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Abstract

India's financial landscape has changed dramatically over the last decade. While India's financial needs are growing, the current regulatory arrangements inhibit growth. This paper discusses the limitations of the present financial regulatory system. The evolving discourse on financial regulatory reforms recognises that the motivation for state intervention in finance must be guided by an understanding of the sources of market failure. This paper summarises the sources of market failure and identifies areas of state intervention in finance. Drawing on this approach, the Government backed Financial Sector Legislative Reforms Commission (FSLRC) prepared a single unified law- the Indian Financial Code (IFC) that seeks to modernise the Indian financial system by transforming the laws, the regulatory architecture and the working of the regulators. This paper discusses the components of the draft Indian Financial Code and describes the state of progress in implementing the IFC framework.

Contents

1 Introduction

A free and competitive market produces an efficient allocation of resources. The case for regulation is founded in market failure i.e. when markets are not able to yield an efficient allocation of resources. The elements of financial regulatory framework must be guided by a clear understanding of market failures.

In India, some elements of financial sector reform were introduced as part of the liberalisation policy tool-kit of nineties. These reforms, though significant were not enough to reform the financial system. From 2005-2011, the process of financial policy reform began with a committee-based process that mapped areas of financial sector reforms through expert committee reports. While these committee reports laid out a blueprint of financial policy reform, it was realised that their implementation would require overhauling of the present financial sector legislative landscape. This led up to the establishment of the Financial Sector Legislative Reforms Commission (FSLRC). The FSLRC gave a blue-print of a law called the Indian Financial Code (IFC) that seeks to transform India's financial laws and regulatory functions with the goal of addressing market failures in the field of finance.

The draft Indian Financial Code addresses nine areas that require state intervention and reform: consumer protection; micro-prudential regulation; resolution mechanisms; systemic risk regulation; capital controls; monetary policy; public debt management; development and redistribution; and contracts, trading, and market abuse. The full adoption of the draft Indian Financial Code will yield an efficient allocation of resources, boost growth and reduce risks.[1] This paper discusses these nine components of financial reform and presents a status update on the implementation of the IFC proposals.

The rest of the paper is structured as follows: Section 2 highlights some of the weaknesses in the current Indian financial system. Section 3 discusses the sources of market failures in finance that motivate the need for regulatory intervention. It also presents a discussion of the forms of financial regulation including new areas of financial regulation post the global financial crisis to address the market failures. Section 4 discusses the setting up of the FSLRC and the nine components of the draft IFC. Finally Section 5 presents the state of progress in implementing the elements of the IFC.

2 The problem

India embarked on a substantial liberalisation in the early nineties. In the field of finance, the major elements of reform were the easing of capital controls to give Indian firms access to foreign capital, gradual liberalisation of interest rates and reduced state pre-emption of bank credit.[2] Alongside these, attempts were made to develop the equity

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[1] Patnaik and Shah, 2014.

[2] Government directed banks to invest a mandated proportion of their deposits in Government securities. Referred to as the Statutory Liquidity Ratio (SLR), it was as high as 40% in the pre-liberalisation period

market because of the importance of equity as a mechanism for financing firms and the recognition of the then weaknesses of the equity market. This involved establishing a new regulator, the Securities and Exchanges Board of India, and new infrastructure institutions, the National Stock Exchange and the National Securities Depository.

While all these reforms were in the right direction, they were inadequate. Bigger challenges persist in the Indian financial sector. An efficient financial system is one which is able to allocate savings to its most productive use at least cost. It should offer a range of financial instruments and institutions for varied categories of investors. It should foster innovation-allowing new technology and products. It should facilitate competition.[3] The Indian financial system is inadequate on these counts.

India's financial needs are growing. Table 1 shows the changing profile of the economy since 2011-12. Table 1 shows that the nominal GDP grew from Rs 87.4 trillion in 201112 to Rs 152.5 trillion in 2016-17. The scale of saving and investment has increased considerably. This points to the need for further financial sector reform. Table 2 presents the changing landscape of the Indian corporate sector. Table shows that total liabilities increased from Rs 19.4 trillion in 1996-97 to Rs 84 trillion in 2006-07. In a span of another ten years, the total liabilities increased four-fold to Rs 352 trillion. While India's financial needs are growing at a fast pace, the current regulatory setting is not conducive to cater to the needs of a dynamically changing financial environment. Most Indian financial laws are archaic. They were enacted when India was a command and control economy. They are motivated by the objective of controlling and restricting financial markets and banning activity. As a consequence, they are out of sync and ill-equipped to cater to the needs of a growing economy. They are inconsistent with the growth of markets, have resulted in inefficiencies, regulatory gaps and is not competition in the financial system. The sub-sections below highlight some of the weaknesses in the present financial system.

[3] Reserve Bank of Australia, 1996.

