Agency must maintain and manage the register of holders of government securities.

(*4*) The register maintained by a depository under section 213 will be deemed to be the register required to be maintained by the Debt Agency.

(*5*) The Central Government must prescribe the terms and conditions of government securities.

Management of government securities.

358. (*1*) The Debt Agency will be responsible for making payment to the holders of government securities, in accordance with their terms.

(*2*) The Central Government may prescribe the manner of claiming payments due on government securities.

Fungibility and transferability of government securities.

359. (*1*) Government securities having identical terms and conditions will be fungible.

(*2*) All government securities will be freely transferable.

(*3*) A transfer or the creation of an interest in a government security is void unless it is recorded by the Debt Agency.

(*4*) The Debt Agency must not record the transfer or creation of an interest in a government security unless it is made in the prescribed manner.

(*5*) Nothing contained in sub-section (*3*) will affect any transfer or creation of an interest pursuant to the operation of law or the order of a court.

(*6*) The Central Government must prescribe the manner in which a government security may be transferred or subjected to an interest.

Fostering the market for government securities.

360. (*1*) The Debt Agency must take steps to foster a liquid and efficient market for government securities.

(*2*) The Debt Agency must advise the Regulator and the Central Government on the policy and design of the market for government securities.

(*3*) The Debt Agency must seek to ensure, –

(*a*) equal access to the market for government securities;

(*b*) growth and diversity in the investor base for government securities;

(*c*) fair competition in the market for government securities; and

(*d*) transparency in the issuance and trading of government securities.

CHAPTER 86

CASH MANAGEMENT

Cash management.

361. (*1*) The Debt Agency must manage the cash of the Central Government by, –

(*a*) collecting information about the cash of the Central Government, including co-ordination with the Central Government and the Reserve Bank to estimate the cash balances every day;

(*b*) monitoring the cash balances of the Central Government;

(*c*) developing systems to calculate and predict cash requirements of the Central Government;

(*d*) issuing and redeeming such short-term securities as may be required to meet the cash requirements of the Central Government;

(*e*) advising the Central Government on management of cash of the Central Government; and

(*f*) advising the Central Government on measures to promote efficient cash management practices and to deal with surpluses and deficits.

(*2*) The Debt Agency must, in consultation with the Central Government, prepare a cash management plan for the Central Government on a daily, weekly or monthly basis, as the Debt Agency may determine to be practicable and necessary.

(*3*) The periodic cash management plan must advise on the following matters, –

(*a*) the forecasts of cash flows of the Central Government;

(*b*) synchronisation of cash flows with public debt management; and

(*c*) aspects of efficiency such as costs and risks associated with cash flows and measures to deal with deficit and surplus including investment of excess cash or buyback of domestic debt.

(*4*) The Central Government must approve the periodic cash management plan, with or without modifications, from time to time, and communicate the approved periodic cash management plan to the Debt Agency, as soon as may be practicable.

(*5*) The Central Government may, in consultation with the Debt Agency, modify the periodic cash management plan at any time as may be necessary.

(*6*) The Debt Agency must implement to the best of its abilities, the periodic cash management plan as approved and modified by the Central Government.

CHAPTER 87

OTHER FUNCTIONS

Research and information.

362. The Debt Agency must,–

(*a*) develop, maintain and manage information systems that are necessary to carry out its functions efficiently;

(*b*) disseminate information and data relating to its functions to the public in a transparent, accountable and timely manner; and

(*c*) conduct and foster research relevant for the efficient discharge of its functions.

Services to others.

363. (*1*) The Debt Agency may on behalf of any public authority, as may be permitted by the Central Government or any State Government, –

(*a*) carry out the functions under section 353(1)(*a*) and 353(1)(*b*); or

(*b*) provide technical assistance to enable the public authority or State Government, as the case may be, to carry out the functions under sections 353(1)(*a*) and 353(1)(*b*).

(*2*) A State Government or public authority is liable to meet the obligations arising from any funds that are raised on behalf of that State Government or public authority by the Debt Agency.

(*3*) The Debt Agency must not carry out any function under this section if there is a conflict of interest with the obligations of the Debt Agency under this Part.

(*4*) The functions carried out under this section must be subject to a written agreement to this effect between the Debt Agency and the public authority or as the case may be the State Government.

(*5*) Unless excluded by the written agreement, the provisions of this Part will apply, with the necessary modifications, to the functions carried out under this section.

(*6*) For an agreement under this section to be valid, it must, –

(*a*) require the Debt Agency to carry out, or provide technical assistance to enable the carrying out of, at least one of the functions provided under sections 354, 355(*1*) or 361; and

(*b*) be published.

(*7*) In this section, "technical assistance" means any advice, assistance or training pertaining to the functions under section 353(1)(*a*) and 353(1)(*b*).

Collection of information or material.

364. (*1*) The Debt Agency may in writing call for such information or material as it determines necessary from the Central Government, a State Government or any public authority with which it has entered into an agreement, to carry out its functions under this Part.

(*2*) The Debt Agency must give reasonable time to the Central Government, State Government or public authority, as the case may be, to provide the information.

(*3*) The information or material may relate to, –

(*a*) public debt;

(*b*) contingent liabilities of the Central Government, a State Government or a public authority which the Debt Agency has entered into an agreement;

(*c*) cash balances of the Central Government, a State Government or a public authority with which the Debt Agency has entered into an agreement; and

(*d*) forecasts of daily cash flows and net cash requirements of the Central Government, a State Government or a public authority with which the Debt Agency has entered into an agreement.

(*4*) The recipient of a request under sub-section (*1*) is bound to provide the information or material, if available with it, to the Debt Agency within the time-period mentioned by the Debt Agency.

Bar on transactions.

365. The Debt Agency must not raise funds or undertake transactions in financial markets on its own behalf.

Fees.

366. (*1*) The Central Government must pay such fees to the Debt Agency, for its services, as may be stipulated in the bye-laws referred to in sub-section (*2*).

(*2*) The Debt Agency must, in consultation with the Central Government, make bye-laws to provide for the scale of fees payable in respect of the services rendered to the Central Government under this Act.

(*3*) The Debt Agency must ensure that the fees are proportionate to the kind or scale of service rendered.

(*4*) While levying fees, the bye-laws must take into account –

(*a*) the financial requirements of the Debt Agency; and

(*b*) the costs associated with the service for which the fee is levied.

(*5*) The State Government or public authority that avails of the services of the Debt Agency under section 363 must pay such fees as may be prescribed in the bye-laws or otherwise as may be agreed between the Debt Agency and the relevant State Government or public authority.

(*6*) The Debt Agency may make bye-laws to provide for the scale of fees payable in respect of its services rendered under section 363.

CHAPTER 88

POWERS OF THE CENTRAL GOVERNMENT

Power of Central Government to issue directions.

367. (*1*) The Central Government may issue to the Debt Agency, by an order in writing, directions on policy from time to time.

(*2*) The decision of the Central Government as to whether a direction is one of policy or not is final.

(*3*) Before issuing any directions under this section, –

(*a*) the Debt Agency must be given a reasonable opportunity to be heard to express its views; and

(*b*) the Central Government must publish any views expressed by the Debt Agency in a manner best suited to bring them to the attention of the public, and consider the same.

(*4*) The Debt Agency is bound by any directions issued under this section in the exercise of its powers or the performance of its functions.

Power of Central Government to temporarily supersede Debt Agency in exigency.

368. (*1*) The Central Government may, by notification, temporarily supersede the Debt Agency Board, if the Central Government is of the opinion that, –

(*a*) on account of an emergency, the Debt Agency is unable to perform its functions; or

(*b*) the Debt Agency has persistently defaulted either in complying with any direction issued by the Central Government under this Part or in the performance of its functions.

(*2*) The notification must provide for the period of supersession, which may not exceed a period of one hundred and eighty days.

(*3*) Before issuing the notification, the Central Government must, –

(*a*) give a reasonable opportunity to the Debt Agency Board to make representations against the proposed supersession; and

(*b*) consider the representations, if any, made by the Debt Agency Board.

(*4*) Upon the publication of the notification, –

(*a*) all the members of the Debt Agency Board will, as from the date of supersession, vacate their offices; and

(*b*) all the powers and functions which may be exercised or performed by the Debt Agency, will, until the Debt Agency Board is reconstituted under section 3(1)(*f*), be exercised and performed by such person or persons as the Central Government may direct.

