



Government of India

Report of the
Financial Sector Legislative Reforms Commission

Volume I: Analysis and Recommendations

March 2013



FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION

New Delhi
22 March, 2013

Shri P. Chidambaram

Finance Minister
Government of India
New Delhi 110001

Dear Finance Minister,

The FSLRC presents its Report to the Government of India. The Report is in two parts: Volume I – text of the findings and recommendations and Volume II – basic framework of a draft law.

The Commission did not release the Report in public domain since the mandate was to submit it to the Government. However, given the high level of stake-holder interest on the subject and the need for transparency, the Government may release the Report at the earliest.

Yours sincerely

B N Srikrishna
Chairman

Dhirendra Swarup
Member Convener

Jayanth Varma
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C K G Nair
Secretary

*Appointed Member of the 14th Finance Commission with effect from 04 February, 2013. Three Members of the FSLRC could not sign the Report. Shri C. Achuthan passed away on 19th September, 2011; Justice Debi Prasad Pal is seriously ill and Joint Secretary, Capital Markets (Nominee Member) could not attend the meetings due to other commitments.

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Acronyms

AAA	Aid, Accounts and Audits Division
ARC	Asset Reconstruction Company
ASIC	Australian Securities and Investment Commission
BOD	Board of Directors
BOM	Board of Management
BSM	Bank Subsidiary Model
CAG	Comptroller and Auditor General of India
CCI	Competition Commission of India
CCP	Central Counter Party
CEA	Chief Economic Advisor
CEO	Chief Executive Officer
CERC	Central Electricity Regulatory Commission
CERSAI	Central Registry of Securitisation Asset Reconstruction and Security Interest of India
CFSA	Committee on Financial Sector Assessment
CFTC	Commodities Futures Trading Commission
CFT	Combating the Financing of Terrorism
CPC	Code for Civil Procedure, 1908
CRR	Cash Reserve Ratio
DEA	Department of Economic Affairs
DICGC	Deposit Insurance and Credit Guarantee Corporation of India
DOP	Department of Post
DRAT	Debt Recovery Appellate Tribunal
DRT	Debt Recovery Tribunal
EPFO	Employees' Provident Fund Organisation
EPF	Employees' Provident Fund
ESIC	Employees' State Insurance Corporation
FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FDI	Foreign Direct Investment
FDMC	Financial Data Management Centre
FHC	Financial Holding Company
FII	Foreign Institutional Investor
FMC	Forward Markets Commission
FMI	Financial Market Intermediary
FRA	Financial Redress Agency

FSAT	Financial Sector Appellate Tribunal
FSA	Financial Services Authority
FSDC	Financial Stability and Development Council
FSLRC	Financial Sector Legislative Reforms Commission
FVCI	Foreign Venture Capital Investor
GDP	Gross Domestic Product
GIC	General Insurance Council
GOI	Government of India
HR	Human Resources
IBA	Indian Banks' Association
IMF	International Monetary Fund
IRA	Independent Regulatory Agency
IRA	Independent Regulatory Agency
IRDA	Insurance Regulatory and Development Authority
KYC	Know Your Customer
LIC	Life Insurance Corporation
MCA	Ministry of Company Affairs, Government of India
MD	Managing Director
MPC	Monetary Policy Committee
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Financial Company
NCDRC	National Consumer Disputes Redressal Commission
NHB	National Housing Bank
NOHC	Non-Operating Holding Company
NPA	Non Performing Asset
NPS	New Pension System
NSSF	National Small Savings Fund
OTC	Over The Counter
PDMA	Public Debt Management Agency
PFRDA	Pension Fund Regulatory and Development Authority
PPF	Public Provident Fund
PSB	Public Sector Bank
PSU	Public Sector Undertaking
QFI	Qualified Foreign Investor
QIB	Qualified Institutional Buyer
RBI	Reserve Bank of India
RDDBI	The Recovery of Debts Due to Banks and Financial Institutions Act, 1993
ROC	Registrar of Companies
RRB	Regional Rural Bank
RTI	Right to Information
SARFAESI	The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act
SAT	Securities Appellate Tribunal
SBI	State Bank of India
SEBI	Securities and Exchange Board of India
SEC	US Securities and Exchange Commission
SIFI	Systemically Important Financial Institution
SLR	Statutory Liquidity Ratio
SOP	Standard Operating Procedure
TOR	Terms of Reference
UCB	Urban Cooperative Bank



UFA	Unified Financial Agency
UIDAI	Unique Identification Authority of India
UK FSMA 2000	UK Financial Services and Markets Act, 2000
UK	United Kingdom
ULIP	Unit Linked Insurance Plan
UPSC	Union Public Service Commission
US	United States
WG	Working Group
WOS	Wholly Owned Subsidiary

Acknowledgement

When the Ministry of Finance approached me in early 2011 to chair a Commission on financial sector legislative reforms, I was somewhat daunted by the magnitude of the task. However, my hesitation disappeared when I saw the mandate of this body and the list of experts being proposed as its members. The remit of the Commission was on an extremely important national issue and the proposed members were renowned experts from an eclectic mix of relevant areas. That diminished my trepidation and imbued me with the confidence needed to take on the task.

Financial sector reforms affect everyone in the country and beyond, given the growing interface of our economy with the rest of the world. Dozens of legislations enacted from the 1870s were the foundations of this important catalytic sector. Many of them were enacted when financial economics was not born and the financial sector was at its infancy. In the last 100 years financial policies and practices have undergone many paradigm shifts. But its legal foundations, though amended in piecemeal fashion at times, remained more or less static with serious fractures visibly harming the system. These 'fault lines', once more or less hidden, are now evident openly in the form of lack of legal clarity on responsibility and powers of regulators, inter-regulatory disputes, regulator-regulated court battles, adventurism of market participants and the growing shadow banking and shadow financial sector. How do we address the new world of finance with the institutions and the equipment from a non-financial era? How do we transform the ossified institutional structures and outdated practices to suit contemporaneous needs? How do we address the transition? These were some of the questions confronting us. What complicated our task further was that the established global models were facing serious crises of confidence as the world economy was passing through one of the most turbulent periods in its economic-financial history. The revelations and lessons, particularly on regulatory models, emanating from the global financial crisis were intimidating even to high profile experts in the domain.

Given the nation as the stake-holder base of the Commission's mandate, it was felt imperative that we approach the issue with an open mind. Several expert committee reports were readily available to the Commission as a first step in helping our inquiry. We acknowledge our intellectual indebtedness to the reports of the committees chaired by M. Narasimham, R.H. Patil, Percy Mistry, Raghuram Rajan, D. Swarup, U.K. Sinha, among others. In addition, the Commission, after a few rounds of internal deliberations, sought the views of many more experts and major stake-holders. The Commission is grateful to all of them who gracefully accepted our invite and frankly shared their views without being coloured by their institutional affiliations. While the full list is annexed to this Report, I would particularly recall some of them. They include Dr. Shankar Acharya, Dr. Bimal Jalan, Mr. Deepak Parekh, Dr. Vijay Kelkar, Dr. Raghuram Rajan, Dr. Percy Mistry, Dr. Viral

Acharya, Dr. Avinash Persaud, the FSDC Sub-Committee [Dr. D. Subbarao, Prof. Kaushik Basu, Mr. U.K. Sinha, Mr. Hari Narayan and Mr. Yogesh Agarwal], Mr. Ashok Chawla, Mr. R. Gopalan, Mr. Rajiv Agarwal, Forward Markets Commission, among others. I also acknowledge the inputs provided by various industry associations such as FICCI, ASSOCHAM, and IBA.

The Working Groups which were set up by the Commission to delve deeper into sector-specific issues on banking, securities, public debt management, payments, insurance, pensions & small savings, carried the consultation/interaction process further. The inputs provided by those experts also were invaluable. Each working group report, chaired by a Member of the FSLRC with domain experts as Members, became a valuable addition to the resource base of this Report. We appreciate the efforts of all in these Working Groups.

I also acknowledge with great satisfaction the interactions we had with regulators, policy makers and other experts in select jurisdictions – Australia, Singapore, UK and Canada. I am also grateful to Mr. Bill Shorten, Minister for Superannuation and Financial Services, Australia, the Indo-US Business Council, City of London and the US Federal Reserve team who met with the Commission and shared their valuable thoughts. The support of Mr. Matt Crooke, Ms. Eva George, Mr. Gideon Lundholm and others who helped in organising these meetings is also appreciated.

Based on the broad contours of the framework emerging from our interactions, research and deliberations the Commission released an Approach Paper in October 2012. We received a number of suggestions which were further deliberated upon and some of them suitably incorporated in this final Report. The feedbacks were particularly helpful in strengthening the internal consistency of the recommendations. We are grateful to those who gave their views, particularly Dr. C. Rangarajan, the RBI, Department of Consumer Affairs and several other experts.

The Commission could embark on its task soon after its Notification in March, 2011, because of the timely logistical support provided by SEBI, National Institute of Public Finance and Policy (NIPFP), and National Institute of Securities Market (NISM). I value the support provided by these organisations which helped the Commission to focus its efforts on its main task from the early days.

The task of the Commission has been quite onerous, but in discharging it every Member of the Commission lived upto his/her name and contributed substantively in shaping this Report. I appreciate and acknowledge the contribution of each Member of the Commission and recall the insightful and animated deliberations in our meetings and through electronic communications. I appreciate the additional responsibility willingly discharged by Mr. Swarup as a mentor and advisor on organisational and critical technical issues. The role played by Dr. C.K.G. Nair, Secretary to the Commission, in designing and executing the structures and processes for the seamless functioning of the Commission and his effective interventions in the deliberations in resolving complex issues was exemplary and deserves particular commendation. The untimely demise of Mr. Achuthan was a great loss to all of us. We were handicapped by the poor health of Justice (Dr.) Debi Prasad Pal during the latter half of our work. Dr. M. Govinda Rao, who was with the FSLRC almost till finalising the Report joined the Fourteenth Finance Commission on 4th February 2013. Joint Secretary, Capital Markets (Nominee Member) could not attend the meetings due to other commitments.

The Commission had the benefit of dedicated research teams set up by the NIPFP and by the NISM. These teams worked as a single unit and Dr. Ajay Shah played the role of an inspirational leader to the research teams, synchronising the various young minds and their outputs into an organic whole and succinctly presenting issues before the Commission. I commend the efforts of Dr. Shah, Dr. Ila Patnaik and every other member of this spirited group of young people who worked untiringly for about two years. I also

appreciate the efforts of the consultants of the Commission; Somasekhar Sundaresan, Bobby Parikh and Rajsekhar Rao in guiding the research team on many issues as well as contributing to the deliberations of the Commission.

A number of experts peer-reviewed the draft documents. K.P. Krishnan, Yesha Yadav, M.S. Sahoo, Bindu Ananth and many others provided extensive support in reviewing the drafts. I appreciate their help and useful suggestions.

Financial sector being a catalyst for the real sector growth has to be dynamic enough to support the growth aspirations. The institutional framework – laws, policies and organisations – governing the financial sector should enable its orderly growth in tune with such aspirations. A status-quo framework of a low level, fragmented financial sector supporting the current modest economic size of our nation is incapable and insufficient to perform this aspirational role which our economic institutions should play for our future. Further, such a framework encourages the growth of twilight zones like shadow banking and other shadow financial entities leading to major issues of consumer protection and systemic risk. Given this, the Commission was fully convinced of the need for disbanding the sectoral thinking and incumbent organisational affiliations while designing a new institutional foundation for the aspiring, future Indian economy.

The findings and recommendations of the Commission are the result of distilled wisdom of dozens of high-calibre minds and extensive research on the financial sector laws, policies and practices in India and some of the major jurisdictions abroad, the latter mainly for focusing on post-crisis developments. Using these expert views, feedbacks, research material and the expertise in the Commission, we debated and deliberated on the most appropriate model for India taking the ground realities of the Indian system on board. After all the model we build should be country-specific, tailored to our milieu; laws cannot be formulated without a model, in the vacuum or in a fluid state. We were conscious of the fact that we were attempting something on a magnitude with perhaps no parallel in independent India and legislative changes on a holistic scale are not a regular activity we can undertake. As such, our effort has been futuristic and expected to be sustaining for decades, as institutional changes happen only in a matter of decades as famously stated by Nobel Laureate Oliver Williamson.

The suggested full-scale legislative reforms may look ambitious. The Commission debated this issue at length and, despite many organisation-affiliated views, was fully convinced that a full-scale revamp was needed as piecemeal amendments to the existing legislations were grossly inadequate for a rapidly growing and fast globalising Indian financial sector. It was also clear to us that the foundations of modern financial legal-regulatory structures should be erected during peaceful times rather than wait for a crisis to unfold and then embark on a fire-fighting mode of institution building, which would be muddled and fragile. The need for streamlining the laws and reducing the number of regulatory authorities and giving them clear mandate was a common train of thought of all the experts we consulted.

In brief, this Report is the result of enormous efforts put in by the Commission Members, Secretary, Consultants and Researchers and the intellectual inputs drawn from a large number of experts and stake-holders. I gratefully appreciate and acknowledge all these inputs and support, without which we would have had to settle for sub-optimal outcomes.

New Delhi
22 March, 2013



B.N. Srikrishna

Executive Summary

Mandate

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. For example, the Reserve Bank of India (RBI) Act and the Insurance Act are of 1934 and 1938 vintage respectively. Financial economic governance has been modified in a piecemeal fashion 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 is 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. This is similar to the tradition of Law Commissions in India, which review legislation and propose modifications.

The main outcome of the Commission's work is a draft 'Indian Financial Code' which is non-sectoral in nature (referred to as the draft Code throughout), which is in Volume II of the report and replaces the bulk of the existing financial law.

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 expe-

rience till date. Some elements of the work process that are used in India in Law Commissions were utilised. The Commission embarked upon an intense two year process, which started in April 2011. Three elements were emphasised in the work process. Commission has followed a *consultative approach*, reaching out into knowledge and perspective across all elements of Indian finance. Commission has cultivated a *multi-disciplinary approach*, drawing on the fields of public economics, law, finance, macroeconomics and public administration. Finally, Commission has drawn on *the experiences of emerging markets and developed jurisdictions* in understanding how financial law and agencies have been constructed worldwide.

The drafting of law in a democracy must necessarily give opportunities for all viewpoints to be heard. In addition, the drafting of law in finance involves considerable technical challenges. Over this two year period, more than 120 individuals participated in the process of the Commission in various capacities. This has helped ensure that diverse viewpoints fed into the debates of the Commission, and that the draft Code is characterised by technical soundness in terms of finance, economics, law, and public administration.

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 comprises 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. Regulators will issue regulations, that will often be sectoral and often be rules-based. The advantage of this arrangement is that specific details of technology and market process are not embedded in the law. Over the years, changes in technology and institutions would lead to modifications in regulations. Timeless principles would be re-interpreted in the future by courts and the tribunal, which would create case law. The Commission believes that 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.

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 has 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 law-making 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 India, 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 recommends that they be converted into companies under the Companies Act, 1956. This would help 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 recommends 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 proposes 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 footprint of regulation

As a first step in determining the appropriate form and extent of regulation for the Indian financial sector, the Commission began with an identification of the basic subject matter of regulation - financial products and services. In the view of the Commission, particular forms of dealings in financial products, such as securities, insurance contracts, deposits and credit arrangements, constitute the rendering of financial services. This includes services such as, sale of securities, acceptance of public deposits, operating investment schemes and providing credit facilities. The Commission however recognises that a principles-based approach to defining financial products and financial services comes with the risk of unintentionally casting the net of regulation too wide. Therefore, it was decided that financial regulation should apply to only those persons who are *engaged in the business of carrying on financial services*.

While proposing a list of financial products and services in the draft Code, the Commission is fully aware of the constant innovation in the field of finance. In order to ensure that the law can keep pace with these changes, the draft Code empowers the Government to expand the list of financial products and services, as required. At the same time, the draft Code also allows the regulators to exclude specific financial services carried out by specific categories of persons from the scope of financial services. Using this power the regulator will be able to specify exemptions, e.g. for hedge funds that do not access funds from more than a particular number of persons or investment firms that only advise their related persons. In doing so, the regulator would of course be bound by the objectives and guided by the principles set out under the draft Code.

Structure of the regulator

Just as the draft Code does not differentiate between different sectors in the financial system, the draft Code establishes a single framework for regulatory governance across all agencies. This is rooted in the fact that the requirements of independence and accountability are the same across the financial system. With small adaptations, this standard framework is used in the draft Code for all agencies created therein.

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.

The draft Code establishes certain elements of the functioning of board meetings, so as to ensure adequate oversight of the board over the organisation, and an emphasis on transparency.

A general framework for establishing advisory councils, that will support the board, has been created. This is sometimes invoked in the draft Code in constructing statutory advisory councils. Apart from this, the board will be free to construct additional advisory councils based on its needs.

The Commission envisages that fees charged to the financial system will fund all regulatory agencies. Financial regulation will, therefore, generally impose no burden upon the exchequer. This will assist independence by giving regulators greater autonomy, and help the creation of a specialised workforce.

Functions and powers of the regulator

The actual functioning of the regulator lies in three areas: regulation-making, executive functions and administrative law functions. In each area, the draft Code defines the functioning of regulators with considerable specificity.

At present, in India, there is a confusing situation with regulators utilising many instruments such as regulations, guidelines, circulars, letters, notices and press releases. The draft Code requires all regulators to operate through a small number of well defined instruments only.

The first task of a regulator is that of issuing regulations. If laws are poorly drafted, there is a possibility of excessive delegation by Parliament, where a regulatory agency is given sweeping powers to draft regulations. The Commission has consistently sought to define specific objectives, define specific powers and articulate principles that guide the use of powers. Through this, regulation-making at the regulator would not take place in a vacuum.

A structured process has been defined in the draft Code, through which regulation-making would take place. The regulator would be required to articulate the objective of the regulation, a statement of the problem or market failure that the regulation seeks to address, and analyse the costs and benefits associated with the proposed regulation. A systematic public consultation process is written into the draft Code. This structured regulation-making process would reduce arbitrariness and help improve the quality of regulations.

This structured regulation-making process requires a considerable expenditure of time and effort at the regulator. This is commensurate with the remarkable fact that Parliament has delegated law-making power to a regulator. In an emergency, the regulator

can issue regulations without going through the full regulation-making process. However, these regulations would lapse within six months.

Alongside regulations, the draft Code envisages a process through which regulators can issue ‘guidelines’. Guidelines clarify the interpretation of regulations but do not, themselves, constitute regulations. Specifically, violation of guidelines alone would not constitute violation of the law.

