Approach Paper

Financial Sector Legislative Reforms Commission
Ministry of Finance
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1 The context

1. The Financial Sector Legislative Reforms Commission (FSLRC) was constituted by the Government of India, Ministry of Finance, *vide* a resolution dated 24th March, 2011. The setting up of the FSLRC was the result of a felt need that the legal and institutional structures of the financial sector in India need to be reviewed and recast in tune with the contemporary requirements of the sector.

2. The institutional framework governing the financial sector has been built up over a century. There are over 60 Acts and multiple rules and regulations that govern the financial sector. Many of the financial sector laws date back several decades, when the financial landscape was very different from that seen today. For example, the RBI Act and the Insurance Act are of 1934 and 1938 vintage respectively. The Securities Contract Regulation Act was enacted in 1956, when derivatives and statutory regulators were unknown. The superstructure of the financial sector governance regime has been modified in a piecemeal fashion from time to time, without substantial changes to the underlying foundations. These piecemeal changes have induced complex and cumbersome legislation, and raised difficulties in harmonising contradictory provisions. Such harmonisation is imperative for effectively regulating a dynamic market in the era of financial globalisation.

3. The piecemeal amendments have generated unintended outcomes including regulatory gaps, overlaps, inconsistencies and regulatory arbitrage. The fragmented regulatory architecture has led to a loss of scale and scope that could be available from a seamless financial market with all its attendant benefits of minimising the intermediation cost. For instance, complex financial intermediation by financial conglomerates of today falls under the purview of multiple regulators with gaps and overlaps. A number of expert committees have pointed out these discrepancies, and recommended the need for revisiting the financial sector legislations to rectify them. The need for complete review of the existing financial sector laws has been underlined to make the Indian financial sector more vibrant and dynamic in an increasingly interconnected world.

4. The remit of FSLRC, as contained in its Terms of Reference (ToR), comprises the following:

1. Review, simplify and rewrite the legislations affecting the financial markets in India, focussing on broad principles

2. Evolve a common set of principles for governance of financial sector regula-

tory institutions

3. Remove inconsistencies and uncertainties in legislations/Rules and Regulations
4. Make legislations consistent with each other
5. Make legislations dynamic to automatically bring them in tune with the changing financial landscape
6. Streamline the regulatory architecture of financial markets

5. The FSLRC has been deliberating on these issues since April 2011 both internally and through consultation/interaction with a wide spectrum of experts and stakeholders. This Approach Paper is the outcome of these deliberations and substantive research work. It shows the contours of the legal-institutional framework that the FSLRC may recommend. It is a provisional document, and the thinking of FSLRC will evolve in coming months, utilising various inputs including the analysis of this document in the public domain.

2 The setting

6. Finance is an integral element of India's growth and development. Joseph Stiglitz said that finance is 'the brain of the economy'. The financial system allocates resources. The extent to which a given amount of investment translates into GDP growth depends on the financial system. A good quality financial system processes information, makes forecasts, and allocates capital to the right projects. A bad financial system misallocates capital, which yields reduced growth. A strong academic literature has demonstrated that countries with a better financial system obtain better economic growth.

7. A better financial system can improve the lives of people. Across an array of life events, financial products and services help households deal with time and uncertainty. Finance helps in transferring resources from the working years into old age, and cushions people facing events such as illness or unemployment.

8. Many apparently simple situations that we see around us in India today, pose difficult problems in financing. As an example, consider infrastructure financing. It is well understood that India requires over 50% of GDP or over Rs.55 trillion by way of investment in infrastructure. A capable

financial system would be able to give funding to a developer, and ask for repayments spread out over many decades. This would reduce the required revenue in each year, and thus result in reduced user charges. Reduced user charges would, in turn, yield larger traffic, thus making more projects viable.

9. Most infrastructure projects earn revenues in rupees, hence the best financing structures are those where repayments are to be made in rupees. While multi-decade financing in local currency is available in mature market economies worldwide, in India today it is not feasible. Repayment over short time periods drives up user charges. Many infrastructure projects have borrowed in foreign currency: there is a mismatch between rupee revenues and foreign currency repayment obligations. This has generated acute difficulties for infrastructure developers.

10. Similarly, consider a farmer who grows oilseeds without irrigation. He is subject to an array of risks such as monsoon failure and oilseed price fluctuations. A capable financial system would give the farmer the ability to manage this uncertainty.

11. Another example where a capable financial system can help is that of a small handicraft maker in Agra who has a workshop which employs 35 persons. This would generally be considered a small firm. However, this firm engages in imports and exports with exposures to 16 currencies. A sophisticated multi-currency hedging program is required for this firm.

12. India is now an economy with a GDP of Rs.110 trillion, with increasing financial integration with the world economy. Gross flows on the current and the capital accounts have exceeded 100% of GDP in each of the last six years. This depth of international integration makes new demands on the financial system. The analysis of international financial crises has shown that countries with a more capable financial system are better able to absorb international financing shocks. In the international experience, we have seen several developing countries embarking on efforts like FSLRC – of fully rewriting financial law – when they approach the status of middle income economies with substantial international integration.

13. With a high savings rate, vast pools of capital are now being processed by the financial system each year. Household survey evidence shows that 85 per cent of households in India now have savings. A more capable financial system would utilise these resources better: this would simultaneously give households a better deal, and generate higher GDP growth.

14. In the medium term, Indian GDP growth is likely to average between 6 to 8 per cent. At 6 per cent growth, GDP doubles every 11.5 years. At

8 per cent growth, GDP doubles every 8.3 years. As a consequence, three doublings are likely to take place in 25 to 35 years. This will give an eight-fold increase in the Indian GDP in real terms. After this eight-fold increase, the Indian GDP will be bigger than that of the United States in 2011. This shapes our thinking about the kind of financial system that we envision.

15. These arguments suggest a substantial gap between the financial system as it exists in India today, and the nature of the financial system that is required to enable and support India's growth in the coming 25 to 30 years.

16. At the level of economic policy, in India, the expert committee process of the last five years has done enormous work on diagnosing the problems of the financial system and proposing roadmaps for reform. Key elements of this include groups chaired by R. H. Patil (focusing on the corporate bond market, 2005), Percy Mistry (focusing on international finance, 2007), Raghuram Rajan (focusing on domestic finance, 2008), Jahangir Aziz (focusing on debt management, 2008), D. Swarup (focusing on consumer protection, 2009) and U. K. Sinha (focusing on capital controls, 2010). These reports help us understand the economic and financial policy transformation that is required. Hundreds of experts have contributed to these committee processes, and the reports have been extensively discussed in the public domain. These reports have set the policy framework within which reform of financial law can commence.