(*5*) Before the period of supersession expires, the Central Government must take action towards reconstituting the Debt Agency Board.

(*6*) The Central Government may reconstitute the Board of the Debt Agency by fresh appointments, and no person who vacated office under sub-section (4)(*a*) will be deemed disqualified for appointment.

(*7*) The Central Government must, at the earliest, lay before each House of Parliament, the notification and a report of the action taken under this section and the circumstances leading to such action.

E Legislative amendments towards setting up an independent debt management agency

E.1 Amendments to the *RBI Act*

Amendments to Section 17 of the *RBI Act* The following proviso shall be inserted after clause (f) of sub-section (11) of section 17 of the *RBI Act*–

> Provided that the Bank may exercise the functions specified in clauses (e) and (f) of this sub-fifftsection for the Central Government, if the Central Government issues a notification under Section 21(2) of this Act, entrusting the Bank with the function of managing public debt and issuing and managing bonds and debentures of the Central Government.fi

Amendments to Section 21 of the *RBI Act*

Sub-section (2) of Section 21 of the Reserve Bank of India Act shall be substituted as under -

> '(2) The Central Government shall, by notification in the Official Gazette, entrust the Bank or the Public Debt Management Agency, on such conditions as may be agreed upon, with the management of the public debt, issue and management of bonds and debentures of the Central Government and issue of any new loans.'

Once the PDMA is fully operational, these sections will be deleted.

> 'Sections 17(11)(e), 17(11)(f) and Section 21(2) of the *RBI Act* shall stand deleted.'

E.2 Amendments to the *Government Securities Act*

The following section shall be inserted as Section 34A in the *Government Securities Act* -

> '**34A. Power of the Bank transitioned to the Public Debt Management Agency**
> - All references to the Bank in this Act shall be construed as references to the Public Debt Management Agency.
> Provided that -
> (a) all directions issued by the Bank under this Act, before the date on which this amendment is notified, shall stand repealed;
> (b) all actions taken by any person under any direction issued by the Bank under this Act, before the date on which this amendment is notified, shall be valid and legal.'

Once the PDMA is fully operational, the *Government Securities Act* will be repealed.

E.3 Repeal of the *Government Securities Act*

After section 35 of the *Government Securities Act*, the following section shall be inserted, namely -

> "35A. The Government Securities Act, 2006 is hereby repealed."

F Legislative amendments to achieve unification of market regulation

F.1 Amendments to the *RBI Act*

Sections 45U, 45V, 45W and 45X of Chapter IIID of the Reserve Bank of India Act, shall stand deleted.

Provided that -

1. any direction issued by the Reserve Bank before the date on which this amendment is notified, under Chapter IIID of the Reserve Bank of India Act, shall stand repealed;
2. any action taken by any person, before the date on which this amendment is notified, in pursuance of any direction issued by the Reserve Bank under Chapter IIID of the Reserve Bank of India Act, shall be valid and legal.

F.2 Amendments to the *Securities Contract (Regulation) Act*

The following amendments shall be made in Section 2 of the Securities Contracts Regulation Act–

after sub-clause (C) of clause (ac), the following sub-clauses shall be inserted –
(D) repo and reverse repo;
(E) a contract which derives its value from change in interest rate, foreign exchange rate or credit index or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options; and

after clause (f), the following clauses shall be inserted–

'(fa) "repo" means an instrument for borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed;

(fb) "reverse repo" means an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent;'

The following words shall stand deleted in Section 29A of the Securities Contracts Regulation Act
'or the Reserve Bank of India constituted under Section 3 of the Reserve Bank of India Act, 1934 (2 of 1934)'

Provided that -

1. any notification issued by the Reserve Bank, before the date on which this amendment is notified, in exercise of any power delegated to it by the Central Government under Section 29A of the Securities Contracts Regulation Act, shall stand repealed;
2. any action taken by any person, before the date on which this amendment is notified, in pursuance of any notification issued by the Reserve Bank under the said Section 29A of the Securities Contracts Regulation Act, shall be valid and legal.

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Indian bankruptcy reforms: Where we are and where we go next

ajayshahblog.blogspot.in/2016/05/indian-bankruptcy-reforms-where-we-are.html

by Ajay Shah and Susan Thomas.

Note: The 2017 state of the art is out.

Bankruptcy reforms have been moving forward at a blistering pace for the last few weeks, with the Insolvency and Bankruptcy Code ("IBC") being enacted by the Lok Sabha and then the Rajya Sabha. In this article, we take a look at where we are in Indian bankruptcy reform, and where we need to go next.

1 Bankruptcy reforms in the context of Indian economic reform

All business plans are speculative views of the future. Some will inevitably go wrong, either because of failures of conception or of execution. As India lacks the requisite institutional arrangements, at present, when a firm goes into default, the management, capital and labour get stuck in an interminable mess. With a sound bankruptcy process, we would be able to rapidly resolve the situation, and everyone would move on. This is the best outcome for society at large. In such a world, there would be more entrepreneurship, more risk taking, more debt, more unsecured debt, and more non-bank debt.

In India, the lack of a sound bankruptcy process implies a flawed legal foundation of limited liability companies. The classic definition of limited liability is a bargain: *Equity is in charge of the company as long as all dues to Debt are met. When the firm defaults on its debt obligations, control over the assets of the firm shifts from Equity to Debt*. This is not how India understands limited liability today. We tend to think that a company belongs to its founding family no matter what happens by way of firm default.

As a financial agency with a keen interest in good bankruptcy outcomes for banks, RBI has led many attempts at bankruptcy reform. These include CDR, SDR, wilful defaulters, and ARCs. However, these have not delivered results. Even if these policy initiatives had been better designed, the role of RBI in the credit market is inherently limited because there is much more to lending than lending by banks. The bankruptcy process requires a machinery that is grounded in Parliamentary law, which is beyond the powers of regulations or informal arrangements made by a financial agency.

One component needed for bankruptcy reforms was built by the Financial Sector Legislative Reforms Commission (FSLRC), led by Justice Srikrishna from 2011 to 2013. The `resolution corporation' in the draft `Indian Financial Code' (version 1.0 in 2013 and then version 1.1 in 2015) is a specialised bankruptcy process for two kinds of financial firms: those that make intense promises to consumers, and those that are systemically important. This component has been slowly moving towards implementation, after MOF first setup a `Task Force' on the subject, and then made an announcement in Para 90(i) of the budget speech of February 2016. But the bankruptcy process for all other firms was a project waiting to be done. Some work on these lines went into the Companies Act, 2013, but it only partly dealt with the mechanisms of restructuring and winding up.

2 The journey to the law

The Budget Speech in July 2014 had one sentence in Paragraph 106:

> *Entrepreneur friendly legal bankruptcy (sic) framework will also be developed for SMEs to enable easy exit.*

This sentence could have been done in an incremental way. Instead, it was taken on a more ambitious scale at the Ministry of Finance (MOF) with a policy project that would go beyond just an SME bankruptcy framework for India. In late 2014, MOF setup the Bankruptcy Legislative Reforms Committee or the BLRC, led by Dr. T. K. Viswanathan, with the objective of building a full fledged bankruptcy code.

The work of the BLRC was placed in the FSLRC division of the Department of Economic Affairs (DEA), so as to harness the institutional memory about the working of FSLRC. The BLRC submitted a two volume report on 4 November 2015. The report is similar to the output of the FSLRC: the economic rationale and design features of a new legislative framework to resolve insolvency and bankruptcy was in Volume 1 and the draft bill was in Volume 2. These materials were put on the MOF website. A modified version of this bill, with public comments incorporated, was tabled in Parliament in the winter session on 23 December 2015.

After the IBC was tabled, the Joint Parliamentary Committee on Insolvency and Bankruptcy Code, 2015 (JPC) was set up on the same day to analyse the draft bill in detail. The JPC submitted its report which included a new draft of the law. This is the draft Insolvency and Bankruptcy Code (IBC) that has since been passed by both houses of Parliament.

3 The key ideas of the BLRC report

The essence of the BLRC proposal is a formal procedure, termed the `insolvency resolution process' (IRP) which starts when a firm or an individual defaults on any credit contract. Any creditor is empowered to initiate an IRP: a financial firm or an operational creditor whether it is a non-financial firm or an employee. An insolvency professional (IP) called the `resolution professional' (RP) manages the working of the IRP, and is responsible for compliance with the law.