At present, regulations are not subject to judicial review. The Commission envisages an important process of judicial review of regulations. It would be possible to challenge regulations either on process issues (i.e. the full regulation-making process was not followed) or substantive content (i.e. the regulation does not pursue the objectives, or exceeds the powers, or violates the principles, that are in the Act). The Commission believes that these checks and balances will yield considerable improvements in the quality of regulation-making in India.

Turning to executive functions, the draft Code has specifics about each element of the executive powers. The first stage is the processing of permissions. A systematic process has been laid down through which permissions would be given.

The second element is information gathering. Regulators require a substantial scale of regular information flow from financial firms. The Commission envisages a single ‘Financial Data Management Centre’. All financial firms will submit regular information filings electronically to this single facility. This would reduce the cost of compliance, and help improve data management within regulators.

Turning to penalties, the draft Code has a systematic approach where certain standard categories are defined, and principles guide the application of penalties. This would help induce greater consistency, and help produce greater deterrence. A critical component of the framework for penalties is the mechanisms for compounding, which are laid on a sound foundation, and consistently applied across the entire financial system.

Once an investigation has taken place, and the supervisory team within a regulator believes there have been violations, the principles of public administration suggest that the actual order should be written by disinterested party. At the level of the board, an ‘administrative law member’ would have oversight of ‘administrative law officers’ who would not have any responsibilities within the organisation other than performing quasi-judicial functions. A systematic process would operate within the regulator, where administrative law officers and the administrative law member would be presented with evidence and write orders.

The working of the regulator ultimately results in regulations and orders. These would face judicial review at the Tribunal. The Commission envisages a unified Financial Sector Appellate Tribunal (FSAT) that would hear all appeals in finance. A considerable focus has been placed, in the draft Code, on the functioning of the registry of FSAT, so as to achieve high efficiency.

Consumer protection

The work of the Commission in the field of consumer protection marks a watershed compared with traditional approaches in Indian financial law. It marks a break with the tradition of *caveat emptor*, and moves towards a position where a significant burden of consumer protection is placed upon financial firms.

The draft Code first establishes certain basic rights for all financial consumers. In addition, the Code defines what is an unsophisticated consumer, and an additional set of protections are defined for these consumers. The basic protections are:

1. Financial service providers must act with professional diligence;
2. Protection against unfair contract terms;

3. Protection against unfair conduct;
4. Protection of personal information;
5. Requirement of fair disclosure;
6. Redress of complaints by financial service providers.

In addition, unsophisticated consumers have three additional protections:

1. The right to receive suitable advice;
2. Protection from conflicts of interest of advisors;
3. Access to the redress agency for redress of grievances.

The regulator has been given an enumerated set of powers through which it must implement these protections. Alongside these objectives and powers, the regulator has been given a set of principles that guide the use of the powers.

This framework of rights – powers – principles will shape the drafting of regulations. Once this has been done, regulators are obliged to undertake supervisory actions to verify that regulations are being complied with. This goes along with enforcement and disciplinary actions.

This regulatory and supervisory strategy will yield considerable gains in consumer protection, when compared with the present Indian practices. At the same time, there will be certain consumers who are aggrieved. The Commission envisages a single unified Financial Redress Agency (FRA) which would serve any aggrieved consumer, across all sectors. This would feature a low-cost process through which the complaint of the consumer against the financial firm would be heard, and remedies awarded.

As with the FSAT considerable effort has been made by the Commission to obtain an FRA that has high operational capabilities and thus imposes low transactions costs upon all participants.

The FRA is important as a mechanism for addressing the unfair treatment of one consumer. The FRA is also envisaged as a valuable measurement system, for the case database of the FRA is a map that shows where the problems of consumer protection lie. Hence, the Commission envisages a systematic process through which the analysis of this data would feed back into improvements in regulation and supervision.

The Commission recognises that competition is a powerful tool for the protection of consumers. The Competition Act enshrines a non-sectoral approach to competition policy. The Commission has envisaged a detailed mechanism for better co-operation between financial regulators and the Competition Commission through which there is greater harmony in the quest for greater competition.

Micro-prudential regulation

The pursuit of consumer protection logically requires micro-prudential regulation: the task of constraining the behaviour of financial firms so as to reduce the probability of failure. When a financial firm makes a promise to a consumer, it should be regulated so as to achieve a certain high probability that this promise is upheld.

The first component of the draft Code is a definition of the class of situations where micro-prudential regulation is required. This is done in a principles-based way, focusing on the ability of consumers to understand firm failure, to co-ordinate between themselves, and the consequences of firm failure for consumers.

Regulators have five powers through which they can pursue the micro-prudential goal: regulation of entry, regulation of risk-taking, regulation of loss absorption, regulation of governance and management, and monitoring/supervision. The draft Code specifies each of these powers in precise legal detail.

Alongside this, it specifies a set of principles that guide the use of these powers. Eleven principles have been identified that must be complied with. For example, principles require proportionality (greater restrictions for greater risk), equal treatment (equal treatment of equal risk), and so on.

It is envisaged that regulators will pursue the micro-prudential objective by writing regulations that utilise the five powers. At the same time, these regulations would have to satisfy the ten principles.

In this framework, there may be broadly three grounds for appeal against regulations. A regulation engages in micro-prudential regulation of an activity where micro-prudential regulation is not required. A regulation utilises powers which are not prescribed in the law. Finally, a regulation violates the principles which the regulator is required to follow.

Resolution

The Indian financial system has traditionally been dominated by public sector firms. When consumers deal with a Public Sector Undertaking (PSU) bank or insurance company, 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.

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.

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.

At present, for all practical purposes, at present, an unceremonious failure by a large private financial firm in India is not politically feasible. Lacking a formal resolution corporation, in India, the problems of failing private financial firms are placed upon customers, tax-payers, and the shareholders of public sector financial firms. This is an unfair arrangement.

Establishing a sophisticated resolution corporation is thus essential. Drawing on the best international practice, the draft Code envisages a unified resolution corporation that will deal with an array of financial firms such as banks and insurance companies. 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.

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 tax-payer. 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 tax-payer. 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 and mergers.

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 co-ordination 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.

The resolution corporation will charge fees to all covered entities, who benefit from greater trust of unsophisticated consumers. This fee will vary based on the probability of failure, and on the financial consequences for the resolution corporation of the event of failure. This risk-based premium would help improve the pricing of risk in the economy, and generate incentives for financial firms to be more mindful of risk-taking.

The first three pillars of the work of Commission – 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.

Capital controls

India has a fully open current account, but many restrictions on the capital account are in place. A major debate in the field of economic policy concerns the sequencing and timing towards capital account convertibility. The Commission has no view on this question. The focus of the Commission has been on establishing sound principles of public administration and law for capital account restrictions. A large array of the difficulties with the present arrangements would be addressed by emphasising the rule of law and by establishing sound principles of public administration.

In terms of creation of rules, it is envisaged that the Ministry of Finance would make ‘rules’ that control inbound capital flows (and their repatriation) and that RBI would make ‘regulations’ about outbound capital flows (and their repatriation). With RBI, the regulation-making process would be exactly the same as that used in all regulation-making in the Commission framework. With Ministry of Finance, the rule-making process would be substantially similar.

The implementation of all capital controls would vest with the RBI. The draft Code envisages the full operation of the rule of law in this implementation.

Systemic risk

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

The problem of systemic risk requires a bird’s eye perspective of the financial system: it requires seeing the woods and not the trees. This is a very different perspective when compared with the engagement of conventional financial regulation, which tends

to analyse one consumer, one financial product, one financial market or one financial firm at a time. The essence of the systemic risk perspective to look at the financial system as a whole. This differs from the perspective of any one financial regulatory agency, and particularly divergent from the perspective of any one *sectoral* regulator which is likely to see that sector and not the overall financial system.

To some extent, systemic crises are the manifestation of failures on the core tasks of financial regulation, i.e. consumer protection, micro-prudential regulation and resolution. If the three pillars of financial regulation would work well, many of the crises of the past, and hypothetical crisis scenarios of the future, would be defused. Systemic risk in India will go down if institutional capacity is built for the problems of consumer protection, micro-prudential regulation and resolution. However, it will not be eliminated.

First, despite the best intentions, errors of constructing the institutional framework, and human errors, will take place. Second, even if all three pillars work perfectly, some systemic crises would not be forestalled. This calls for work in the field of systemic risk, as a fourth pillar of financial regulation.

While there is a clear case for establishing institutional capacity in these areas, it is also important to be specific in the drafting of law. Unless systemic risk regulation is envisioned as a precise set of steps that would be performed by Government agencies, there is the danger that systemic risk law degenerates into vaguely specified sweeping powers with lack of clarity of objectives.

The Commission deeply analysed the problem 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. In order to achieve this, Commission envisages a five-part process.

The first step is the construction and analysis of a system-wide database. This effort, which will be located at the Financial Stability and Development Council (Financial Stability and Development Council (FSDC)), will analyse the entire financial system and not a subset of it. The discussions at FSDC would communicate the results of this analysis to all regulators, who would co-operate in proposing and implementing solutions.

The second step is the identification of Systemically Important Financial Institutions (SIFIs). The analysis of the unified database, using rules which are agreed upon at FSDC, will be used to make a checklist of SIFIs. These will be subjected to heightened micro-prudential regulation by their respective supervisors.

The third step is the construction and application of system-wide tools for systemic risk regulation.

The fourth step is inter-regulatory co-ordination. Effective co-ordination across a wide array of policy questions is an essential tool for systemic risk reduction.

Finally, the fifth step is crisis management. The Commission envisages the Ministry of Finance as playing the leadership role in a crisis. Here, FSDC will only play a supporting role.

Four of the five elements of the systemic risk process involve a leadership role at FSDC. The Commission envisages that FSDC would be a new statutory agency, in contrast with its relatively informal existence at present.

Financial inclusion and market development

The development agenda in Indian financial economic policy comprises two elements: (i) The development of market infrastructure and processes, and (ii) Redistribution and financial inclusion initiatives, where certain sectors, income or occupational categories are the beneficiaries.

The framework proposed by the Commission involves placing the first objective with regulators and the second with the Government. The draft Code envisages regulators undertaking initiatives in the first area. For the second area, the Government would issue notifications in the Gazette, instructing regulators to impose certain requirements upon stated financial firms. The Government would be obliged to make payments to firms to reflect the costs borne by them.

The Commission felt that all initiatives of this nature – in the pursuit of inclusion or of development – should be subject to systematic evaluation after a period of three years. Decision making would be improved by a process of articulation of specific goals, followed by an evaluation of the extent to which these goals were met.

Monetary policy

The framework envisaged by the Commission features a strong combination of independence and accountability for RBI in its conduct of monetary policy.

The first stage lies in defining the objective of monetary policy. The Ministry of Finance would put out a Statement defining a quantitative monitorable ‘predominant’ target. Additional, subsidiary targets could also be specified, which would be pursued when there are no difficulties in meeting the predominant target.

The draft Code places an array of powers with RBI in the pursuit of this objective. Decisions on the use of these powers would be taken at an executive Monetary Policy Committee (MPC). The MPC would meet regularly, and vote on the exercise of these powers, based on forecasts about the economy and the extent to which the objectives are likely to be met.

The MPC would operate under conditions of high transparency, thus ensuring that the economy at large has a good sense about how the central bank responds to future events.

Alongside this core monetary policy function, RBI would operate a real time gross settlement system, that would be used by banks and clearing houses. It would also operate mechanisms for liquidity assistance through which certain financial firms would be able to obtain credit against collateral.

Public debt management agency

The management of public debt requires a specialised investment banking capability 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.

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. These functions are integrated into a single agency through the draft Code.

Contracts, trading and market abuse

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

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

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

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

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

Financial regulatory architecture

We now turn to the financial regulatory architecture, or the division of the overall work of financial regulation across a set of regulatory agencies. Many alternative structures can be envisioned for the financial regulatory architecture. 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.

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). The draft Code does not have such integration. Changes in the work allocation should not require changes to the underlying laws themselves. From the outset, and over coming decades, decisions about the legal framework governing finance would proceed separately from decisions about the financial regulatory architecture. This would yield greater legal certainty, while facilitating rational choices about financial regulatory architecture motivated by considerations in public administration and public economics.

At present, India has a legacy financial regulatory architecture. The present work allocation, between RBI, SEBI, Insurance Regulatory and Development Authority (IRDA), Pension Fund Regulatory and Development Authority (PFRDA) and Forward Markets Commission (FMC), was not designed. It evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time.

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.

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

An approach of multiple sectoral regulators that construct ‘silos’ induces economic inefficiency. At present, many activities that naturally sit together in one financial firm are forcibly spread across multiple financial firms, in order to suit the contours of the Indian financial regulatory architecture. Financial regulatory architecture should be conducive to greater economies of scale and scope in the financial system. In addition, when the true activities a financial firm are split up across many entities, each of which has oversight of a different supervisor, no one supervisor has a full picture of the risks that are present.

When a regulator focuses on one *sector*, there are certain unique problems of public administration which tend to arise. Assisted by lobbying of financial firms, the regulator tends to share the aspirations of the regulated financial firms. These objectives often conflict with the core economic goals of financial regulation such as consumer protection and swift resolution.

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 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.

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

The Commission proposes a financial regulatory architecture featuring seven agencies. This 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.

The outputs of the Commission

The main result of the work of the Commission is the draft ‘Indian Financial Code’, a single unified and internally consistent draft law that replaces a large part of the existing Indian legal framework governing finance. As has been emphasised earlier, the use of simple English should help ensure that everyone connected with the field would be able to understand the draft Code. This relatively large draft law – which is comprised of 450 sections – constitutes Volume II of the report. Volume I expresses the arguments that led up to the key decisions embedded in the draft Code.

The Commission vigorously debated the ideas expressed in the draft Code over a period of two years, in twenty four full-day meetings. In any law of 450 sections, there are bound to be certain areas of disagreement. The five areas of disagreement within the Commission, which are expressed in four dissent notes, are as follows:

1. *Authorisation requirements*: Prof. Jayanth Varma expresses concerns about the authorisation requirements for financial service providers.
2. *Capital controls*: Mrs. K. J. Udeshi, Dr. P. J. Nayak and Mr. Y. H. Malegam disagree with allocation of responsibilities on capital controls between the Ministry of Finance and RBI.
3. *The role of the Ministry of Finance*: Dr. P. J. Nayak disagrees with the role envisaged for the Ministry of Finance in draft Code especially the role of the FSDC.
4. *Common-law tradition, principles-based law*. Dr. P. J. Nayak expresses concerns about the strategy of the Commission that has favoured a common law, principles-based approach.
5. *Regulation of Non-Banking Financial Company (NBFC)s*: Mr. Y. H. Malegam disagrees with the allocation of regulatory responsibilities for NBFCs.

Conclusion

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 objectives, powers and accountability mechanisms. Commission has focused itself upon this task, of establishing a sound regulatory process.

Most policy debates in the field of finance pertain to the subordinated legislation that is drafted by financial regulatory agencies. The work of Commission does not directly engage with these debates. As an example, Commission does not have a view on the timing and sequencing of capital account liberalisation. Similarly, a large number of the recommendations of the Working Groups which studied individual sectors fall in the domain of modifications to subordinated legislation. The work of Commission 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, and by its own Working Groups, it does not directly address them.

When the proposals of Commission are enacted by Parliament, they will set in motion a modified set of incentives in public administration. Clear objectives in law, and a sound regulation-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 Commission 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.

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.

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.

Introduction

1.1. FSLRC and its Mandate

The Ministry of Finance, Government of India, constituted the Commission¹ vide Resolution dated the 24th March, 2011, ‘with a view to rewriting and cleaning up the financial sector laws to bring them in tune with the current requirements’. The Resolution, detailing the imposition and Terms of Reference (TOR) of the Commission, is in Annex 19.1.

The TOR are quite broad and cover a gamut of issues related to the financial sector in India. Broadly, the Commission has been tasked with examining and reviewing the legislative and regulatory systems; the inter-play of jurisdictions of various regulators; the issues relating to conflict of interest of regulators; the manner of drafting and implementation of subordinate legislation; the criteria and terms of appointment of senior officials in the regulatory authorities and appellate systems of financial sector; clarifying the principles of legislative intent; the issues relating to independence and autonomy of regulators; re-statement and/or repeal of legislations on the basis of liberalisation and other developments in the last two decades; the issues on data privacy and protection of consumers of financial services; the role of information technology and effectiveness of delivery of financial services; the recommendations made by expert committees in the past; the issues relating to inter-state aspect of financial services infrastructure and any other related issues; and evaluating the *raison d’être* of the several laws governing the financial sector, some of them as old as 140 years. Keeping them in context and fitting them to the broad framework of the economy’s future requirements has been a daunting task. The Commission was given a time-frame of twenty four months to complete this effort.

The Commission was set up at a time when the global economy was recovering from the 2008 financial crisis. At the time, lessons from what went wrong and the possible options were being debated. These ideas and inputs were freshly available to the Commission. India escaped the crisis fairly unscathed; and therefore, the Commission did not have to work on regulatory structures and laws in a fire-fighting mode, which is not an appropriate way of building sustainable institutional structures. The Commission could, therefore, assimilate the lessons from the crisis, and at the same time, think and construct a model relevant to the Indian context in a calm and detached manner supported by quality research, extensive deliberations and detailed interaction with a host of experts and stake-holders.

¹The terms *Commission* and *the Commission* are used interchangeably in this report

1.2. Deliberations in the Commission

The Commission followed a multi-pronged approach in completing its task of preparing this report, as well as in drafting laws. This included: scanning expert committee recommendations; extensive research; deliberations by the Commission; deliberations, in its five Working Groups (wgs), on specific issues; interaction with several experts and stakeholders from the financial sector, as well as with financial policy makers, experts and regulators of select jurisdictions abroad. A team of consultants, researchers and other officials assisted the Commission in its task; the list is given in Annex 19.2.

The objective has been to assemble a solid information base relating to the current state of the economy and the financial sector, the institutional constraints, developments elsewhere and to make an assessment of what is needed to institutionalise the structure of the financial sector, in tune with the requirements of a fast growing economy. In its inquiry, the Commission also tried to understand the reasons for the 2008 financial crisis and the lessons that may be followed for the future India, as her institutions have to achieve the strength and maturity to withstand possible financial crises in the future.

The Commission had twenty four meetings over a span of two years. During the early days itself, an approach towards completing its task was designed. It was decided that the Commission would deliberate on the basic framework and the fundamental principles governing the financial sector and decide the same. Based on this framework and principles, the wgs would delve deep into select sector-specific issues that require detailed analysis. Based on the deliberations and decisions in the Commission and its wgs, draft documents would be prepared by the research team and debated further in subsequent meetings.

