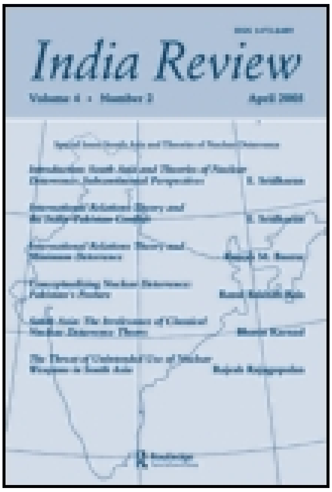

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Fundamental Redesign of Financial Law: The Indian Approach

Ila Patnaik[a] & Ajay Shah[b]
[a] Economic Advisor at the Ministry of Finance
[b] National Institute for Public Finance and Policy
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Fundamental Redesign of Financial Law: The Indian Approach

ILA PATNAIK and AJAY SHAH

Introduction

India is at the cusp of important financial sector regulatory reform. The reform aims at deeper changes in financial sector laws and regulatory architecture. While many incremental reforms were undertaken in the last two decades, the pace of change has slowed down owing to the constraints posed by the underlying legal framework.

The key problems in the financial sector include: lack of financial inclusion, a glacial pace of innovation, the growth of an unregulated shadow financial system, numerous ponzi schemes, high inflation, and barriers to capital flows. In the last decade, there have been many efforts in rethinking financial sector regulation to address these problems. A group of expert committees created a consensus around a strategy for change, which has led to a draft law proposed by the "Financial Sector Legislative Reforms Commission (FSLRC)" set up by the Ministry of Finance of the Government of India.

The FSLRC was set up to rewrite the laws. After two years of deliberations and consultation, the Commission submitted its report and a proposed draft law, the Indian *Financial Code*. The draft law recommends that most of the existing laws in finance be repealed and a new, modern, coherent and consistent framework based on rule of law, independence, accountability, and an over-riding objective of consumer protection be put in place.

The government is holding consultations on this draft law. Although the draft law can only be enacted by the Parliament, many reform ideas can be voluntarily adopted by the regulators, within their legal mandate. These include: improved processes for accountability and rule of law, as well as consumer protection measures. Furthermore, as the Commission proposes new agencies, that normally take time to build, the government has initiated the construction of institutional capacity for enforcing the new law.

Problem

India embarked on substantial economic liberalization in 1991. An integral part of this was a scaling back of capital controls, and fostering 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.

Ila Patnaik is a Principal Economic Advisor at the Ministry of Finance. Ajay Shah is a Professor at the National Institute for Public Finance and Policy.

In the early period, important progress was made in four areas. Capital controls were reduced substantially.[1] A new defined-contribution pension system, the New Pension System (NPS), was setup.[2] A new insurance regulator, the Insurance Regulation and Development Agency (IRDA), was setup and the public sector monopolies in the field of insurance were broken.

Most important, there was a big burst of activity in building the equity market.[3] This involved establishing a new regulator, the Securities and Exchange Board of India (SEBI), and new infrastructure institutions: the National Stock Exchange (NSE) and the National Securities Depository (NSDL). As an example of the close linkage between economic reform and legislative changes: the reforms of the equity market involved 10 Acts of Parliament, the creation of one new regulatory agency and one Constitutional amendment.

These events ran from 1992 to 2004. While all these moves were in the right direction, a large number of problems of the financial system remained unresolved. There are diverse views on the difficulties of the financial system, and we offer some illustrations:

- Households are suffering substantial losses owing to miss selling.[4]
- There is a rash of Ponzi schemes, which damage households.[5]
- The Bond–Currency–Derivatives Nexus is characterized by illiquidity and failures of market efficiency. The absence of a long-term bond market hampers corporate financial planning, e.g., in the field of infrastructure investment.[6]
- An elaborate system of financial repression confiscates resources from households and makes them available to the government.
- Weaknesses of the Bond–Currency–Derivatives Nexus, and of the banking system, have given a weak monetary policy transmission.
- This has contributed to a sustained failure in achieving low and stable inflation.[7]
- In recent years, there has been a rapid loss of onshore financial intermediation.[8]
- Poorly defined allocation of responsibilities has generated regulatory turf battles.[9]
- There are weaknesses of regulatory governance giving violations of the rule of law.
- Given the hurdles faced by innovation and competition, large parts of the country are cutoff from the formal financial system.[10] This has resulted in financing constraints for firms and households.

The overlaps and cracks in the regulatory apparatus, and the weak framework for consumer protection, have resulted in a procession of scandals. Table 1 shows three of the large crises of recent times.

This picture is consistent with the evidence about the Indian financial system obtained from all cross-country databases that measure the capability of the financial system. India is typically found in the bottom quartile of countries. This is particularly problematic, as a 30 percent savings rate yields savings of $600 billion in a year at present levels of GDP. Such a large scale of resource flow merits a better allocative mechanism.