Once the IRP commences, power shifts from shareholders/managers to the Committee of Creditors. This includes the power to take over management of the firm, the ability to change management, to bring in fresh financing, to ask for all information required in order to invite bids for commercial contracts, including from the existing creditors and debtor, to keep the enterprise going. Decisions are made by voting in the Committee of Creditors.

For firms who have significant organisational capital, the value of the firm as a going concern in the eyes of a buyer would exceed the liquidation value of the assets of the firm. Such firms are likely to attract bids where the value of the firm is more than the value of its physical building blocks. However, organisational capital rapidly depreciates. Hence, it is critical for the IRP to begin quickly and move forward quickly, aiming to get closure while the firm is still a going concern, so as to avoid value destruction with the firm becoming defunct.

Speedy resolution is incentivised in the IBC by having a time limit of 180 days for the IRP. If, in 180 days, 75% votes in the Committee of Creditors do not favour one resolution plan, the debtor is declared bankrupt. The IBC then provides clarity about which assets are available for liquidation, and a clear prioritisation of who has rights to these assets for recovery, in liquidation.

In general, the recovery rate for creditors is lower when a firm goes into liquidation. This creates incentives for the creditors to be rational about their activities in the critical 180 days.

The process of resolving insolvency is similar for firms and for individuals. In the case of individuals, however, the final resolution plan must have the consent of the debtor. There are additional innovations in the process of individual insolvency in the IBC that will increase individual default resolution efficiency in India. One is the concept of the Fresh Start, which gives a debt write-off for individuals who are below certain thresholds of wealth and income at the time of default.

Another innovation concerns an individual who has offered personal guarantees to support firm loans. When the firm default triggers these guarantees, it is likely to stress the personal guarantor to default and trigger individual IRP. Under the IBC, ordinarily, this individual insolvency case is heard at a Debt Recovery Tribunal (DRT). S.60

establishes that the IRP of the personal guarantor will be heard in the same court as the firm IRP, which is the National Company Law Tribunal (NCLT). This can lead to a quicker resolution and recovery for creditors who lent to the firm based on the personal guarantee.

This is the essence of the IBC. In order to make this work in India, IBC envisages four critical pillars of institutional infrastructure:

1. Robust and efficient adjudication infrastructure will be required, on the lines of the Financial Sector Appellate Tribunal that is proposed in the Indian Financial Code.

2. A new regulated profession -- of Insolvency Professionals (IPs) who can be Resolution Professionals and Liquidators -- is required. India has a long history of failure in regulation of professions, as is seen with lawyers, chartered accountants, doctors, etc. The success story here is the regulatory system run by exchanges for brokers. These ideas need to be brought into making the insolvency profession work.

3. Delays destroy value, and disputes about *facts* in India can drag on for years. A new industry of `information utilities' (IUs) is required who will control trusted data, pertinent to the operation of the IRP as well as used during Liquidation. This would draw on the success that India has had with the working of the securities markets depositories.

4. A regulator is required, to perform (a) The legislative function of drafting regulations which embed details about the working of the IRP; (b) Legislative, executive and quasi-judicial functions for the regulated industries of information utilities and the insolvency profession; and (c) Statistical system functions.

4 Strengths of the BLRC process

The BLRC process had four sound features.

1. *Systemic reform*. BLRC embarked on a systemic reform. It did not incrementally modify existing laws such as the Companies Act, 2013, or SARFAESI.

2. *Using local domain knowledge*. The project was staffed with people who were grounded in knowledge of India. While international experience was fully utilised, it was not mechanically transplanted. As an example, the BLRC was aware of the US `debtor in possession' mechanism, and consciously chose to not use it based on wisdom about how this would work under Indian conditions. These decisions were made based on local knowledge about how alternative institutional arrangements would work in India.

3. *Innovation*. The BLRC was not merely imitative. The proposals were novel in many respects, with a focus on solving problems rather than reshuffling a fixed menu of possibilities. One example of this is the concept of a regulator that writes subordinate legislation in order to obtain malleability in the design of the bankruptcy process, which is not found in the bankruptcy process elsewhere in the world. Another example is the rearranging of incentives for rapid and rational thinking during the IRP, in recognition of the difficulties of banks in India.

The conventional Indian solution for information utilities would have been a government-run monopoly like MCA21. Instead, the BLRC envisaged a private competitive industry of IUs. The conventional Indian solution for regulated professionals would have been a monopolistic association, similar to ICAI, ICSI, MCI, BCI. Instead, the BLRC visualised a private competitive industry of self regulatory organisations, the IPAs, who would oversee IPs.

4. *Capacity building*. The journey to the BLRC report and draft law has created new knowledge (web site) and a community which has expertise on this subject. This opens the possibility of sustained progress on India's journey to bankruptcy reform, with a local community of expertise, who are committed to work on the reform over a sustained period.

5 Analysis of the law

Our reading of the law reveals seven areas of concern.

1. *Precision of language*. In all countries, insolvency and bankruptcy law is a detailed procedural law, where the efficiency of the outcome is driven by the clarity and precision of the provisions in the law. This is unlike other laws, e.g. the Indian Financial Code, which have more of concepts and less of gritty procedures. This clarity is critical to ensure that any party reading the law comes to the same interpretation of the law -- be it lawyers, practitioners or judges. Vijay Mallya and his ilk are not going to accept their loss of power and assets without a tough legal fight. IBC as passed by the Parliament has many flaws which give grounds for concern. As an example:

- The law is silent on what denotes evidence of default, which was proposed by the BLRC to be a record in an IU.
  The law requires a *financial creditor who has triggered an IRP to furnish a record of the default from an IU or such other record or evidence of default as may be specified by the Regulator.* Similarly, the law requires an interim RP to collect claims. However, it does not specify the kind of proof that a claimant needs to submit to the interim RP. Both these provisions negate the incentive to file financial information in an IU, especially where the law is generally silent on what kind of firms need to file financial information in IUs mandatorily.
- Section 30(2)(c) says the resolution plan must *provide for the management of the affairs of the Corporate debtor after approval of the resolution plan*. This imposes uncertainty on how the resolution plan can be assessed, which in turn, increases the possibility of higher judicial intervention.
- The numerical values included in the law for many time limits could give cause for the adjudicator to permit an extension on the time to decide on a resolution plan. This raises concerns about the extent to which the core objective of bankruptcy reform -- speed -- would be achieved.

2. *The working of the regulator*. India has ample experience with bad performance of regulators. One important source of these persistent failures is the faulty legal foundations that define the working of regulators. Other countries solve this problem by having a general legal framework for the working of regulators (as in the case of the U.S., but absent in India) or in the laws that establish regulators (which is present in IFC but missing in the IBC). While the report submitted by the JPC reiterates the criticality of role of the regulator, a sound chapter in the law that establishes the regulator is absent.
Particularly worrisome are elements such as S.226 which gives the power to the government to reconstitute and supercede the Board, which hampers regulatory independence.

3. *Information utilities*. The legal provisions for the IUs ought to have been as detailed as the Depositories Act. This has not been done. Examples of faulty provisions include:

- IUs are supposed to be a private competitive market. However, the law has failed to incorporate insights about the competitive market within which IUs were intended to operate. There was to be only one price, for data submission, and multiple IUs would compete in offering lower prices to those who submit mandatory information. The draft bill now has the concept of a one-time registration fee. It is not clear how IUs will have a revenue stream and effective mechanisms for competition.
- Provisions on authenticity and repudiability of IU records as evidence of claims and default have not been introduced into the draft bill.
- Provisions for data privacy are lacking.

4. *Insolvency profession* Provisions governing the legislative, executive and quasi-judicial functions of the IPAs ought to have been as detailed and complex as provisions governing the creation of exchanges and other such financial market infrastructure institutions as in the IFC. This is missing in the law.

5. *Forbearance*. At several places in the law, there are exemptions in the process that can be granted by the Central Government. This is a matter of grave concern. As an example, forbearance in banking regulation gave us the banking crisis today.

During the IRP, the Central Government can exempt transactions from the moratorium, in consultation with any financial sector regulator (Section 14(3)). Likewise during liquidation, while no suit can be instituted against the corporate debtor once a liquidation order is passed, the Central Government can exempt legal proceedings from this provision, again in consultation with any financial sector regulator (Section 33(6)). These provisions are dangerous.

6. *Judicial infrastructure*. The law does not set in motion a world class tribunal. By being silent on this issue, the draft bill ran the risk of delays and transactions costs associated with courts and tribunals in India today. A bankruptcy process that works in the unit of days is alien to today's courts that work in the unit of months.