From the beginning, there had been a consensus that the Indian financial sector has been operating at a low-level equilibrium, although in this world of ‘small finance’, it may be doing reasonably well, according to established thinking. The Commission learned a lot from the various expert committee reports already available on the Indian financial sector. There was also unanimity that the trajectory had to be scaled up from this low-level equilibrium so that the financial sector effectively performs its catalytic role for a new aspiring India, which is expected to reach the size of the 2012 Gross Domestic Product (GDP) of the USA (us\$15 trillion) by 2025-30. While India wanted to avoid the path of runaway financial innovation and unmitigated risk-taking that led to the 2008 financial crisis, which continues to threaten the global economy, there was unanimity that the Indian financial structure needs to grow considerably. To enable this, the institutional structure needs to be revamped given that supporting laws are obsolete and organisational structures fragmented. In short, a consolidation of the financial sector laws and organisations was an essential prerequisite for unleashing the potential of the financial sector and in supporting the vaulting ambitions of the real sector.

1.3. Interaction with experts and stake-holders

Interactions with experts and stake-holders were held in parallel from the third meeting of the Commission. The list of experts and entities that the Commission invited for interaction is in Annex 19.3. A broad list of issues and questions was given to these experts; this list is in Annex 19.4. The Commission also interacted with policy makers, experts and regulatory authorities in select jurisdictions abroad; the list is in Annex 19.5. Ideas that emerged from these interactions have also been used in calibrating the position and drawing the broad contours of the stand that the Commission has adopted in its approach.

The broad themes emerging from these interactions are as follows:

1. The legislative foundation of India's financial sector is too complex and cumbersome. These legislations, of which many are outdated - with occasional, piecemeal amendment, do not provide a holistic framework for the harmonious development of the financial sector and its interplay with the needs of the economy. As such, there is an urgent need for an overhaul of the legislative-regulatory framework of the financial sector. However, there were different views with regard to the process of consolidating and harmonising this framework. Some suggested a complete overhaul, while a few suggested substantive surgery of the existing framework.
2. The regulatory architecture is too fragmented, leaving substantial scope for grey areas and overlaps, capture, and bargaining. While many experts were agnostic about the exact model to be adopted (from a single super-regulator to a dual structure of prudential regulation and conduct regulation to a limited number of functionally homogeneous regulators with a strong co-ordination mechanism), many expressed the need for greater consolidation. Further, the legal-institutional framework should provide clarity of purpose, powers and functions, as well as a statutory mechanism of accountability for the regulators. While many of the expert views were for total or greater consolidation, the existing regulatory authorities argued for status quo.
3. The current architecture is not conducive enough for addressing the issues emanating from the global context of financial development. Fragmented regulation and regulatory responsibilities and lack of clarity would hinder both domestic and global co-ordination efforts in addressing issues of contagion and global financial shocks. There is a need for strengthening the fundamental architecture in addressing such issues, as well as for evolving a framework for dealing with systemic risk and resolution. Though the tools for addressing these issues are still on the drawing board, some of the institutional structures available in select jurisdictions, such as resolution framework, have proved to be essential for preserving the stability of the financial system. A more streamlined structure is also needed for dealing with financial issues related to terrorism and other connected issues, which are a major global concern that national authorities have to address through international protocols.
4. There is a need for strengthening the consumer protection and grievance redress mechanism in the financial sector. This is particularly important given the low level of financial literacy, low penetration of financial services, absence of clear regulatory mandate on composite and complex products and on the roles of product distributors and financial advisers. Given the complexity of these issues, the main focus was on the necessity of placing consumer protection at the centre of the philosophy on financial regulation. This issue needs to be addressed both from the preventive and curative sides; by the regulators, as well as the redress agency, respectively.
5. The current architecture encourages turf battles and conflicts of interest. This is a result of the lack of clarity of functions of the various regulatory authorities, as well as of assigning conflicting functions to the same regulatory agency. Despite the explicit development objectives given to the sector-specific regulators, market development has been far from satisfactory as is evidenced in the time-frame on developing products and systems such as in the corporate bond markets. These need to be improved by clarifying the statutory provisions, streamlining regulatory architecture, and removing the conflicting functions from the mandate of some of the regulators.
6. There have been various arguments on the issue of adopting a principles-based approach to regulation, particularly as practised in some jurisdictions prior to the global crisis. At the same time, there has been strong support for adopting a principles-based approach to primary legislations so that these legislations do not go for

amendments frequently and, in the process, lead to regulatory uncertainties. It was also argued that the primary legislation should provide a template for expanding the basic principles into concrete regulations, which at times could be rules-based. It was also argued that the limited regulatory capabilities available should be harmonised and consolidated to promote the skills for administering the principles-based approach to regulation, rather than spreading such scarce skills across a large number of entities with fragmented mandate. These principles and regulations should address the incentive issues fundamentally, so as to minimise financial market adventures, rather than micro-manage product structures and market micro-structures.

7. While every regulator should encourage competition in their sector, the ultimate responsibility of managing economy-wide competition issues should be left to the Competition Commission. While this would help address many macro-level consumer issues, such micro-level issues should be addressed by the sector specific regulators and the grievance redress fora/forum. There should be greater, and institutionalised, interface between the Competition Commission and sectoral regulators in promoting competition and competition practices and culture.
8. While there has been a view that the redress mechanism under the Consumer Protection Act has been functioning satisfactorily, there were also arguments that this framework, as it exists today, is insufficient to deal with the growing complexities in the financial sector. While some of the respondents argued for strengthening consumer redress mechanism in each sector under the aegis of the existing regulators, there were also suggestions for consolidating the consumer redress mechanism by means of a single redress agency for the financial sector.
9. While some of the arguments for retaining sector specific regulators favoured retention of commodity market regulation as a separate area, there were also arguments that derivative markets are financial markets, there is growing financialisation of even physical commodities, players in the system are the same, irrespective of the underlying, and there is the need for consolidated regulation of organised trading to be effective.
10. There were also strong views on the need for strengthening the corporate governance process of regulators – the process of appointment, tenure, compensation and overall skill formation and development of domain expertise. Regulatory expertise, it was felt, is in short supply and should be made a thrust area of focus. Transplanting civil service structures to regulatory authorities is against the basic premise of setting up independent regulatory authorities and a new culture should be built alongside constructing new structures.
11. On issues related to transition arrangements, there were views which encouraged a gradual transition and those which argued for a sudden shift. The former was based on the premise that organisations and market entities take time to adjust to new laws and regulations, while the latter argued that greater flexibility would lead to bargaining for longer time-frame and in the process dilute the efforts towards institutional restructuring.

1.4. Working Group Process

As stated in an earlier section, the Commission decided to multi-task its approach by a parallel process of wgs. Five areas were identified for detailed analysis: (i) Banking, (ii) Securities, (iii) Public Debt Management, (iv) Payment Systems, and (v) Insurance, Pensions & Small Savings. Each Working Group was chaired by a Member of the Commission. Other Members were free to join any of the wgs as per their preference and attend any of

the meetings. Secretary to the Commission was part of all wgs and acted as a link between the Commission and the wgs, as well as between the various wgs in harmonising their approach and ideas in tune with the decisions of the Commission. The composition, terms of reference, and recommendations of these five wgs can be found in Annex 19.6, 19.7, 19.8, 19.9 and 19.10.

Apart from the Chairperson, each wg comprised domain experts, who brought in considerable domain knowledge to the deliberations. All wgs were supported by the research team of the Commission; the team provided substantive inputs and drafted documents. Each wg had intensive deliberations and interacted with a number of stake-holders and experts from various institutions; a list of these institutions is in Annex 19.11.

After substantive deliberations and interactions, each wg came out with sector-specific aspects on consumer protection, micro-prudential regulation, legal process, and other aspects specific to the sector within the broad contours designed by the Commission. The Chairpersons of the wgs presented their reports before the Commission. Their recommendations were debated, analysed and finally accepted by the Commission, with appropriate modifications as deemed fit. The work of these wgs has been incorporated in the relevant parts of this report. Prior to the review by the Commission, many of the draft documents were peer reviewed by domain experts whose names are in Annex 19.12. The drafts were also intensively scrutinised by sub-groups of the Commission.

1.5. Analysis and assessment

The Commission has been tasked with the mandate of reviewing and rewriting financial sector legislations built up over a century. However, laws cannot be scripted in vacuum. Laws have to support a certain policy-organisational framework. In the context of financial sector laws, the laws should support India's financial sector structure and the delicate balance between the state policy and instruments and the market. The financial sector is a catalyst supporting that economic framework. Therefore, while designing the legislative framework for the financial sector, the contours of the financial sector, as well as the contours of the macro economy need to be clearly understood and the linkages harmonised for synergy.

After substantive deliberations and interactions, the Commission released an Approach Paper outlining the broad contours of the proposed financial sector institutional framework. The feedback on this Approach Paper, received from various stake-holders and the public, as well as, in general, through its website and correspondences (Annex 19.13), has also been analysed and incorporated into the analytical framework.

1.5.1. Long-term views on the Indian economy

Changes contemplated by the Commission are of high magnitude in terms of its impact on institutions. As such, the recommendations of the Commission cannot be viewed in a short-term framework, nor can the implementation and impact process be completed within a short horizon. Therefore, the Commission has envisioned a medium- to long-term view on the Indian economy and tried to structure the requirements of the financial sector in terms of laws and institutions to support this vision.

In 2012, the size of the Indian economy was about US\$2 trillion. The economy is expected to grow at a moderately high pace, despite periodic fluctuations on account of structural and cyclical reasons. Given the nominal growth rate in the vicinity of 15 per cent, the nominal GDP would double in about 5 years and would reach about US\$15 trillion by 2026. This was the size of the US economy in 2012. This implies that by around 2026, India's GDP will be the size of the present day US GDP. There will be changes in the

sectoral composition of GDP as well. Newer activities will enter the services and manufacturing sectors, making the primary sector smaller, implying a reduced share of agriculture in the overall GDP. All this means a greater role of the financial sector through the need for effective and qualitative financial intermediation. Even by keeping aside inclusion as an objective, the financial sector is expected to grow manifold in terms of size, strength, and efficiency to support the growing requirements of a fast growing economy. The small world of finance that exists in India today, howsoever effective, will not be able to cater to the requirements of the huge economic opportunities that would be unleashed by the growth process. Therefore, even in static terms of assuming just normal growth as envisioned by the GDP growth rates, the financial sector needs to expand, innovate and experiment. The agenda of inclusion magnifies this need manifold.

1.5.2. Fragility of the current system

Through its own deliberations, research, and interactions with various experts, the Commission was convinced that the current regulatory financial structure of the Indian financial sector regulation is not only fragmented, but also fragile. This is evident from the fact that there is no uniform philosophy of regulation; different regulators approach similar issues in different ways. The financial sector lacks a uniform legal process, uniform appellate mechanism, and a uniform appointment process. This lack of coherence in the philosophy of regulation is a fundamental weakness of the regulatory architecture.

The Commission also noted several instances where the independent/statutory regulatory authorities were considered similar to the field agencies of the executive; instructions are passed on to regulators as if they are extensions of the executive. This blurred vision of agency structure needs to be corrected as statutory Independent Regulatory Agencies (IRAs) are quite different from the traditional field agencies of the Government. The IRAs are statutorily empowered to perform the three functions of the state – regulation-making (legislation), administration (executive), and adjudication (quasi judicial) – even at the perceived cost of blurring the principle of separation of powers embedded in the Constitution. This is a conscious decision taken by the Parliament in empowering IRAs to help efficiently perform their task for which they were created. In order to prevent regulatory excesses, minimise ‘democratic deficit’, and make the IRAs restrict themselves to effectively performing their mandated responsibilities, an effective accountability framework is to be provided in the statute itself. Thus, statutory autonomy in performing their mandate and statutory accountability mechanisms are the balancing pillars of the principal-agent relationship while designing the IRAs.

Some of the developments in the regulatory sphere of financial markets in India in the last few years have raised doubts on the efficacy of the current model of delegation to regulatory authorities. Increasing tensions between the Government and the regulators, and between the regulators, has come to the fore during this period. These internecine steps were the result of an imperfect balancing of autonomy and accountability and a blurred picture on the type of principal-agent relationship. It dented the basic foundations of conditional delegation and the ability of the model to effectively regulate the financial system.

Instances of such mutually conflicting postures adopted by regulators are many. These include the oversight battle over Unit Linked Insurance Plans (ULIPs) between SEBI and IRDA, the conflicts between SEBI and FMC on commodity based exchange traded funds, the conflicts between FMC and Central Electricity Regulatory Commission (CERC) (even when the latter is a non-financial sector regulator) on electricity futures trading, the conflicts between Competition Commission of India (CCI) and sector-specific regulators, the frequency with which regulated entities challenge the regulators, all of which happened in the last few years, underlining the growing tensions and fissures in the regulatory-institutional framework of financial sector regulation.

The difficulty in addressing financial sector regulation on a holistic basis has given rise to a rapidly growing shadow financial sector. This includes shadow banking and other shadow financial service providers who collect huge amounts of money from the public, particularly the retail investors, leading to fundamental concerns on consumer protection and at times generating issues of financial stability and systemic risk. There have been increased incidences of such entities operating between the regulatory boundaries at their will, defrauding investors in the name of emus, plantations, and pyramid formations. Unless issues of regulatory grey areas and governance are addressed early in a systematic manner, all these issues are likely to aggravate in the future, given that innovations on products, practices and organisational structures very often happen outside regulatory boundaries.

The setting up of the FSDC and the formation of the Commission itself has been a clear recognition of the limitations of the existing statutory and organisational arrangements. While the FSDC as an apex council for regulatory co-ordination and financial sector development, was an interim response, the Commission, mandated to rewrite and clean up the financial sector legislations and architecture, was to provide the long-term institutional answer to the problems haunting the current institutional ethos of the financial sector. This is what has been attempted in this report.

1.5.3. Financial inclusion and literacy

Financial inclusion is a major policy objective that India has been trying to achieve over the years. The Commission has noted that inclusion, even in terms of basic banking accounts, has reached only about half the population; in terms of financial instruments such as insurance and securities, inclusion is far limited. Though the level of inclusion should depend on the type of financial products, financial services, such as basic banking and pure insurance products, should reach almost all; other products, enabling risk management and income generation, should reach a sizeable population so that the benefits of modern finance are available to a large part of the population.

The Commission debated issues emanating from mandated development and financial inclusion as a regulatory responsibility. While expert opinion is divided on the subject, the underlying line of thinking has been that regulatory mandating has to be avoided because the regulatory approach should be to provide an enabling framework wherein service providers would be able to use innovative approaches, including usage of modern technologies, in achieving the desired macro objectives. Moreover, micro-level targeting and licencing approaches may be too slow in achieving this objective.

1.5.4. Financial globalisation and lessons from the crisis

No major economy in the world today can be viewed in isolation from the rest of the world. Given the size and the growing magnitude of interaction – in terms of trade, services, and capital flows – and the greater openness to globalisation, India is in a different economic milieu today than it was two decades ago. India is virtually part of the world of globalised finance and is learning to walk, negotiating the strong currents both positive and negative, generated by the forces of financial globalisation.

Negative aspects of financial globalisation and run away innovations in certain parts of the world resulted in the global financial crisis of 2008. The world has learnt a number of lessons from this crisis. The Commission, through its research, interactions with regulatory authorities and experts from different parts of the world, and through India's own experience during the crisis, has understood the need for a carefully calibrated regulatory approach to address the limitations of the market, particularly its tendency to travel too fast and become too complex, both in terms of product and organisational innovations.

The Commission has understood that the world has learnt the lessons of financial instability and therefore provided for an effective and continuous mechanism for addressing issues of systemic risk, as well as, the need for addressing failures of individual entities through resolution. The messages coming clear and loud from the financial crisis on the need for more closely and effectively regulating the market, emphasis on systemic risk, and an effective resolution framework have been factored into the recommendations of the Commission.

1.5.5. Regulatory developments elsewhere

Following the financial crisis of 2008, there have been several efforts in some jurisdictions for strengthening, and in a few cases, recasting regulatory structures. These are particularly pronounced in the case of the us and the uk, while other jurisdictions are contemplating limited changes in strengthening the weaker links in their structures. The Commission had extensive interaction with the officials and experts on the changes being made in the uk, Canada, Australia, Singapore and limited dialogue with agencies such as the us Fed and Indo-us Business Council. The most radical changes are being contemplated in the uk, where the super regulator, Financial Services Authority (FSA), has been divided and the mandate relating to prudential regulation transferred to the Bank of England as its subsidiary and converting the FSA into a Financial Conduct Authority (FCA). Our understanding of the reasons for this change was that FSA's focus on the market conduct dimensions at the cost of relative neglect of the prudential dimension led to building up of risks for the banking sector, which was not observed in time. In the case of Australia, on the other hand, prudential regulation and conduct regulation had been divided and mandated to two distinct agencies (Australian Prudential Regulatory Authority and the Australian Securities Investment Commission) in their twin-peak model which was adopted in the mid 90's. This model withstood the crisis relatively better. Similarly, in Canada, prudential regulation and conduct regulation has been placed in two different agencies, the Office of the Superintendent of Financial Institutions as well as the Financial Consumer Agency. While the importance of treating prudential and conduct regulation distinctly in these jurisdictions has been well understood, the Commission has not recommended a similar approach in the Indian context because of the reason that the required regulatory expertise is not yet available. Hence, the recommendation for the same regulator dealing with both prudential and market conduct aspects for the medium run, while in the long run this could be modified depending on the experiences gained within this country and elsewhere. The legal and statutory framework also tries to provide for easy changes in regulatory mandate so that changes in functions would involve only limited statutory changes.

1.5.6. Global co-ordination in the emerging context

Along with financial globalisation, complexities of financial regulation have also increased. This became more complex after the crisis and following the adoption of greater scrutiny of the concerns arising from terrorism-related financial activities. The new obligations under the Financial Action Task Force (FATF) and Combating the Financing of Terrorism (CFT) regimes have necessitated co-ordination between domestic financial regulators amongst all the jurisdictions and between the global co-ordinating institutions. Greater co-ordination has also become imperative in the context of concerns on financial stability. The Commission is fully aware of the onus that these additional tasks would bring upon domestic regulatory authorities as well as the enabling legal framework.

1.5.7. Harmonisation of laws

All the factors outlined in the previous sub-sections necessitate the need to redraft our legislations and harmonise them. Our laws have been built up over a century and have

been modified multiple times, creating newer and greater complexities. Sector-wise fragmentation and segmented approach to regulation further amplified these basic frictions. There is also a lack of coherence in terms of their underlying philosophy, since these laws had been enacted at different periods of time when financial sector needs were of a different type and nature. Many of these legislations are of pre-independence origin, where the objective functions were also different from what is desirable for a modern interdependent economy.