It is likely that in roughly 40 years from now, India's GDP will exceed that of the United States today (i.e., in 2014). This gives us a flavor of the complexity of finance

TABLE 1
SOME RECENT FINANCIAL SCANDALS

Scandal	Description
Saradha	The Saradha group was one of eastern India's biggest deposit-taking companies defaulted on its payments. It was a Ponzi scheme. It was supposed to be regulated by the state government in West Bengal.
Sahara	Two firms of Sahara Conglomerate issued Optionally Fully Convertible Debentures to collect money from investors. They obtained investments from 23 million people, mostly from villages and small towns. SEBI investigated the scheme and ordered Sahara to refund the investors. Sahara questioned the jurisdiction of SEBI claiming that this was a private placement by unlisted companies. The main problem was: there is no principles based definition of the term "security." Hence, issuers can escape the jurisdiction of the regulator by claiming that their product is not a security.
Unit linked insurance plans	From 2004–05 to 2009–10, insurance companies started selling market-linked products called unit linked insurance plans (ULIPs). A large fraction of the premium was invested in a mutual fund with a small insurance payout in case of death. ULIPs were similar to Mutual Funds except for the small component of insurance that it carries. However, they were not subject to SEBI regulations. Loopholes in the laws that allowed these policies to be front-loaded encouraged mis-selling of these products. Halan et al., "The Case of the Missing Billions," estimates that the extent of consumer losses on account of mis-selling of these products was estimated to be around Rs 1.5 trillion (USD 28 billion).[11] In 2010 SEBI passed an order that such products should be within its jurisdiction. That resulted in a regulatory turf battle between SEBI and IRDA. Finally, in 2010 an ordinance was passed that placed these products within the jurisdiction of IRDA.

that will be experienced on this journey. In the journey of coming 40 years, India will need to build up the institutional machinery for markets as complex as the financial system seen in advanced economies today.

A Fresh Look at Financial Regulation

Faced with these questions, by 2004, it was becoming increasingly clear that large-scale rethinking about financial regulation was required. As is the convention in India, the consensus on desired reforms was constructed through a group of four expert committee reports:

1. A committee led by Percy Mistry, focused on international finance, in 2007;[12]
2. A committee led by Raghuram Rajan, focused on domestic finance, in 2008;[13]
3. A committee led by U. K. Sinha, focused on capital controls, in 2010;[14] and
4. A committee led by Dhirendra Swarup, focused on consumer protection, in 2010.

Table 2 describes the focus and main recommendations of these expert committees. These four reports add up to an internally consistent, and comprehensive framework, on Indian financial reforms. The findings were widely discussed and debated in the public discourse. They have been highly influential in diagnosing problems, proposing solutions, and reshaping the consensus.

Some parts of these reports were readily implementable and have been gradually implemented in the following years. However, the bulk of the work program envisaged by these four expert committees is incompatible with the present laws.

TABLE 2
EXPERT COMMITTEES

Group and chairman	Result
High Powered Expert Committee on Making Mumbai an International Financial Center; Percy Mistry, 2007[15]	The report outlined the roadmap 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 international financial center, in addition to the capabilities of the financial firms. It recommended increasing financial market integration, creating a Bond-Currency-Derivatives nexus, capital account convertibility, and competition.
The Committee on Financial Sector Reforms; Raghuram Rajan, 2008[16]	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 levelling the playing field, broadening access to finance and creating liquid and efficient markets.
Committee on investor awareness and protection; Dhirendra Swarup, 2009[17]	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 which induces problems like mis-selling, 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; UK Sinha, 2010[18]	The Working Group's prime 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 non-existent 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 (QFI) frame- work, and the promulgation of KYC requirements that meet OECD standards of best practices.

Reforms of the financial system will only be graced by legal certainty if they are fully rounded in laws. Hence, the only way to obtain deep-rooted progress in the financial system is to amend the laws. Actions by financial regulators that are not thoroughly grounded in laws are vulnerable to arbitrary changes in the future.

Weaknesses of Existing Laws

The present framework of laws in India has numerous problems. A large number of laws exist, each of which was designed to solve a small problem that was then prevalent. These laws are often inconsistent and generally out of touch with the requirements of a middle-income economy. As an example, the preamble of the Reserve Bank of India Act, which ewas enacted by the British in 1934, reads:

> Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency any credit system of the country to its advantage;
>
> 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.[19]

Although the Act has been amended periodically, such a "temporary" arrangement setup in 1934, serving the objectives of colonial authorities, is not likely to be optimal for India from 2014 to 2064.

Most existing financial laws were enacted when India was a command and control economy. They are guided by the objective of containing and controlling financial markets, rather than regulating and supervising them. 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.

Regulations and Regulators

The four-committee reports identified numerous shortcomings of the present arrangements. Almost all aspects of the present arrangements are specified in *regulations* that are written by regulators. At first blush, it appears that the bulk of these problems can be merely solved by writing better regulations. As an example, the importance of the Bond-Currency-Derivatives Nexus has been apparent, and there is a strong case to change regulations that have prevented its emergence. However, more than twenty years after India started constructing a market-based economy, more rational regulations have not come about. The equity market got a great leap forward, but the transfer of ideas and institutional capacity from the equity market into the bond market and the currency market did not take place. This raises deeper questions about the *regulators*. Why do existing regulators issue faulty regulations?

As there are persistent shortcomings in the output of regulators (regulations and the enforcement of these), it is necessary to open the black box of the regulator and modify the workings therein. The answers lie in the objectives and accountability of regulators.