17. After the global financial crisis of 2007/2008, a new literature has emerged asking whether some countries have a financial system that is too large. There is possibly a case for caution in financial development in such situations. However, the present state of the Indian financial system lies far below the thresholds that are tentatively identified where difficulties can arise. For a few decades, these considerations will not be a constraint in India.

3 Reforming laws in finance

18. The mandate of FSLRC lies in constructing a set of financial laws, so as to lay a strong legal foundation for the Indian financial system over the coming 25 to 30 years, that will enable and support the emergence of a capable financial system that will meet India's needs. This requires addressing the live issues faced today, where India has a Rs.110 trillion GDP. It also requires envisaging the future of finance in India, and supporting and enabling

an eight-fold enlargement of Indian GDP.

19. We will face a fast pace of change in Indian finance in coming years. Laws need to be drafted with an orientation towards these changes. At the same time, laws must aspire to be like the Indian Contract Act of 1872, which expressed timeless principles, avoided getting into institutional or technological detail, and have thus survived the test of time.

20. The policy analysis by a number of expert committees has helped set the stage for drafting financial laws in FSLRC. At the same time, most of the tangible policy shortcomings analysed by these reports lie in subordinate legislation, and not in primary legislation (i.e. the laws enacted by Parliament). The prime focus in FSLRC is upon the legislative framework within which financial regulators work, and on creating the enabling framework within which regulators will write regulations.

21. The present landscape of financial law is less than satisfactory in certain respects. As an example, the preamble of the RBI Act, 1934, describes the law as a 'temporary' measure. Many laws from the 1950s and the 1960s have an emphasis on banning certain financial activity, rather than on establishing regulatory structures for it. The legal structure of SEBI marks the first time a full-blown independent financial regulator was constructed in India : with a rule-making process, a quasi-judicial function for issuing reasoned orders, and an appeals mechanism. As a consequence, there is a valuable body of experience that has built up over the last 20 years, about the functioning of SEBI and the appropriate drafting of law for an independent regulator.

22. In the areas of electoral law and criminal law, India has a tradition of emphasising the rule of law. However, many laws in the fields of economics and finance have many weaknesses on core issues of rule of law. A strong emphasis on the rule of law must shape all financial legislations.

23. The growth of the economy and the growing capabilities of the financial system have revealed gaps and overlaps, which have often shaped up as major problems for policy makers. A fresh look at the legal foundations would help create a consistent framework, covering the entire financial system, thus eliminating gaps and overlaps.

24. This analysis helps set the stage for the working of FSLRC, which was constituted to comprehensively re-examine Indian financial law.

4 Work process

25. FSLRC proposes to draft a report comprising of four components:

I Conceptual foundations in the fields of financial economics, law, and public administration;

II Chapters that fully explain the principles of and rationale for legislation;

III Draft bills;

IV Transition issues.

26. Part I will set up a conceptual framework which will consistently guide all the drafting work. Part II and Part III will be a tightly interconnected set of draft bills and the rationale for every element of them. Such an integrated approach will be useful in the public debate about the bills. In addition, when the bills are enacted into law, the accompanying chapters will communicate the legislative intent. Finally, Part IV will suggest a roadmap through which the proposals could be implemented.

27. The first question that FSLRC needed to address was that of establishing a work process that would deliver high quality outcomes on all four fronts. The natural institutional template for this is India's experience with Law Commissions, particularly in the early decades after independence. FSLRC has drawn on these experiences, and built on them.

28. Three elements were emphasised in the work process. FSLRC has followed a *consultative approach*, reaching out into knowledge and perspective across all elements of Indian finance. FSLRC has cultivated a *multi-disciplinary approach*, drawing on the fields of public economics, law, finance, macroeconomics and public administration. Finally, FSLRC has drawn on *the experiences of emerging markets and developed jurisdictions* in understanding how financial law and agencies have been constructed worldwide.

29. Specifically, the process adopted by FSLRC has involved six elements:

1. The Commission established a dedicated research team, with skills in public economics, finance, macroeconomics, public administration and law.
2. The Commission reached out to a diverse array of skills in India and abroad in various ways including conceptual guidance, technical inputs and peer review.

3. The Commission conducted formal consultation processes through which the views of practitioners and existing financial regulatory staff were solicited.

4. In order to ensure in-depth knowledge of the existing landscape of Indian finance and the agenda for reform, a group of sector reports were produced. In some cases, this was done by establishing Working Groups under FSLRC which were composed of experts and practitioners in those sectors.

5. An in-depth examination of a group of countries was undertaken, so that multiple alternative solutions for each question, that have been used internationally, are known to the Commission. This has helped bring a comparative law perspective into the work. On each question faced, the work of FSLRC has benefited from an awareness of the solutions adopted in multiple countries, and their strengths and weaknesses.

6. The release of this approach paper constitutes an important element of the consultative process. The Commission will take feedback about this document, and use it to strengthen the full report which will be released in March 2013.

5 Regulatory governance

30. The main work of FSLRC lies in eight areas in which government agencies will perform complex functions – consumer protection, micro-prudential regulation, resolution of failing financial firms, capital controls, systemic risk, development, monetary policy and debt management. For these functions to be appropriately performed, well structured government agencies are required.

31. A critical pillar of financial law is, thus, the construction of independent regulators and their functioning. Hence, we analyse the governance puzzles of establishing sound independent regulators, which involves the twin goals of independence and accountability.

5.1 Independence of the regulator and its problems

32. In recent decades, independent regulators have become an important part of the policy landscape, particularly with 20 years of development of law, jurisprudence and institutional capacity at SEBI. At the same time,

constructing sound independent regulators is a complex puzzle. Many elements of the existing indian arrangement need to be revisited, drawing on our experiences of the last two decades, and on global best practices.

33. Parliament *delegates powers to make regulations* to independent regulators. The regulator then combines the three functions of writing law, enforcing it, and the quasi-judicial function of adjudicating disputes. In the normal functioning of government, the three functions of rule-making, enforcement and adjudication are kept separate under the 'separation of powers' doctrine. Independent regulators are unique in being 'mini-states' with powers similar to the legislature, executive and judiciary all under a single entity.