7. *Transition issues*. Full care on repeals is required. Some of these are repeals of primary laws, and some are incompatibilities with subordinate legislation. However, these are absent in the law.

6 The way forward

That Parliament has passed the law is a major step forward. However, in and of itself, this does not yield success in the sense of getting to the desired economic outcomes. While some elements of the process that led up to this law were well done, in many respects, there were shortcomings compared with the 11 principles of sound process design for drafting of laws. The IBC, 2016, is an important milestone, an important way station in the long journey of Indian bankruptcy reform. But it does not, in and of itself, deliver an improved bankruptcy process for India. Now, seven areas of work are required.

7 Work area 1: Improvements of the law

The first area of concern is a thorough review of the law. This is a law that is going to be actively litigated. Defaulters of the future are not going to cede power to the Creditors Committee without a fight. Expert input should be sought now, on anticipating these problems, and strengthening the draft. This will require an understanding of not just the law, but all the points in the process which interacts with other laws of the land.

The alternative way to fixing the law will be to run through cases that are lost in the Supreme Court over the next five years. For example, in the case of the Companies Act, 2013, many years elapsed between enacting the law and starting to solve the problems of a poorly drafted law. If such delays can be avoided with the IBC, this would improve matters.

8 Work areas 2: Drafting of subordinated legislation

The law embeds large areas for subordinated legislation, both rules (by the government) and regulations (by the regulator). Even when the law is faulty, it is possible to rescue things by good quality drafting of this subordinated legislation. Whether this possibility materialises depends on the choice of team, and the regulation-making process that is employed.

9 Work areas 3,4,5,6: Building the four pillars of institutional infrastructure

The second key concern is the four pillars of institutional infrastructure. Enacting a law does not induce the requisite State capacity. The regulator has to be built. The DRTs have to be upgraded and the NCLT has yet to be set up. An engagement with the private sector is required in bringing forth the first wave of firms who will be information utilities (IUs) and insolvency profession agencies (IPAs). Without these four pillars of institutional infrastructure, the law is infructuous.

A well drafted IBC would have created better incentives for the sound working of the four pillars of institutional infrastructure. Given the flaws in the IBC, this task has become harder. An even higher quality effort is now required, to achieve sound institutions. In parallel, the law requires many modifications as an integral part of this process of institution building.

For example, there are proposals today to improve adjudication infrastructure through the use of information technology. In and of itself, this will not deliver the desired results. Just as in education, it is necessary to have school buildings, but this is not a sufficient condition. The problem is much more complex, it is about establishing sound processes for the judiciary. The mere presence of a computer terminal in every court room will not deliver the outcomes desired here: to ensure that an IRP can be admitted within the day of the application, or that a creditors' committee can be finalised within a fortnight that the IRP starts.

A `Task Forces' process was used to implement institutional infrastructure for the FSLRC report. MOF initiated `Task Forces' with a group of subject experts to plan and oversee the implementation. A similar approach needs to be adopted by the implementing ministry for the IBC to create the four pillars of institutional infrastructure.

10 Work area 7: Project management for the transition

The last one year of the old regime and the first one year of the new regime are going to require particularly careful planning and handover.

For example, the RDDBFI Act needs to be amended in order to have the DRTs serve as the adjudication infrastructure for individual cases under IBC. At present, amendments have been proposed to both the RDDBFI Act as well as the SARFAESI Act, been tabled in the Lok Sabha and referred to the same JPC as IBC. The legislative process here should be taken as an opportunity to align these laws to suit the purpose of bankruptcy reform.

11 Conclusion

The BLRC process, and the law enacted by Parliament, are major milestones in India's economic reform. However, they are the beginning of the journey to bankruptcy reform and not the destination.

What would constitute tangible proof of success in Indian bankruptcy reform? Two events and four key data series define the report card for this.

Event 1. When a default of a Rs.10 billion firm takes place, it swiftly goes into the bankruptcy process, which leads to a transaction where the firm is sold as a going concern to a new strategic buyer or a private equity fund, and a good recovery rate is obtained by the lenders.

Event 2. When a default by a Rs.10 billion firm takes place, the firm gets smoothly put into liquidation within a short time, and a good recovery rate is obtained by the lenders.

Four key measures. Successful bankruptcy reform should mean an increase in four measures through time:

1. The leverage of firms (holding business risk constant),
2. The share of borrowing from the financial system in the total debt of firms.
3. The share of non-bank borrowing in borrowing from the financial system.
4. The share of unsecured borrowing in total debt.

Here is where we are on these metrics, based on non-financial firms in the CMIE database. In all cases, values shown are the average for 3 years, centred at the year of interest, and the firms that are observed in all 3 years are used for the computation. If bankruptcy reform makes progress in India, then we will see bigger values in coming years on all four metrics:

Indicator	Units	1990	2000	2013
1. Leverage	Times	3.41	2.87	2.77
2. Financial debt to total debt	Per cent	42.9	42.5	37.5
3. Non-bank debt to Financial debt	Per cent	56.2	56.0	31.3
4. Unsecured borrowing to total debt	Per cent	20.3	22.1	18.4
Number of firms		1163	5858	10594
Total assets	Rs.Trn.	1.37	12.44	94.35

On all four metrics, things in India have become *worse* over the 1990-2013 period. Everyone is keen on the outcome: the six dimensions of success articulated above. A strong team, with focus and competence, is needed to work on these issues, and this could yield success in a few years.

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JANUARY 2014

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This publication can be downloaded at no cost
at CarnegieEndowment.org/pubs.

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Summary

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.

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.
- The IFC will transform India's financial laws, regulatory architecture, and regulatory functions, providing a modern and consistent framework based on the rule of law, regulatory independence, and accountability.
- The draft code addresses nine areas that require reforms: consumer protection; micro-prudential regulation; resolution mechanisms; systemic risk regulation; capital controls; monetary policy; public debt management; development and redistribution; and contracts, trading, and market abuse.
- The full adoption of the IFC will help build a financial system that allocates resources well, achieves higher growth, and reduces risk.

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.

- The government should build up its institutional capacity now to reduce the delay between enacting and fully implementing the IFC. This requires setting up new institutions and changing the way regulators and the government function and interact with firms and consumers. It will necessitate large-scale training of the staff of the regulatory agencies and the Ministry of Finance.

Introduction

In the elder days of art
Builders wrought with greatest care
Each minute and unseen part,
For the Gods are everywhere.

–Henry Wadsworth Longfellow

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.

In recent years, a series of expert committees developed a consensus around a strategy for change. The reforms proposed by these committees require legislative changes, leading India's Ministry of Finance to set up the Financial Sector Legislative Reforms Commission to rewrite the laws. After two years of deliberations and consultation, the commission submitted the proposed Indian Financial Code. This draft law is a new, modern, coherent, and consistent framework based on the rule of law, independence, accountability, and an overriding objective of consumer protection. 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.

Any attempts at building a government agency must begin with a set of hypotheses about the problem in the world that this agency is required to solve. Alongside this market-failure perspective, there is value in looking at reform from the perspective of public choice theory, which views bureaucrats and politicians as self-interested. The IFC is based on such an analysis: an understanding of the market failures that motivate government interventions in finance, and a framework for thinking about the endemic failures of state capacity in India from a public administration viewpoint with an emphasis on the themes of accountability and the rule of law.

Lessons from the global financial crisis have influenced the IFC in many dimensions. One flawed element of the global financial system revealed by the crisis was underregulation of parts of the system, such as over-the-counter derivatives, and weaknesses in handling unsound financial firms, particularly large ones. Under the IFC, no part of finance is unregulated. Financial firms face forms of regulation appropriate to their roles, including regulations to prevent consumer abuse, maintain the safety and soundness of financial firms, ensure the orderly resolution of failing financial firms, and enhance the oversight of systemically important firms.

While a draft IFC was released to the public on March 22, 2013, there is a long journey ahead. In the ideal scenario, the code will be enacted as law by parliament somewhere between 2015 and 2017. The draft code, however, is already having an impact. The Ministry of Finance has begun work on an implementation process in which a subset of governance-enhancing measures from the IFC is voluntarily adopted by all existing financial agencies, and project teams are being established to lay the groundwork for new institutions required under the IFC.