The proximate source of under-performance of financial agencies lies in poor organization design and low quality staffing. A superficial perspective on State capacity places an exclusive emphasis upon the recruitment process. It is argued that if only we could recruit a few remarkable persons, our problems would be solved. However, even remarkable people respond to incentives, and the very appointment process is shaped by incentives.

We need to look deeper, at why the leadership of financial agencies has chosen to perpetuate ineffective management structures. In the private sector, the accountability mechanism of competition in the market solves this problem. This mechanism is not found in public administration. The leadership of a financial agency chooses comfortable paths, when left to itself, without the pressure of competition. As an example, it is difficult to regulate and supervise a futures market properly, while it is easy to ban it. What is required is that the leadership of a regulatory agency undertakes the internal restructuring so as to create adequate staff capacity for regulation and supervision of the financial markets that are required by the economy.

We must, therefore, focus on the *accountability mechanisms*: that will impel them to undertake the uncomfortable task of reshaping these organizations so as to deliver performance. Modifications to the objectives and accountability of regulators are essential to transform the quality of future regulations and enforcement strategies. This requires an analysis of regulators based on public choice theory.

Weaknesses in the Landscape in Public Administration

Existing laws in India are rooted in the notion that the State is benevolent. They pre-date insights from public choice theory, which developed around the idea that public servants are not just maximizing public interest, but are also motivated by private interest. The existing laws feature very little in terms of the checks and balances, and accountability mechanisms, for government agencies. The under-performance of financial agencies is similar to that observed with public bodies across the Indian landscape.

For a 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 US. No comparable law exists in India. Existing financial regulators blur the lines between legislative, executive, and judicial functions.

The construction of financial law in India thus requires understanding and consequential legal drafting based on two pillars of knowledge: market failures in finance (which shape appropriate interventions by the government) and modern public administration (which shapes the working of government agencies).

There is no tradition in India of improving the multiple laws governing an entire sector. From 2009 onward, the Ministry of Finance started grappling with this problem, and chose to adapt an existing institution of "Law Commissions," which are nonpartisan bodies that propose modifications of laws.

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. A multi-disciplinary 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, the international experience, and designed a new legal foundation for Indian finance.

The Commission delivered a draft of what has been termed the "Indian Financial Code" (IFC) on 22 March 2013. This is a single internally consistent law, of 450 sections, that replaces the bulk of existing Indian financial law.[20]

Financial Regulatory Process

A critical pillar of financial law is the construction of independent regulators and their functioning. The IFC breaks new ground in India, on establishing independent regulators and on holding them accountable. A great deal of knowledge of public administration, which is well understood internationally, has been utilized in the drafting of the IFC in India.

Parliament gives *the power to write regulations to independent regulators*. The regulator then combines the legislative function (writing law), the executive function (enforcing it) and the judicial function (of adjudicating violations and disputes). These three functions should be kept separate under the "separation of powers" doctrine. The IFC breaks with present Indian practice in requiring the quasi-judicial function to be performed by a vertical within the regulator that is held apart from the legislative and executive functions.

Independence and Accountability

Laws for the financial sector need to enshrine regulatory independence. This involves an appointment process for senior regulatory staff, fixed contractual terms, controlling the loss of independence that comes from the possibility of extension of term or promotion, removing the power of government to give directions, bringing transparency to board meetings, etc.

At the same time, independence cannot be given to an agency in isolation. Parliament *should* not delegate power to unelected officials without adequate accountability mechanisms. New channels of accountability need to be constructed, as independent agencies are not subject to accountability through elections. An example of accountability is found with central banks worldwide: when lawmakers gave central banks independence, in most cases, they placed the burden upon central banks to deliver on an inflation target. This was the accountability mechanism through which the independent agency was brought under check. In most other areas of financial law, the accountability mechanisms required are much more complex.

Design of independent regulators should avoid two extremes. At one extreme is excessive delegation. As an example, if legislation sets up an independent regulator with the mandate of "serving the public interest" or "improving the welfare of the people of India," and arms it with sweeping powers, this would raise concerns about what such an agency would do. Laws need to write down the objectives of an agency, its powers, and the accountability mechanisms. On the other extreme is the issue of micro-management in the legislation. If laws embed institutional details of markets, technology and financial sector activities, the key purpose of establishing independent regulators would be lost.

The key insight of the IFC lies in seeing that regulatory failures are often explained by the lack of accountability. The leadership of financial agencies in India has not been under adequate pressure and has, hence, chosen the comfortable path of delivering low quality outcomes for the economy. The IFC pursues four pathways to accountability:

1. clarity of purpose;
2. a well-structured regulation-making process;
3. the rule of law; and
4. reporting.

Clarity of purpose. If the objectives *of* the agency are not clearly defined, there is unfettered discretion on how powers will be used. When a government agency has multiple, conflicting objectives, it is easier for the agency to explain away failure. When one goal conflicts with another, it is always easy for an agency to avoid accountability: failures in one dimension are explained away, through claims that the other goal was being emphasized. The IFC structures regulatory bodies with greater clarity of purpose.

Regulation-making process. The independent regulator is a unique institution in that Parliament delegates *regulation-making power* to unelected officials. Regulators may sometimes draft regulations that are comfortable for the regulator rather than pursuing the interests of society at large. The regulation-making process of the IFC features checks and balances to help avoid suboptimal outcomes.