Given these underlying factors about the vintage, philosophy, structure, and constraints of the regulatory framework, the existing framework cannot be used effectively by a resurgent India, expecting to reach the size of current US economy in about two decades. It cannot also be used to address issues emanating from financial globalisation and for addressing the lessons learnt from the global crisis. It cannot address the requirements of a large, modern economy wherein the financial sector plays a significant role. It cannot address issues of effective global co-ordination, both as a requirement for global financial stability and supervisory requirement for combating terrorism and related financial issues. A fragmented approach, based on multiple laws and organisations, cannot effectively include the excluded population into the modern financial sector. Given these reasons, the Commission felt the need for a complete overhaul of the statutory framework. This involves repealing many of the statutes, substantially amending another set of legislations, and amending certain provisions in other related legislations.

1.5.8. Strengthening the regulatory framework

The existing regulatory environment in India is fragmented and complex. There are multiple regulators, each one tasked with a silo within the financial sector. Given the fluidity and the fungibility of financial markets, such a fragmented approach cannot possibly achieve the results desired in terms of providing an organic unity to the sector in addressing domestic and global co-ordination, addressing financial development and inclusion, and dealing with systemic stability and other concerns. In fact, the experience of regulatory co-operation in India has not been very encouraging and has witnessed escalation of conflicts in the recent past. The Commission, therefore, feels that the fragmented approach to financial sector regulation in India has failed on many grounds, which need to be corrected. But at the same time, learning from the global crisis and the consequential regulatory rethinking in multiple jurisdictions, and the need for aligning the regulatory requirements to our own milieu, the Commission deliberated the issue of appropriate regulatory structure in detail.

The tasks of financial law

The Commission has envisaged certain key components of the financial legal framework. 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. The Commission strongly feels that laws must be defined in terms of their economic purpose, rather than in terms of the powers conferred upon regulatory agencies or in terms of the entities who are affected by the law. This clarity on *objectives* is essential for obtaining accountability in regulation. 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, regulated.

From this perspective, the tasks of financial law can be envisioned as the following nine components:

1. *Consumer protection*: A prime motivation of all financial regulation is to protect consumers. The relationship between financial firms and their customers is one where, many times, the outcomes may harm customers. These problems are not sporadic or accidental; but are often rooted in basic problems of information and incentives and will not be alleviated through financial literacy campaigns. The central purpose of financial regulation is to intervene in the relationship between financial firms and their customers, and address market failures. This requires a comprehensive consumer protection framework that covers both the problem of prevention (interventions that induce financial firms towards fair play) and cure (addressing consumer grievances).
2. *Micro-prudential regulation*: One element of protecting consumers is to constrain financial firms to take lower risk, so as to improve the extent to which promises by a financial firm to a consumer are upheld. This is the task of micro-prudential regulation. In addition to being motivated by consumer protection, high quality micro-prudential regulation also reduces systemic risk. This calls for a comprehensive micro-prudential framework.
3. *Resolution*: The best efforts of micro-prudential regulation will reduce, but not eliminate, the failure of financial firms. When such episodes arise, a specialised resolution capability is required to ensure graceful winding up of a financial firm that has become unviable, and transition the customers of the erstwhile firm. Under a formal arrangement such as this, a key difference that will be induced by a resolution corporation will be reduced burden on tax payer resources by failing financial firms. When a financial firm is healthy, it would face micro-prudential regulation, while the resolution corporation would lie in the background. When the firm approaches failure, it would increasingly face the resolution corporation. This requires the legal framework to create a resolution corporation and set it in motion.
4. *Capital controls*: India now has an open current account, but many capital account restrictions remain. The Commission agreed that the timing and sequencing of capital account liberalisation should be chosen by policy makers in the future. The drafting of law needs to establish a sound legal foundation for capital controls, with a focus on objectives and accountability in regulation-making, and an emphasis on the rule of law. The regulations governing inward flows should

be framed by the Central Government, in consultation with the RBI. The regulations governing outward flows should be framed by the RBI, in consultation with the Central Government.

5. *Systemic risk*: Micro-prudential regulation focuses on one financial firm at a time. While this is important in its own right, there is a requirement for an additional, and different, perspective on risk of the financial system as a whole. This requires analysis of the entire financial system, understanding the build-up of risk across all elements of the financial system, and undertaking co-ordinated actions (through multiple regulatory agencies) to reduce the probability of a systemic crisis.

The terms *financial stability* and *macro-prudential regulation* are sometimes used in this discourse. The Commission has chosen to consistently use the phrases *systemic risk* and *systemic risk regulation* as they lend greater clarity in communicating the problem and the task.

6. *Development and redistribution*: In addition to the above components of financial law, financial economic governance in India is also charged with the objectives of development and redistribution. At the same time, these functions need to be placed on sound legal foundation.
7. *Monetary policy*: The conduct of monetary policy is covered by a law that establishes the central bank and defines the triad of objectives, powers and accountability mechanisms.
8. *Public debt management*: A specialised framework on public debt management is needed to cover the function of analysing the comprehensive structure of liabilities of the Government, and embarking on strategies for minimising the cost of raising and servicing public debt over the long-term within an acceptable level of risk.
9. *Foundations of contracts and property*: A specialised framework setting out the foundations of financial contracts, and making adaptations to general commercial laws, is required for the proper functioning of the financial system.

Each of these components is associated with a chapter in this report and a part in the accompanying draft Indian Financial Code ('draft Code').

2.1. Shifting away from a sectoral perspective

The discussion above has focused on nine areas of work:

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

The Commission has prepared a draft Code covering these nine areas. The draft Code also contains a specialised law to address governance processes associated with regulators and other financial agencies, addressing the problems of independence and accountability. Putting these ten elements together, the draft Code constitutes a fairly comprehensive and unified treatment of financial law.

This strategy differs from the current Indian law, which is sectoral in nature. Current 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 regulatory governance law would apply to all financial agencies.

This is a superior approach from many points of view. Shifting away from sectoral laws yields consistent treatment across sectors. It has become 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.

While the draft Code proposed by the Commission is 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 part of the draft Code, 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.

As an example, the 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 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 the main NBFC activities: deposit-taking, raising capital through securities issuance, and lending to consumers and investment. Under the framework proposed by the Commission, all these activities would be analysed through the objectives and powers contained in the draft Code under the parts 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. If a NBFC does not take deposits, the nature of promises made to consumers changes, and the micro-prudential regulatory strategy would be correspondingly different.

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

2.2. Adopting a principles-based approach

The Commission believes that 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 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. This approach, which may be termed an Occam's razor applied to the field of law, has worked well with components of Indian law such as the Evidence Act and the Contract Act, both of which were enacted in 1872, and have largely stood the test of time.

In the field of finance, this implies a 'principles-based' approach. Laws will articulate broad principles that do not vary with financial or technological innovation. Regulators will write subordinated legislation that could either be in the form of detailed prescriptive rules or be principles-based, depending on the situation and the judgment of the regulator. Subordinated legislation will be frequently modified by regulators, through a process defined by Parliament, and thus constantly adapt to financial and technological innovation. This combination of legislation and subordinated legislation yields a body of law that evolves smoothly over time. For a contrast, if detailed features of financial products

and processes were embedded in law, the requirement of frequent amendments to the law would hinder progress.

This approach also substantively improves the compliance culture. Under rules-based regulation, there is the risk that financial firms set up complex harmful structures that comply with the letter of the rules. The Commission recommends that laws should 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 finance and technology. The workload of complex cases will go up, when we move towards a common law approach. The Commission has decided to build on India's success with the SAT, which will be subsumed in a FSAT that will serve as an appellate authority for the entire financial system and will also review validity of rules and regulations on the touchstone of principles-based law. Rulings of the FSAT, and the Supreme Court, would build a living body of jurisprudence alongside the principles-based laws recommended by the Commission.

2.3. Approach to drafting

In formulating the draft Code, the Commission surveyed drafting techniques adopted domestically and internationally. One option was to draft the provisions in the fashion that readers of Indian law have been familiar with for years, that uses compound and archaic words such as “shall”, “notwithstanding” and “heretofore”, or open-ended terms. Another option was to adopt the internationally accepted “plain and simple” drafting technique, which attempts to convey clear and precise meaning in simple English. It avoids usage of complex, archaic phrases and legal jargon and aims to ensure that ideas are presented in a logical and effective manner. It brings clarity to the reader and balances simplicity and precision.

A drafting technique must be consistent with the objective that the draft intends to convey. Sometimes, vague phrases might indeed convey the requisite meaning, while on other occasions, a precise formulation is necessary. The draft Code has attempted to balance these in the best possible manner, without compromising on the essence of the law.

After much deliberation, the Commission decided to adopt the plain language technique, to the extent practical. The Commission believes that this is the best possible manner in which timeless principles can be articulated in the primary law and the intent can be communicated clearly to the regulators.

Adopting plain language technique would lead to avoiding usage of traditionally accepted, well understood and judicially recognised phrases, but in the interest of clarity and achieving international standards, this is a necessary bargain. It is expected that jurisprudence and interpretative meanings of new phrases would develop with time.

Plain language technique also advocates usage of gender neutral language. While the *General Clauses Act, 1897* provides that “words importing the masculine gender shall be taken to include females”, the Commission has deliberately steered clear of referring to either, and sought to use language that is gender neutral, to the extent practical.

The following indicative list encapsulates the kind of standards that have been adopted in preparing the draft Code:

1. Active voice has been used to the extent possible.
2. Plain English words, and simple and short sentences have been used. For instance

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- ▶ “in case” or “if” instead of “in the event of”;
 - ▶ “if” or “when” instead of “provided that”; and
 - ▶ “within” instead of “with a period of”, “before the end of”.
3. Archaic phrases have been avoided, to the extent possible, for instance, “aforesaid”, “thereof”, “best of knowledge”, “wherein”, and “shall”.
 4. Double negatives and complex sentences have been avoided to the extent possible.
 5. The use of explanations, exceptions, “non-obstante”, “notwithstanding” and “subject to” clauses have been avoided to the extent possible.
 6. Words in pairs have been avoided, particularly if one of the words convey the full meaning, such as “null and void”, “agreed and declared”, “force and effect”, “contravene and fail to comply”, “freed and discharged”.
 7. Vague words have been avoided, to the extent possible, for instance, “public interest”, “as it may deem fit”, “good faith”.
 8. Latin and foreign words have been avoided, such as “*mutatis mutandis*”, “*ultra vires*”, “*ex parte*”, and “*bona fide*”.
 9. Use of un-numbered paragraphs have been avoided.

2.4. Financial regulatory governance

The bulk of the law that financial firms actually interact with is *regulations* and not the primary legislation. In order to cope with the specialised technical demands of the field, and the rapid pace of financial and technological innovation, the architecture that has been adopted the world over consists of Parliament drafting laws that establish financial regulators and set them in motion. The regulators then draft regulations, which embed intricate market knowledge, and evolve rapidly.

The central task of financial law, then, consists of setting up regulators and ensuring that they operate correctly. The Commission has made the sound structuring of financial regulators, and thus laying the foundation for a sound financial regulatory process, a prime objective. The work of the Commission revolves around four themes: (a) Clarity on objectives and avoiding conflicts of interest; (b) Precisely defined powers; (c) Operational and political independence; and (d) Accountability mechanisms.

2.4.1. Independence of regulators

In recent decades, independent regulators have become an important part of the policy landscape in India and worldwide. There are four arguments in favour of having the supervision and regulation of the financial sector done by regulatory agencies that are independent of the Government:

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; and
4. The presence of independent regulators improves legal certainty by ensuring that the regulatory approach does not fluctuate with political changes.

Mere physical separation of the regulator from the Government is however not sufficient to ensure its independence. This needs to be accompanied by legal and administrative processes that clearly delineate the functioning of the regulator from the rest of the Government.

In the normal functioning of Government, the three functions of regulation-making, enforcement and adjudication are kept separate under the ‘separation of powers’ doctrine. When the Parliament delegates these functions to the regulators, it places them in the unique position of being ‘mini-states’ with powers similar to the legislature, executive and judiciary all under a single entity. The Commission has strived to achieve greater separation of powers in the functioning of the regulator, particularly by separating out adjudication from other activities.

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 could do. At 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. To avoid both these extremes, the Commission recommends that independent regulators should be given precise objectives, and a specific toolkit of powers through which those objectives are to be pursued, with the independence to decide the manner in which the powers are to be used. Any action of the regulator will however remain subject to extensive mechanisms of accountability.

2.4.2. Accountability of regulators

As argued above, regulatory independence is essential to support the functioning of the regulator as an expert body, and to ensure that regulation-making and enforcement do not fluctuate with changes in political executives. But independence is not an unmixed blessing: when unelected officials are given strong powers, this needs to be accompanied by appropriate accountability mechanisms.

The Commission recommends that the substance of financial regulation is too minute and dynamic to be legislated upon by Parliament, however, the *process* through which financial regulation is to be effected should be clearly detailed in the law. Parliamentary legislation should therefore incorporate high standards of *procedure* that the regulator will be required to adhere to. Drawing on practical Indian experiences of the last twenty years and global best practices, the draft Code embeds an array of mechanisms through which independence of the regulator can be actually operationalised, and accountability achieved.

The Commission has adopted the following pathways to accountability:

1. Setting out of clear objective standards of governance that the regulator must adhere to;
2. A well-structured regulation-making process with appropriate checks and balances to ensure that all regulations are backed by thorough analysis of costs and benefits and are made through an open consultative process;
3. A formal and transparent system of regulation and supervision, rooted in the rule of law, which will include:
 - ▶ Duty of the regulator to explain its actions to regulated entities and the public at large; and
 - ▶ Requirements that regulatory actions and changes should be imposed with adequate prior information to persons likely to be affected (unless inappropriate for a particular situation) and should rarely be carried out without hearing the concerned parties;
4. Reporting requirements that mandate the regulator to disclose how it fared on pursuing its desired outcomes and at what cost; and
5. Placing the judicial oversight of the regulator in FSAT which will ensure greater scrutiny over the actions of the regulator and with greater efficiency. Principles of efficiency and measurement of performance will also be applied to the FSAT.

2.5. Ownership neutrality and competition

The Indian financial system has an array of firms: co-operatives, private Indian firms, foreign firms and public sector firms. The Commission envisages a regulatory framework where governance standards for regulated entities will not depend on the form of organisation of the financial firm or its ownership structure. This will yield ‘competitive neutrality’. In this framework, the regulatory treatment of companies, co-operatives and partnerships; public and private financial firms; and domestic and foreign firms, will be identical.

2.5.1. Treatment of foreign firms

Whether or not, or the extent to which, participation by foreign firms should be allowed in the financial sector is a policy matter to be determined by the Government. However, once a decision to allow foreign participation in a particular financial market has been made, there should be consistency in the regulatory treatment of foreign and domestic participants performing similar functions or undertaking similar risks in the market.

For example, if the foreign investment policy for a particular sector permits wholly owned foreign subsidiaries, the regulator must ensure that the net worth requirements, capital adequacy norms, investment limits and all other regulatory interventions should be the same for foreign subsidiaries and domestically owned firms.

Hence, the Commission recommends, under the capital controls framework of the draft Code, that subject to control restrictions as prescribed, there should be full national treatment for foreign firms.

2.5.2. Public sector financial institutions

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 continue to be with us. The Commission has therefore identified 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 draft Code emphasises the principles of equal treatment and a pro-competitive environment.
3. To the extent that competition concerns in the financial sector arise on account of existing laws that confer special privileges on state-owned enterprises, the Commission recommends amendments to the laws to create a level playing field between regulated entities, irrespective of their ownership structure.

The goal of achieving competitive neutrality in the financial sector necessarily involves a rethinking of laws such as the State Bank of India Act, 1955 and the Life Insurance Corporation Act, 1956, that were enacted to create specific financial institutions. These laws contain provisions that vary or exclude the applicability of general corporate and financial laws to the institutions created under them. They also confer special privileges as seen in the case of the explicit Government guarantee under the Life Insurance Corporation Act, 1956, for all sums assured under LIC policies. The existence of such a provision in the law despite the entry of private insurers in the market induces an unfair competitive advantage in favour of LIC as many customers would tend to choose its policies over those offered by private insurers on account of the Government guarantee.

The Commission therefore recommends the repeal or large scale amendment of all special legislations that (a) establish statutory financial institutions; or (b) lay down specific provisions to govern any aspect of the operation or functioning of public sector financial institutions (see Table 2.1). The undertakings of all statutory institutions should

Table of Recommendations 2.1 List of statutory financial institutions

The following is a list of statutes that provide for the establishment of statutory financial institutions or contain special provisions to govern the operation and functioning of public sector financial institutions:

1. The State Financial Corporations Act, 1951:
Andhra Pradesh State Financial Corporation; Himachal Pradesh Financial Corporation; Madhya Pradesh Financial Corporation; North Eastern Development Finance Corporation; Rajasthan Finance Corporation; Tamil Nadu Industrial Investment Corporation Limited; Uttar Pradesh Financial Corporation; Delhi Financial Corporation; Gujarat State Financial Corporation; The Economic Development Corporation of Goa; Haryana Financial Corporation; Jammu & Kashmir State Financial Corporation; Karnataka State Financial Corporation; Kerala Financial Corporation; Maharashtra State Financial Corporation; Odisha State Financial Corporation; Punjab Financial Corporation; West Bengal Financial Corporation
 2. The State Bank of India Act, 1955
 3. The Life Insurance Corporation Act, 1956
 4. The State Bank of India (Subsidiary Banks) Act, 1959:
State Bank of Bikaner and Jaipur; State Bank of Indore; State Bank of Mysore; State Bank of Patiala; State Bank of Travancore; and State Bank of Hyderabad established under the State Bank of Hyderabad Act, 1956
 5. The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970:
Central Bank of India; Bank of India; Punjab National Bank; Bank of Baroda; UCO Bank; Canara Bank; United Bank of India; Dena Bank; Syndicate Bank; Union Bank of India; Allahabad Bank; Indian Bank; Bank of Maharashtra; and Indian Overseas Bank
 6. The General Insurance Business (Nationalisation) Act, 1972:
General Insurance Corporation of India; National Insurance Company Limited; New India Assurance Company Limited; Oriental Insurance Company Limited; and United India Insurance Company Limited
 7. The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980:
Andhra Bank; Corporation Bank; New Bank of India; Oriental Bank of Commerce; Punjab and Sind Bank; and Vijaya Bank
 8. The Export-Import Bank of India Act, 1981
 9. The National Bank for Agriculture and Rural Development Act, 1981
 10. The National Housing Bank Act, 1987
 11. The Small Industries Development Bank of India Act, 1989
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be transferred to ordinary companies incorporated under the Companies Act, 1956 and their regulatory treatment should be identical as that applicable to all other financial companies. This has previously been done in case of the following institutions which were statutory corporations that were subsequently converted to companies under the Acts mentioned below:

1. IFCI Limited (previously called the Industrial Finance Corporation of India) through the Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993;
2. Industrial Investment Bank of India Limited (previously called the Industrial Reconstruction Bank of India) through the Industrial Reconstruction Bank (Transfer of Undertakings and Repeal) Act, 1997;
3. Unit Trust of India through the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002; and
4. IDBI Bank Limited (previously called the Industrial Development Bank of India) through the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003.