The Problem

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. The reforms of the equity market involved ten acts of parliament and one constitutional amendment, indicative of the close linkage between deeper economic reforms and legislative change.

While all these moves were in the right direction, they were inadequate. A large number of problems with the financial system remain unresolved. In cross-country rankings of the capability of financial systems, India is typically found in the bottom quartile of countries. A financial system can be judged on the extent to which it caters to growth, stability, and inclusion, and the Indian system is deficient on all of those counts. By misallocating resources, it hampers growth. The entire financial system suffers from high systemic risk.

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The households and firms of India are extremely diverse, and often have characteristics not seen elsewhere in the world. For finance to reach a large fraction of firms and households, financial firms need to energetically modify their products and processes, and innovate to discover how to serve customers. But in the field of finance, the forces of competition and innovation have been blocked by the present policy framework. This means there are substantial gaps between the products and processes of the financial system, and the needs of households and firms.

It is likely that around 2053, India's GDP will exceed that of the United States as of 2013. 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.

A Group of Expert Committees

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 on desired reforms was constructed through reports from four expert committees on:

1. International finance, led by Percy Mistry in 2007
2. Domestic finance, led by Raghuram Rajan in 2008
3. Capital controls, led by U. K. Sinha in 2010
4. 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.

Table 1. Expert Committee Recommendations

Group and Chairman	Result
High-Powered Expert Committee on Making Mumbai an 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; Dhirendra Swarup; 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 misselling, 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. The report 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. The working group proposed reforms for rationalization of capital account regulation. It recommended the unification of the existing multiple portfolio investor classes into a single qualified foreign investment framework, and the promulgation of know-your-customer requirements that meet the standards of best practices of the Organization for Economic Cooperation and Development.

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.

Weaknesses of Existing Laws

Most existing financial laws in India were enacted when the country was a command and control economy. They are guided by the objective of containing and controlling financial markets and banning activity, rather than regulating and supervising markets and achieving sophisticated interventions through which market failures are addressed. The existing laws are not rooted in an understanding of the market failures that are found in finance and the mechanisms through which these are addressed.

A large number of laws exists, each of which was designed to solve a small problem that was prevalent at the time the law was developed. These laws are often inconsistent with each other, and generally out of touch with the requirements of India as a middle income economy. As an example, the very preamble of the Reserve Bank of India Act, which was enacted by the British in 1934, includes a candid admission about the lack of knowledge of monetary economics at that time:

> And whereas in the present disorganization of the monetary systems of the world it is not possible to determine what will be suitable as a permanent basis for the Indian monetary system;
>
> But whereas it is expedient to make temporary provision on the basis of the existing monetary system, and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures.

Such a "temporary" arrangement, serving the objectives of colonial authorities, is not optimal for the India of 2013 or 2053.

The Financial Sector Legislative Reforms Commission

In India, laws traditionally evolve piecemeal and on a problem-by-problem basis. The government made no attempt to comprehensively rethink the laws that govern an entire sector. In the case of financial law, the Ministry of Finance started grappling with this problem in 2009, and chose to adapt an existing institution of Law Commissions, which are nonpartisan bodies that propose modifications of laws, to the task of writing laws for finance.

A former judge of the Supreme Court, Justice B. N. Srikrishna, was chosen to lead the project, which ran for two years, involved 146 persons, and had a dedicated 35-person technical team. The commission itself was nonpartisan and in most cases did not have representation of the special interests of existing financial agencies. A multidisciplinary approach was taken, drawing together skills in economics, finance, public administration, and law. The commission weighed the infirmities of the Indian financial system, the recommendations of expert committees, and the international experience, and designed a new legal foundation for Indian finance.

The Indian Financial Code is the commission's product. It is a single, internally consistent law of 450 sections that is expected to replace the bulk of existing Indian financial law.

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.

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.

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.

In the private sector, the leadership of a firm gets feedback from the market. When the firm is faring poorly, reduced profits are immediately visible and generate an impetus for the firm to reshape itself even though this involves making uncomfortable decisions to restructure the organization and change personnel, for instance. Firms that fail to reinvent themselves go out of business.

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.

In this environment, leaders are biased toward decisions that keep them in a comfortable position. As an example, when a financial agency sees a new class of financial products, such as Internet-based payment systems, it faces the problem of constructing regulatory and supervisory capacity to deal with this—a difficult process. It is easier to claim that innovation is dangerous and to ban new financial products.

At the core of this issue is the fact that existing laws in India are rooted in the notion that the state is benevolent. They feature little in terms of the checks and balances and accountability mechanism, that is, the feedback loops that keep the leadership of government agencies in check. By contrast, in the United States, a general strategy for dealing with public bodies is embedded in the Federal Administrative Procedure Act of 1946. This shapes the agency problem for all financial agencies in the United States. No comparable law exists in India.

The draft legislation aims to solve the principal-agent problem that every legislature faces when establishing financial regulators. The conventional discourse in India uses the term "functions" to describe the responsibilities of a government regulatory agency. Existing laws give certain functions to an agency. The agency is then equipped with certain powers to perform these functions. The IFC consciously steps away from such a notion of power without accountability. It sets up the relationship between the principal (parliament) and the agent (the financial agency) through clarity of objectives, precise and enumerated powers, and extensive accountability mechanisms.

For an analogy, consider the relationship between a consumer and the person that is contracted to paint a house. Conventional Indian laws say that the painter can go into a house and paint it as he likes, using all possible choices of colors and equipment. Conventional Indian laws believe the painter is benevolent and will pursue the welfare of the people. This is a breeding ground for laziness and corruption. The IFC would give the painter precise instructions for how the house must be painted and defined and limited powers to use in pursuit of his objective. It sets up an inspector to verify that the house has been painted correctly and imposes negative consequences on the painter when the work is poor.

Separation of Powers

Under India's current system, parliament gives independent regulators three responsibilities—a legislative function of writing regulations that have the status of law, an executive function of enforcing regulations, and a judicial function of awarding penalties. Commonly accepted practice in many systems holds that these three functions should be kept separate under the separation of powers doctrine. India's lack of separation of powers in this area is one source of underperformance of existing financial agencies. The IFC takes one step toward separation of powers by requiring that the judicial responsibilities be held separate from the legislative and executive functions in the internal working of the regulator.

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Independence

All over the world, laws governing the financial sector enshrine regulatory independence. This protects the regulatory process from the political imperatives of the administration that is in power. Independence is also required to protect against the attempts by financial firms to unduly influence decisions.

To achieve regulatory independence, numerous modifications are required in financial laws. These include: sound structure for the appointment process for senior regulatory staff, fixed contractual terms for them, removing the power for the administration to give directions to financial agencies, and transparency of board meetings where nominees of the Ministry of Finance are present.

Accountability

The key insight of the IFC is the idea that the failures of financial agencies in India stem from the lack of accountability for the leadership. For example, many existing laws establish independent regulators with the broad mandates of serving the public interest or improving the welfare of the people of India, and they then arm those agencies with sweeping powers. Instead, as the IFC proposes, laws should be explicit about agencies' objectives, powers, and accountability mechanisms. There are four components of accountability in the IFC: clarity of purpose, a well-structured regulation-making process, the rule of law, and reporting mechanisms.

Clarity of Purpose

Agencies' objectives should be defined clearly to ensure that these bodies do not have unfettered discretion over how to exercise their power and to hold specific actors accountable for failures.

One important barrier to clarity of purpose is conflicts of interest. When one goal conflicts with another, agencies can explain away failure in one dimension by claiming that the conflicting goal was being emphasized. Conflicting objectives are at the foundation of chronic underperformance of some financial regulators in India today.

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One example is found in the Reserve Bank of India. It has the power to set interest rates, and it is also responsible for raising debt for the government and for regulating banks. These functions are in conflict. Banks are the main buyers of government debt, and with the power to regulate banks and set interest rates, the Reserve Bank of India can potentially exert influence over those bodies and push them toward purchasing government debt. It can also keep interest rates low to ensure that the government's cost of debt stays low. Its interest-rate-setting function may be used to pursue objectives other than those related to monetary policy as well—because, for instance, when interest rates are raised, banks may suffer losses on their portfolio.

The IFC structures regulatory bodies with greater clarity of purpose and minimizes conflicting objectives.