Under the IFC, the regulator is obliged to analyze the costs and benefits of a proposed regulation. The costs must be compared against the market failures that motivate the regulation. In other words, for every regulation that is proposed, the IFC requires:

1. A statement of the objects and reasons of the subordinate legislation;
2. A description of the market outcome, which is an inefficient one ("a market failure");
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; and
7. Demonstration that the costs to society through complying with the intervention are outweighed by the gains to society from addressing the market failure.

A regulator would release documentation covering the aforementioned elements every time a draft regulation is produced. This will help ensure that adequate analysis has preceded regulation making and show the full regulatory intent to citizens and judges.

A consultative process would commence, where the regulator unveils the analytical documentation coupled with draft regulations into the public domain. Market participants would be given sufficient time to understand a draft regulation, and to comment on it. The regulator would substantively respond to all public comments. After that, modified regulations would be released in public, with a starting date that is sufficiently out in the future so as to avoid surprises.

One key element of the process is appeal. The IFC articulates specific objectives and specific powers. If the regulator strays from either of these—catering to objectives that were not specified in the law, or claiming powers that were not mentioned in the law—it would be possible to strike down the regulation through appeal. Similarly, violations of the requirements for the regulation-making process as prescribed in the law would be grounds for striking down regulations. While such appeals take place through High Courts and the Supreme Court in India at present, the IFC envisions these appeals going to the Financial Sector Appellate Tribunal (FSAT), a specialized court with greater skills in finance.

Well after a regulation is in place, the IFC requires ex-post analysis, looking back at the objectives of a regulation, examining micro-data to obtain evidence about the extent to which the stated objectives have been met, and reviewing the litigation that has come about.

These are broad awareness and agreement among regulators in India today, such that a regulation-making process is desirable. Most elements of this process have been used in some situation in India. However, there is idiosyncratic variation depending on personalities involved. Drawing on global best practices, the IFC places this detailed regulation making in *the law*, whereby it would be mandatory every time a regulation is issued.

The rule of law. A crucial element of accountability and independence of regulators is the rule of law, which comprises three key principles:

1. Laws should be known before an action takes place.
2. Laws should be applied uniformly across similar situations.
3. Every application of law should provide the private party with information about the application of the law, the reasoning by which the conclusion was arrived at, and a mechanism for appeal.

Under the IFC, the operation of this formal process, and a body of laws and jurisprudence, would be visible to all private parties. This would provide stability and certainty about the law and its application.

Reporting. Once the objectives of an agency have been defined, it is meaningful to ask the agency to report (e.g., in the Annual Report) the extent to which it has achieved these objectives. Each agency would report on how it has fared on pursuing its desired outcomes, and at what cost. This would generate accountability.

A report about the activities of each agency would be placed into the public domain. As an example, for a supervisory process, the agency would be obliged to release data about investigations conducted, orders issued, orders appealed, orders that got struck down, a post-facto analysis about the orders that got struck down, etc.

A Fresh Look at the Principal-Agent Problem of Public Administration

The present laws in India give fairly sweeping powers to financial agencies. Under the IFC, for all agencies, there is a triad of clear objectives, enumerated powers and accountability mechanisms. Every agency is required to pursue its clearly stated objectives using its precise toolkit of powers. An array of accountability mechanisms would generate feedback loops through which the principal-agent problem would be addressed.

The conventional Indian discourse uses the term "functions" of a government agency. A law is constructed which places certain functions upon a government agency. The agency is then seen as a bureaucracy equipped with certain powers, which has to perform these functions. The IFC consciously steps away from such a notion of power without accountability. The vocabulary employed by the IFC is consistently one of *objectives, powers,* and *accountability mechanisms*. Every financial agency is required to pursue objectives that are clearly stated in the law, employ specific powers in the pursuit of these objectives, and be held accountable through an array of mechanisms.

Nine Components of the Law

We now turn to the actual work of identifying and addressing market failures. The draft IFC classifies the substantive work of government in finance into nine components. Each of these components is guided by a clear understanding of market failures:

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
9. contracts, trading and market abuse.

Consumer Protection

The first objective of financial regulation is consumer protection. The existing strategy on consumer protection in Indian finance is rooted in a *caveat emptor doctrine*, where consumers are protected from fraud, and there is a program to ensure full disclosure. For the rest, consumers are left to their own devices. Academic research and the events of recent decades, on a global scale, have established the inadequacy of such an approach. Due to market failures, especially information asymmetry and market power, consumers of financial services are often quite vulnerable, and require a special effort by the State.

The IFC establishes mechanisms for prevention and redress in the field of consumer protection. The *prevention* problem requires regulation making and enforcement across the entire financial system from the viewpoint of protecting consumers.

Under the IFC, there are rights and protections for consumers, an enumerated set of powers through which financial regulators will uphold these rights and protections, and principles that guide the use of powers. The details of consumer protection would, of course, lie in the regulations that regulators would draft.

Some of the rights and protections of consumers are: protection against unfair terms of contract, protection against misleading and deceptive conduct, right to receive the support to enter into suitable contract, and right to data privacy and security.