Table 1 Growth of the economy

Parameter	Level (Rs. Trillion)		Change (Times)	Share in GDP(Percent)	
	2011-12	2016-17		2011-12	2016-17
GDP at market prices	87.4	152.5	1.7	100.0	100.0
Gross domestic saving	30.3	45.7	1.5	34.7	30.0
Household sector	20.7	24.8	1.2	23.7	16.3
Private	8.3	18.5	2.2	9.5	12.1
Public	2.9	3.6	1.2	3.4	2.4
Gross capital formation	32.1	44.5	1.4	36.7	29.2
Public	6.6	11.2	1.7	7.5	7.4
Private	11.6	19.3	1.7	13.3	12.7
Household	13.9	14.0	1.0	15.9	9.2
Central Government Debt-GDP	45.1	74.3	1.6	51.7	48.7

Source: National Accounts Statistics, various years

Table 2 Liabilities of corporate India

Indicator	1996-97	2006-07	2016-17
Total liabilities	19.4	84.0	352.2
Shareholders' funds	4.3	18.5	79.1
Borrowings	6.3	21.7	98.3
Borrowings from banks	1.3	7.5	30.1
Foreign currency borrowings	0.8	3.2	12.8
Bonds & Debentures	1.4	3.5	21.6
Current liabilities & provisions	2.8	11.5	43.3
Count*	7485	21069	22844

Source: CMIE Economic Outlook

Table 3 Indian financial regulatory architecture

RBI	Regulation of banks, NBFCs, debt management for the Government. Regulation of OTC trading on government bonds, currency market and currency and interest rate derivatives. Shares regulation of corporate bonds, and exchange traded derivatives on currency or interest rate underlyings with SEBI. Regulator of capital controls
SEBI	Regulation of equity spot and derivatives. Regulation of mutual funds. Shares regulation of corporate bonds, interest rate futures and currency futures with SEBI. Regulation of foreign investors operating on the markets which SEBI regulates. Regulates commodity derivatives.
Insurance Regulatory and Development Authority (IRDA)	Regulation of insurance
Pension Fund Regulatory and Development Authority (PFRDA)	Regulation of pensions
Department of industrial policy and promotion (DIPP)	Administers policy on Foreign direct investment

2.1 Difficulties with sector-based financial regulation

Indian financial regulatory framework is sectoral in nature. Laws and regulations are organised around sub-sectors such as banking, securities, insurance, pensions and payments. Table 3 shows the architecture of Indian financial regulation. Sectoral approach to financial regulation is ill-equipped to deal with entities that are hybrids, such as banks cum insurers. Such entities then face overlapping and often contradictory regulations. Sectorally oriented regulation often results in turf wars between regulators. For instance, the introduction of Unit Linked Insurance Products (ULIPs) sparked a turf war between the securities regulator (SEBI) and the insurance regulator (IRDA). Ulips are hybrid products that provide life cover and invest part of the premium in stocks and bonds. While the insurance regulator maintained that ULIPs provide mortality benefits and hence should be within its jurisdiction, the securities market regulator was of the view that since such products generate returns on investment they should be regulated as Collective Investment Schemes (CIS). After a period of confusion, it was decided that ULIPS would be regulated by the insurance regulator.

Financial regulation organised on sectoral lines can create situation of missing regulation. Financial firms can tweak some features of products such that they escape regulatory oversight. A case in point is the raising of large sums of money from public through the issue of Optional Fully Convertible Debentures (OFCDs) by two companies of the Sahara Group. One of the points of contention was that OFCDs were hybrid instruments and hybrids did not fall under the definition of *securities* under the Securities legislation. The company contended that the issue was outside the regulatory purview of the securities market regulator.[4]

Another limitation of sectoral regulation is that it is ill-equipped to deal with conglomerates whose activities blur the traditional boundaries between different types of financial firms. The sectoral nature of regulation inhibits the competencies of firms in reaping the economies of scale. The sectoral orientation towards regulation is ill-equipped to handle system-wise risks to the financial system as there is no agency looking at inter-connections between various financial firms.

2.2 The case of missing markets

While significant progress was made in the field of equity markets, other segments of financial markets are weak. The bond and currency markets are characterised by illiquidity and inefficiency. The lack of a long term corporate bond market hampers the ability of firms to finance large scale infrastructure investment. Corporate bond market in India is characterised by a shallow investor base. The demand for corporate bond as an investment option is mainly confined to institutional investors. Even among institutional investors, the demand is constrained by prudential norms.[5]. Foreign investors who could have played a role in deepening the bond market are constrained by investment limits.[6]

A key weakness of the present financial system is the lack of a well-developed Bond Currency-Derivatives nexus. The Bond-Currency-Derivatives (BCD) Nexus is the interlinked set of markets on government bonds, corporate bonds and currencies.[7] The domestic bond markets are linked to the global markets through currency spot and derivatives market. When a foreign investor buys a rupee-denominated bond, she would need a currency derivatives market to hedge the foreign currency exposure. There may be an interest rate derivatives also at play, as the foreign investor may not like to take the risk that interest rates will go up. In India, from a regulatory standpoint, each of these markets are treated separately. Expert committees such as the *Planning Commission, Report of the Committee on Financial Sector Reforms, September, 2008* (2008) and Ministry of Finance, Government of India (2007) have highlighted the deficiencies in the present set-up and made out a case for linking the bond-currency-derivatives markets and for these markets to be linked to other financial markets such as the equity markets.