The Commission recognises that the repeal or large scale amendments of the statutes identified in Table 2.1 is a long drawn process that may take some time for the Central Government to implement. However, there are certain specific provisions relating to winding up and liquidation of the concerned institutions under these laws that need to be amended immediately to give effect to the resolution framework envisaged by the Commission. This is being done in part on resolution in the draft Code.

It has also been observed that certain financial activities that are owned and managed by Government agencies tend to fall outside the sphere of financial regulation although they are functionally identical to regulated financial activities. This includes fund management services offered by the Employees' Provident Fund Organisation (EPFO), insurance services of postal life insurance and the Employees' State Insurance Corporation (ESIC) and the various small savings products issued by the Government. To the extent that these bodies are performing a social welfare function, it would not be practical or

desirable to apply all areas of financial regulation to them with the same rigour that is used for private enterprises. However, the Commission recommends that there is a need for proportional regulation of these activities, particularly in the field of consumer protection so that consumers are entitled to the same rights and protections irrespective of the ownership status of the service providers.

Hence, the Commission recommends that:

1. The Government should formulate a plan for the review of the following laws and schemes, which involve the provision of financial services directly by the Government or by agencies created by it:
 - ▶ The Government Savings Bank Act, 1873
 - ▶ The Employees' State Insurance Act, 1948
 - ▶ The Coal Mines Provident Fund Act, 1948
 - ▶ The Employees' Provident Funds and Miscellaneous Provisions Act, 1952
 - ▶ The Assam Tea Plantation Provident Fund Act, 1955
 - ▶ The Jammu & Kashmir Employees' Provident Fund Act, 1961
 - ▶ The Seamen's Provident Fund Act, 1966
 - ▶ The Public Provident Fund Act, 1968
 - ▶ Post Office Life Insurance Rules, 2011
2. The laws and schemes should be examined from the perspective of assessing the changes required in order to bring them within the purview of financial regulation and to ensure compatibility with the laws drafted by the Commission.

2.5.3. Treatment of co-operatives

In understanding the wide spectrum of the financial system in India, the Commission also focused on the role of co-operative societies. The subject of co-operative societies falls under Entry 32, List II of the Seventh Schedule of the Constitution of India, which provides that the incorporation, regulation and winding up of these bodies falls within the purview of the State Governments.

In addition, when co-operative societies engage in the business of financial services, they need to be regulated and supervised by financial regulators in a manner that is commensurate with the nature of their business and the risks undertaken by them. Since financial co-operatives often cater to the needs of small households, the Commission is of the view that such institutions should carry out their business under sound prudential regulation and resolution framework, with strong protections for their consumers and appropriate safeguards to ensure that in the eventuality of their failure, the burden does not fall upon tax payers. For this to be possible, the draft Code should apply in its entirety to co-operative societies providing financial services, to the same extent as it would apply to corporate entities.

Under the current laws, co-operative banks are subject to a system of dual regulation – by the Registrars of Co-operative Societies in State Governments and the RBI, as the banking regulator. This has resulted in operational and governance challenges in the regulation of co-operative banks that have been attempted to be addressed through memorandums of understanding entered into between the RBI and State Governments. The Commission recommends that financial regulators should have statutory control over the regulation and supervision of financial co-operatives, without having to rely on contractual arrangements with State Governments. This can be achieved under Article 252 of the Constitution which allows two or more State Legislatures to pass a resolution accepting the authority of the Parliament to make laws for the State on any matter on which the Parliament otherwise does not have the capacity to legislate. Using this provision, State Governments could pass resolutions to transfer the power to make laws on the regulation and supervision of co-operative societies carrying on financial services to the Parliament.

The grant of authorisation to carry on financial services is the prerogative of the financial regulator. The draft Code provides that while laying down the criteria for carrying on a financial service, the regulator may specify the permissible forms of organisation for a proposed financial service provider. The regulator may therefore decide that co-operative societies from States that have not allowed the Central Government to legislate on the regulation and supervision of co-operative societies carrying on financial services:

1. will not be granted the authorisation to carry out certain financial services, such as banking or insurance, which require intense micro-prudential regulation; or
2. will be granted authorisation to carry on specific financial services subject to certain limitations, such as, restrictions on access to the real-time gross settlement and discount window facilities provided by the central bank and exclusion from the protection of deposit insurance provided by the resolution corporation.

The Commission therefore makes the following recommendations with respect to co-operative societies:

1. In consonance with the recommendations on competitive neutrality, co-operative societies carrying on financial services should be subject to similar prudential regulation, consumer protection and resolution frameworks as other entities carrying on similar activities.
2. Using Article 252 of the Constitution of India, State Governments should accept the authority of the Parliament to legislate on matters relating to the regulation and supervision of co-operative societies carrying on financial services.
3. The regulator may impose restrictions on the carrying on of specified financial services by co-operative societies belonging to States whose Governments have not accepted the authority of the Parliament to legislate on the regulation of co-operative societies carrying on financial services.

Structure of the regulator

Government agencies are required to perform complex functions in eight areas in finance: 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. This is sought to be achieved through a specialised and consolidated set of provisions on regulatory governance in the draft Code.

The Commission believes that the requirements of independence and accountability of financial regulators are the same across the financial system and hence it recommends a unified set of provisions on financial regulatory governance for all areas of finance. The objective of the proposed Code on regulatory governance is to create a series of obligations for the Government and for regulators. The Code will cover all functions of the regulator and lay down the principles and standards of behaviour expected from the regulator. It will also provide for a system of monitoring the functions of the regulator with a process to ensure that the regulator is fully transparent and they act in compliance with the best practices of public administration. Table 3.1 captures the recommendations of the Commission for the creation of an appropriate regulatory structure.

The Commission recommends that the structure of the regulator be standardised for all financial regulators. However, there may be exceptions required in respect of certain specific functions where the general regulatory processes may not apply. These exceptions to the general process law should be kept to the minimum and generally avoided.

3.1. Selection of the regulator's board

Regulators in India are statutory entities headed by a board. It is the responsibility of the Government to appoint the members on the board of the regulator. The Commission believes that it is necessary to create a statutory system for selecting board members in a fair and transparent manner. It is recommended that the Government should be aided in this process by a professional search and selection committee. This will help ensure that the selected members are competent persons with relevant knowledge and experience.

The Commission looked at various systems of selection committees present under Indian laws along with the practice in other common law jurisdictions. Based on this analysis, it recommends that the government should maintain a panel of experts who will serve as members of the selection committee at all times. Their expertise would be

Table of Recommendations 3.1 Basic structure of the regulator

1. The regulator will be set up as a corporate entity;
 2. It will have the powers of a body corporate, including the power to enter into contracts, employ persons, acquire assets, hire agents and delegate certain functions to them; and
 3. The regulatory organisation will be composed of three parts:
 - (a) *Board of the regulator*: responsible for oversight and governance of the regulator;
 - (b) *Chairperson*: will be the chief executive of the regulator and will chair its board; and
 - (c) *Office of the regulator*: comprising of the employees, agents and assets of the regulator.
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Table of Recommendations 3.2 Selection of board members

1. The responsibility for appointing board members vests with the Government. While discharging this responsibility, the Government will be guided by the recommendations of a selection committee.
 2. The selection committee will shortlist at least three candidates for every position and provide the list to the Government.
 3. The structure of the selection committee will be as follows:
 - (a) The members will be appointed out of a list of experts maintained by the Government at all times, consisting of experts in the fields of finance, economics, law and public administration.
 - (b) It will consist of: a representative of the Government (who will serve as the chairperson), the chairperson of the regulator (and in the case of selection of the chairperson, another Government representative), and three experts from the list maintained by the Government.
 - (c) The majority of the members must be persons who are not related to the Government. This is to ensure that the selection committee is not biased towards short listing only Government officials.
 4. Merit will be the guiding principle for the appointment of board members. Therefore, if the pool of applicants in a selection process is weak, the selection committee will have the right (after recording the reasons) to suggest other names to be considered for selection. Nominations by any member of the selection committee should be in writing, accompanied by a statement of competence and experience of the person.
 5. The regulator must, in advance, inform the search and selection committee of any foreseeable vacancies and it will be the duty of the selection committee to forward the names of short-listed candidates before the vacancy arises, and give the Government reasonable time to make a decision.
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utilised by rotation as and when appointments to the board are to take place. The selection system will be governed by the process provided in Table 3.2.

The selection procedure should be designed in a manner that achieves a balance between the requirements of flexibility and transparency. Therefore, the draft Code does not lay down such level of detail that the selection committee is unable to shortlist deserving candidates or takes too long to do so. At the same time, the integrity of the selection procedure will be protected by requiring that all short-listing and decision making are done in a transparent manner - the committee should disclose all the relevant documents considered by it and prepare a report after the completion of the selection procedure. This will include the minutes of the discussion for nominating names, the criteria and process of selection and the reasons why specific persons were selected. The committee would however, not be required to disclose any discussion about candidates who were not short-listed.

3.2. Composition of the board of the regulator

The Commission suggests that the Board of a regulator should have four types of members:

1. *Chairperson* - There will be one chairperson of the board of a regulator. He/she will be responsible for the functioning of the board and the office of the regulator. He/she will also be responsible for and empowered with the day-to-day management of the regulator. In the event the chairperson is not available, the longest serving member of the board shall act as the chairperson.
2. *Executive members* - The chairperson will be accompanied by a set of executive members. Within

Table of Recommendations 3.3 Types of members on the board of the regulator

1. Chairperson of the board
2. Executive members, including a set of designated administrative law members
3. Non-executive members
4. Government nominees

this category of members, some persons will be designated as administrative law members. *Administrative law members* will be responsible for:

- (a) Reviewing the performance and carrying out the oversight of a designated set of employees of the regulator, referred to as administrative law officers; and
- (b) Reviewing the decisions taken by the administrative law officers.

The executive members will devote their entire time to the management of the regulator and will not be permitted to take up any other employment during their appointment. These members will be responsible for the oversight of the regulator's personnel, except for administrative law officers who will be monitored only by administrative law members.

3. *Non-executive members* - This category will consist of persons who are experts in the fields of finance, law, economics, etc., and are appointed to the board on a part-time basis. They will not be involved in the day to day functions of the regulator. Non-executive members may take up other engagements but will have to manage conflict of interest issues when participating in board meetings.
4. *Government nominees* - The Government will have the right to nominate ex-officio members on the board of the regulator. These members will represent the perspective of their departments/ministries or other regulators in the functioning of the regulator.

The Commission believes that it is crucial for the draft Code on regulatory governance to lay down the functions and powers of each type of member on the board of a regulator. Accordingly, the law will state that the chairperson and executive members are responsible for the day to day functioning of the regulator. The role of the administrative law members will be to focus on the regulator's adjudication and administrative law functions. Having a category of non-executive members is a continuation of the present system of appointing part-time members on the boards of financial regulators. Such non-executive members will provide two important benefits to the management of the regulator:

1. Since they will not be employees of the regulator, it is expected that they will be neutral observers in the functioning of the regulator and alert the Government of any violations of law by the regulator.
2. Such members should have expertise in finance and allied fields, and preferably also some experience in providing financial services. This will bring in expertise and information about the financial sector to the board of the regulator.

Unlike ordinary civil servants, board members are appointed for a limited time and do not have a guarantee of continued employment. Therefore, one of the crucial requirements of independence is that the members should be protected from pressure through change in their terms of appointment. For this reason, the Commission recommends that the draft code should provide the conditions of appointment of members - duration, entitlements, system of removal and conflicts of interests (see Table 3.4).

3.3. Functioning of the board

The functioning of the board of regulators should primarily be left to the rules and regulations formed by the regulator. However, in the interest of accountability, certain principles must be laid down to govern the actions of the board. The Commission is of the opinion that best practices of conducting the functions of deliberative bodies should be incorporated in the functioning of the regulator. The recommendations with regard to what should be contained in the draft Code to govern board meetings is provided in Table 3.5.

Table of Recommendations 3.4 Appointment conditions for board members

1. *Duration of employment:* All members of a board (including the chairperson) would have a fixed term of five years, subject to a retirement age for executive members. The age of retirement for executive members must be equivalent to the age of retirement for the equivalent senior-most Government positions.
 2. *Protection of entitlements:* The salaries and other entitlements of the members of the board should be fixed by the Government. However, once they are set, they should not be varied to the detriment of the incumbent members of the board, or require further approvals from the Government.
 3. *Terms of removal:* The draft Code provides for both, the reasons for which a member may be removed and the process by which removal will take place. This may be done for:
 - ▶ **Regular Reasons:** Completion of term, reaching the prescribed age limit, declaration of insolvency and conviction by a criminal court which involves imprisonment.
 - ▶ **Special Reasons:** Incapacity (physical and mental), behaviour unbecoming of the position held, conviction by a criminal court which does not involve imprisonment and dereliction of duty. For removal under special reasons to take place the Government should establish a judicial committee (under the supervision of the Supreme Court), which will investigate whether removal is necessary on the suggested grounds and create a public report on the issue.
 4. *Re-appointment:* Members of the board can be reappointed for another term of five years as members. This provision will however not be available for the chairperson of the board who cannot be reappointed. There will be no automatic re-appointments - the incumbent member will be considered by the selection committee alongside other prospective candidates. If the selection committee finds the member suitable, he/she will be short-listed and the Government then may choose to reappoint such members. The Commission believes that this will ensure that the tenure of members is not extended as matter of course.
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Table of Recommendations 3.5 Law governing board meetings

The principles governing the following matters must be covered by the draft Code:

1. Frequency of meetings;
 2. Quorum;
 3. Method of taking and recording decisions;
 4. Decisions without meetings;
 5. Legitimacy of decisions; and
 6. Conflicts of interest.
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The Commission is of the view that very high regard should be given to the need for transparency in the board meetings of the regulator. While there may be some specific decisions or deliberations of the regulator which may have commercial implications and may not be released immediately, this should not be unduly used as a reason to deviate from the general principle of transparency. The draft Code will therefore require the regulators to be transparent about meetings *as far as possible* and when any information is kept confidential, reasons for doing so must be recorded. For instance, pending investigations and queries about violations by a regulated entity should be kept outside the purview of publication as they have an impact on the reputation on the institution without a finding of violation of laws. However, the decisions of the regulator should be published to provide information to the regulated entities on the standards of conduct expected by the regulator.

There is also a need for a formal mechanism to evaluate the regulator's compliance systems. This will be achieved by setting up a *review committee* that will be comprised only of non-executive members of the board (see Table 3.6).

3.4. Advisory councils of the regulator

The regulators will be responsible for regulating a large and rapidly developing financial system in India consisting of a large number of stake-holders, including financial service providers, intermediaries, consumers and other users of the financial system. It is not possible to ensure that all these stake-holders are adequately represented at all times

Table of Recommendations 3.6 Role of the review committee

The Commission recommends that the non-executive members of the board of a regulator form a special committee called the *review committee*. This committee will discharge the following functions:

1. Oversight of compliance of the regulator with the governing laws;
2. Maintaining whistle-blower policies about violations of process within the office of the regulator;
3. Ensuring that all board meetings are held in compliance with the law and all meetings are minuted and votes are recorded by creating a report;
4. Creating a system to monitor compliance of the office of the regulator with the decisions of the board through reporting systems; and
5. Reviewing all risk management policies of the board of the regulator.

The review committee will make its observations in a report which will be annexed to the annual report of the regulator. The objective of this procedure is to ensure greater transparency in the functioning of the board of the regulator.

at the level of the board of the regulator. In particular, it is extremely difficult to identify persons who can represent the interests of the common Indian household. Similarly, special fields of financial service may require the regulator to gain expertise in specific areas, such as, insurance, algorithmic trading, detailed analysis of data, etc. The Commission proposes that these issues should be addressed by creating advisory councils to advise the board of the regulator (see Table 3.7).

3.5. Resource allocation of the regulator

Financial sector regulation is a resource intensive function. The sophisticated character of financial markets coupled with rapid innovations in products and processes make it necessary for the regulator to have the capability and resources to keep pace with developments in the sector. The need for financial independence is one of the primary reasons for creating an independent regulator – it allows the regulator to have the required flexibility and human resources that are more difficult to achieve within a traditional government setup.

As the regulator is empowered to hold assets independently, it can create physical infrastructure dedicated to the enforcement of financial regulations. These resources can be scaled up and modified quickly. Being independent of the Government also allows the regulator to develop its own recruitment criteria and processes, which are necessary for mobilising required human resources. The Commission notes that the provisions governing financial independence of the regulators are wide and have worked till now. Therefore, the Commission is of the opinion that there is no need to substantially modify them.

The present financial laws allow regulators to charge fees from the regulated entities to cover their costs of functioning. In certain cases the Government has also provided

Table of Recommendations 3.7 Advisory councils

The Commission recommends creation of advisory councils to advise the board of the regulator. The councils will be created by the board of the regulator (unless specifically created by the law). The composition and functioning of the advisory councils will be as follows:

1. *Composition:*
 - (a) Include experts in the field for which it has been created; and
 - (b) Include persons with relevant experience in the area of finance.
 2. *Functions:*
 - (a) Inform the board about issues in the specific areas for which they have been constituted; and
 - (b) Create a report on all draft regulations published by the regulator stating the council's views.
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Table of Recommendations 3.8 Principles governing regulator's resources

1. The regulator should be funded through fees levied on the financial firms.
 2. The regulator should have the freedom to allocate the resources in the manner that it considers most appropriate to meet its regulatory objectives.
 3. The Government may loan money to the regulator to offset initial setting up costs. However, apart from this the involvement of the Government in the financial matters of the regulator should be minimal.
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initial grants or loans to regulators as a corpus to start their operations. Table 3.8 covers the recommendations of the Commission on the principles governing the finances of the regulator. It includes the recommendation that the regulator should be funded primarily through fees.

Allowing the regulator to fund itself from fees collected from regulated entities has the following advantages:

1. It ensures that financial stake-holders, who are the main beneficiaries of regulated markets, bear the cost of regulation instead of the cost being spread across the entire budget of the Government.
2. It creates operational efficiency for the regulator. As the financial market grows, the number of transactions and firms increase and that increases the resource flow into the regulator. In turn, the regulator can increase its spending on enforcement, inspections and other functions which help improve the confidence of users.
3. It helps achieve freedom from Government rules on pay and budgeting, and thus facilitates the hiring of experts.
4. It helps address issues of conflict of interests in a context, where, in addition to other dimensions of political economy, the Government is the owner of many regulated entities in the form of public sector financial firms.

