**FINANCIAL SECTOR LEGISLATIVE REFORMS**

**Need for the reforms**

The Financial Sector Legislative Reforms Commission was constituted by the Government of India, Ministry of Finance, in March, 2011. The setting up of the Commission 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.

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.

Financial economic governance has been modified from time to time, without substantial changes to the underlying foundations. Over the years, as the economy and the financial system have grown in size and sophistication, an increasing gap has come about between the requirements of the country and the present legal and regulatory arrangements.

Unintended consequences include 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. A number of expert committees have pointed out these discrepancies, and recommended the need for revisiting the financial sector legislations to rectify them. These reports help us understand the economic and financial policy transformation that is required. They have defined the policy framework within which reform of financial law can commence.

The remit of the Commission was to comprehensively review and redraft the legislations governing India’s financial system, in order to evolve a common set of principles for governance of financial sector regulatory institutions. The main outcome of the Commission’s work was a draft ‘Indian Financial Code’.

**Approach and Important Reforms:**

**Work process of the Commission**

The Commission took a comprehensive, first principles approach to the task, rooting its analysis and decisions in a conceptual analysis of financial regulation and review of experience.

**The tasks of financial law**

The first set of questions that the Commission dealt with was about the purpose of the financial legal framework. Regulation is not an end in itself; it exists in order to address market failures. From this point of view, nine components were envisioned:

1. Consumer protection – The Commission found that a mere ‘buyer beware’ approach is not adequate in finance; regulators must place the burden upon financial firms of doing more in the pursuit of consumer protection. This perspective shapes interventions aimed at prevention (of inducing financial firms towards fair play) and cure (redress of grievances).

2. Micro-prudential regulation – When financial firms make promises to consumers, e.g. the repayment of a bank deposit, regulators are required to monitor the failure probability of the financial firm, and undertake interventions that reduce this failure probability.

3. Resolution – Micro-prudential regulation will diminish, but not eliminate, the failure of financial firms. A specialised resolution capability is required, which swiftly and efficiently winds down stressed financial firms, and protects the interests of small customers.

4. Capital controls – These are restrictions on cross-border activity on the capital account.

The Commission has no view on the sequencing and timing of capital account liberalisation. The work of the Commission in this field was focused on placing the formulation and implementation of capital controls on a sound footing in terms of public administration and law.

5. Systemic risk – Micro-prudential regulation thinks about the collapse of one financial firm at a time. A very different point of view is required when thinking of the collapse of the entire financial system. Micro-prudential regulation is about the trees, and systemic risk regulation is about the forest. It calls for measurement of systemic risk, and undertaking interventions at the scale of the entire financial system (and not just one sector) that diminish systemic risk.

6. Development and redistribution – Financial economic governance in India is charged with the development of market infrastructure and processes, and with redistribution. These objectives have to be achieved through sound principles of public administration and law.

7. Monetary policy – Objectives, powers and accountability mechanisms have to be setup for monetary policy.

8. Public debt management – A specialised framework on public debt management has to be setup that takes a comprehensive view of the liabilities of Government, and establishes the strategy for low-cost financing in the long run.

9. Contracts, trading and market abuse – Certain adaptations to the foundations of commercial law, surrounding contracts and property, are required to enable the financial system. Alongside this, the legal foundations for the securities markets are established.

The overall task of constructing financial law comprised the above nine elements, and of establishing sound foundations of regulatory governance.

This problem statement differs considerably from approach taken by existing laws in India, which are sector-specific. The existing laws deal with sectors such as banking, securities and payments. The Commission analysed this issue at length, and concluded that non-sectoral laws constitute a superior strategy.

As an example, a non-sectoral consumer protection law would lead to harmonisation of the consumer protection across multiple sectors. If this approach were not taken, there is the possibility of a certain sector having more lax standards of consumer protection than another. Profit-seeking financial firms would rush to exploit the profit opportunities, and distort the structure of the financial system.

In similar fashion, a non-sectoral micro-prudential law would ensure that similar reasoning about risk is applied all across the financial system. If micro-prudential regulation is done differently in different sectors, then profit-seeking financial firms will have an incentive to portray activities as belonging to sectors where capital requirements are weaker.

Non-sectoral laws are closely related to the idea of principles-based law. The draft Code is non-sectoral principles-based law. The draft Code will, with no more than minor modifications, represent the essence of financial law for many decades to come. In this respect, the work of the Commission has taken Indian financial law closer to its roots in the common law tradition.

The Commission observed that, at present, financial law in India is fairly complex. The drafting style used in most current laws is relatively complex and thus unreadable to non-specialists. The Commission has tried to achieve a simple writing style for the draft Code. The unification of many laws into a single draft Code has greatly assisted simplification. A single set of definitions of terms is utilised across all 450 sections of the law. The entire draft Code is internally consistent, and has a simple and logical table of contents. This emphasis on simplicity would reduce the complexity faced by law-makers, bureaucrats, legal professionals and finance practitioners in understanding the law and working within it.

The first task of financial law is to establish a clear strategy for the nine areas listed above. The second task of financial law is to establish financial regulators. In a liberal democracy, the ‘separation of powers’ doctrine encourages a separation between the legislative, executive and judicial functions. Financial regulators are unique in the extent to which all three functions are placed in a single agency. This concentration of power needs to go along with strong accountability mechanisms.

There is a strong case for independence of regulators. Independent regulators would yield greater legal certainty. The quest for independence of the regulator requires two planks of work. On one hand, independence needs to be enshrined in the law, by setting out many processes in great detail in the law. On the other hand, alongside independence there is a requirement of accountability mechanisms.