Regulators are empowered under the IFC to impose a range of requirements for financial service providers, starting from disclosures, to advice requirements, to regulation of incentive structures. The choice and application of these powers will be informed by a set of principles that would ensure that they are used where they are most required ("the principle of proportionality"), they do not excessively restrict innovation and competition, and other such balancing considerations.

As an example, a major debate is taking place worldwide with consumer protection issues associated with conflicted remuneration structures. When a sales agent sells a financial product to a household, and gets paid a fee by the producer of this financial product, is there a problem with conflict of interest? How do we evolve a structure where the provider acts in the best interest of the consumer? Under the IFC, regulators are obliged to grapple with this question. The regulator would use the powers provided, to pursue the goals specified in the law, by writing regulations. Alongside this regulation-making mandate, there is supervision to ensure compliance with the regulations.

Turning from prevention to cure, the IFC envisages a unified *Financial Redressal Agency* (FRA). FRA would have front-ends in every district of India, where consumers of all financial products would be able to submit complaints. Modern technology would be used to connect up these front-ends into a centralized lightweight adjudication process. A well-structured workflow process would support speedy and fair handling of cases. Consumers would deal only with FRA when they have grievances in any financial activity: they would not have to deal with multiple Ombudsmen. A feedback loop has been designed, through which the incidence of problems being seen at the FRA feeds back to improved regulations.

Micro-Prudential Regulation

Micro-prudential regulation consists of reducing the probability of financial firm failure. The motivation for micro-prudential regulation is rooted in consumer protection. When a consumer deals with (say) an insurance company, there should be a high probability that the insurance company will be able to discharge on its promises. In addition, if a large number of financial firms fail at the same time, this can disrupt the overall financial system. Sound micro-prudential regulation thus caters to reducing systemic risk. Firms are keen to avoid their own bankruptcy. However, they cannot be left to their own devices, as managers and shareholders stand to gain if the firm does well, and walk away when the firm fails.

The extent of intrusive micro-prudential regulation depends on the "intensity" of the financial promise. Three factors are of consequence: how inherently difficult it is to honor the promise; how difficult it is for the consumers to assess the ability of the firm to keep its promise; and how much hardship would be caused if the promise is not kept. For example, in a bank deposit, as 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 creditworthiness assessment difficult; and there is significant hardship for households if the bank should fail. In contrast, NAV-linked investments involve a very different set of promises, which requires the corresponding design of an appropriate micro-prudential regulatory strategy.

In the IFC, the main micro-prudential objective is to reduce the probability of firm failure, but this is balanced with a principle that requires the regulator to consider the consequences for efficiency. Regulators have the power to impose requirements around capital adequacy, corporate governance standards, liquidity norms, investment norms, and other instruments. There is a principle of proportionality; regulatory interventions should be related to the risks faced.

A single micro-prudential law for the entire financial system ensures uniform treatment of all aspects of the financial system, and largely eliminates areas of regulatory arbitrage. At the same time, multiple regulators could enforce the law for various components of the financial system.

Resolution

Failure of financial firms can be highly disruptive for their consumers, and for the economy as a whole. Sound micro-prudential regulation will reduce the probability of firm failure. However, eliminating all failure is neither feasible nor desirable. Failure of financial firms is an integral part of the regenerative processes of the market economies: weak firms *should* fail and thus free up labor and capital that would then be utilized by better firms. However, it is important to ensure smooth functioning of the economy, and avoid disruptive firm failure.

While India presently has deposit insurance for banks, there is no resolution capability. So, the problems of failing private financial firms are mostly placed upon customers, taxpayers, and the shareholders of public sector financial firms. Establishing a sophisticated resolution corporation is thus essential.

A Resolution Corporation would watch all financial firms which have made intense promises to households, such as banks, insurance companies, defined benefit pension funds, and payment systems, and intervene when the net worth of the firm is near zero (but not yet negative). It will also take responsibility for resolution of systemically important financial firms. It would force the merger of the firm or sale of some of its assets, or run it temporarily, or liquidate it, to protect the consumers. In the case of some kinds of firms, such as banks, the resolution corporation would operate an insurance program.

Micro-prudential regulation and supervision is a continuous affair. For strong firms, the resolution corporation will stay in the background. As the firm approaches default, the resolution corporation will assume primacy. The resolution corporation is analogous to a specialized disaster management agency, which is not involved in everyday matters of governance, but assumes primacy at the time of a disaster.

Systemic Risk Regulation

The field of financial regulation was traditionally focused on consumer protection, micro-prudential regulation and resolution. In recent years, a fresh focus on the fourth field of systemic risk has arisen. Systemic risk is about a collapse in functioning of the financial system, through which the real economy gets adversely affected. In the aftermath of the 2008 crisis, governments and lawmakers worldwide desire regulatory strategies that would avoid systemic crises.

The problem of systemic risk requires a bird's eye perspective of the financial system: it requires seeing the woods and not the trees. This is a different perspective when compared with the engagement of conventional financial regulation. The essence of the systemic risk perspective is to look at the financial system as a whole. In contrast, conventional micro-prudential regulators are oriented toward seeing one firm at a time, and sectorial regulators are oriented towards information, regulatory instruments, and the interests of one sector at a time.