2.3 Limited focus on consumer protection

Another concern with the present framework is the limited reference towards financial consumer protection. While consumer protection is part of the mandate of all existing financial regulators, the regulatory strategy is inadequate. Each regulator has its own process of registration, grievance redress mechanisms, code of conduct. The focus is on

[4] Mukul Aggarwal and Reis, 2012.

[5] As an example, insurance companies are under obligation to invest 50% of their resources in government bonds

[6] Ganguly, 2019.

[7] *Planning Commission, Report of the Committee on Financial Sector Reforms, September, 2008*, 2008.

check-box compliance rather than *outcomes*. The system does not identify basic rights of a consumer. The system does not place responsibility on market intermediaries to assess the suitability of a product to a specific consumer. As an outcome, the incidence of mis-selling is pervasive.[8]

2.4 Lack of competition

The financial regulatory framework inhibits competition and innovation. Regulators in India have often been reluctant to grant permission for new businesses to operate. As an example, there are hindrances to competition *to* the banking sector and *in* the banking sector. Consequently money market mutual funds, bond markets, fintech are restricted in size and activity. Similarly within the banking sector, very few entities are permitted, thus favouring the incumbents.[9]

2.5 Financial repression

In the area of government borrowing, regulations require that financial firms allocate a part of their assets towards investment in Government bonds. Banks, insurance companies and pension funds are required to place part of their assets in government bonds. The closest motivation for such an arrangement could be prudential regulation where investment in government securities is motivated by a need for safety and soundness.

This arrangement is inconsistent with the approach towards financial regulation adopted in OECD countries.[10] Resource pre-emption is not a sound instrument of prudential regulation. It creates distorted incentives for fiscal prudence.

3. Rethinking financial regulation

By early 2000s it became increasingly clear that while some elements of financial reform had taken place in the nineties, financial regulation needs to be revisited on a much larger scale to address the loopholes in the regulatory framework.[11] In the Indian policy space, the consensus on a broad agenda of financial sector reforms was achieved through an expert committee process.[11] The reforms proposed by these committees required legislative changes, leading Ministry of Finance to set up the Financial Sector Legislative Reforms Commission (FSLRC) to rewrite the laws. The philosophy that shaped the Commission's working was that constructing effective financial law requires an understanding of market failures in finance that will motivate appropriate interventions by the government. It is imperative to understand the sources of market failure in the field of finance.

[8] Sane, 2013.

[9] Agarwal and Eswar, 2018.

[10] Shah and Patnaik, 2011.

[11] Patnaik and Shah, 2014.

[11] For example, *Planning Commission, Report of the Committee on Financial Sector Reforms, September, 2008* (2008), Ministry of Finance, Government of India (2007), Ministry of Finance (MoF, 2008) proposed a blue-print for the next generation of financial sector reforms. [13] Wallis, 1997.

3.1 Sources of market failure

Global best practises highlight that regulation of financial markets should seek to overcome sources of market failure. This sub-section discusses the sources of market failure in finance.[13]

3.1.1 Information asymmetry

An key source of market failure in finance emerges from information asymmetry between financial institutions and retail consumers of financial products and services. In a market economy, consumers are assumed, to be the best judges of their self-interests. In such cases, disclosure requirements play an important role in assisting consumers to make informed judgments. However, disclosure is not always sufficient. For many complex financial products, consumers lack the knowledge, experience or judgment required to make informed decisions. This is known as information asymmetry: a situation where further disclosure cannot overcome market failure.[12] This warrants government intervention aimed at ensuring product suitability[13], stronger disclosure norms and redress mechanisms to help protect consumers against inappropriate conduct of financial market intermediaries.

3.1.2 Anti-competitive behaviour

Large financial institutions may exert significant influence over prices leading to the potential exclusion of other willing participants.

3.1.3 Risks attached to financial promises

Financial contracts play a fundamental role in the efficient functioning of financial markets. The basic element of a financial contract is financial promise- promises to make payments of specified amounts, at specified durations and in specified conditions. From the perspective of government intervention it is useful to distinguish financial promises based on the following three characteristics:

1. the inherent difficulty of honouring promises;
2. the difficulty in assessing the creditworthiness of promisors; and
3. the adversity caused if the promise is breached

The lest onerous financial promise is one which requires payments to be made only if certain circumstances permit and that too in specified proportion of some underlying value. This kind of promise is made by the issuers of equity instruments. The most onerous promise is to make payment on demand by the promisee. Demand deposits is an example of this kind of promise. In between these two extremes, there are other kinds of promises. The issue of debt instrument involves making payments at specified

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[12] Wallis, 1997.

[13] "the degree to which the product or service offered by the intermediary matches the retail client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience (Basel Committee on Banking Supervision: The Joint Forum, 2008).

instruments. Pure vanilla insurance contracts trigger payments in specified circumstances.