The Commission recognises that the power to impose fees on regulated entities leads to cost on all consumers of financial services and therefore the draft Code provides certain guiding principles on the charging of fees instead of simply empowering the regulator to make the collection (see Table 3.9). It is particularly important to ensure that the imposition of fees should not impose an undue burden on regulated firms or transfer the cost of regulating one class of firms or transactions to others. To pursue this policy, the Commission recommends that regulators be empowered to charge three different types of fees.

1. **Flat fees for registration:** This fee should be as small as possible to ensure that it does not prevent entry of new financial firms.
2. **Fees dependant on the nature of the transaction:** This type of fee will vary depending on the *nature* of financial business being carried out. For example, if the cost of regulating an insurance firm is higher than the cost of regulating a brokerage firm, the fees levied on the insurance firm should be higher.
3. **Fees dependent on the number or value of transactions:** This type of fee will vary depending on the frequency and size of transactions. For example, a brokerage firm may have to pay fees depending upon the number of transactions it carries out. Similarly, an insurance firm would be charged depending on the number of insured contracts it executes.

As noted earlier, regulatory independence requires that the Government's right to intervene in the financial matters of the regulator is kept at a minimal. The Commission therefore recommends that the Government must only control the salary and perquisites of the members of the board of the regulator. The board should in turn be responsible for maintaining adequate staff and expertise to meet its statutory objectives within its financial capacity. The board should therefore be charged with the responsibility of designing a set of Human Resources (HR) practices that are conducive to the accomplishment of its regulatory objectives.

Table of Recommendations 3.9 Principles governing the charging of fees by the regulator

The legal provisions empowering the regulator to charge fees will incorporate the following aspects:

1. The regulator should charge fees only to cover expenses and keep adequate reserves;
 2. Fees should be charged only through regulations made after following the legislative processes specified in the draft Code;
 3. The regulator should clearly explain the fees it is charging and demonstrate that the fee is not disproportional to the cost for the regulator;
 4. Applying the principle of proportionality, the regulator should place higher financial burdens on firms that have more transactions, and thereby increase its work load and functions; and
 5. The regulator should break up the fees into different categories.
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Table of Recommendations 3.10 Performance measurement and reporting

The allocation of resources by the regulator is intrinsically tied to the performance of the regulator. Therefore the Commission recommends the following principles for the measurement of the regulator's performance and financial reporting:

1. The regulator should create two annual reports:
 - (a) Audited report which is comparable to traditional financial reporting; and
 - (b) Performance report which incorporates global best practice systems of measuring the efficiency of the regulatory system.
 2. The performance report should use modern systems of measuring each activity of the regulator as objectively as possible.
 3. Performance systems must require the regulator to create and publish performance targets.
 4. All performance measures must be published in the annual report.
 5. Performance measurement system should be reviewed every three years to incorporate global best practices.
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3.6. Performance assessment and reporting

The Commission noted that the present system of financial accounting of the regulator is focused primarily on the reporting of expenditures incurred by the regulator under various heads. This, according to the Commission, does not constitute a sufficient test of the fulfilment of *regulatory objectives* or the assessment of the regulator's *performance*. Therefore, there is need to require regulators to adhere to a more comprehensive system of measuring their performance.

Measurement systems for assessing the performance of regulators should include an assessment of the regulator's processes on metrics such as, the time taken for granting an approval, measurement of efficiency of internal administration systems, costs imposed on regulated entities and rates of successful prosecution for violation of laws. Adopting such an approach would constitute a departure from the present system where most financial regulators focus on measuring the activities of regulated entities and financial markets as a standard for their own performance. The Commission noted that while these measurements are important, measurement of various activities undertaken by the regulator will provide much greater transparency and accountability.

The measurement of activities of the regulator also needs to be tied with the financial resources spent by the regulator to carry out those activities. A system which merely measures the expenses of the regulator was therefore considered to be inadequate and the Commission recommends a move towards tying the measurement of regulatory activities and the expenditure incurred for it as a crucial link for improving regulatory governance. Accordingly, the Commission recommends the following measurement processes for the regulator (Table 3.10):

1. **Budgeting Process:** This process will measure the allocation of resources by the regulator for its different objectives and try to assess the regulator's performance in pursuing each objective in

the most comprehensive manner possible. Emulating the performance measure based auditing system used globally by financial regulators, this process will:

- ▶ relate the exercise of functions by the regulator with its expenses;
- ▶ require the regulator to create performance metrics and targets which it will be required to achieve;
- ▶ help in tracking the regulator's performance across financial years.

2. **Financial Accounting:** This will be the traditional accounting of expenses for the purposes of maintaining financial control and audit, which is currently being done by financial regulators. The financial accounts will be audited by the CAG.

Functions and powers of the regulator

The regulator acts like a mini-state in that it exercises legislative powers in the form of drafting regulations that are binding on regulated entities; it acts as the executive in its supervision and enforcement actions; and it performs a quasi-judicial function while assessing compliance with the law by regulated entities and compliance of processes by the regulator while imposing penalties on them.

While giving these wide ranging powers to the regulators, the draft Code on regulatory governance needs to put in place appropriate checks and balances to ensure that the powers are not misused and proper regulatory governance processes are followed in every action taken by the regulator.

The Commission has identified the following areas for which regulatory governance processes need to be clearly detailed in the draft Code:

1. Process for issuing regulations and guidelines;
2. Executive functions - granting permission to carry on financial activities, information gathering, investigation, imposition of penalties and compounding of offences; and
3. Administrative law functions.

4.1. Issuing regulations and guidelines

The primary function of a financial sector regulator is to set down standards of behaviour expected from regulated entities. This encompasses making regulations governing how the regulated entities should interact with the regulator, consumers, financial markets and other regulated entities. Regulations also guide the internal functions and actions of regulated entities in the conduct of financial activities.

In a system governed by the rule of law, no action should be judged against unknown standards. Therefore, before the regulator can carry out any supervision or adjudication functions it has the responsibility to lay down in clear and unambiguous terms, the behaviour that it expects from regulated entities. While doing so, the regulator needs to follow a structured process that allows all stake-holders to be fully informed of and participate in the regulation-making process.

Some existing regulators have already adopted the good practice of carrying out public consultations in the course of making regulations. However, the Commission

noted that since this is not mandated by legislation, the processes employed are not adequately rooted in a thorough analysis of the public administration problems faced in the regulation-making process. In addition, as with most other aspects of the legal process in Indian financial regulatory governance, the practices followed by different financial regulators differ in idiosyncratic ways.

The Commission has therefore identified detailed requirements to define the process that the regulators should follow while making regulations and the mechanisms for the judicial review of legislative powers exercised by regulators.

If laws do not define a fixed set of instruments that can be used by the regulator, the same regulatory agency might adopt multiple regulatory instruments – circulars, notices, letters, regulations, guidelines, master circulars, press notes – with similar outcomes but differing regulation-making processes. To avoid this situation, the Commission recommends that the draft Code should clearly define the legislative powers of the regulator and the instruments. The Commission recommends that the regulator should be empowered to issue only two types of instruments – regulations and guidelines.

4.1.1. Process for making regulations

The draft Code must determine the process to be followed for the formulation of regulations, starting with the manner in which the drafting of regulations is to be initiated. Given the wide impact of regulations, the Commission recommends that the regulation-making process should be directly overseen by the board of the regulator. This will ensure that the issues that require regulatory intervention are discussed and approved at the highest level within the regulator's organisation. Therefore, after the process of drafting regulations has been initiated within the regulator, it will have to be approved by the board of the regulator before being published to the public for comments.

The Commission believes that effective public participation in the regulation-making process is necessary to ensure that subsidiary legislations are responsive to the actual requirements of the economy. It will also help check and improve the information used and analysis done by the regulator. Therefore, the Commission recommends that the details of the process to be followed for carrying out consultations and receiving public comments should be laid down in the draft Code. Doing so will allow for the standardisation of best practices and hence lead to a more structured system for making subordinate legislations. The expected overall impact is that regulations will become more responsive to the needs of the financial system.

4.1.2. Emergency regulations

The Commission recognises that the regulator may sometimes be faced with an emergency situation that requires the rapid introduction of a new regulation. In such cases, it may not be feasible for the regulator to follow the detailed regulation-making process discussed above. Therefore, the draft Code envisages a separate emergency regulation-making process, as outlined in Table 4.3.

The Commission recommends that the draft Code will require the regulator to carry out the consultation process in two stages. The first stage will be the issuance of a set of introductory documents to inform the public of the proposed regulations and provide a system for giving comments (see Table 4.1). This will be followed by a requirement to respond to the comments received by the regulator and the issuance of final regulations (see Table 4.2).

4.1.3. Issuing guidelines

In a system of principles-based provisions that are to be interpreted and applied by the regulator, there is a genuine need for clarifications and explanations. This would require

Table of Recommendations 4.1 Issuance of documents for public consultation

The regulator will have to publish the following documents in the process of formulating new regulations:

1. The *draft regulations*;
2. The *jurisdiction clause* to identify the legal provision under which the proposed regulations are being made, and the manner in which the regulation is consistent with the principles in the concerned legislation(s). If the parent legislation does not specifically refer to the subject matter of regulations, the regulator will have to establish a logical connection between the subject matter and the empowering provision in the law. The document must contain explanation on how the regulation stands vis-a-vis each of the relevant principles in the part(s) of the draft Code from which the powers are being drawn;
3. A *statement of the problem or market failure* that the regulator seeks to address through the proposed regulations, which will be used to test the effectiveness with which the regulations address the stated problem. The statement must contain:
 - ▶ The principles governing the proposed regulations; and
 - ▶ The outcome the regulator seeks to achieve through the regulation; and
4. An *analysis of the costs and benefits* of the proposed regulation. This is required because every regulatory intervention imposes certain costs on regulated entities and the system as a whole. The Commission recommends that regulations be drafted in a manner that minimises these compliance costs.
In some cases where a pure numerical value based cost-benefit analysis is not possible, the regulator should provide the *best possible* analysis and reasoning for its choice of intervention.

After publishing the above documents, the regulator will specify a designated time for receiving comments from the public on the regulations and the accompanying documents. The draft Code will ensure that the time period and the mode of participation specified by the regulator is appropriate to allow for widespread public participation.

Table of Recommendations 4.2 Process after receiving public comments

After the time specified for making comments has lapsed, it will be the responsibility of the regulator to:

1. Publish all comments received;
 2. Provide reasoned general response to the comments received, and specific response to some comments if there is requirement stipulated in the draft Code for such response;
 3. Publish the review of the draft regulations carried out by the regulator's advisory council;
 4. Have the final regulations approved by the board of the regulator. In the interests of transparency, the Commission recommends that deliberations and voting by the board members should be available publicly; and
 5. Publish the final regulations.
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Table of Recommendations 4.3 Emergency regulation making

In emergency situations the regulator would be empowered to pass regulations without following the consultation process and without conducting a cost-benefit analysis, subject to the following conditions:

1. Regulations passed under this provision will lapse after a period of six months; and
 2. The regulator must publish a reasoned order for using this power.
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the regulator to have the power to issue guidelines explaining the interpretation of the regulator of laws and regulations. The Commission believes that allowing the regulator to issue guidelines of this nature will constitute an important step in reducing uncertainty about the approach that the regulator may take.

The mechanism of issuing guidelines should not be used to (in effect) make regulations without complying with the procedural requirements laid down for regulation-making. For this reason, the draft Code clarifies that guidelines are merely recommendatory in nature and the violations of guidelines alone will not empower the regulator to initiate enforcement action against regulated entities. Table 4.4 shows the recommendations of the Commission in relation to issuance of guidelines.

4.1.4. Accountability to the Parliament

Since the power to issue regulations is a legislative power delegated by the Parliament to the regulators, regulations formulated by the regulator should be placed before the Par-

Table of Recommendations 4.4 Issuance of guidelines

The law governing the issuance of guidelines should:

1. Require the regulator to clearly explain the connection between the guidelines and the principles and provisions in the Parliamentary law that the regulator seeks to enforce;
 2. Ensure that the guidelines are not used as a mechanism to create substantially new regulations;
 3. Allow guidelines to be issued without a cost-benefit analysis but subject to the consultation process under which the draft guidelines will be issued for comments and responses of persons affected by the guidelines;
 4. Clearly state that violation of guidelines alone would not constitute the violation of regulations or law; and
 5. If regulated entities ask for the interpretation or application of law for a specific transaction, the regulator should provide it for a reasonable fee.
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Table of Recommendations 4.5 Judicial review of regulations

The Commission recommends that any challenge to a regulation framed by the regulator should be reviewed by the appellate tribunal on the following grounds:

1. The regulations should have been made within the bounds specified by the law. This would include ensuring compliance with the specific provision of law under which the regulation is made and the general objectives and principles of the regulator;
 2. The regulations should have been made in compliance with the process laid down in the law; and
 3. The documents published along with the regulations should not have any substantive material defects, which may be proved through expert evidence or data.
-

liament. This allows the Parliament to review whether the regulator, acting in its capacity as an agent, has acted within its scope of authority while formulating the regulations.

The current system of review by the Parliament involves sending subordinate legislation (regulations made by the regulator in the present case) to a different committee than the one which reviews laws presented to the Parliament. The Commission recommends that it may be appropriate for these to be considered by the same committee.

4.1.5. Judicial review of regulations

At present, judicial review is largely limited to executive actions. However, the Commission recognises that it is equally important to have a mechanism that allows regulated entities and others to question the regulations made by the regulator in exercise of its legislative powers, if regulations exceed the mandate given to the regulator under the primary law or if the specified process for making regulations has not been duly followed. The Commission therefore recommends that the process to challenge subsidiary legislation made by regulators should also be provided in the draft Code.

The first point of challenge of regulations would be before the FSAT, a specialised tribunal that will be created for the financial sector as a whole. In addition to this, the power of the Constitutional courts to review legislation would of course continue.

The judicial review of the regulation-making process by the appellate tribunal should ideally provide a more detailed scrutiny than compliance with Constitutional provisions. In the course of this process, the regulations should be checked for compliance on the grounds mentioned in Table 4.5.

4.2. Executive functions

A major responsibility of any regulator involves the exercise of executive functions. This includes inspections, investigations, enforcement of orders and processing of complaints. The exercise of supervision and monitoring powers is fundamental to the effective enforcement of laws by the regulator. However, it is often seen that the manner of exercise

Table of Recommendations 4.6 General executive functions of a regulator

The Commission recognises that regulator must carry out certain general executive functions on a routine basis. These include:

1. Grant of approvals, including licensing or registration;
 2. Inspections, which may be routine or special;
 3. Proving violation of regulations to the judicial officers (by leading evidence);
 4. In the case of successful prosecution before the administrative law department, suggesting enforcement actions; and
 5. Compounding of offences with the involvement of the administrative law department.
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of executive function may place an undue burden on regulated entities and financial markets.

Long pending investigations create uncertainty for businesses. When news of on-going investigations leaks, it may inflict damage to the reputation of any financial firm. Similarly, injunctions placed on businesses under investigation have strong economic implications and should be placed for the shortest possible period. These problems can be checked by putting in place legal measures that require investigations to be finished within specified time, and kept confidential from the public.

The Commission notes that the overall approach of the draft Code should be to provide for strong executive powers, balanced with greater transparency and accountability, to prevent abuse. Executive functions of regulator do not have standardised statutory checks under present legislations. Therefore, the Commission recommends that adequate transparency requirements, checks and judicial oversight be placed on the exercise of executive functions by regulator. This will also reduce allegations of possible bias and arbitrariness to the minimum.

It is also important to ensure that there is no overlap in the legislative and executive functions of the regulator. The executive should not be allowed to issue instructions of a general nature to all regulated entities or a class of regulated entities. Such instructions should only be possible after the full regulation-making process has been followed.

Table 4.6 sets out the areas in which the Commission has made specific recommendations regarding the exercise of executive powers.

4.2.1. Permission and approvals

Granting permissions to start a business is the core function of any regulator. This is also the first barrier to entry for new entrants to any business. Each new business permission also increases the burden on the regulator as it increases the number of entities it has to monitor. The draft Code must grant the regulator discretion to approve or reject applications. The Commission has decided that the power must be exercised in a manner guided by regulations. As far as possible the discretion of the regulator should be guided through an underlying duty to explain. The power of the regulator to reject applications should be balanced with the requirement for allowing legitimate parties getting approvals in a time bound manner for smoother functioning of the regulatory system. Table 4.7 summarises the recommendations of the Commission for governing the procedure for disposing applications.

4.2.2. Information gathering

Regulator requires information about the activities of their regulated entities. It may also require information from private sources and other government agencies. At present, a diverse array of mechanisms are used by firms to submit information to regulatory

Table of Recommendations 4.7 Giving permission to carry out a business

The system of giving permission to new entities must be strictly governed by regulations and finished within a time bound manner. The provisions must:

- ▶ Provide a system for persons to apply for authorisation to provide financial services;
 - ▶ Ensure that all applications are accepted or rejected within a specified time;
 - ▶ Ensure that whenever an application is rejected, reasons for the rejection are provided; and
 - ▶ Provide that the regulator gives warning to the applicant before rejecting an application.
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Table of Recommendations 4.8 Information gathering

The draft Code contains the following provisions on information gathering:

1. The regulator should have the power to collect information from regulated entities;
 2. The regulator should have power to collect information from other government agencies;
 3. Information should be collected in electronic format as far as possible; and
 4. The regulator should publish information it generates (orders, decision, list of regulated entities) in the public domain (apart from confidential information).
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agencies. Harmonisation into a single mechanism for electronic submission of information will reduce the cost of compliance for firms and also reduce the cost of information management for regulator. The Commission proposes to create a centralised database, through which all the information is collected by regulator and other agencies. A more detailed discussion on this centralised database can be found in the chapter on systemic risk. Maintaining and analysing this information is an important indicator of violation of provisions in many situations. Even at present, most regulators have the power to require regulated entities to produce documents and information in normal course of regulation. This power should be continued in the proposed legislation. Table 4.8 contains other details regarding information gathering powers.

The Commission also noted that the use of technology is crucial in the context of the information gathering function. Using electronic systems will affect stake-holders in the financial system in the following ways:

1. **Regulator:** Use of electronic data management will provide regulator with real-time information about financial entities. It will also provide regulator with modern analytical systems to track violations or risks. Toward this end, the Commission proposes to create a centralised database that will use state-of-the-art data management systems to route regulatory data.
2. **Regulated entities:** Use of electronic reporting systems may reduce compliance costs for regulated entities. It will also allow regulated entities to provide information to the regulator in a seamless manner.
3. **Consumers:** Access to records of the regulator about regulated entities in electronic format will allow consumers to gain information quickly. It will also help consumers to access their own records and check for financial frauds.