To some extent, systemic crises are the manifestation of failures on the core tasks of financial regulation, i.e. micro-prudential regulation and resolution. If these pillars of financial regulation had worked well, many of the crises of the past would have been defused. Systemic risk in India will go down if institutional capacity is built for the problems of micro-prudential regulation and resolution. However, it will not be eliminated. This calls for systemic risk regulation, as a fourth pillar of financial regulation.

Unless systemic risk regulation is envisioned as a precise set of steps that would be performed by government agencies, there is the danger that systemic risk law degenerates into vaguely specified sweeping powers with lack of clarity of objectives. In the IFC, systemic risk regulation is centered in the "Financial Stability and Development Council." This will have a compact membership of five persons: Minister of Finance, Head of the Central Bank, Head of the Non-Banking Financial Agency, Head of the Resolution Corporation, and Head of the Debt Management Office. The IFC envisions systemic risk regulation as consisting of four steps:

1. Constructing a system-wide database to support understanding of the overall financial system. Research about systemic risk, based on a system-wide database, would be brought to the attention of the council;
2. Identifying systemically important financial firms and conglomerates, which would be subjected to enhanced micro-prudential regulation and supervision;
3. Power with the council to establish and operate system-wise tools for modifying the risk taken by the financial system as a whole, across all sectors, in a counter-cyclical manner; and
4. An array of coordinated emergency measures is called for when there is a financial crisis.

Capital Controls

Capital controls are restrictions on cross-border activities. It is useful to classify them 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 (e.g., barriers to FDI in retail) or national security considerations (e.g., barriers against control of vital infrastructure by hostile nations); and
3. Restrictions against financial integration.

There are differences between the objectives and instruments required in the three areas. Hence, each of these three elements requires a distinct strategy for law and accountability. The first one—observing and preventing criminal activities—is adequately addressed by the Prevention of Money Laundering Act, 2002, and by India's ongoing membership in the FATF. On the second front, the IFC defines inbound FDI, and gives the government the powers to introduce restrictions on FDI. In the third area, which is cross-border financial flows, the question is about appropriate sequencing and pace of India's capital account liberalization. Indian policy makers 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 policy makers in the future. The full strictures of the rule of law apply, including due process for making regulations, written orders, appeals, etc.

Monetary Policy

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 a monsoon failure, such considerations do not explain sustained inflation on multi-year horizons. All advanced economies, and sophisticated emerging markets, have achieved price stability by establishing appropriate institutional arrangements for monetary policy.

In India, policy makers have long operated with an informal target zone where year-on-year CPI-IW inflation is sought to be kept between four and five per cent. However, the Indian experience shows that apart from the 1999–2006 period, there have been sustained problems with achieving price stability. This suggests that new thinking is required in establishing institutional arrangements of monetary policy.

The IFC envisions three key elements of the monetary policy arrangement. The Ministry of Finance will specify a quantifiable and monitorable objective for the RBI. The RBI will have independence in the pursuit of the objective. The policy rate will be determined by voting in an executive monetary policy committee (MPC). This presents a straightforward solution to the public administration problem in monetary policy.

Public Debt Management

The management of public debt requires a specialized investment banking capability. A series of expert committees have suggested that this should be done in a professional debt management office for two reasons:

1. Debt management requires an integrated picture of all onshore and offshore liabilities of the government. At present, this information is fragmented across RBI and the Ministry of Finance. Unifying this information, and the related debt management functions, will yield better decisions and thus improved debt management.
2. A central bank that sells government bonds faces conflicting objectives. When RBI is given the objective of obtaining low cost financing for the government, this may give RBI a bias in favor of low interest rates, which could interfere with the goal of price stability.

In its entirety, the problem of debt management for the government includes the tasks of cash management and an overall picture of the contingent liabilities of the government. The IFC places this task upon a new agency, the Public Debt Management Agency.

Development and Redistribution

The development and redistribution agenda in Indian financial economic policy comprises two elements:

1. The development of missing markets, such as the bond market: This requires coordinated action on the scale of the full financial system, rather than within one sector. Successful State initiatives of this nature include the establishment of securities Infrastructure Institutions.
2. Redistribution and financial inclusion initiatives: This comprises an array of interventions in the financial system. Well-known initiatives of this nature include restrictions on branch licensing (to force banks to branches in rural areas) and priority sector lending.

These areas pose difficult puzzles for design of public administration. As an example, consider an attempt at increasing the flow of credit into certain sectors. If a financial regulator does this, three problems are encountered:

1. When a regulation forces banks to give more loans to a certain target constituency, this imposes a cost—a tax—upon other customers of loans, and also depositors and shareholders. A fundamental principle of democracy is that authorization for all taxation should come from Parliament.
2. If market development or redistributive objectives are also placed with regulators, an agency can explain away failures in consumer protection or micro-prudential regulation on the grounds that development objectives were being pursued. As an example, it may be possible to quickly increase the number of households who participate in a certain financial product by reducing the regulatory burden of consumer protection.
3. When redistributive functions are performed by a financial regulatory agency, it induces economic inefficiency. When a transfer is achieved by taxing some consumers in order to deliver gains to others, this is an inefficient mechanism of taxation. It would be more efficient if taxation were done through income tax, etc. Second, the Government has a substantially larger perspective and a wider range of instruments than financial regulators. The decision making at a financial regulator is necessarily constrained to a narrow set of interventions, and will hence generate an inferior utilization per unit rupee spent.