34. The analysis conducted by FSLRC suggests a need for separating out the adjudication function from the mainstream activities of a regulator, so as to achieve a greater separation of powers. This is sought to be achieved by requiring that individuals who perform adjudication within a regulator should not, at that time, have any other functions. This would bring back a certain element of separation of powers.

35. Turning to the issue of independence, there are four arguments in favour of independence:

1. The regulator is able to setup a specialised workforce that has superior technical knowledge.
2. This is assisted by modified human resource and other processes, when compared with the functioning of mainstream government departments.
3. With such knowledge, and close observation of the industry, an independent regulator is able to move rapidly in modifying regulations, thus giving *malleability* to laws.
4. The presence of independent regulators improves legal certainty.

36. These arguments have much merit; laws for the financial sector need to enshrine regulatory independence. this involves enshrining 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.

37. 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.

38. A well structured independent regulator needs to 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 specifics about 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.

39. FSLRC will endeavour to find a judicious middle road which combines appropriate levels of independence achieved through concrete mechanisms in the law, coupled with an array of accountability mechanisms, through which sound outcomes will come about under indian conditions. This will yield substantial gains for the indian economy when compared with the present arrangements.

40. At the level of principles, four ideas will guide our work:

Harnessing our common law tradition The Commission believes there is value in harnessing India's common law tradition, where laws enacted by Parliament work at the level of high principles, and do not embed specific details. These relatively timeless principles are linked up to the continuously evolving world of technology, institutional arrangements and financial sector processes through two methods: continuous revision of subordinated legislation that is drafted by the regulator, and interpretation by the judiciary. Examples of this approach to drafting law include the the Indian Contract Act, 1872 and the Indian Evidence Act, 1872, which have stood the test of time.

In the field of finance, this is called the 'principles based' approach. Laws will articulate broad principles which do not vary with financial or technological innovation. Regulators will write subordinated legislation which could either utilise detailed prescriptive rules or be principles-based, depending on the situation and the judgment of the regulator. This combination of legislation

and subordinated legislation yields a body of law that evolves smoothly over time.

This approach also substantively improves the compliance culture. Under rules-based regulation, there is the risk that financial firms setup complex harmful structures that comply with the letter of the rules. The Commission would want laws to hold financial firms to a higher standard: that of complying with *the principles*.

Central to common law is the role of judges. When laws are written in terms of principles, there would be legitimate disagreements about the interpretation of principles. These are resolved by judges who build up the jurisprudence that clarifies what a principle means in the light of the continuous evolution of technology and finance. The workload of complex cases will go up, when we move towards a common law approach. FSLRC envisages building on India's success with the Securities Appellate Tribunal (SAT). SAT is proposed to be subsumed in a Financial Sector Appellate Tribunal (FSAT) which will serve the entire financial system. Rulings at FSAT, and at the Supreme Court, would build a living body of jurisprudence alongside the laws.

Mechanisms for independence and accountability While the notion of independence is considered a good thing in India, an array of *mechanisms* through which independence is actually operationalised, and accountability achieved, have not been put into place. FSLRC will draw on global best practices, and practical Indian experiences of the last 20 years, in order to lay down the precise legal foundations for regulatory independence. Alongside this, an array of accountability mechanisms will be put in, so that the independent regulator will be held accountable for pursuing and achieving specific objectives.

Precise statements of objectives and powers Independent regulators will have precise objectives, and a specific toolkit of powers through which those objectives are to be pursued. Objectives like 'serving the public interest', and unlimited powers with legal text such as "any other actions", will not be written into law.

Greater care in drafting law The last key element lies in the drafting of law. For the envisaged structure – independence, specific objectives, specific powers and accountability mechanisms – to work correctly, extreme care is required on precision and simplicity of drafting. FSLRC will aspire to obtain significant improvements on the quality of legal texts in its draft bills.

5.2 Accountability of regulators

41. As argued above, regulatory independence is desirable so as to support the functioning of the regulator as an expert body, and to ensure that rule-making and enforcement of rules does not fluctuate with changes in political executives. But independence is not an unmixed blessing: when unelected officials are given power, this needs to be accompanied by accountability mechanisms. FSLRC will pursue all four pathways to accountability:

1. Avoid conflicting objectives
2. A well structured rule-making process;
3. The rule of law;
4. Reporting.

5.2.1 Pathways to accountability #1: Avoid conflicting objectives

42. When a government agency has multiple objectives, it is easier for the agency to explain away failure. This problem is heightened when there are conflicts of interest. 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 emphasised. It is, hence, desirable to structure regulatory bodies with clarity of purpose and the absence of conflicting objectives. This perspective has shaped the thinking of FSLRC on the financial regulatory architecture.

5.2.2 Pathways to accountability #2: A well-structured rule-making process

43. The independent regulator is a unique institution in that Parliament delegates *rule-making power* to unelected officials. Public choice theory teaches us that regulators may sometimes draft regulations that are convenient for the regulator rather than the larger national interest. A well structured rule-making process will introduce checks and balances that will avoid suboptimal outcomes.

44. All regulation imposes costs upon society. The regulator should be obliged to analyse the costs and benefits of a proposed regulation. The costs should be compared against the market failures that motivate the regulation. In other words, for every regulation that is proposed, there should be:

1. A compact 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" in Economics parlance);
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.

45. Documentation covering the above elements should be released by a regulator every time a draft regulation is produced. This will help ensure that adequate analysis has preceded rule-making, and show the full regulatory intent to citizens and judges.

46. A consultative process should now commence, where the regulator unveils the analytical documentation coupled with draft regulations into the public domain. Market participants should be given sufficient time to understand a draft regulation, and to comment on it. The regulator should substantively respond to all public comments. After that, modified guidelines should be released in public, with an adequately forward starting date when it becomes effective.

47. One key element of the rule-making process is appeal. When an independent regulator comes into being through a well drafted law, this law contains 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 should be possible to strike down the regulation through appeal. Similarly, violations of the requirements for the rule-making process as prescribed in the law should be grounds for striking down regulations. Improved mechanisms of appeal need to be developed, through which challenge of regulations becomes convenient and commonplace.

48. These is broad awareness and agreement among regulators in India today, that such a rule-making process is desirable. Drawing on global best practices, the Commission believes that when Parliament delegates the drafting of law to an independent regulator, the detailed rule-making process should be specified in the law.