The second distinguishing feature of financial contracts relates to the creditworthiness of the person or institution making financial promises. It is easier to assess creditworthiness in some cases than in others. For example the creditworthiness of mutual fund holding government securities may be easy while the creditworthiness of an insurance firm underwriting weather risks may be difficult. The difficulty of assessing credit risk may be further exacerbated by information asymmetry whereby promisees cannot make a reliable assessment of risk.

The third feature of financial promises is the adversity caused by breach of financial promises. The consequences of breach of some of the financial promises may extend beyond the individuals who are directly affected. As an instance, an institution failing to honour its promises could trigger a system-wide panic that similar institutions could also dishonour their promises.

3.1.4 Negative externalities

Another manifestation of market failure is negative externality. A negative externality occurs when a transaction between two parties results in costs which accrue, in part, to one or more third parties or to society as a whole. Consumers end up paying higher prices and or taxes in the presence of negative externality. A classic case of negative externality in the field of finance is the systemic financial risk. System-wide risk is potentially costly to consumers, financial markets and economy as a whole. The large-scale bail-outs using tax-payer funded money is a cost to society which can be minimised through state intervention in the form of appropriate regulation.

3.1.5 Public goods of financial market infrastructure institutions

Institutions such as exchanges, securities depository, central counterparty form the infrastructure underlying the operation of financial markets. Referred to as Financial Market Infrastructure Institutions (FMIIs), they provide beneficial public goods or services. FMIIs allow consumers and firms to safely and efficiently purchase goods and services, make financial investments, and transfer funds. Regulatory intervention is needed to foster the delivery of public goods by FMIIs.

3.2 Approach to financial regulation

The above sources of market failure translate into the following functional forms of financial regulation: a) financial market conduct and integrity regulation b) retail consumer protection c) competition regulation and d) safety and soundness regulation: prudential regulation. The functional regulation of finance transcends the bounds placed by the architecture of regulatory jurisdiction.

Market conduct and integrity regulation: Market conduct considers how persons involved in the financial sector conduct themselves and their businesses in relation to clients, customers, and each other, with a focus on fairness and integrity.[14] Some of the challenges in the realm of market conduct are:

- Opaque and complex fee structures undermine product comparisons;
- Poor disclosure of risks of complex products such as securitised assets
- Incentives and inducements reduce consumer scrutiny of core product features and distort decision-making
- Conflicted commission-based remuneration structures of intermediaries or service providers in life insurance
- Tick-box compliance: Disclosure documentation meant to fulfil regulatory requirements but does not consumer information needs

A number of jurisdictions are revisiting their regulatory frameworks to incorporate a robust market conduct and integrity regulation. A survey of global experiences shows that an effective market conduct and integrity regulation should comprise the following:

- An activity rather than an institution based system of authorisation of regulated entities with tough fit and proper standards for authorised activities.
- Setting conduct standards for providers of financial products and services. These standards include fit and proper person requirements for financial institutions and key persons, disclosures in relation to financial products and services, remuneration practises, outsourcing and insourcing arrangements, remuneration practises and standards on advice, guidance and recommendations offered to financial consumers.
- Periodic review of information gathering from regulated entities
- Effective enforcement framework to deter misconduct and

Retail consumer protection: Regulation oriented towards consumer protection aims at ensuring that retail consumers have adequate information, are treated fairly and have adequate avenues for redress. General market conduct regulation is not sufficient to protect the interests of retail consumers. The complexity of financial products increases the probability that financially unsophisticated consumers could be misled about the nature of financial promises particularly the risks attached to such products. Complexity of financial products also increases the incidence of dispute. Given the high cost of litigation, many countries have imposed specific regulation on financial advice based on the obligation to demonstrate suitability of advice to retail consumers and established low cost dispute settlement mechanisms.

Competition regulation: Competition regulation ensures that financial markets are competitive. Collusion amongst a few players can lead to overpricing and underprovision of goods and services. The tools for competition regulation in financial markets are similar to other markets. Any assessment of competition requires an understanding of features of relevant market. Clear rules need to be put

[14] National Treasury, Republic of South Africa, 2014.

in place to establish both the bounds of acceptable competitive behaviour and rules for mergers and acquisitions which are common to all industries.[15]

Prudential regulation: Some financial promises that are (a) difficult to honour, (b) difficult to assess and (c) pose grave consequences if breached for system in addition to the promise require a higher intensity of regulation. This form of regulation aimed at promoting safety of financial system is referred to as prudential regulation. While it is the responsibility of the management and board of the financial firm that it delivers on the promises made, prudential regulation adds an extra layer of oversight beyond regulation of disclosure of regulation and market conduct. The aim of prudential regulation is to *prevent* the breach of financial promises. At the same time, it must be acknowledged that prudential regulator should not guarantee that all financial promises are kept under all circumstances.