Regulation-Making Process

In the current system, parliament delegates regulation-making power to unelected officials in independent regulators. There is a danger that these officials will choose to draft regulations that are the easiest to implement. For instance, regulators in India have often been very reluctant to grant permissions for businesses to operate, perhaps because it makes their supervisory tasks more difficult when they have to oversee large numbers of businesses. There are also substantial restrictions against creating new kinds of products or processes that cater to the convenience of existing staff and organization structures.

These limitations hinder competition and innovation. Through this, they interfere with the ability of the financial system to serve the needs of the diverse kinds of households and firms present all across the country. Alongside these barriers are numerous regulations that stray from the economic purpose of financial regulation—identifying and addressing market failures in finance—toward central planning where the government usurps the role of designing financial products and processes.

The regulation-making process of the IFC has checks and balances to help avoid such suboptimal outcomes. Under the IFC, the regulator is obliged to analyze the costs and benefits of a proposed regulation. The costs to society of implementing the regulation must be compared to costs of the market failures that motivate the regulation before a decision can be made. For every regulation that is proposed, the IFC requires:

1. A compact statement of the objectives of and reasons for the legislation
2. A description of the market failure that motivates the regulation
3. Demonstration that solving this market failure is within the objectives of the regulator
4. Clear and precise exposition of the proposed intervention
5. Demonstration that the proposed intervention is within the powers of the regulator
6. Demonstration that the proposed intervention would address the identified market failure
7. Demonstration that the costs to society through complying with the intervention are outweighed by the gains to society from addressing the market failure

The documentation of these elements must be produced by a regulator every time a regulation is drafted. This will help ensure that adequate thinking precedes regulation making. It will also show the full regulatory intent to citizens and to judges who have to adjudicate disputes.

After the relevant documentation is produced, a consultative process will commence in which the regulator releases this material and the draft regulation into the public domain. Market participants will be given sufficient time to review the draft regulation and to comment on it, and the regulator will be required to substantively respond to all public comments. Following that period, a modified regulation will be released to the public with a starting date that is far enough in the future to give firms and households adequate time to cope with the changes.

One key element of this regulation-making process is appeal. If the regulator strays from either the objectives or powers specified by the IFC, or the regulation-making process required in the IFC, the regulation in question can be struck down through judicial review.

Following the implementation of a regulation, the IFC requires an ex-post analysis to be conducted. In this process, the objectives of a regulation are reviewed, including an examination of data to determine the extent to which the stated objectives have been met and a review of the enforcement experience and litigation that has been undertaken in relation to the regulation.

The Rule of Law

When a financial agency is not bound by the rule of law, it wields power without accountability. Upholding the rule of law introduces checks and balances that induce greater accountability. In India, there are weaknesses of regulatory governance that lead to violations of the rule of law. The IFC addresses these issues in a comprehensive manner.

Legislation that reinforces the rule-of-law framework is accessible, intelligible, clear, and predictable. Under the IFC, the operation of the formal process of financial regulation, as well as the body of laws and jurisprudence, would be visible to the public. This would provide stability and certainty about the law and its application.

Questions of legal rights and liability should be resolved by application of the law rather than through bureaucratic discretion. The IFC significantly limits the discretionary powers given to regulators and other agencies by specifying powers for these actors that can only be used for pursuing specific objectives.

In a system that respects the rule of law, legislation should apply equally to all parties, except if objective differences justify differentiation. Under the IFC, by default, all regulated entities would be treated alike. The draft legislation puts the onus on the regulators to justify any variation in treatment between two firms or two subsectors on the basis of differences in risks posed and other material differences.

Public officers at all levels must exercise the powers conferred on them in good faith, fairly, for their intended purpose without exceeding their limits. The IFC's accountability mechanisms, especially the regulation-making process, ensure that public officers carry out their duties in this manner.

The IFC provides for a system that would help consumers find redress for disputes with financial firms. Appeals against actions of financial agencies would be heard at the Financial Sector Appellate Tribunal, a court with specialized skills in financial law that would feature modern court processes.

Reporting

Once the objectives of a regulatory agency are defined, reporting mechanisms are envisioned under the IFC to determine the extent to which the agency has achieved its objectives. Under the IFC, each agency would submit such a progress report to the government. As an example, for a supervisory process, the agency would be obliged to release data about investigations conducted, orders issued, orders appealed, and the orders that struck down. Transparency would be required with a functional classification of the expenditure of the agency across its objectives.

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 long time 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.

In order to forestall this, the IFC places consumer protection at the heart of financial regulation. It establishes mechanisms for both prevention and cure. Prevention involves making and enforcing regulations across the entire financial system. This has three components: a set of rights and protections for consumers, a set of powers through which financial agencies will uphold these rights and protections, and principles that guide which powers should be used under which circumstances. These three components would shape the detailed regulations surrounding consumer protection.

Some of the rights and protections that the IFC would guarantee consumers are protection against unfair contract terms and against misleading and deceptive conduct. The draft legislation also outlines the right to receive reasonable quality of service and to data privacy and security.

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.

Part of the reason consumer protection issues are so prevalent in India is that the financial regulatory structure has traditionally been defined by sector, with multiple laws and often multiple agencies covering various sectors. This has led to inconsistent treatment, and regulatory arbitrage. The Ponzi schemes in operation, for instance, often exploit the gaps between existing laws. There is a greater risk of regulatory capture of sectoral regulators where they come to adopt the worldview of the firms with which they deal. These problems would be reduced by having a single, principles-based law—the IFC—that covers the entire financial system.

Turning from prevention to cure, the IFC envisions a unified Financial Redress Agency. The agency would have a presence in every district in India and would be a place where consumers of all financial products could submit complaints. Consumers would only have to deal with one agency in this area rather than multiple regulators. 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.

Micro-Prudential Regulation

The Indian financial system has traditionally been dominated by public sector firms. When consumers deal with a government-owned firm, for all practical purposes, they deal with the government; there is no perceived possibility of failure.

But in order to build a modern Indian financial system, private firms will have to proliferate. These firms can fail, and that can be highly disruptive for households who are customers of a failing firm, and for the economy as a whole. The aim of micro-prudential regulation is to reduce the probability that financial firms fail.

When a consumer deals with any financial firm, there should be a high probability that it will be solvent and able to make good on its promises. It is the responsibility of financial regulatory agencies to achieve this objective, as individuals do not have the incentive or capacity to ensure that companies are solvent.

Beyond the individual consumer, the failure of a large number of financial firms within a small period of time can disrupt the whole financial system. Sound micro-prudential regulation can help reduce this systemic risk.

Firms are generally eager to avoid their own bankruptcy and failure. However, this does not always result in a low failure probability. Managers and shareholders stand to gain handsomely if a firm does well, but they can simply walk away when a firm fails. Many financial firms in India assume that the Indian government will come to the rescue and bail out the failing firm. Indeed, the history of bank failures in India is replete with examples of forbearance and support of failing firms by the Reserve Bank of India and by the government. This generates incentives for financial firms to ratchet up risks, profit from the outcomes if things go well, and fall back on the support of the government if they do not. For these reasons, financial agencies are required to conduct micro-prudential regulation, which pushes firms into having a ceiling on their failure probability.

How intrusive micro-prudential regulation would be under the IFC depends on the nature of the promise made by a given financial firm. The IFC enjoins upon regulators to think about each promise that is made by a financial firm from three points of view: first, how difficult it is for the financial firm to honor the promise; second, how difficult it is for consumers to assess the ability of the financial firm to keep its promise; and third, how much hardship would be caused to consumers if the promise were not kept.

To illustrate these three ideas, consider two examples. In a bank deposit, since the promise is to make the payment at par on demand, there is an inherent difficulty in keeping the promise. The opacity of a bank's balance sheet makes an assessment of creditworthiness difficult, and there is significant hardship for households if the bank should fail. These problems shape the micro-prudential strategy for bank deposits. In contrast, consider a mutual fund that reports a net asset value (NAV) every day and makes no promise about future returns. This product involves a very different set of promises (that the NAV is correctly calculated, that the consumer can cash out his investment at an NAV-linked value, and requires a commensurate micro-prudential regulatory strategy).

The ability of consumers to coordinate and influence the behavior of a firm is also a factor to consider in determining how intrusive regulatory agencies should be. For some firms with a small number of investors, such as private equity funds, investors wield considerable influence over the firm. This is not true of many firms that have numerous consumers each with a small exposure to the firm, so the IFC would call for more intrusive regulation in that case.