Redistribution and development are legitimate political goals. However, the right place where these goals should be pursued is Government and not regulators. The fiscal authority should only perform quasi-fiscal functions. This calls for placing regulation-making functions related to development (e.g., regulations for priority sector lending) at the fiscal authority, while asking financial regulators to verify compliance (i.e., to perform the supervisory function).

At the same time, financial regulators, given their knowledge close to the field, usefully perform certain technical developmental functions. As an example, there is a possibility of a regulator forcing a cross-subsidy, such as asking exchanges to charge nothing for currency futures, in the interests of moving the market away from non-transparent OTC trading. Such a decision would also constitute a tax-and-transfer scheme. However, the magnitudes involved are much smaller.

From this perspective, the IFC envisages the following arrangement:

1. Financial regulatory agencies will have market development as an objective. However, this objective will be clearly subsidiary to the prime functions of consumer protection and micro-prudential regulation.
2. The Ministry of Finance would have the power to enact regulations for schemes that pursue market development, or do redistribution.
3. When such regulations are issued by the Ministry of Finance, they would have to satisfy the full IFC regulation-making process. In addition, they would be obliged to release data into the public domain, and evaluate the costs and benefits every three years. Each such regulation would expire in three years, and would need to undergo the full IFC regulation-making process afresh.
4. Financial regulatory agencies would enforce the regulations issued by the Ministry of Finance.
5. In addition to this, financial regulatory agencies could undertake development initiatives for building market infrastructure and strengthening market processes.

Contracts, Trading, and Market Abuse

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

The framework of the securities markets requires legal foundations for the issuance and trading of securities. Issuance of securities requires three kinds of restrictions. At the time of the issue, adequate information must be available for an investor to make an informed decision about valuation. Once trading commences, a continuous flow of information must be available through which the investor can make informed decisions. Finally, a set of rules must be in place through which all holders of a given class of securities obtain the identical payoffs. These three objectives would be achieved through regulations.

Financial markets feature an important role for Infrastructure Institution. The rules made by these organizations shape the design of financial markets to a substantial extent. The draft Code constrains the behavior of Infrastructure Institutions in three respects:

1. Infrastructure Institutions are required to issue byelaws and abide by them;
2. The objectives that these byelaws must pursue are defined in the IFC; and
3. They are required to obtain approval from the regulator for bylaws.

The information regarding prices and liquidity that is produced by financial markets has a public goods character. The IFC has provisions that require dissemination of this information. In addition, the falsification of this information is termed "market abuse." The IFC defines market abuse and establishes the framework for enforcement against it.

A New Agency Landscape

We now turn to the financial regulatory architecture, or the division of the overall work of financial regulation across a set of regulatory agencies. At present, India has a legacy financial regulatory architecture. The present work allocation, among RBI, SEBI, IRDA, Pension Fund Regulatory and Development Authority (PFRDA), and Forward Markets Commission (FMC) was not designed. It evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time.

This arrangement has gaps where no regulator is in charge, such as the diverse kinds of Ponzi schemes, which periodically surface in India, which are regulated by none of the existing agencies. It also contains overlaps where conflicts between laws have consumed the energy of top economic policy makers.

Over the years, these problems will be exacerbated through technological and financial innovation. Financial firms will harness innovation to place their activities into the gaps, so as to avoid regulation. When there are overlaps, financial firms will undertake forum shopping, where the most lenient regulator is chosen, and portray their activities as belonging to that favored jurisdiction.

An approach of multiple sectorial regulators that construct "silos" induces economic inefficiency. At present, many activities that naturally sit together in one financial firm are forcibly spread across multiple financial firms, in order to suit the contours of the Indian financial regulatory architecture. In addition, when the true activities of a financial firm are split up across many entities, each of which has oversight of a different supervisor, no one supervisor has a full picture of the risks that are present.

Rational thinking in financial regulatory architecture is based on the following considerations:

Accountability. Accountability is best achieved when an agency has clear purposes. The notion that a regulator has powers over a sector but lacks specific objectives and accountability mechanisms is an unsatisfactory one.

Conflicts of interest. Direct conflicts of interest are harmful for accountability and must be avoided.

Political objectives. Political objectives are best performed by the executive (the government), with decisions by the political authorities. Technical objectives are those that can be contracted-out to independent regulators that can then be held accountable for objectively defined outcomes.

A complete picture of firms. A financial regulatory architecture that enables a comprehensive view of complex multi-product firms, and thus a full understanding of the risks that they take, is desirable.

Economies of scale in government agencies. In India, there is a paucity of talent and domain expertise in Government, and constructing a large number of agencies is relatively difficult from a staffing perspective. It is efficient to place functions that require related skills into a single agency.

Transition issues.. It is useful to envision a full transition into a set of small and implementable measures.

Based on these considerations, the IFC envisages a financial regulatory architecture featuring seven agencies:

1. The existing RBI will continue to exist, with modified functions.
2. The existing SEBI, FMC, IRDA, and PFRDA will be merged into a new unified agency.
3. The existing SAT will be subsumed into the FSAT.
4. The existing Deposit Insurance and Credit Guarantee Corporation will be subsumed into the Resolution Corporation.
5. A new Financial Redressal Agency (FRA) will be created.
6. A new Public Debt Management Agency (PDMA) will be created.
7. The existing FSDC will continue to exist, with modified functions and a statutory framework.