The scale and intensity of prudential regulation also varies. Regardless of the institutional design, financial firms making similar *intensity* of promise should be regulated similarly. In terms of intensity, firms in the payments space and those seeking deposits should be subject to intense form of prudential regulation. The difficulty of honouring promises through transformation of illiquid assets into liquid liabilities, the information asymmetry faced by bank depositors and the possibility of systemic risk in the event of breach of promise warrants intense prudential regulation. At the heart of prudential regulation is to ensure the safety and soundness of financial institutions.

3.3 Financial regulation post the global financial crisis

The global financial crisis triggered by the collapse of the U.S real estate market and subsequent collapse of the U.S mortgage giants Fannie Mae and Freddie Mac exposed the inadequacies of pre-crisis micro-prudential regulation in dealing with systemically important financial institutions (SIFIs). It was felt that the regulatory framework was not equipped to:

1. monitor the inter-connectedness in the financial system and,
2. handle the systemic consequences of failure of large financial institutions upon other institutions and markets. As an outcome, the Government had to frequently resort to taxpayer funded bailouts.

The financial crisis of 2008 and the scope of emergency public funding created the conditions for a fresh thinking on financial regulation. This led to a discussion of systemic risk regulation: regulation to protect the financial system's capacity to serve as a *network* within which its underlying functions can be conducted. The essence of the job of a systemic risk regulator is to look across markets and across institutions. To do its job effectively, the systemic risk regulator must have access to good quality data and analysis spanning across the financial system.

[15] Wallis, 1997.

In the U.S, this thinking led to a legislative change in the form of the Dodd-Frank Act. One of the important features of the Act was the creation of a new systemic risk council of regulators. The mandate of the Council is to identify and respond to emerging risks that could pose a threat to financial stability.[16] As an example, to help with the identification of emerging risks to financial stability, the Council is supported by the Office of Financial Research (OFR) that delivers high quality financial data, standards and analysis to monitor and assess risks in the financial system.

At the time of the global financial crisis, countries did not have a mechanism to deal with banks and financial institutions which failed. This led to two choices: a) allowing banks to fail risking system-wide consequences to businesses, households and economy or b) bail them out. The then arrangements were also antithetical to consumers as it laid no emphasis on continuity of critical economic functions.

A framework for failure resolution aims to change this. It ensures that financial institutions should be allowed to fail in an orderly manner limiting the costs on public and incentivising banks to operate more prudently. Ten years after the crisis, authorities are around the globe are implementing failure resolution mechanisms to ensure that losses are borne by investors rather than tax payers with minimal disruption to the financial system.

4. Financial Sector Legislative Reforms Commission

A number of expert committees proposed a number of reforms to the financial regulatory system. They mapped out the ideas and established an internally consistent picture. The Government realised that it was not possible to make progress without fundamental changes to the legal foundations of finance. The then finance minister created the Financial Sector Legislative Reforms Commission (FSLRC), chaired by Justice Srikrishna in March 2011. The commission analysed the infirmities of the Indian financial system, the recommendations of expert committees and global standard setting bodies and cross-country experience, and designed a new legal foundation for Indian finance. The basis of the Commission's work was the recognition that constructing effective financial law requires an understanding of market failures in finance that will shape appropriate interventions by the government.

The draft Indian Financial Code that the Commission formulated is a single, internally consistent law of 450 sections that is expected to replace the bulk of existing Indian financial law. It has nine components[17]

1. Consumer protection: As discussed earlier, there is limited focus on consumer protection in Indian financial regulation. The report of the Commission recognises that consumers of financial services are often more vulnerable than consumers of ordinary goods because of the complexity of the services, and the adversity of consequences. Hence consumer protection in finance requires a special effort by

[16] U.S. Department of the Treasury, 2018.

[17] Patnaik and Shah, 2014; of Finance [MoF], 2015.

the state. The complexity of products, the focus on check-box compliance, complicated disclosures alongside overlaps in regulatory apparatus have resulted in a series of scandals such as ponzi schemes. In order to address the IFC places consumer protection as the focal point of financial regulation. The IFC envisions mechanisms for both prevention and cure. Prevention involves guaranteeing a set of rights and protection and enforcing a set of regulations to uphold these rights and protection. Some of the rights and protection that the IFC guarantees are protection against unfair contract terms and against misleading conduct. Regulators are empowered to place a range of requirements upon financial service providers, from disclosures to assessing suitability and advice to regulation to address incompatible incentive structures.

In addition to tools of prevention, the IFC envisages curative strategy in the form of a unified Financial Redress Agency. The agency would have a presence in every district in India and would be a one-stop-shop where consumers of all financial products could submit complaints. The local operations would be connected to a centralised adjudication process, and a well-structured work flow would support the speedy and fair handling of cases.