5.2.3 Pathways to accountability #3: The rule of law

49. A crucial element of accountability and independence of regulators is three core principles of the rule of law:

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 the information for application of the law, the reasoning by which the conclusion was arrived at, and a mechanism for appeal.

50. 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. While informal guidance and moral suasion form part of any regulatory toolkit, the Commission recognises the need to use such methods only in the rarest of situations. The Commission believes that a formal and transparent system of regulation, rooted in the rule of law, encourages entry of new financial service providers and thereby reduces costs and financial exclusion.

5.2.4 Pathways to accountability #4: Reporting

51. 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 should report on how it has fared on pursuing its desired outcomes, and at what cost.

52. A full management information system about the activities of each agency should be placed into the public domain. As an example, for a supervisory process, the agency should be obliged to release data about investigations conducted, orders issued, orders appealed at FSAT, orders that got struck down, a post-facto analysis about the orders that got struck down, etc. Similarly, if an agency clears the offer document for securities issuance,

it should be obliged to release data about the speed at which offer documents are cleared.

6 The tasks of financial law

53. We now discuss the main components of the legal framework for finance, as envisaged by FSLRC. Each of these components is guided by a clear understanding of market failures. Regulation is not an end in itself; it exists in order to address market failures. Laws must be defined in terms of their economic purpose, rather than in terms of the powers conferred upon regulatory agencies or the entities who are affected by the law. This clarity on *objectives* is essential for obtaining accountability. If an agency is given the objective of 'regulation', then accountability is lost because the agency will always be able to demonstrate that it has, indeed, done regulation.

6.1 Consumer protection

54. The first objective of financial regulation is consumer protection. The existing strategy on consumer protection in Indian finance is primarily focused on 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.

55. After extensive analysis and debate on these questions, the Commission has come to the view that in the field of finance, such approaches are not good enough; a higher standard is required. Consumers of financial services are often more vulnerable than consumers of ordinary goods and require a special effort by the State. The present body of financial law is not animated by consumer protection. The Commission believes this is a major gap in Indian financial law and regulation, which needs to be addressed.

56. State apparatus should work on two fronts in this field: prevention and cure. The *prevention* problem requires rule-making and enforcement across the entire financial system from the viewpoint of protecting consumers.

57. 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 conflicts of interest? How do we evolve a structure where the provider acts in

the best interest of the consumer? Regulators should be obliged to grapple with questions such as these.

58. FSLRC proposes a unified consumer protection law which would contain three components: an enumerated set of rights and protections for consumers, an enumerated set of powers, and principles that guide what power should be used under what circumstances. The details of consumer protection would, of course, lie in the subordinated legislation that financial regulators would draft. As an example, whether or not loads and other conflicted remuneration structures should be banned is a question that would be addressed by the regulator. The proposed law will clearly pose this question to the regulator. The regulators would then utilise the powers provided to pursue the goals specified in the law, through subordinated legislation which would evolve over the years reflecting financial innovation, technological change, and the changing nature of the Indian economy. Alongside this rule-making mandate, there would be a supervisory function to ensure compliance with these rules.

59. Some of the rights and protections FSLRC proposes for consumers are: protection against unfair terms of contract, protection against misleading and deceptive conduct, right to receive the support to enter into suitable contract, right to receive reasonable quality of service, and right to data privacy and security. Regulators would pursue the objective of maintaining these rights and protections of consumers. The regulators will be empowered to impose a range of requirements for financial service providers, starting from disclosures, to suitability and advice requirements, to regulation of incentive structures, and going on to fairly intrusive powers such as recommending modifications in design of services and products. 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.

60. In India, so far, the financial regulatory structure has been defined by sector, with multiple laws and often multiple agencies covering various sectors. This has led to inconsistent treatment, and regulatory arbitrage. Regulators of a sector have sometimes adopted the perspective of the industry, and opted for lax regulation as a path to growth of the industry. These problems would be reduced by having a single principles-based law which would cover the entire financial system. It is, then, likely that consumers would be treated fairly with consistent treatment across all aspects of their engagement of the financial system.

61. Turning from prevention to cure, FSLRC will propose the creation of 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 centralised light-weight 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 regulators.

62. The problems being seen at FRA should shed light on where the problems of consumer protection are to be found, and thus suggest areas for improvement in subordinated legislation. Hence, a key feature of FRA that FSLRC will recommend is a feedback loop through which a computerised case database from FRA will be analysed, and feed back into improved rule-making and systemic improvement.

63. India needs a capable financial system, with sophisticated private financial firms. However, the emergence of this financial system should not become a *carte blanche* for clever financial firms who achieve undue influence with their regulators, to take unfair advantage of customers. The present financial laws in India are vulnerable to such a prospect. It is, hence, essential to place the function of consumer protection at the heart of financial regulation.

6.2 Micro-prudential regulation

64. We now turn to micro-prudential regulation, which is the efforts by financial regulators to reduce the probability that a financial firm collapses. The motivation for micro-prudential regulation is rooted in consumer protection. When a consumer deals with (say) an insurance company, there should be a very high probability that the insurance company will be solvent and 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.

65. Firms are generally keen to avoid bankruptcy on their own. They cannot, however, be left to their own devices for two reasons. First, the managers of a firm may not work in the best interests of shareholders: managers may stand to make huge profits if the firm does well and walk away if a firm collapses. Particularly, when managers have high-powered incentives such as share ownership, stock options, or profit-linked bonuses, they

are likely to engage in excessive risk-taking. Micro-prudential regulation is, then, required to constrain the behaviour of financial firms.

66. In addition, governments often rescue failing financial firms. This generates 'moral hazard'. A firm may like to take very high risk, knowing that it keeps the profits if things go well, but the taxpayer will bear the burden of losses if these should arise. While FSLRC will propose a substantial work program in avoiding taxpayer-funded rescues of financial firms, it recognises that many financial firms in India today assume that such support from the government will be forthcoming. To the extent that this moral hazard induces excessive risk taking, there is a case for micro-prudential regulation which forces reduced risk taking.

67. The extent of intrusive micro-prudential regulation depends on the nature of the financial promise. Three factors are of consequence here: how difficult it is to honour 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, 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 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.