The role of each of these agencies is as follows:

- RBI will do monetary policy, as well as regulation and supervision of banking and payments.
- Unified financial agency (UFA) will regulate and supervise all financial sectors other than 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 the regulatory agency with one sector; it would help address the difficulties of finding the appropriate talent in Government agencies.
- FSAT will subsume the present SAT. Aggrieved persons will submit applications to the FSAT for review of all financial regulations. Appeals against decisions of the FRA and orders of regulators will also go to FSAT.
- Resolution Corporation will subsume the present DICGC, and will perform the resolution function across the financial system.
- Financial Redressal Agency (FRA) will setup a nationwide machinery to be-come a one-stop-shop where consumers can carry complaints against all financial firms.
- PDMA will work as an investment banker and cash manager to the government.
- FSDC will become a statutory agency and have modified functions in the fields of systemic risk and development. It will have a Financial Data Management Center (FDMC) as a comprehensive database of all financial regulatory data.

This proposed financial regulatory architecture is a modest step away from present practice, embeds important improvements, and will serve India well in coming years.

From Ideas to Action

The FSLRC has proposed a draft of the Indian Financial Code. This draft law is presently being debated in the public domain. If the political leadership supports this draft, then there is a possibility that it may be enacted by the Parliament.

On October, 2013, the FSDC passed a resolution supporting voluntary adoption of ideas such as better regulation making processes and improved consumer protection regulations. The implementation of this resolution is underway. In October, 2014, the government embarked on preparatory work for some of the agencies recommended by FSLRC. Task forces comprising of experts from the relevant domain areas have been constituted for building Resolution Corporation, PDMA, FSAT, and FDMC.

Building state capacity to implement the changes proposed by FSLRC is going to be a central challenge. Will it require new institutions to be set up? It will also require a change in the way regulators and the government function and interact with firms and consumers. This will require large-scale training for the staff of the regulators as well as of the Ministry of Finance. The judiciary will be faced with the challenge of learning and interpreting the new law. A body of jurisprudence will have to build up before a full understanding of the law and regulations can be achieved.

Conclusion

Comprehensive rewrite of law has seldom been attempted in India. The Indian Financial Code is hence an unusual enterprise. It reflects a confluence of two streams of thought. The first is an understanding of the market failures that motivate government interventions in finance. The second is a framework for thinking about public administration and the rule of law. The Indian State has profound shortcomings on the State capacity, with repeated failures in numerous fields. Any attempts at building financial agencies must begin with a set of hypotheses about the sources of failure, which can guide better design of organizations.

The global financial crisis has triggered a substantial re-examination of financial regulation worldwide. This has influenced the IFC in many dimensions. Under the IFC, there is no part of finance that is unregulated. Mistakes of consumer protection, micro-prudential regulation and resolution all played a prominent role in the global crisis. Well-structured law and financial agencies, as envisioned in the IFC, would help to rule out these events. At the same time, systemic crises can potentially arise even if there are no mistakes in these three fields. Hence, the IFC has a layer of systemic risk regulation that is designed at the level of the overall financial system.

The drafting of the IFC was rooted in a decade-long effort of understanding the problems of Indian finance and public administration. This process has drawn on contemporary thinking after the global financial crisis, but has avoided the political problems associated with a rapid legislative response to the global crisis.

While a draft IFC has been released into the public domain, there is a long journey ahead. In the ideal scenario, the Indian Financial Code will be enacted as law by Parliament somewhere between 2015 and 2017.

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NOTES

1. See: Ila Patnaik and Ajay Shah, "Did the Indian Capital Controls Work as a Tool of Macroeconomic Policy." *IMF Economic Review* 60, no. 3 (2012): 439–64 and Ajay Shah and Ila Patnaik, "India's Reintegration into the

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3. See Susan Thomas, "How the Financial Sector in India was Reformed," in *Documenting Reforms: Case Studies from India*, ed. S. Narayan (New Delhi: Macmillan India), 171–210.
4. Monica Halan, Renuka Sane, and Susan Thomas, "The Case of the Missing Billions: Estimating Losses to Customers Due to Missold Life Insurance Policies," *Journal of Economic Policy Reforms* 17, no. 4 (October 2014): 285–302.
5. See the entry in *Ajay Shah's blog*, "Addressing Ponzi Schemes: The Three Parts of the Solution Strategy," April 30, 2013, http://goo.gl/ydYUUq/
6. See Percy Mistry, *Making Mumbai an International Financial Centre* (Committee report) (New Delhi: Sage Publishing and Ministry of Finance, Government of India, 2007).
7. As an example, while the informal inflation target is y-o-y CPI inflation from four to five percent, inflation has been above seven percent most of the time since 2008.
8. See Shah and Patnaik, "India's Reintegration."
9. These have been observed between RBI and SEBI, between SEBI and FMC, and between SEBI and IRDA.
10. As an example, the banking regulator, the Reserve Bank of India, did not issue any banking licenses for eleven years (from 2003 to 2014), and then gave two banking licenses in 2014.
11. Halan et al., "The Case of the Missing Billions."
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