2. Micro-prudential regulation: The aim of micro-prudential regulation is to ensure the safety and soundness of financial system by *reducing* the probability of failure of financial firms. When a consumer deals with any financial firm, there should be a high probability that it will be solvent and able to honour its promises. How intrusive micro-prudential regulation would be under the IFC depends upon the kind of promises made by a financial firm. The promises which are onerous based on the characteristics discussed in section 3.1.3 would call for more intrusive prudential regulation. Under the IFC, the regulators have the power to impose requirements on capital adequacy, corporate governance standards, investment norms, liquidity norms, separation of customer assets from firms' assets and other instruments.[18]Regulatory interventions are proportional to the nature of promises made by financial firms. The IFC envisages a single micro-prudential law that would eliminate possibility of regulatory arbitrage. At the same time, multiple regulators could enforce the law for their spheres of jurisdiction.
3. Resolution: While micro-prudential regulation aims to reduce the probability of failure, eliminating all firm failure is neither feasible nor desirable. Weak firms should be allowed to fail so that capital and labour can be allocated to more efficient firms. The IFC envisages a resolution corporation that would supervise all financial firms that have made promises to households such as banks, insurance companies, defined benefit pension funds, and payment system. Both the micro-prudential regulator and the resolution corporation would jointly supervise financial firms proportional to their *risk to viability*. Risk to viability is defined in terms of probability of failure of financial firms. As the risk to viability progresses from low to material to imminent and then critical, the scale of intervention by the Corporation increases. At the stage of critical risk to viability, the Corporation would force the closure of the financial firm and protect customers by transferring their investments to a solvent firm or by paying them what they are owed. For example, in the case of banks, the deposit insurance program in which all households are guaranteed upto a specified limit would be operated by the

[18] Patnaik and Shah, 2014.

Corporation, The Corporation would also be responsible for resolving systemically important financial firms that have no direct links with consumers.[19]

4. Systemic risk regulation: Systemic risk regulation has assumed greater prominence in the aftermath of the global financial crisis. It essentially involves having a bird's eye view of the financial system as a whole. Conventional micro-prudential regulator focusses on seeing one firm at a time and sectoral regulators are oriented towards monitoring one sector at a time. To monitor system-wide concerns arising out of inter-connections amongst the various sectors and to take actions to mitigate systemic risk, the IFC envisages a council of regulators called the Financial Stability and Development Council (FSDC). The Council will monitor and analyse data to identify risks in the financial system. It will also be tasked with developing systemic indicators for designating financial firms as Systemically Important Financial Institutions (SIFIs). These entities would be subject to enhanced regulation and supervision in a coordinated manner. The tools in response to emerging system-wide risks are expected to play a counter-cyclical role reigning in risks in boom periods and avoiding abrupt fire sales in bad times. The IFC also envisages setting up of a Financial Data Management Centre (FDMC) which will serve as a repository for financial system database for assessment of systemic risk.
5. Capital controls: Capital controls are restrictions on cross-border flow of capital. Analysis by the Commission shows that restrictions imposed on cross-border capital flows in advanced economies is driven by national security considerations. For other types of capital, there are negligible restrictions. Drawing on global best practises, the IFC envisages approval from the central government in relation to capital flows that affect national security. Under the IFC framework, rules on capital controls would be made by the central government in consultation with the central bank. The rules governing capital flows would be administered by the central bank. The IFC gives powers to the central government to make rules in relation to capital controls during emergency conditions. All these elements of capital controls are placed under an environment of sound governance with the rule of law. This would constitute a significant improvement when compared with the present arrangements.[20]
6. Monetary policy: Low and stable inflation is an essential ingredient of a sound macroeconomic policy. In recent decades many advanced and emerging economies have achieved price stability by bringing in appropriate institutional arrangements for monetary policy. The monetary policy framework of the RBI prior to the adoption of inflation-targeting regime involved analysing a number of variables for determining monetary policy stance such as money, credit, output, trade, capital flows and fiscal position as well as rate variables such as rates of return in different markets, inflation rate and exchange rate. While this framework may have worked well in the beginning, in late 2000's, the credibility of this framework had weakened as persistently high inflation and weakening growth have plagued the economy.

   The IFC recommended that the predominant objective of monetary policy should be to achieve price stability while striking a balance with the objective of the

[19] Patnaik and Shah, 2014.

[20] Patnaik and Shah, 2014.

Central Government to achieve growth. The Ministry of Finance will specify a quantifiable objective for the Reserve Bank of India that can be monitored. The bank will have independence in the pursuit of the clearly outlined objective. The interest rate at which the central bank lends to banks, the policy rate, will be determined by voting in an executive monetary policy committee consisting of internal and external members.

7. Public debt management: The current framework of debt management in India suffers from three key challenges. First, the borrowing programme of the Central and State Government is fragmented across various agencies. It is scattered across the Reserve Bank of India and the various Ministries and Departments of the Central Government. As a consequence, Government debt in India is not consolidated to get a holistic picture of the total government liabilities at one place and in near real time.

   Second, a conflict of interest arises between the role of the RBI as a debt manager for the government and that of being a monetary authority. This can have negative consequences on economic and financial policy. Third, the investor base for government debt, especially market borrowings of the government, remains concentrated and shallow. At present, the debt market is confined to domestic players in a financially repressed environment.