The IFC's objective to reduce the probability of failure of financial firms is balanced by a principle that requires the regulator to consider the consequences for efficiency. Regulators have the power to impose requirements on capital adequacy, corporate governance standards, liquidity norms, investment norms, and other instruments. But in imposing those requirements, a principle of proportionality is in play; regulatory interventions should be proportional to the risks faced.

Under the IFC, all of these issues are governed by a single micro-prudential law that would ensure uniform treatment of all aspects of the financial system and largely eliminate areas of regulatory arbitrage. At the same time, multiple regulators could enforce the law for various components of the financial system.

Resolution

Eliminating all firm failure is neither feasible nor desirable. Failure of financial firms is an integral part of the regenerative processes of the market economy: weak firms should fail and thus free up labor and capital that can then be utilized by stronger firms. However, when micro-prudential regulation is not enough and disruptive firm failure looms, the government needs to be able to step in to help avoid such an outcome.

The IFC proposes a resolution corporation that would oversee all financial firms that have made significant promises to households, such as banks, insurance companies, defined benefit pension funds, and payment systems, and intervene when the net worth of such a firm is near zero (but not yet negative). The corporation would force the closure or sale of the financial firm and protect small consumers either by transferring their investments to a solvent firm or by paying them what they are owed. In the case of banks, for instance, the deposit insurance program in which all households are guaranteed up to 100,000 rupees of their bank deposits would be operated by the resolution corporation. (While India currently has deposit insurance, there is no resolution corporation.) The proposed entity will also take responsibility for the graceful resolution of systemically important financial firms, even if they have no direct links to consumers.

A key feature of the resolution corporation is the speed with which it takes action. International experience has shown that delays in resolution almost always leave the firms in question with negative net worth, which generally imposes costs on the taxpayer. The IFC embeds the full legal framework for a resolution corporation that will act swiftly to stop weak financial firms while they are still solvent. The resolution corporation will choose between many tools through which the interests of consumers are protected, including sales, assisted sales, and mergers.

For strong firms, the resolution corporation will largely be removed from the firms' operations. It will only assume primacy if a firm approaches default. In this way, it is analogous to a specialized disaster management agency, which is not involved in everyday matters of governance but assumes primacy after a natural disaster.

Systemic Risk Regulation

Systemic risk is the probability that a financial system will stop functioning altogether, which then adversely affects the real economy. This has moved to prominence in the aftermath of the 2008 financial crisis, when governments and lawmakers worldwide saw the need to employ regulatory strategies that would avoid systemic crises and reduce the costs to society and to the treasury of resolving them.

Addressing systemic risk requires a bird's eye view of the financial system as a whole. This is a very different perspective when compared to conventional financial regulation, which tends to analyze one consumer, one financial product, one financial market, or one financial firm at a time. Conventional micro-prudential regulators are oriented toward seeing one firm at a time, and sectoral regulators are oriented toward information, regulatory instruments, and the interests of one sector at a time.

To a certain extent, systemic crises are the manifestation of failures in carrying out the core tasks of financial regulation—that is, consumer protection, micro-prudential regulation, and resolution. The road to the global crisis of 2008 in the crisis countries was paved with numerous failures in these three elements. By addressing these issues, systemic risk can be reduced, but it will not be eliminated. Moreover, there is always the possibility that errors will be made in those areas.

Mechanisms to address systemic risk must thus be established by law. At the same time, a precise set of steps must be outlined for government agencies to perform, or else the law could degenerate into vague, sweeping powers that lack clear objectives. The IFC addresses the question of systemic risk in four steps.

First, it requires the establishment of a comprehensive database about all financial firms and markets. That information should be analyzed, and any systemic concerns that arise should be brought to the attention of the Ministry of Finance and all financial agencies. A council of regulators could choose to act in response to the evidence.

Second, systemically important financial firms and conglomerates should be identified. Those entities would be subjected to enhanced micro-prudential regulation and supervision in a coordinated manner across all agencies. This would help target a lower desired failure probability.

Third, tools for modifying the risk taken by the financial system as a whole, across all sectors, should be established to act as a countercyclical influence, reining in risk taking when times are good and avoiding abrupt deleveraging and fire sales when times are difficult.

Fourth, an array of coordinated emergency measures is necessary when there is a financial crisis.

Under the IFC, these steps are placed at a council of regulators called the Financial Stability and Development Council. The IFC intends that this body will have five members: the minister of finance, the head of the central bank, the head of the Non-Banking Financial Agency, the head of the Resolution Corporation, the head of the Debt Management Office.

Capital Controls

Capital controls are restrictions on cross-border contracting. In the IFC, capital controls are classified into three groups:

1. Those motivated by the desire to observe and prevent criminal activities
2. Restrictions against foreign direct investment (FDI), motivated either by political considerations (which are applied in the Indian retail sector, for instance) or national security considerations (for example, barriers aimed at preventing hostile nations from controlling vital infrastructure)
3. Restrictions against cross-border financial flows

There are significant differences between the objectives and instruments required in the three areas. Hence, each requires a distinct strategy to ensure rule of law and accountability.

The first—observing and preventing criminal activities—is adequately addressed by the Prevention of Money Laundering Act of 2002 and by India's ongoing membership in the Financial Action Task Force.

On the second front, the IFC defines inbound FDI and gives the government the powers necessary to introduce restrictions on FDI. While the IFC does not explicitly state this, over the years, it would make sense if the focus of restrictions against FDI shifted away from political objectives toward national security objectives.

In the third area, cross-border financial flows, there is a question about the appropriate sequencing and pace of India's capital account liberalization. All prosperous countries have negligible capital controls, and India's peers among developing countries have greater capital account openness than India. Indian policymakers have stated that in the long run, India will move toward capital account openness. Under the IFC, the timing and sequencing of capital account liberalization is left to future policymakers.

As with everything else in the IFC, these three elements of capital controls are placed under an environment of sound governance with the rule of law. This would be a significant improvement when compared with the present arrangements.

Monetary Policy

Low and stable prices lay a sound foundation for long-range planning by households and firms, and improve the information processing of firms. For these reasons, low and stable inflation is an essential ingredient of macroeconomic stability and sustained growth.

In the long run, the dominant determinant of price stability in a country is the conduct of monetary policy. While price fluctuations on a horizon of a few months can be influenced by other considerations, such as monsoons, such considerations do not explain sustained price inflation over a number of years. Many advanced economies and sophisticated emerging markets have achieved price stability by establishing appropriate institutional arrangements for monetary policy.

In India, policymakers have long operated with an informal target zone where year-on-year consumer price inflation of between 4 and 5 percent is desired. However, in recent decades, this aspiration was only achieved for seven years from 1999 to 2006. This raises questions about the soundness of present monetary policy arrangements.

The IFC lays out three key elements of the monetary policy arrangement. The Ministry of Finance will specify a quantifiable objective for the Reserve Bank of India that can be monitored. The bank will have independence in the pursuit of the clearly outlined objective. And the interest rate at which the central bank lends to banks, the policy rate, will be determined by voting in an executive monetary policy committee.

Public Debt Management

The problem of public debt management involves cash management for the treasury and investment banking capabilities for borrowing across an array of maturities and contractual arrangements. A competent debt management capability would deliver low costs of borrowing on average in the long run. In India, a series of expert committees have suggested that this should be done in a professional debt management office.

Debt management requires an integrated picture of all onshore and offshore liabilities of the government. At present, this information is fragmented between the Reserve Bank of India and the Ministry of Finance. Unifying this information, and the related debt management functions, will yield better decisions and improved debt management.

Moreover, a central bank that sells government bonds faces conflicting objectives. When the Reserve Bank of India is given the objective of obtaining low cost financing for the government, this may make the bank favor low interest rates, which could interfere with the goal of price stability.

For these reasons, the IFC gives this task to a new agency, the Public Debt Management Agency.

Development and Redistribution

The development and redistribution agenda in Indian financial policy involves the development of missing markets, such as the bond market, in which there is nonexistent or weak activity. It also involves redistribution and financial inclusion initiatives, in which certain sectors or income or occupational categories are the beneficiaries.

India's markets are significantly underdeveloped. As an example, the bond market and the currency market are characterized by illiquidity and failures of market efficiency. The lack of a long-term bond market hampers corporate financial planning in the field of infrastructure investment, for instance. The effectiveness of monetary policy is limited as small changes in the policy rate (made by the central bank) do not impact a large number of economic agents, as they do in a more developed financial system. This has contributed to a sustained failure to achieve low and stable inflation. While dramatic progress was obtained in the last twenty years on the equity market, commensurate progress has not been obtained on the bond and currency markets. In the last decade, there has been a substantial shift in the trading of interest rate and currency derivatives to overseas locations such as London, Dubai, and Singapore.