4.2.3. Investigations

It is important that the powers of investigation and enforcement are carried out in the least arbitrary and the most effective manner. The Commission has noted that executive functions in the financial market can have serious consequences. The information that a firm is under investigation may cause undue panic in the market and even if the result of investigation is a positive outcome for the firm, the intervening period may cause irreparable damage to the reputation and business of the firm. The system of investigations should therefore be such that it does not harm or unduly burden the entity under investigation (see Table 4.9).

The Commission is of the opinion that the executive investigation process should be carried out in:

Table of Recommendations 4.9 Investigations

The Commission recommends that investigations should be:

- ▶ Carried out according to the written terms of investigation;
- ▶ Carried out by an appointed investigator;
- ▶ Finished within a time bound manner, unless extended by an administrative law officer; and
- ▶ Carried out with least disruption to the function or reputation of a business.

The investigators empowered under the draft Code should have the power to:

1. Require production of documents;
 2. Require persons to answer questions;
 3. Require co-operation of non-regulated entities in investigation; and
 4. Require co-operation from other government agencies.
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Table of Recommendations 4.10 Information-sharing between regulators

1. The draft Code should require the regulator to create a framework for sharing of information.
 2. The electronic information framework of each regulator should be compatible with that of other regulator(s) and agencies with which it regularly shares information.
 3. The legal framework should have adequate checks and records to prevent misuse of informations.
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1. A confidential manner so as to prevent panic before any finding; and
 2. A time bound manner so as not to unduly burden the entity under investigation.
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4.2.4. Sharing of information

Investigations are greatly assisted by a strong database providing details of the regulated entities and the transactions they have undertaken. The Commission recognises that this information may not be available at a single source. Hence, the Commission suggests the creation of a single database, through which all information collected by regulator (and other agencies in the financial sector architecture), will be routed (see the chapter on systemic risk for a detailed discussion on this issue). Where regulator needs to obtain information from other regulator(s) or government agencies, the draft Code creates a framework for sharing information between the agencies. Table 4.10 provides the system suggested by the Commission for sharing of information.

4.2.5. Consequence of violations

The Commission found that different regulators have different consequences for violations of laws and regulations enforced by them. This creates detriment to the rule of law and increases uncertainty about violations.

The Commission recommends that:

1. The consequence of violations be standardised;
2. The way the consequence is determined be regulated by law;
3. Similar violations be treated with similar consequence; and
4. The consequence be proportional to the violation and the behaviour of the violator.

The Commission recommends that whenever a violation is detected the regulator must determine which of the following conditions led to the violation:

1. The violation was a result of an informed intent to commit the violation;
2. The violation was a result of serious negligence of maintaining standards expected of a reasonable person carrying out the activity; or
3. The violation was a result of a mistake or was of a technical nature.

The Commission recommends that depending on the cause of the violation the regulator must apply the following consequences in increasing order:

1. Issuing a private warning;
2. Issue a public notice;
3. Require a corrective action applicable to the violation;
4. Impose a monetary penalty;
5. Suspend the permission to carry out certain transactions;
6. Permanently revoke the permission to carry out regulated activities; and/or
7. Institute criminal proceedings in appropriate courts.

4.2.6. Imposition of monetary penalties

The Commission noted that the present system of specifying statutory limits on the amount of penalties that can be imposed for any violation has a critical flaw – it does not ensure that a violator pays a fine higher than the gain made through the violation. This is because it is impossible to predict the benefit a violator will gain by committing an offence. The maximum limit on penalties is sometimes lower than the benefit gained by the violator through violation. This leads to a situation where even if the violator is caught and required to pay the fine, he or she may still emerge monetarily better off.

The Commission notes that the level of penalties should be an effective *deterrent* to future violations and signal all other regulated entities that the potential of gain from violation will be outweighed by the penalty which will be applied in the case of detection of the violation. This principle also acknowledges that all violators of any law are never detected. Therefore, to act as a deterrence, the penalty should be a *multiple* of the illegitimate gain from the violation. The amount of penalty should also be dependent on whether the action was deliberately done or due to reckless behaviour or due to negligence of the person.

The system of imposing financial penalties should be guided by the following principles:

1. The penalty system should require the violator to pay a multiple of the illegitimate gain made from the violation;
2. Out of the penalty collected, the regulator should try to compensate any directly identifiable victims of the violations;
3. Any surplus at this point should be deposited with the Consolidated Fund of India;
4. In the event that there are no direct victims, the regulator must transfer all the penalty (after deducting administration costs) to the Consolidated Fund of India;
5. If there is no clearly identifiable illegal gain from the violation, the regulator must impose a penalty that is a proportion of the income of the violator from financial activities; and
6. All systems of monetary penalties must be regulated by regulations that consider the magnitude of the violations and the previous violations of the violator.

The doctrine of unjust enrichment allows the regulator to recover all the profit the violator made from the violation. Unjust enrichment should be recovered, in addition to the fine applied for violation of regulations. This should be recovered and then, if possible, distributed amongst persons who were adversely affected on account of the violation. Punitive damages create a deterrence for future violators who will know that in the event that they are successfully prosecuted the penalty they will face will surely outweigh the profits that they make. It requires the regulator to expressly impose fines which are higher than the benefit gained out of the violation. This is usually carried out by providing penalties as a multiple of the amount of gain by the violator. The Commission found that this principle has already been provided in some Indian legislations and should be extended to the financial sector as a whole.

Table 4.11 summarises the recommendations of the Commission for creating a legal system governing penalties.

Table of Recommendations 4.11 Requirement for proportional penalties

The regulator must ensure that the penalties deter potential violators in the future. It is impossible to ensure that all violators are caught. However, violators must pay fines proportional to the damage and the illegal gain. The following are the steps the regulator must follow:

- ▶ For each violation, the regulator must carry out an investigation on the illegitimate gain made by the violator;
 - ▶ The regulator must make an effort to determine the amount of illegitimate gains made by the violator;
 - ▶ The penalty will be a multiple of the illegitimate gain, but limited to a maximum of 3 times the illegitimate gain;
 - ▶ The regulator must compensate any direct victims of the violations if they can be ascertained; and
 - ▶ The regulator must have regulations and processes for calculating and enforcing the fines.
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Table of Recommendations 4.12 Compounding of offences

The system for compounding offences must:

- ▶ Be guided by a policy set out by the regulator;
 - ▶ Have adequate checks and balances to prevent interference from external parties;
 - ▶ Be transparent to prevent allegations of favouritism;
 - ▶ Consider previous behaviour of the party; and
 - ▶ Consider whether the party itself offered compounding before any investigation was started.
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4.2.7. Compounding of offences

The Commission believes that the system of compounding offences is important for reducing judicial burden and addressing minor violations, which are common in the financial sector. However, the system of compounding offences requires a standardised structure across all regulators which is not present as of date. The recommendations of the Commission are provided in Table 4.12.

4.3. Administrative law and role of tribunals

In exercise of their supervisory and enforcement powers, regulators need to assess whether or not regulated entities have adequately complied with the provisions of financial laws and in case of any detected breach, they have the power to impose appropriate penalties. These wide ranging executive powers given to regulators necessarily need to be balanced with proper systems governing the application of administrative law. Therefore, the Commission recommends that the exercise of quasi-judicial (administrative law) functions by regulators needs to be carried out within the bounds of a sound legal framework that ensures the separation of administrative law powers from other powers of the regulator.

In addition, there also needs to be a mechanism to review the actions taken by regulators in exercise of their quasi-judicial functions. Given the specialised character of financial markets and the complicated nature of issues involved, the Commission finds that there is a strong case for having a dedicated appellate tribunal.

The Commission therefore makes specific recommendations in respect of the processes governing these two areas:

1. *Administrative law functions carried out by the regulator*: How the regulator separates and carries out regulatory function within its organisation.
2. *Judicial review by appellate tribunals*: How the decisions of the regulator are reviewed through a dedicated financial sector appellate tribunal.

4.3.1. Administrative law functions of the regulator

At the level of the regulator's board, at least one executive member should be designated

Table of Recommendations 4.13 Requirement of administrative law officers

The system of administrative law functions requires:

- ▶ The board of the regulator will appoint one of its member as administrative law member;
 - ▶ The creation of a special class of officers called administrative law officers; and
 - ▶ While serving as administrative law officers, these persons shall not carry out other functions. This is necessary to maintain separation of their roles and responsibilities from the other staff members of the regulator.
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Table of Recommendations 4.14 Judicial review of executive actions

The Commission recommends the following principles for application of administrative law by the regulator:

1. All investigations and internal processes should strictly conform to procedures of fairness;
 2. Even minor non-compliance to procedure should be required to be adequately explained by the regulator;
 3. Administrative law officers should act as disinterested third parties in a dispute; and
 4. The decisions of administrative law officers will lead to the development of a body of cases similar to common law jurisprudence.
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Table of Recommendations 4.15 Procedure for administrative law functions

1. All decisions to impose penalty or decisions requiring any action against any regulated entity should be carried out by administrative law officers;
 2. Administrative law officers should place the proposed decision of the executive and the material on which the decision was arrived at, before the regulated entity through a notice called a *warning notice*;
 3. The regulated entity must be allowed to respond before a decision is taken;
 4. The decision of the administrative office must be a reasoned decision and should be provided to the regulated entity or other concerned person through a notice called the *decision notice*; and
 5. The regulated entity may ask the administrative law member of the board to review the decision taken by the administrative law officer.
-

as an administrative law member. Under the member, the regulator will maintain a class of administrative law officers. The administrative law member will be responsible for oversight of the functioning of the administrative law officers. Consequently, such member will not take active part in executive functions of the regulator and not be involved in any investigation, inspection or similar other functions.

Like the administrative law members, the administrative law officers will also not be involved in any investigation proceedings. This would, however, be achieved without creating a wall of separation within the regulator – administrative law officers would be drawn from the general pool of employees of the regulator but as long as such persons are involved in judicial functions they would not be involved in any other regulatory functions (see Table 4.13).

4.3.2. Procedure for administrative law functions

The administrative law functions of the regulator are at two levels. The first level adjudication will be done by administrative law officers who will work inside the agency of the regulator but will not be involved in executive functions. While exercising their functions, the administrative law officers will examine the data and evidence collected by the regulator's executive officers and will assess the appropriateness of their executive orders (see Table 4.14).

Appeals from the orders of the administrative law officers will go to the administrative law members of the board. This process will act as a performance review of the administrative law officers and also reduce the number of appeals to the tribunal by weeding out flawed orders. Table 4.15 summarises the administrative law related processes of the regulator.

Table of Recommendations 4.16 Approach to judicial review of regulatory actions

1. All functions including the quasi-judicial function of regulator should be subject to judicial review;
2. This review should be done through an appellate mechanism;
3. There should be a single dedicated appellate tribunal for the entire financial sector that will cover all financial regulators;
4. The appellate tribunal will hear appeals against the decisions made by and the regulations framed by financial regulators;
5. The appellate tribunal will be funded by an appropriate fee from all regulated entities; and
6. The appellate tribunal's structure is clearly detailed out in the draft Code.

The Commission is of the opinion that while the entire Code for Civil Procedure, 1908 (CPC) need not be followed by the administrative law officers and members, the draft Code provides the basic rubric of the procedure of judicial determination and appeals. Therefore, it will be the responsibility of the board of the regulator to create appropriate subsidiary legislation to establish the procedures to be followed for the discharge of administrative law functions by the regulator.

4.3.3. Judicial review and appellate tribunals

The Commission recognises that actions taken by regulators can impose significant penalties and burden on regulated entities. Therefore, the *rule of law* requires that a clear judicial process be available to persons who seek to challenge regulatory actions. The needs of a modern financial system require us to move beyond a system where appeals against regulatory decisions can be made to an authority within the regulator or to the Government to the creation of a specialised FSAT. The appellate framework envisaged by the Commission is outlined in Table 4.16.

4.3.4. Structure of the appellate tribunal

As regards the structure and functioning of the FSAT, the Commission finds that there is need for clearly demarcating and concentrating on two important functions:

1. Judicial functions of the tribunal, which require persons with qualification and experience in law and finance; and
2. Administrative functions of the tribunal, which include service of documents, collecting evidence, accepting written submissions, managing dates for hearings and arguments.

The judicial functions of the tribunal requires expertise in various fields of law and finance. In order to satisfy the requirements of separation of powers envisaged in the Constitution, the Commission recommends that the tribunal must remain under the control of judicial officers. This is also consistent with the present structure of tribunals in India. Table 4.17 summarises the recommendations of the Commission in relation to the judicial functions of the appellate tribunal.

4.3.5. Functioning of the tribunal's registry

The present systems of management of courts and tribunals often involve mandating the chief judicial officer of the court or the senior-most judge to be responsible for the administration of the tribunal or court. This can interfere with the person's core appellate functions by causing him or her to divert attention to administrative matters. In some cases, this challenge has been addressed by appointing a separate *registrar* for the court or tribunal.

The Commission recommends that the appellate tribunal should be supported by an efficient registry which will be headed by a *registrar* having specialised management

Table of Recommendations 4.17 Judicial structure of tribunal

For creating a clear judicial structure for the appellate tribunal, the Commission recommends the following provisions:

1. The appellate tribunal will be headed by a presiding officer who is qualified to be a Judge of Supreme Court, Chief Justice of a High Court, or has served for at least seven years as a Judge of a High Court;
 2. The tribunal will have at least two members; the specific number of members of a tribunal will be determined by the case load;
 3. The members of the tribunal must have experience in the fields of finance, economics, accountancy and law;
 4. The members may be formed into benches, in which case, each bench must have a person who is qualified in law; and
 5. There will be a statutory appeal available against the decisions of the appellate tribunal to the Supreme Court.
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Table of Recommendations 4.18 Rules of procedure for appellate tribunal

The appellate tribunal should devote attention to standardising the systems for:

1. Application of complaints and responses;
 2. Implementation of temporary orders;
 3. Introduction of evidence;
 4. Hearing of arguments;
 5. Determination of the case; and
 6. Determination of the penalty.
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skills who will be responsible for all the infrastructure and administrative functions of the appellate tribunal. To ensure that the separate registry does not undermine the independence of the tribunal, the registrar should be under the supervision of the chief judicial officer of the appellate tribunal.

The Commission recommends the following provisions relating to the registry of the appellate tribunal to ensure its efficient functioning:

1. *Developing details of procedure:* The draft Code requires the appellate tribunal to formulate its own regulations on procedure, and publish them so as to induce clarity amongst financial firms. These regulations, on the areas mentioned in Table 4.18, should be formed by the appellate tribunal itself.
2. *Using information technology:* The processes of the appellate tribunal should be geared towards using information technology to integrate its entire judicial functions into an electronic form. The objective of the use of technology would be to reduce the cost of approaching the tribunal, greater efficiency in the functioning of the tribunal and greater transparency in the performance of the tribunal. Information technology should be used to reduce requirements for physical travel, keeping paper records, and following up on compliance with orders.
3. *Resources and reporting:* The efficiency of the tribunal's procedures need to be continuously monitored and measured. The draft Code will help achieve this by specifying that the tribunal must comply with accountability requirements through the production of detailed performance statistics, annual reports and audit reports similar to that of regulators.

4.4. Conclusion

The functioning of regulatory agencies is a critical component of financial law. Regulatory agencies are remarkable in featuring a combination of regulation-making power that is delegated by Parliament, executive functions, and quasi-judicial functions. In addition, there are sound reasons for favouring significant political and operational independence in regulatory agencies. In order to obtain sound outcomes, the Commission has applied meticulous care in clearly establishing unconflicted objectives, processes governing legislative and executive functions, bringing in an element of separation of powers for per-



forming quasi-judicial functions, and establishing an effective specialised mechanism for substantive judicial review of regulations and orders.

The basic public administration challenge of establishing a regulatory agency does not vary from one agency to the next. Hence, the Commission proposes a single and consistent framework that is applied to all regulatory agencies.

Consumer protection

5.1. Strategic picture

A well functioning financial system should allow individuals, households and enterprises to efficiently allocate and manage their resources and protect themselves from risk, through the use of financial products and services. This involves complex interactions between consumers and financial service providers. At a first level, these interactions require the support of law to define and protect property rights and facilitate the enforcement of contracts.

However, the complexity of financial markets and the existence of *market failures* in the form of information asymmetries, market externalities and differences in the bargaining powers of consumers and service providers, create the need for a higher standard of protection for financial consumers. The need for financial consumers to be treated fairly makes it appropriate to adopt a more intrusive approach to financial regulation, when compared with most other fields.

Currently, the strategy in Indian finance is focused on the doctrine of *caveat emptor*: let the buyer beware. Beyond protection from fraud and provisions to ensure full disclosure, consumers are generally left to their own devices. After extensive analysis and debate on these questions, the Commission believes that to the extent that consumers of financial services are more vulnerable than consumers of ordinary goods and services, higher standards of protection ensured by special efforts of the State are justified.

The vulnerability of consumers reflects a major gap in Indian financial regulation, which needs to be addressed. As such, the Commission recommends the adoption of a consolidated, non-sector-specific, consumer protection framework for the entire financial system that will empower and require regulators to pursue consumer protection for the financial activities regulated by them. In this context, the draft Code approaches the problems of consumer protection on two fronts: prevention and cure.

Prevention requires regulation-making and enforcement across the entire financial system from the viewpoint of consumer interests. For example, looking at questions of remuneration and conflicts of interest, 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.

The consumer protection part of the draft Code has three components: an enumerated set of rights and protections for consumers, an enumerated set of powers in the hands of the regulator, 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 to be drafted by financial regulators. Whether or not, for example, loads and other conflicted remuneration structures should be banned is a question that would need to be addressed by the regulator. The regulator will use its authority to develop subordinate legislation which will adapt over the years to reflect financial innovation, technological change, and the evolving nature of the Indian economy. Alongside this regulation-making mandate, the regulator would also have supervisory roles to ensure compliance with the law.

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 have sometimes been lax in developing required protections out of notions of facilitating growth in the industry. These problems would be reduced by having a single principles-based law which would cover the entire financial system. The Commission believes that an overarching principles-based body of law would allow regulatory flexibility, consistent treatment of consumers across all aspects of their engagement with the financial system, fairness and ultimately a more stable financial system.

Turning from prevention to cure, the Commission proposes the creation of a unified financial redress agency. The redress agency is expected to have front-ends in every district of India, where consumers of all financial products will be able to submit complaints. Modern technology will be used to connect these front-ends into a centralised light-weight adjudication process. A well structured work-flow process will support speedy and fair handling of cases. Consumers will deal only with the redress agency when they have grievances in any financial activity: they will not have to deal with multiple agencies.

The complaints brought before the redress agency will shed light on where the problems of consumer protection are being found, and thus suggest areas for improvement in subordinated legislation. As such, a key feature of the redress agency will be the creation of a feedback loop through which the computerised case database of the redress agency will be utilised by the regulator to make better regulations on a systematic basis.