   The need for a specialised agency to manage government debt becomes imperative in light of these challenges. Since the late 1990s, numerous expert committee reports have raised concerns on this institutional vacuum and have argued for a unified and independent debt management agency: Ministry of Finance, Government of India (2007), *Planning Commission, Report of the Committee on Financial Sector Reforms, September, 2008* (2008) and MoF (2008). Drawing on the expert committees' recommendations and a review of international best practices, the Financial Sector Legislative Reforms Commission (FSLRC) recommended fast-tracking of the setting up of an independent debt management office The IFC, proposed a PDMA with a mandate to manage public debt.

8. Development and redistribution: The development and redistribution objective in the realm of financial policy involves: a) development of missing markets and achieving depth and liquidity with the nascent markets and b) redistribution and quasifiscal operations where certain sectors, or income groups are the beneficiaries. The development of missing markets and improving the scale and outreach of nascent markets require information gathering and analysis on the scale of the full financial system. This requires inter-regulatory coordination. A single regulator cannot be tasked with this responsibility.

   The principles of public administration suggest that quasi-fiscal functions should be performed by the fiscal authority. This could be achieved by placing rule-making functions in relation to development and redistribution closer to the fiscal authority while asking regulators to achieve compliance. Placing market development and redistributive function creates problem of accountability. Financial regulators are held accountable for their regulatory objectives of consumer protection and micro-prudential regulation. If market development or redistributive objectives are also given to regulators, then there would be a considerable loss of accountability as failures in core financial regulation could be justified on the grounds that development and redistributive activities were pursued. For example it may be possible to quickly increase the outreach of

insurance product, which is a developmental objective, by reducing the regulatory burden of consumer protection in insurance. Acknowledging these challenges, globally financial regulatory agencies are not tasked with development or redistributive functions. Certain market developments functions could be performed by financial regulators given their domain expertise. For example regulators could be tasked with building robust market infrastructure.
From this perspective, the IFC envisages the following arrangement:

- The Ministry of Finance would have the power to enact regulations for market development schemes or for redistribution.
- Financial regulatory agencies would enforce the regulations issued by the Ministry of Finance.
- One of the objectives of financial regulators would be market development or improvement of market infrastructure but this objective should not cause adverse impact on the core functions of consumer protection and macro-prudential regulation.

9. Contracts, trading and market abuse: The ninth component of IFC deals with the adaptations of commercial law to questions of contract in the field of securities and insurance. It deals with rights of holders in relation to financial products and services and enforceability of derivative contracts. Financial markets feature an important role for infrastructure institutions that, develop rules governing the design of financial markets. The IFC constrains the behaviour of these organisations by mandating them to issue by-laws that will govern their functioning and interface with consumers. The IFC has provisions that allow regulators to issue directions to infrastructure institutions. The IFC defines market abuse and establishes the framework for identifying and punishing persons who engage in it.[21]

5. Financial sector reforms: State of progress

The draft Indian Financial Code laid out a broad agenda for financial sector reforms in India. Some elements of the draft Indian Financial Code are in progress. While some are in the initial stages, some have reached completion.

- *Monetary policy*
  The government and the RBI decided to introduce a modern monetary policy framework with a focus on inflation targeting. The first attempt at modernising the monetary policy framework came about with the signing of the Monetary Policy Framework Agreement between the RBI and the Government of India in February 2015. Under this agreement, the objective of monetary policy framework was to maintain price stability, while keeping in mind the objective of growth. As per the Agreement, the target for inflation was set at below 6% by January 2016 and within 4 per cent with a band of (+/-) 2 per cent for 2016-17 and all subsequent years.[22]

[21] Patnaik and Shah, 2014.
[22] Government of India, 2015a.
[25]Government of India, 2016.

In 2016, India statutorily adopted inflation targeting as an objective of monetary policy through an amendment to the RBI Act.[25] The amendment also set up a Monetary Policy Committee to set a policy rate to pursue inflation target. Following the MPC law, monetary policy started targeting the CPI combined series (also known as headline inflation) which is a more robust measure of true inflation that consumers face in the retail market.

- *Regulation-making power on capital controls*: The draft IFC had proposed that regulation-making power in relation to capital controls should move to the Central Government. Finance Act of 2015, through legislative amendments provided that controls on non-debt capital flows would be exercised by the Government, in consultation with the RBI. However this amendment has not yet been enforced. This requires the Government to first issue a notification distinguishing debt and non-debt instruments. Four years on, the discussion on what constitutes debt and non-debt instrument is still a work-in progress.
- *Public debt management and bond market*: The draft IFC proposed a unified public debt management agency that would be tasked with the management of public debt with the minimum cost within an acceptable level of risk over the long term. "The Finance Bill, 2015" had proposed setting up a PDMA but the move was rolled back in April that year. A year later, the Government took the first step by setting up the Public Debt Management Cell (PDMC). The memorandum setting up the PDMC mentions that it is an interim arrangement and envisages a two year transition path towards setting up a statutory PDMA.[23] This is still work in progress. A real measure of reform would involve introducing a law that would establish a statutory PDMA.[24]
- *Consumer protection*: Three important initiatives are in progress:[25]
    1. Financial Redress Agency: The draft IFC had envisaged setting up a unified Financial Redress Agency that would act as a one stop forum for speedy and convenient settlement of complaints of retail financial consumers. In the budget speech of 2015, the Finance Minister had proposed to create a Task Force to establish a sector-neutral FRA. In June 2016, the Task Force recommended enacting a financial sector consumer protection law by adopting the relevant provisions of the draft Indian Financial Code, and proposed an operational framework for the FRA.[26] The government invited public comments on the report of the Task-force in late 2016. The next step should consist of a draft bill on consumer protection and the establishment of the redress agency.
    2. Curbing ponzi schemes: There is a great deal of moral outrage of the role of ponzi schemes. In the budget speech of 2017, the Finance Minister proposed to introduce the Bill on the banning of unregulated deposit scheme. The Bill provides for a mechanism to ban unregulated deposit schemes and protect the interests of depositors. In February 2019, the lower house passed the bill to ban unregulated deposit schemes.