68. As with the field of consumer protection, the law that FSLRC will propose will have enumerated objectives, enumerated powers and principles that guide the use of the power. The main objective would be to reduce the probability of failure of financial firms, but this will be balanced with a principle that requires the regulator to consider the consequences for efficiency. The regulators will have the powers to impose requirements around capital adequacy, corporate governance standards, liquidity norms, investment norms, and other instruments. The principle of proportionality will apply: regulatory interventions should be related to the risks faced.

69. A single micro-prudential law will govern the entire financial system, thus ensuring uniform treatment of all aspects of the financial system, and largely eliminating areas of regulatory arbitrage. Multiple regulators may enforce the law for various components of the financial system.

70. In the field of consumer protection in finance, the draft bill proposed by FSLRC will break new ground compared with existing Indian financial law. In contrast, the work on micro-prudential regulation covers relatively familiar

ground. At the same time, there is a role for a unified micro-prudential law which has clarity of objectives and powers, and applies uniformly across the entire financial system.

6.3 Resolution

71. The Indian financial system has traditionally been dominated by public sector firms (PSUs). When consumers deal with a PSU bank, for all practical purposes, they are dealing with the Government, and there is no perceived possibility of failure. Over the last 20 years, however, India has increasingly opened up entry into finance, and a new breed of private financial firms has arisen. These firms can fail, and when this happens, it can be highly disruptive for households who were customers of the failing firm, and for the economy as a whole.

72. 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 labour and capital that would then be utilised by better firms. However, it is important to ensure smooth functioning of the economy, and avoid disruptive firm failure.

73. This requires a specialised 'resolution mechanism'. A 'Resolution Corporation' would watch all financial firms which have made intense promises to households, and intervene when the net worth of the firm is near zero (but not yet negative). It would force the closure or sale of the financial firm, and protect small consumers either by transferring them to a solvent firm or by paying them. In the case of banks, the deposit insurance program (where all households are guaranteed up to Rs.100,000 of their bank deposits) would be operated by the resolution corporation.

74. At present, in India, we have a deposit insurance corporation. However, it is not a resolution corporation; it only pays depositors and is otherwise unable to play a role in the late days of a financial firm. This is a serious gap in the Indian financial system. For all practical purposes, at present, an unceremonious failure by a large private financial firm is not politically feasible. Lacking a formal resolution corporation, in India, the problems of failing private financial firms are placed upon customers, taxpayers, and the shareholders of public sector financial firms. This is an unfair arrangement.

75. Establishing a sophisticated resolution corporation is thus essential. Drawing on the best international practice, the FSLRC proposal will involve

a unified resolution corporation that will deal with an array of financial firms such as banks and insurance companies; it will not just be a bank deposit insurance corporation. It will concern itself with all financial firms which make highly intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and payment systems. It will also take responsibility for the graceful resolution of systemically important financial firms, even if they have no direct links to consumers.

76. A key feature of the resolution corporation will be *speed of action*. It must stop a financial firm while the firm is not yet bankrupt. The international experience has shown that delays in resolution almost always lead to a situation where the net worth is negative, which would generally impose costs upon the taxpayer. The choice that we face is between a swift resolution corporation, which will stop financial firms when they are weak but solvent, and a slow resolution corporation which will make claims upon the taxpayer. Hence, a sophisticated legal apparatus is being designed, 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, mergers, etc.

77. It is important to make a clear distinction between micro-prudential regulation and resolution. Micro-prudential regulation and supervision is a continuous affair. Occasionally, when a firm approaches failure, resolution would come into action, and it would behave very differently from micro-prudential regulation. The resolution corporation would be analogous to a specialised disaster management agency, which is not involved in everyday matters of governance, but assumes primacy in a special situation. The resolution corporation will have close coordination with micro-prudential regulation. For strong firms, the resolution corporation will lie in the background. As the firm approaches default, the resolution corporation will assume primacy.

78. The first three pillars of the work of FSLRC – consumer protection, micro-prudential regulation and resolution – are tightly interconnected. All three are motivated by the goal of consumer protection. Micro-prudential regulation aims to reduce, but not eliminate, the probability of the failure of financial firms. Resolution comes into the picture when, despite these efforts, financial firms do fail.

6.4 Capital controls

79. The next component of the work of FSLRC lies in capital controls, i.e. the regulation of cross-border financial flows. The grand question of this field is the appropriate sequencing and pace of India's capital account liberalisation. All prosperous countries have negligible capital controls, and India's peers among developing countries have greater capital account openness than India. As Indian policy makers have repeatedly stated, in the long run, India will move towards capital account openness. The Commission will leave the timing and sequencing of capital account liberalisation entirely to policy makers. However, the drafting of law has to envisage the kinds of regulatory instruments used in this field today and in the future. From this perspective, three key questions can be identified.

80. The first question concerns the economic purpose of capital controls. One possible approach in justifying capital controls lies in the argument that conditions in the global economy are sometimes turbulent. Capital controls could then be useful as a tool for shielding India from those problems. This economic purpose for capital controls suggests the use of *temporary* capital controls, which are brought in during certain periods. The roadmap to full capital account convertibility may, then, involve shifting away from a debate between permanent controls versus permanent decontrol, to a middle road, with *temporary* controls. This would require corresponding thinking about the legal and regulatory structures with clear objectives and accountability.

81. The second question concerns the nature of controls. Capital controls can either be structured as detailed microeconomic interventions (e.g. specialised rules about margin payment by foreign investors trading on exchanges) or they can be structured as macroeconomic instruments (e.g. an unremunerated reserve requirement, that discourages short-term flows). Both these alternatives have strengths and weaknesses.

82. The third issue is about the agency structure. Where should the law, that is enacted by Parliament, place the functions of rule-making and supervision for capital controls? At present, capital controls in the field of FDI (e.g. liberalisation of FDI in multi-brand retail) are determined by the government. In addition, there are tight connections between the liberalisation of outward flows and a fiscal question: the extent of domestic financial repression (the forced lending by households through banks to the government). Further, capital account restrictions are analogous to protectionism in the financial sector. As with liberalisation of trade, capital account decontrol involves analysing the political ramifications of gainers and losers from

liberalisation. This raises questions about whether the rule-making function (i.e. the drafting of subordinated legislation under the capital controls law) should be placed with the Ministry of Finance or the RBI. Similarly, supervisory functions (i.e. the enforcement of the subordinated legislation) could potentially be placed at RBI or at the Financial Intelligence Unit (FIU), which watches India's cross-border flows from the viewpoint of restraining the financing of terrorism. Each of these alternatives has strengths and weaknesses.