The Commission had adopted five pathways to accountability. First, the processes, that the regulator must adhere to, have been written down in considerable detail in the draft Code. Second, the regulation-making process (where Parliament has delegated lawmaking power to regulators) has been established in the draft Code with great care, with elaborate checks and balances. Third, systems of supervision have been established in the draft Code with a great emphasis on the rule of law. Fourth, strong reporting mechanisms have been established in the draft Code so as to achieve accountability. Finally, a mechanism for judicial review has been established for all actions of regulators through a specialised Tribunal.

At present, laws and regulations in India often differentiate between different ownership or corporate structures of financial firms. The Commission has pursued a strategy of ownership-neutrality: the regulatory and supervisory treatment of a financial firm would be the same, regardless of whether it is private, foreign, public sector and co-operative. This would yield a level playing field.

At present, many public sector financial firms (e.g. Life Insurance Corporation of India

(LIC), State Bank of India (SBI) are rooted in a specific law. The Commission has recommended that they be converted into companies under the Companies Act, 1956. This would help to enable ownership-neutrality in regulation and supervision. This recommendation is not embedded in the draft Code.

A related concern arises with co-operatives which fall within the purview of state Governments. The Commission has recommended that State Governments should accept the authority of Parliament (under Article 252 of the Constitution) to legislate on matters relating to the regulation and supervision of co-operative societies carrying on financial services. This recommendation is also not included in the draft Code. The Commission has proposed that regulators may impose restrictions on the carrying on of specified financial services by co-operative societies belonging to States which have not accepted the authority of Parliament to legislate on the regulation of co-operative societies carrying on financial services.

The Commission began with an identification of the basic subject matter of regulation - financial products and services. This included services such as, sale of securities, acceptance of public deposits, operating investment schemes and providing credit facilities. It was decided that financial regulation should apply to only those persons who are *engaged*

*in the business of carrying on financial services.*

The draft Code creates a series of obligations for the Government and for regulators. The draft Code covers all functions of regulators, and defines the behaviour that is required from the regulator.

All regulators will have an empowered board. The Commission has drafted a precise selection-cum-search process for the appointment of all members. Four kinds of members are envisioned: the chairperson, executive members including an administrative law member, non-executive members and Government nominees. The role of each of these kinds of members has been defined. The appointment conditions for board members have been defined.

**Financial regulatory architecture**

Many alternative structures can be envisioned for the financial regulatory architecture. At present, Indian law features tight connections between a particular agency (e.g. Securities and Exchange Board of India (SEBI) and the functions that it performs (e.g. securities regulation). India has a legacy financial regulatory architecture. The present work allocation between RBI, SEBI, Insurance Regulatory and Development Authority of India (IRDAI),

Pension Fund Regulatory and Development Authority (PFRDA) and Forward Markets Commission (FMC), was not designed. It evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time.

The present arrangement has gaps where no regulator is in charge – such as the diverse kinds of ponzi schemes which periodically surface in India, which are regulated by none of the existing agencies. It also contains overlaps where conflicts between laws has consumed the energy of top economic policy makers. When there are overlaps, financial firms will undertake forum-shopping, where the most lenient regulator is chosen, and portray their activities as belonging to that favoured jurisdiction. Hence a need was felt for a financial regulatory architecture that should be conducive to greater economies of scale and scope in the financial system.

In order to analyse alternative proposals in financial regulatory architecture, Commission established the following principles:

**Accountability** Accountability is best achieved when an agency has a clear purpose.

The traditional Indian notion, that a regulator has powers over a sector but lacks specific objectives and accountability mechanisms, is an unsatisfactory one.

**Conflicts of interest** In particular, direct conflicts of interest are harmful for accountability and must be avoided.

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

**Avoiding sectoral regulators** 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 at least many sectors.

**Economies of scale in Government agencies** In India, there is a paucity of talent and domain expertise, 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.

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

The Commission has proposed a financial regulatory architecture featuring seven agencies.

The proposal features seven agencies and is hence not a ‘unified financial regulator’ proposal. It features a modest set of changes, which renders it implementable:

1. The existing RBI will continue to exist, though with modified functions.

2. The existing SEBI, FMC, IRDA and PFRDA will be merged into a new unified agency.

3. The existing Securities Appellate Tribunal (SAT) will be subsumed into the FSAT.

4. The existing Deposit Insurance and Credit Guarantee Corporation of India (DICGC) will be subsumed into the Resolution Corporation.

5. A new Financial Redressal Agency (FRA) will be created.

6. A new Debt Management Office will be created.

7. The existing FSDC will continue to exist, though with modified functions and a statutory framework.

The functions of each of these seven proposed agencies are as follows:

**Reserve Bank of India** 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.

**Unified Financial Agency** The unified financial regulatory agency would implement the consumer protection law and micro-prudential law for all financial firms other than banking and payments. This would yield benefits in terms of economies of scope and scale in the financial system; it would reduce the identification of the regulatory agency with one sector; it would help address the difficulties of finding the appropriate talent in Government agencies.

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 and corporate bonds.

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.

**Financial Sector Appellate Tribunal** 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 FRA and some elements of the work of the resolution corporation.

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

**Financial Redressal Agency** The 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.

**Public Debt Management Agency** An independent debt management office is envisioned.

**Financial Stability and Development Council** Finally, the existing FSDC will become a statutory agency, and have modified functions in the fields of systemic risk and development.

The Commission believes that this proposed financial regulatory architecture is a modest 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 Authority 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.

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 pragmatic 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.

*(Extract from the Report of the Financial Sector Legislative Reforms Commission)*