The development of these missing markets requires information gathering and analysis on the scale of the full financial system, rather than within one sector at a time. Interregulatory coordination is necessary to achieve this aim.

Prominent and well-known initiatives in the area of interventions that foster financial inclusion include restrictions on branch licensing (to force banks to establish branches in rural areas) and priority sector lending. However, the full landscape involves a large number of lesser-known initiatives. As an example, the Reserve Bank of India has subsidized the installation of cash machines or point-of-sale terminals in northeastern states as it believes this will improve the welfare of residents of these states. The logic of these initiatives is questionable, and no cost-benefit analysis has been done.

From the perspective of drafting laws, these issues pose difficult puzzles of public administration. For one, a regulation that forces banks to give more loans to a certain target group imposes a cost—a tax—on other recipients of loans as well as on depositors and shareholders. When the power to impose costs on certain individuals in society is given to unelected officials that head government agencies, this raises fundamental questions of democracy and political system design.

Another problem is achieving accountability. There is considerable global knowledge and experience in constructing financial regulators that are held accountable for delivering consumer protection and micro-prudential regulation. If market development or redistributive objectives are also given to regulators, then there would be a considerable loss of accountability as many actions that damage financial regulation can be justified as part of the pursuit of political objectives. For instance, an agency can explain away failures in the core activities of financial regulation—consumer protection and micro-prudential regulation—on the grounds that developmental objectives were being pursued. It may be possible to quickly increase the number of households that buy insurance, which is a developmental objective, by reducing the regulatory burden of consumer protection in insurance.

When the power to impose costs on certain individuals in society is given to unelected officials that head government agencies, this raises fundamental questions of democracy and political system design.

Reflecting these tensions, on a global scale, no financial regulatory agencies have been tasked with development or redistributive functions. When redistributive functions are performed by a financial regulatory agency, it induces economic inefficiency in two ways.

First, taxing a narrow set of consumers to redistribute gains to others is an inefficient form of taxation. It would be more efficient for a society to raise resources from more broad-based taxes that impose lower deadweight costs, such as the income tax, the value-added tax, and the property tax. Second, even if subsidizing a particular group were the political goal, the government has a more comprehensive view of the group's needs, and a fuller array of instruments, than a financial regulator does. Financial regulators are limited to a narrow set of interventions, and their efforts have less impact per unit rupee spent. As a result of these two problems, tax-and-transfer schemes within any one sector are inefficient in terms of both taxation and transfer.

If greater financial inclusion were a political objective, one important instrument that could be used is on-budget subsidies. A subsidy could be paid by the government to banks that open an account for a household that has none. Such a policy might produce greater returns than the inclusion strategies available at a financial regulator, such as forcing banks to open rural branches or restricting entry of new banks to those that will have more rural branches. However, a regulator is unable to evaluate instruments such as on-budget subsidies and cannot make sound choices about the strategy to achieve greater financial inclusion.

Redistribution and development are legitimate political goals that should be pursued by the government, not independent financial regulatory organizations. Regulation-making functions related to development should be delegated to the fiscal authority, while financial regulators should verify compliance, that is, perform the supervisory function.

Certain technical developmental functions can be performed by financial regulators, given their substantial knowledge of the field. These include building market infrastructure or forcing markets to shift away from problematic mechanisms (such as over-the-counter derivatives) toward better alternatives such as electronic exchanges.

From this perspective, the IFC envisages the following arrangement:

1. An objective of financial regulatory agencies will be market development, but this objective will be a lower priority than the prime functions of consumer protection and microprudential regulation.
2. The Ministry of Finance would have the power to enact regulations for market-development schemes or for redistribution.
3. When such regulations are issued by the Ministry of Finance, they would have to utilize the full IFC regulation-making process. In addition, the ministry would be obliged to capture data, release data into the public domain, and evaluate the costs and benefits of each scheme every three years. Each regulation would expire after three years and would then go through the full regulation-making process again.
4. Financial regulatory agencies would enforce the regulations issued by the Ministry of Finance.

In addition to this, financial regulatory agencies could undertake development initiatives for building market infrastructure and strengthening market processes.

Contracts, Trading, and Market Abuse

Another component of financial law is the set of adaptations of conventional commercial law to questions of contracting and property rights that is required in fields such as securities and insurance.

Securities markets require legal foundations for the issuance and trading of securities. At the time of issue, investors must have adequate information to make an informed decision about valuation. Once trading commences, a continuous flow of information must be provided to investors to keep them informed. Finally, all holders of a given class of securities must obtain the identical payoffs. These three objectives are achieved through regulations.

Financial markets feature an important role for so-called infrastructure institutions that, to a substantial extent, develop rules governing the design of financial markets. The draft IFC constrains the behavior of these organizations by requiring them to issue bylaws and abide by them. The IFC also defines the objectives those bylaws must pursue, and the infrastructure institutions must obtain approval from the regulator for bylaws.

The IFC has provisions that require infrastructure institutions to disseminate information about prices and liquidity. The falsification of this information is termed market abuse. The IFC defines market abuse and establishes the framework for identifying and punishing persons who engage in it.

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.

Work is currently allocated in India between the Reserve Bank of India, the Securities and Exchange Board of India, the Insurance Regulatory and Development Authority, the Pension Fund Regulatory and Development Authority, and the Forward Markets Commission. But the allocation was never deliberately designed. It evolved over the years through a sequence of piecemeal decisions that responded to immediate pressures.

The current arrangement includes gaps where no regulator is in charge. The diverse Ponzi schemes, for instance, are not regulated by existing agencies. Moreover, overlaps in work allocation and conflicts between laws have consumed the energy of top economic policymakers, and poorly defined allocation of responsibilities has generated regulatory turf battles.

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.

When a regulator focuses on one sector, certain unique problems of public administration tend to arise. Assisted by the lobbying of financial firms, the regulator tends to share the aspirations of the regulated financial firms. These objectives often conflict with the core economic goals of financial regulation such as consumer protection, safety and soundness, and swift resolution. Having multiple sectoral regulators that construct "silos" leads to economic inefficiency.

The IFC's take on financial regulatory architecture stems from a number of considerations. The IFC seeks to ensure accountability, which is best achieved when an agency has a clear purpose and clear jurisdiction. It also seeks to avoid conflicts of interest by constructing regulatory architecture that minimizes such conflicts. Political objectives are best pursued by the Ministry of Finance. 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.

Another consideration is that in India, there is a paucity of talent and area-specific expertise in government, and constructing a large number of agencies is relatively difficult from a staffing perspective. Placing functions that require correlated skills into a single agency is more efficient.

Finally, the IFC also considers transition issues, breaking up the overall change 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.

Second, the existing Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Pension Fund Regulatory and Development Authority, and Forward Markets Commission will be merged into a new Unified Financial Agency, which will implement the consumer protection and micro-prudential laws for the entire financial system except banking and payments. This would yield benefits in terms of economies of scope and scale in the financial system; it would reduce the identification of a regulatory agency with a particular sector; and it would help address the difficulties of finding appropriate talent in government agencies.

The Unified Financial Agency would take over the work on organized financial trading that is currently conducted by the Reserve Bank of India. It would thus unify all organized financial trading, including in equities, government bonds, currencies, commodity futures, and corporate bonds. The unification of regulation and supervision of financial firms—such as mutual funds providers, insurance companies, and a diverse array of firms that are not banks or payment providers—would yield consistent treatment in consumer protection and micro-prudential regulation across the range of organizations.

Third, the existing Securities Appellate Tribunal will be subsumed into the Financial Sector Appellate Tribunal. This entity will hear appeals of regulatory actions of the Reserve Bank of India, appeals of Unified Financial Agency actions, appeals of Financial Redress Agency actions, and appeals of some elements of the work of the resolution corporation.

Fourth, the existing Deposit Insurance and Credit Guarantee Corporation will become part of the resolution corporation.

Fifth, the new Financial Redress Agency will provide consumers a single venue to lodge complaints against all financial firms.

Sixth, a new Public Debt Management Agency will be the government's investment banker and cash manager.

And seventh, the existing Financial Stability and Development Council will persist with its functions and statutory framework modified. It will become a statutory agency with different responsibilities in the fields of systemic risk and development.

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.

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