83. The Commission will debate these questions, which define the basic character of capital controls law. The Commission will take a view on them, and draft laws analogous to the approach adopted in other laws: emphasising enumerated objectives, enumerated powers, a sophisticated rule-making process, and the rule of law.

6.5 Systemic risk

84. The problem of systemic risk requires a bird's eye perspective of the financial system. The first function in this field is that of reducing the probability of a breakdown of the financial system. This requires understanding the financial system as a whole, as opposed to individual sectors or firms, and undertaking actions which reduce the possibility of a collapse of the financial system. Each financial regulator tends to focus on regulating and supervising some components of the financial system. With sectoral regulation, financial regulators sometimes share the worldview of their regulated entities. What is of essence in the field of systemic risk is avoiding the worldview of any one sector, and understanding the overall financial system.

85. This process starts with gathering information at the level of the overall financial system and analysing it, from the viewpoint of identifying areas of concern. This leads to a process of inter-agency coordination, through which these concerns can lead to concerted actions between multiple agencies. This requires coordination of decision making and actions across regulatory agencies.

86. Systemically important financial institutions (SIFIs), which are often conglomerates operating across multiple elements of the financial system, pose special problems for micro-prudential regulation and resolution. An integrated statistical picture of the entire financial system would be used to identify SIFIs, and help coordinate joint work between multiple regulatory agencies in their micro-prudential regulation.

87. Despite the best efforts at averting systemic risk, systemic crises can arise. The laws need to envisage mechanisms for crisis management, which is a complex blend of resolution, emergency rule-making, temporary liquidity support, and the potential use of taxpayer resources to protect financial firms.

88. Inter-agency coordination is particularly important in a crisis. Decisions that impact on multiple sectors need to be swiftly taken, and correctly enforced by multiple different agencies. Crisis management might involve utilising taxpayer resources, which can only be authorised by the government. Decisions may also be required about drawing on emergency lines of credit from the central bank, in its capacity as the lender of last resort. This analysis needs to be taken in a coordinated fashion between all financial agencies, drawing on a accurate picture of the full financial system.

89. These broad ideas, in turn, induce questions about public administration and law. The drafting of the law requires specific objectives, specific powers and accountability mechanisms which will yield sound outcomes on these problems.

90. In some countries, in the aftermath of the crisis, systemic risk regulation is evolving into new financial regulatory instruments which are applied across the entire financial system in an attempt at reducing the possibility of a financial crisis. While these innovations merit analysis, there is limited experience with these new ideas, particularly in emerging economies. Two paths are, then, available: to draft laws embedding specific provisions based on existing knowledge, or to recommend that government appoint an expert committee after five years to recommend amendments to the law based on the state of knowledge then prevalent.

91. The role of the central bank in this field is also an important area of debate. On one hand, a central bank can potentially play a lead role in this field, given the economy-perspective that is cultivated in doing monetary policy. However, when a central bank performs a regulatory and supervisory function in one sector (e.g. banking) this raises concerns about the extent of system thinking, and of a neutral treatment of all sub-components of the financial system. In addition, the coordination function, and the stewardship of quasi-fiscal functions are potentially performed better by the government.

92. The Commission will debate these questions, and will take a view on them, and make recommendations accordingly.

6.6 Development

93. A uniquely important policy problem in India is that of financial inclusion. This forms the rationale for the development agenda in finance. The agenda relates to (i) the development of missing markets, such as the bond market, and achieving scale and outreach with nascent markets; (ii) redistribution and quasi-fiscal operations where certain sectors, income or occupational categories are the beneficiaries.

94. The first, or the development of missing markets, requires information gathering and analysis on the scale of the full financial system, rather than within one sector at a time. Inter-regulatory coordination is required.

95. Once certain products come to exist, the question that arises is that of achieving scale and outreach. If this task is placed upon conventional financial regulatory agencies, there are concerns that it would result in a loss of accountability associated with conflicting objectives. 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. There is thus a certain tension between the development objective and the core functions of financial regulation, i.e. consumer protection, micro-prudential regulation and resolution. Conversely, an agency can explain away failures in consumer protection or micro-prudential regulation on the grounds that development objectives were being pursued.

96. The fundamentals of public administration suggest that quasi-fiscal functions should only be performed by the fiscal authority. This could be achieved by placing rule-making functions related to development (e.g. regulations for priority sector lending) closer to the fiscal authority, while asking regulatory agencies to verify compliance (i.e. to perform the supervisory function).

97. The open question in the field concerns the institutional mechanism through which this could be achieved. These functions could be placed at regulatory agencies or elsewhere. The Commission will debate these questions and make recommendations emphasising enumerated objectives, enumerated powers, a sophisticated rule-making process, and the rule of law.

6.7 Monetary policy

98. Monetary policy is the function of creating 'fiat money', i.e. money that derives its value because the State asserts that it is legal tender. It

involves (a) creating the Indian rupee, (b) setting the short term interest rate, and (c) operating a 'lender of last resort' facility whereby liquidity is temporarily extended to solvent but illiquid financial firms.

99. Monetary policy independence is required, in order to avoid election-related cycles in monetary policy. Alongside this independence, an accountability mechanism needs to be setup. The mainstream strategy that is used worldwide is that of tasking the monetary authority with achieving price stability.

100. The Commission will review the laws related to monetary policy and draft a monetary policy law emphasising the issues of independence, enumerated objectives, enumerated powers, and accountability mechanisms.

6.8 Debt management

101. The management of public debt requires a specialised 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 favour of low interest rates which could interfere with the goal of price stability.

102. 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. FSLRC proposes to integrate these functions into the new debt management law.

6.9 Foundations of contracts and property

103. 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. Statutes as well

as case laws have shaped the rules regarding creation of financial contracts, transfer of rights, title or interest in such contracts and enforcement of such rights. These developments have largely been sector specific.

104. The FSLRC has looked into the necessity of keeping these sector specific rules and will retain them only under special circumstances. Where the law can be made sector neutral or the law has been unable to keep pace with financial innovation, the FSLRC will propose new formulations of law.

105. For instance, financial transactions have to be defined in a functional manner to ensure that financial innovations do not exceed regulatory jurisdiction. Rules regarding enforceability of derivative contracts have to be laid down. Clarity in rules of enforcement of contracts involving the market infrastructure institutions such as, exchanges, clearing corporations and depositories, is indispensable for organised financial trading. The priority of clearing houses in the bankruptcy process needs to be examined. Developing the over-the-counter market also comes with its own set of contractual issues. The FSLRC has also looked into issues of market integrity which may have implications on creation and transfer of contracts in the financial sector.