[23] Ministry of Finance, Department of Economic Affairs, 2016.

[24] Pandey and Patnaik, 2017, 3.

[25] Aggarwal, 2017.

[26] Department of Economic Affairs, Ministry of Finance, Government of India, 2016.

3. Securities Appellate Tribunal: The draft Indian Financial Code envisaged a unified Financial Sector Appellate Tribunal (FSAT), subsuming the existing Securities Appellate Tribunal (SAT), to hear all appeals in finance. The Securities Appellate Tribunal (SAT) is now the common tribunal for challenging the decisions of the market regulator SEBI, insurance regulator IRDAI and pension regulator PFRDA. There is no appellate authority for the decisions of the RBI.

- *Systemic risk regulation*: The draft IFC envisaged creation of a statutory Financial Data Management Centre (FDMC) which would serve as a repository of all financial regulatory data, to assist the Financial Stability and Development Council (FSDC) in conducting research on systemic risk. Following steps has been initiated in relation to FDMC:
  - The central government set up a Task Force on setting up of the FDMC. The task-force laid out a roadmap for setting up of FDMC.
  - In the budget of 2016-17, the government announced setting up of FDMC to facilitate integrated data aggregation and analysis in the financial sector.
  - Subsequently, a committee was set up to suggest a draft FDMC Bill. The committee submitted its report and a draft bill in 2016.

  The Government should expedite setting up a statutory FDMC to create an integrated repository for all financial data. It should develop the capacity to provide research and support and should evolve with changing requirements over a period of time.
- *Resolution of failed financial firms*: The draft IFC envisaged creation of a Resolution Corporation as an important segment of the reformed financial system. The developments in relation to resolution of failed financial firms unfolded as follows:[27]
  - In 2014, the Ministry of Finance constituted a Task Force for the Establishment of the Resolution Corporation. The mandate of the Task Force was to work out a plan for the establishment of resolution corporation.
  - The budget speeches of 2015-16 and 2017-18 announced a plan to draft and table a Bill on resolution of financial firms.
  - In September, 2016, a draft of the Bill was placed in public domain for comments.
  - In June, 2017, the Cabinet approved the proposal to introduce a Financial Resolution and Deposit Insurance Bill, 2017 (”the FRDI Bill”).
  - In July, 2018 the Bill was dropped. One clause in the Bill gave the proposed Resolution Corporation the option of “bailing in” troubled banks: using uninsured depositor money to infuse equity into the bank if a buyer is not found. This bill made the depositors jittery who feared that such a clause could harm their life-long savings in bank accounts.

  The dropping of the FRDI Bill is a missed opportunity. The FRDI Bill, if enacted, would have created a mechanism to sell a financial firm as a living concern, run bigger institutions temporarily or as a last resort liquidate them. With no mechanism to resolve banks, the Government has no option but to use the sub-optimal measure of recapitalising inefficient banks through tax-payer funded

[27] Rai, 2017.

money. A better alternative could have been to drop the controversial clause of bail-in.[28]

6. Conclusion

The paper argues that the present financial regulatory system poses challenges for the growth of a competitive and dynamic financial system. While some reforms were introduced in the nineties, bigger challenges persist. Sectoral orientation of financial regulation, missing markets, limited focus on consumer protection, lack of competition and financial repression are some of the problems with the present financial system. Present approach to financial regulatory reform has been piecemeal with a focus on addressing one narrow problem at a time. As an outcome, the financial regulatory system is inconsistent with the general direction of financial market growth.

Drawing on the fundamental premise that any form of state intervention must be guided by an understanding of market failures and recommendations of expert committees, the FSLRC came up with a modern, coherent, non-sectoral law (IFC) with nine areas of state intervention. Consumer protection, micro-prudential regulation, resolution, systemic risk regulation, capital controls, monetary policy, public debt management, development and redistribution and contracts, trading and market abuse are the nine areas requiring state intervention. This paper discusses these nine areas and presents an update on the state of implementation on these fronts.

[28] Patnaik, 2018.

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