6.10 Shifting away from a sectoral perspective

106. This document expresses the approach that FSLRC will take in drafting financial law. The discussion above has focused on 9 areas of work:

- Consumer protection
- Micro-prudential regulation
- Resolution
- Capital controls
- Systemic risk
- Development
- Monetary policy
- Debt management
- Foundations of contracts and property.

107. FSLRC will work on drafting law in each of these areas. In addition, a body of law will be developed to address the legal process associated with regulators, addressing the problems of independence and accountability.

108. This checklist is intended to show nine areas of work in drafting law. This is not to suggest that there will be nine bills. This work will be expressed into a group of logically coherent bills. In addition, many smaller bills may be required.

109. This strategy differs from present Indian law, which is sectoral in nature. The present laws are organised around sub-sectors of finance, such as securities or insurance or payments. The Commission debated this at length, and concluded that there was merit in shifting to a non-sectoral approach. Laws must be animated by an economic purpose and the market failures that they seek to address. Once this is done, the ideas apply consistently across all sectors of finance. As an example, a well drafted micro-prudential law would apply to all components of finance. A well drafted legal process law would apply to all financial regulators.

110. Shifting away from sectoral laws yields consistent treatment across sectors. It is increasingly clear that the lines that separate banking or insurance or mutual funds or pension fund management are hard to define. Under this situation, if sectoral laws are applied, regulatory arbitrage becomes feasible where the same activity is portrayed as belonging in the sector where the law is conducive to a higher profit rate. Non-sectoral laws that apply uniformly across the financial system eliminate such inconsistencies of treatment. They also eliminate the problems of gaps and overlaps.

111. While the primary legislation that FSLRC proposes will be non-sectoral in nature, it is likely that regulators will draft sector-specific subordinated legislation. For example, the principles of consumer protection, embedded in the consumer protection law that FSLRC will propose, will be translated by multiple regulatory bodies into detailed regulations that shape how consumers of banking or insurance are treated. The subordinated rules and regulations will, however, have to be consistent with the broad principles laid down in the primary law.

112. As an example, the present term 'NBFC' in India includes a wide array of activities. Rational and consistent treatment of a broad class of firms requires a clear conceptual framework. The approach taken by the Commission emphasises that the approach to regulation should flow from the economic and legal concern that the law seeks to address. It is useful to focus on the regulatory concerns associated with three main activities of NBFCs: deposit taking, raising capital through securities issuance, and lending to consumers.

113. Under the proposed framework of FSLRC, all these activities would be

analysed through the objectives and powers of the proposed laws on micro-prudential regulation, consumer protection and resolution. As an example, when a NBFC gives a loan to a consumer, the regulatory focus would be on consumer protection. On the other hand, if an NBFC does not take deposits, the nature of promises made to consumers changes, and the micro-prudential regulatory strategy would be correspondingly different.

114. In this fashion, the conceptual clarity of the purposes of regulation would help regulators understand the diverse array of financial firms and activities, and apply the suitable regulatory instruments to each situation.

6.11 Ownership neutrality and competition

115. The Indian financial system will have an array of firms: cooperatives, private Indian firms, foreign firms, public sector firms, etc. The Commission will envisage a regulatory framework where governance standards for regulated entities will not depend on the form of organisation of the financial firm. This will yield 'ownership neutrality'. In this framework, the regulatory treatment of public or private financial companies will identical.

116. FSLRC recognises that the future of public sector financial firms is an important policy question which will shape the contours of Indian finance. In coming decades, public sector financial firms are likely to be with us. FSLRC will focus on three elements in the treatment of these firms:

1. Public sector financial firms require effective regulation and supervision. If there are problems with these firms, they impose costs upon the exchequer. Improvements in regulation and supervision will reduce the potential problems faced with public sector ownership.

2. At the same time, the Commission will emphasise principles of equal treatment and a pro-competitive environment.

3. India has embarked upon entry of the private sector into most elements of finance. The supervisory problem with private firms is much more demanding when compared with that seen with public sector firms. This evolution of the Indian financial system requires commensurate strengthening of regulation and supervision.

117. All over the world, there are complex interconnections between competition authorities and financial regulation. The Commission will re-evaluate the mechanisms embedded in the present competition law and recommend certain areas of reform.

7 Financial regulatory architecture

118. We now turn to the financial regulatory architecture, or the division of the overall work of financial regulation across a set of regulatory agencies. The thinking of the Commission in this area comprises two elements.

7.1 The analysis of financial regulatory architecture

119. Many alternative structures can be envisioned for the financial regulatory architecture:

Single regulator All financial regulation can be placed with one agency. In this case, this one agency will enforce micro-prudential and consumer protection law, for all financial activities.

Twin peaks model Some countries have constructed two regulators: one doing micro-prudential regulation and another doing consumer protection.

More complex structures The United States has a highly fragmented regulatory model. As an example, the CFTC regulates derivatives trading while the SEC regulates the spot market. The US also has state level regulators in some fields.

120. Parliament must evaluate alternative block diagrams through which a suitable group of statutory agencies is handed out the work associated with the laws. These decisions could conceivably change over the years.

121. At present, Indian law features tight connections between a particular agency (e.g. SEBI) and the functions that it performs (e.g. securities regulation). The laws that FSLRC would draft will not have such integration. There is a role for a *Financial Regulatory Architecture Act* which sets out the work allocation across different agencies. Changes in the work allocation should not require changes to the underlying laws themselves.

122. The choice of the work allocation is guided by a group of considerations:

1. Accountability is best achieved when an agency has a clear purpose.
2. In particular, direct conflicts of interest are harmful for accountability.
3. 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. Financial regulatory

architecture should be conducive to greater economies of scale and scope in the financial system.

4. When a financial regulator works on a *sector*, there is a possibility of an alignment coming about between the goals of the sector (growth and profitability) and the goals of the regulator. The regulator then tends to advocate policy directions which are conducive for the growth of its sector. Such problems are less likely to arise when a regulatory agency works towards an *economic purpose* such as consumer protection across all or atleast many sectors.

5. 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 correlated skills into a single agency.

7.2 A proposal for the financial regulatory architecture

123. While many different alternatives for the financial regulatory architecture can and should be considered, the Commission will propose the following structure, featuring seven agencies:

1. A central bank, that does monetary policy, and enforces the consumer protection law and micro-prudential law in the fields of banking and payments;

2. A unified financial regulatory agency, which enforces the consumer protection law and micro-prudential law in all finance other than banking and payments;

3. A resolution agency which implements the proposed law on resolution of financial firms;

4. The Financial Sector Appellate Tribunal (FSAT), which hears appeals against all financial regulatory agencies;

5. The Financial Redressal Agency (FRA), which addresses consumer complaints across the entire financial system;

6. The Financial Stability and Development Council (FSDC).

7. An independent debt management office.

124. Table 1 summarises the changes in the financial regulatory architecture that will be proposed. These changes will alter the Indian financial landscape from eight financial regulatory agencies to seven.

Table 1 Present and proposed financial regulatory architecture

Present	Proposed
(1) RBI	(1) RBI
(2) SEBI (3) FMC (4) IRDA (5) PFRDA	(2) Unified Financial Agency (UFA)
(6) SAT	(3) FSAT
(7) DICGC	(4) Resolution corporation
	(5) Financial Redressal Agency (FRA) (6) Debt management office
(8) FSDC	(7) FSDC

125. At a conceptual level, it is proposed that RBI will perform three functions: monetary policy, regulation and supervision of banking in enforcing the proposed consumer protection law and the proposed micro-prudential law, and regulation and supervision of payment systems in enforcing these two laws.

126. In order to minimise conflicts of interest across these three fields, and to develop specialised skills, the Commission will recommend that the three functions be performed by distinct boards which oversee the three areas of work of monetary policy, payments regulation and supervision, and banking regulation and supervision.

127. The unified financial regulatory agency, which would deal with all financial firms other than banking and payments, 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. This proposed unified financial regulatory agency would also take over the work on organised financial trading from RBI in the areas connected with the Bond-Currency-Derivatives Nexus, and from FMC for commodity futures, thus giving a unification of all organised financial trading including equities, government bonds, currencies, commodity futures, corporate bonds, etc. The unification of regulation and supervision of financial firms such as mutual funds, insurance companies, and a diverse array of firms which are not banks or payment providers, would yield consistent treatment in consumer protection and micro-prudential regulation across all of them.

128. The present SAT will be subsumed in FSAT, which will hear appeals

against RBI for its regulatory functions, the unified financial agency, decisions of the Financial Redressal Agency (FRA) and some elements of the work of the resolution corporation.

129. The present DICGC will be subsumed into the Resolution Corporation which will work across the financial system.

130. The Financial Redressal Agency (FRA) is a new agency which will have to be created in implementing this financial regulatory architecture. It will setup a nationwide machinery to become a one stop shop where consumers can carry complaints against all financial firms.

131. An independent debt management office is envisioned.

132. Finally, the existing FSDC will have modified functions in the fields of systemic risk and development.

133. The Commission believes that this proposed financial regulatory architecture is a small step away from present practice, embeds important improvements, and will serve India well in coming years. Over a horizon of five to ten years after the proposed laws come into effect, it would advocate a fresh look at these questions, with two possible solutions. One possibility is the construction of a single unified financial regulatory agency, which would combine all the activities of the proposed Unified Financial Agency and also the work on payments and banking. Another possibility is to shift to a two-agency structure, with one Consumer Protection Agency which enforces the proposed consumer protection law across the entire financial system and a second Prudential Regulation Agency which enforces the micro-prudential regulation law across the entire financial system. In either of these paths, RBI would then concentrate on monetary policy.

134. These changes in the financial regulatory architecture would be relatively conveniently achieved, given the strategy of emphasising separability between laws which define functions, and the agencies that would enforce the laws. Over the years, based on a practical assessment of what works and what does not work, the Government and Parliament can evolve the financial regulatory architecture so as to achieve the best possible enforcement of a stable set of laws.

8 Transition issues

135. Alongside the drafting of bills, the Commission will carefully anal-

yse the transition issues that will be faced in phasing in the new arrangements. How will changes to financial regulatory architecture be achieved? How would existing subordinated legislation be replaced by new subordinated legislation that complies with the new rule-making process required under the new laws? How would the Ministry of Finance have to reorganise itself to function effectively under the new laws?

136. The Commission would specifically consider the need for setting up a dedicated unit in the MoF to process the recommendations and initiate action for implementation of the Report. One of the first steps would be re-organize the regulatory set up in the manner suggested and then proceed to change the legislative structure over the next 12 to 24 months. Careful thought will be given to these transition issues, and a full workplan will be proposed.

9 Conclusion

137. Financial economic policy is implemented by front-line agencies who are assigned functions by Parliament. The main purpose of financial law is to put these agencies on a sound footing, with the trio of goals, powers and accountability mechanisms. FSLRC has focused itself upon this task.

138. Most policy debates in the field of finance pertain to the subordinated legislation that is drafted by financial regulatory agencies. The work of FSLRC does not directly engage with these debates. As an example, FSLRC does not have a view on the timing and sequencing of capital account liberalisation. The work of FSLRC is focused on the incentives in public administration that shape the drafting and implementation of subordinated legislation. As a consequence, while the Commission has fully taken cognisance of the policy problems analysed by the expert committees of the last five years, it will not directly address them.

139. When the proposals of FSLRC are enacted by Parliament, they will set in motion a modified set of incentives in public administration. Clear objectives in law, and a sound rule-making process, will improve the quality of subordinated legislation that is issued by regulatory agencies. The emphasis on legal process in the laws drafted by FSLRC will induce improved working of the supervisory process. A common consumer protection law will greatly benefit the users of financial services. These elements will yield a gradual process of change.

140. The Commission is mindful that over the coming 25 to 30 years, Indian GDP is likely to become eight times larger than the present level, and is likely to be bigger than the United States GDP as of today. Over these coming years, there will be substantial changes in the financial system. The technological change, and the financial products and processes which will come into play, cannot be envisaged today.

141. The aspiration of the Commission is to draft a body of law that will stand the test of time. The Commission has hence focused on establishing sound financial regulatory agencies, which will continually reinterpret principles-based laws in the light of contemporary change, and draft subordinated legislation that serves the needs of the Indian economy. This subordinated legislation, coupled with the jurisprudence built up at the FSAT and the Supreme Court, will continually reflect the changing needs of the Indian economy.