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

Table of Recommendations 5.1 Framework on consumer protection

The draft Code contains a consolidated non-sector-specific financial consumer protection framework. It identifies consumer protection as a key regulatory objective and contains the following preventive and curative components:

1. Preventive tools

- ▶ Certain *protections* are provided to all financial consumers.
- ▶ An *additional set of protections* are provided to unsophisticated or *retail* consumers.
- ▶ The regulator is given a list of *enumerated powers* which it can use in order to implement these protections.
- ▶ The regulator will be guided by a list of principles that should inform *the exercise of its powers*.
- ▶ The regulator has been given the *power to supervise* financial service providers and initiate *enforcement and disciplinary* actions.

2. Curative tools

- ▶ Creation of an independent financial redress agency to redress complaints of retail consumers against all financial service providers.
 - ▶ A research program, applied to the data emanating from the redress agency, will feed back to the regulator and thus enable improvements in its work.
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Table of Recommendations 5.2 Meaning of “consumer” and “retail consumer”

The terms “consumer” and “retail consumer” are defined in the draft Code to mean:

1. *Consumer*: A person who has availed, avails, or intends to avail a financial service or has a right or interest in a financial product.
 2. *Retail consumer*: A consumer that is an individual or an eligible enterprise, if the value of the financial product or service does not exceed the limit specified by the regulator in relation to that product or service. The regulator may specify different limits for different categories of financial products and services.
 3. *Eligible enterprise*: An enterprise that has less than a specified level of net asset value or has less than a specified level of turnover. Each of these caps will be specified by the regulator.
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advantage of customers. The present financial laws in India are vulnerable to such a prospect. As such, the Commission believes that it is essential to place the function of consumer protection at the heart of financial regulation (see Table 5.1).

5.2. Scope of the law

In some jurisdictions, the protections under financial laws are available only to consumers who are individuals or households, and often only when they use financial services for personal or household purposes. This helps in limiting the coverage of the law to only the most vulnerable categories of users and avoiding regulatory intervention in markets involving sophisticated users. The Commission considered this position but found that in the present state of development of the Indian financial sector and the sophistication levels of consumers, adopting a limiting definition could lead to undue exclusions. It therefore opted for a wider definition of *consumer*, which includes any person who avails a financial product or service, without regard to the person’s legal status or the purpose of use.

The draft Code empowers the regulator to classify consumers into different categories, based on their levels of sophistication, and issue subordinated legislations suited to the needs of particular categories. In addition to giving this discretion to the regulator, the Commission agreed that the law itself should contain additional safeguards for consumers who are identified as being most vulnerable and susceptible to abuse. This category of persons, referred to as *retail consumers*, will include individuals and small and medium enterprises, which are identified as eligible enterprises.

However, in order to exclude very high net worth individuals and enterprises undertaking large value transactions from its ambit, the category of retail consumers will be limited to persons who acquire financial services for a consideration that is below a specified limit (see Table 5.2).

5.3. Objectives and principles

The objectives of consumer protection are to guard consumer interests and to promote public awareness (see Table 5.3). While pursuing these objectives, the regulator will be empowered to make regulations to determine the manner and extent to which the protections under the law will apply to the users of different financial products and services.

Table of Recommendations 5.3 Objectives

The consumer protection part of the draft Code will direct the regulator to pursue the twin objectives of:

1. Protecting and furthering the interests of consumers of financial products and services; and
 2. Promoting public awareness in financial matters.
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Table of Recommendations 5.4 Principles to guide the regulators

The regulator must consider the following principles while carrying out any functions or exercising any powers relating to consumer protection:

1. The level of protection given to a consumer and the level of responsibility on the financial service provider should vary depending on:
 - ▶ the level of sophistication of the consumer;
 - ▶ the nature and degree of risk embodied in a financial product or service; and
 - ▶ the extent of dependence of the consumer on the financial service provider.
 2. Consumers should take reasonable responsibility for their decisions.
 3. Any obligation imposed on a financial service provider should be consistent with the benefits expected from such obligation.
 4. Barriers to competition owing to adverse effects of regulatory actions should be minimised and there should be competitive neutrality in the treatment of financial service providers.
 5. The need to promote, and not hamper, innovation and access to financial products and services.
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Table of Recommendations 5.5 Protections available to consumers

- ▶ Basic protections for all consumers:
 1. Financial service providers must act with professional diligence;
 2. Protection against unfair contract terms;
 3. Protection against unfair conduct;
 4. Protection of personal information;
 5. Requirement of fair disclosure; and
 6. Redress of complaints by the financial service provider.
 - ▶ Additional protections for retail consumers:
 7. Right to receive suitable advice;
 8. Protection from conflict of interest of advisors; and
 9. Access to the redress agency for redress of grievances.
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The regulator will also be able to impose a range of requirements on financial service providers, spanning from disclosure, suitability and advice requirements, regulation of incentive structures, and more intrusive powers such as recommending modifications in the design of financial products and services.

The Commission believes that regulatory powers should be used where they are most required and in a least-distortionary manner. As such, guiding principles to inform the choice and application of powers should accompany the grant of any broad range of powers. These principles will require the regulator to pay special attention to diversity in consumer profiles and differences in the kind of risks that different financial products pose to consumers. Further, the principle of proportionality suggests that the intensity of any obligation imposed on a financial service provider should be consistent with the benefits that are expected to arise from imposing the obligation.

Currently, rapid expansion of financial access is a major policy goal of the Government. This requires significant leaps in innovations in financial products and processes, and business models. These innovations will be fostered by two elements: higher levels of competition and an appropriate regulatory climate that supports and enables innovation. Table 5.4 summarises the principles that are being stated in the draft Code to guide the regulators on the subject of consumer protection.

5.4. Protections for all consumers

To be able to confidently participate in the financial markets, all consumers should be provided with certain basic protections. In addition, a wider set of protections need to be

Table of Recommendations 5.6 Unfair contract terms

- (a) An *unfair term* found in a financial contract that has *not been negotiated* between the parties will be void.
 - (b) *Non-negotiated contracts* include contracts in which the consumer has very little or no bargaining power compared to the financial service provider and standard form contracts.
 - (c) A term is *unfair* if it causes a significant imbalance in the rights and obligations of the parties, to the detriment of the consumer. However, this will not include a term that:
 - ▶ is reasonably required to protect the legitimate interests of the service provider;
 - ▶ sets the basic terms of the financial contract, such as the price; or
 - ▶ is required under any law or regulations.
 - (d) The court or redress agency may strike down a term for being unfair, while allowing the rest of the financial contract to continue.
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Table of Recommendations 5.7 Protection of personal information

Personal information means any information that relates to a person or permits the inference of a person's identity. This includes *demographic information* such as the person's name and contact information; *biometric information*; and *transactional information* about holdings and dealings in financial products and services. The draft Code provides for the following protections for personal information:

- (a) A prohibition on collection of personal information beyond what is required for providing the relevant financial service.
 - (b) A requirement to maintain confidentiality of personal information, unless the consumer has consented to the disclosure or it is otherwise permitted by law.
 - (c) An obligation to maintain accurate, up-to-date and complete personal information, and to allow consumers reasonable access to their personal information.
 - (d) Powers given to the regulator to specify additional requirements, exempt some financial service providers from application of this protection and establish mechanisms to ensure that consumers can access their personal information.
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available only to retail consumers. The Commission suggests six types of protections for all consumers and three additional protections for retail consumers (see Table 5.5).

1. *Right to professional diligence*

Consumers should be assured that any interaction that they have with a financial service provider will be carried out in good faith and in line with honest market practices. The level of diligence expected from a provider will vary depending on the honest practices followed in that line of business, the consumer's knowledge and expertise level and the nature of risk involved in the financial service.

2. *Protection against unfair contract terms*

Due to differences in the bargaining power of consumers and financial intermediaries, consumers are often forced to accept unreasonable contractual terms that are not in their best interests. To prevent this, the draft Code declares unfair terms in financial contracts that have not been explicitly negotiated between the parties to be void (see Table 5.6).

3. *Protection against unfair conduct*

A consumer's decision on whether or not to enter into a financial contract or the manner in which to exercise any rights under a contract should be taken in a fully informed environment, free of any undue influence. The draft Code therefore protects the consumer from any unfair conduct that is geared towards unfairly influencing the consumer's transactional decisions. This includes situations where a consumer's transactional decision is affected by:

- (a) *Misleading conduct*: Knowingly providing consumers with false information or information that is correct but is provided in a deceptive manner. Any failure to correct an evident and important misapprehension on the part of the consumer will also be covered under the law.
- (b) *Abusive conduct*: Use of coercion or undue influence to influence a consumer's transactional decisions.

4. *Protection of personal information*

Any information relating to *an identifiable person* belongs to that person and should be protected from unauthorised use. Financial service providers will therefore be restrained from collecting,

using or disclosing any personal information belonging to consumers, except to the extent required for the purposes of carrying out their business or expressly permitted under the draft Code. The draft Code also provides safeguards for consumers to be able to access their personal information held by service providers and ensure that the information is accurate and complete (see Table 5.7).

5. *Requirement of fair disclosure*

Information asymmetry between consumers and financial firms affects the quality of financial decisions made by consumers. This asymmetry needs to be addressed by imposing a positive obligation on financial service providers to provide consumers with all the information that is relevant for them to make informed decisions. This includes disclosures required to be made prior to entering a financial contract and continuing disclosures regarding material changes to previously provided information or the status or performance of a financial product.

Given the wide array of financial services being covered under the draft Code, the regulator may find it useful to specify different disclosure requirements for various financial products and services. With this objective, the draft Code empowers the regulator to make differing provisions regarding the types of information required to be disclosed, the manner in which disclosures must be made and the appropriate time-periods for making required disclosures.

6. *Redress of complaints*

The Commission envisages a two-tier approach for the redress of consumer complaints: first at the level of the financial service provider and subsequently at the level of the redress agency (for retail consumers).

If a consumer is dissatisfied with a financial product or service, the consumer should first take up the issue with the relevant financial service provider. For this purpose, the draft Code requires all financial service providers to have in place an effective mechanism to redress complaints from consumers. They will also be obliged to inform consumers about their right to seek redress and the process to be followed for it. The regulator may supplement these requirements by laying down specific details of the process to be followed by financial service providers to receive and redress complaints.

In certain cases the regulator may also envisage an additional layer of grievance assessment to take place after, or instead of, the service provider's own grievance redress mechanism and before the complaint goes to the redress agency. The stock exchange arbitration process would be an example of such an arrangement.

5.5. Additional protections for retail consumers

The Commission believes that the following rights and protections should be available to retail consumers over and above the protections available to consumers generally. These protections are needed due to the generally low levels of knowledge and experience of retail consumers.

1. *Assessment of suitability*

Retail consumers may often be in a situation where they are not able to fully appreciate the features or implications of a financial product, even with full disclosure of information to them. This makes a strong case for a thorough suitability assessment of the products being sold to them. The draft Code provides this protection by requiring that any person who advises a retail consumer in relation to the purchase of a financial product or service must obtain relevant information about the needs and circumstances of the consumer before making a recommendation to the consumer (see Table 5.8).

2. *Dealing with conflict of interests*

One of the best ways to ensure good consumer protection is to align the incentives of financial service providers with those of consumers and ensure that in case of a conflict, the interests of consumers take precedence. The draft Code incorporates this principle of prioritising the interests of retail consumers over those of the provider. It also requires advisors to inform retail consumers about any conflicted remuneration they stand to receive, which may influence the advice being given to the retail consumer. The regulator may, in addition, specify the nature, type and

Table of Recommendations 5.8 Suitability assessment process

1. A person making a recommendation to a retail consumer about the purchase of a financial product or service must make efforts to obtain correct and complete relevant information about the consumer's personal circumstances. Advice given to the retail consumer must be based on due consideration of the relevant personal circumstances.
 2. If the advisor finds that the information is inaccurate or incomplete, the retail consumer must be warned about the consequences of using such information.
 3. If a retail consumer plans to avail a financial product or service that the advisor does not deem suitable, it is the obligation of the advisor to clearly communicate the consequences to the retail consumer.
 4. The regulator must specify the financial products or services that may be provided to retail consumers or a class of retail consumers only after proper advice has been given to them. Suitability assessment should be mandatory for those categories of products and services.
 5. The regulator must take into account the following factors while making advice mandatory for any financial product or service:
 - ▶ the potential negative consequences to financial access due to the cost that will be imposed on financial service providers on account of suitability requirements; and
 - ▶ the extent to which fair disclosures required under the law may suffice to enable retail consumers to assess the suitability of the financial product or service for their purposes.
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structure of benefits permitted to be received by an advisor for a particular financial product or service.

5.6. Functions and powers of the regulator

The Commission recommends the creation of a single consumer protection framework which will apply to all parts of the financial system. The consumer protection framework may be implemented by one or more regulators, depending on the views of lawmakers about financial regulatory architecture. While the financial regulatory architecture may change, it is expected that the consumer protection framework would not.

The general functions of a regulator include: making regulations to carry out the purposes of the law; issuing guidance to financial service providers; supervising the conduct of financial service providers to ensure compliance with the law; and taking appropriate enforcement actions to deal with any violations.

The regulator will also be responsible for the existence of financial awareness programmes in order to meet the objective of promoting public awareness in financial matters. This will involve spreading awareness about the benefits of financial planning, protections available to consumers, and features and functions of financial products and services. If required, the regulator may also choose to establish a separate financial awareness body to pursue this function.

In exercise of its supervisory functions, the regulator will need to put in place appropriate arrangements for seeking relevant information from financial service providers, imposing record-keeping requirements, conducting investigations, inspecting premises and holding meetings with the officers of financial service providers. If the regulator has reasonable grounds to suspect a violation of the law, it may initiate appropriate enforcement actions.

In addition to the general functions of rule-making, supervision and enforcement, the draft Code will contain the following specific provisions:

1. *Registration of individuals*

Proper training and qualification of front line staff can be an effective tool for ensuring that the protections envisaged by the law translate into actual practice. To achieve this, the draft Code will require registration of all individuals who deal with consumers in connection with provision of a financial product or service. This would include individuals who deal with consumers in their capacity as financial service providers or as employees or representatives of financial service

providers. The regulator will specify the requirements and process for the registration of such individuals as well as any code of conduct applicable to them.

2. *Information on new products*

The Commission believes that consumer protection regulation, as in other areas of law, should be guided by the principle of *allow-and-respond*, instead of following the *banned-until-permitted* approach. Accordingly, the draft Code does not require every financial product to be approved by the regulator.

Financial service providers will be able to provide any financial product to consumers subject to following a *file and use* process. This will require the regulator to make regulations to specify the kind of information required by it on any new product that is proposed to be launched in the market. A financial service provider will be required to file the specified information with the regulator two months before the planned launch, so that the regulator may assess its risks and merits and if required, make appropriate regulations. The regulator may seek additional information about the product during the two month period but will not have the power to block it from being launched after the expiry of that period.

3. *Power to specify modifications*

The regulator should be able to intervene in situations where certain features or aspects of a financial product or service are found to be harmful for consumers after it has been introduced in the market. The draft Code therefore allows the regulator to specify modifications in the terms and conditions of particular financial contracts or the process of delivering particular financial services. The Commission however recognises that this is a very strong power and its frequent use can cause undue hardships to financial service providers. Any such regulatory interventions must therefore be accompanied by a statement explaining the other interventions that were considered by the regulator to address the problem and the reasons why such interventions were found to be inadequate. This statement is in addition to the regular requirements of the regulation-making process.

5.7. Advisory council on consumer protection

In order to monitor and contribute towards the regulator's consumer protection objectives, the Commission recommends the creation of an advisory council on consumer protection (see Table 5.9). The advisory council will be responsible for:

1. Making representations, in the form of advice, comments or recommendations, on the regulator's policies and practices;
2. Reviewing, monitoring, and reporting to the regulator on the effectiveness of its policies and practices; and
3. Creating reports stating its views on all draft regulations published by the regulator.

The regulator must take into account any representations or reports received by it from the advisory council and provide a written response in cases where the regulator disagrees with the views or proposals made by the council.

5.8. Financial redress agency

The Commission recommends the creation of a new statutory body to redress complaints of retail consumers through a process of mediation and adjudication. The redress agency will function as a unified grievance redress system for all financial services. To ensure complete fairness and avoid any conflicts of interest, the redress agency will function independently from the regulators.

The financial redress mechanism proposed by the Commission will replace the existing financial sector-specific ombudsman systems such as the banking ombudsman and

Table of Recommendations 5.9 Composition of the advisory council on consumer protection

1. The advisory council will consist of persons who are consumers or persons representing the interests of consumers.
 2. The appointment of members of the council should also:
 - (a) give a fair degree of representation to experts in the fields of personal finance and consumer rights; and
 - (b) take into account the need to ensure proper geographical representation from across the country.
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Table of Recommendations 5.10 Composition of the redress agency's board

The general superintendence, direction and management of the affairs of the redress agency will vest in its board of directors, which will be comprised of:

1. A chairperson to be appointed by the regulators through a selection process, in consultation with the Central Government.
 2. One official to be nominated by each of the regulators.
 3. Four other members to be appointed by the regulators through a selection process.
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the insurance ombudsman although retail consumers will continue to have the option to approach other available forums, such as the consumer courts established under the Consumer Protection Act, 1986 and regular courts. In the future, if the Government is of the view that the redress agency has acquired sufficient scale and expertise to be able to efficiently address all complaints from retail consumers, it will have the power to exclude the applicability of the Consumer Protection Act, 1986 to retail consumers covered by the redress agency.

In any case, once a retail consumer opts for a remedy before the redress agency, it will not be permitted to institute fresh proceedings before another forum, either simultaneously or after a final order has been issued by the redress agency. Similarly, action initiated before any other forum will bar any action before the redress agency.

The redress agency will be managed by a board of directors (see Table 5.10 for the composition of the board). The agency will be funded through a combination of allocations from the Central Government, standard fees payable by all financial service providers and a complaint-based fee that will be collected as and when a complaint is brought against a financial service provider.

An effective dispute resolution body needs to be designed in a manner that ensures access, convenience, efficiency and speedy remedies. It needs to address two kinds of difficulties: a scenario where a genuine consumer is not able to obtain redress, and one where multiple cases are filed against a financial firm as a strategy of harassment. The Commission envisages the redress agency to function as a technologically modern organisation that will carry out video hearings, digital handling of documents, telephonic/online registration of complaints, maintenance of a high quality electronic database and online tracking of compensation payments. To ensure that the processes designed by the redress agency are in line with these requirements, the draft Code expressly requires the redress agency to put in place adequate systems, processes, technology and infrastructure to enable it to efficiently discharge its functions. The draft Code also empowers the regulators to impose service level requirements on the redress agency with measurable targets on matters such as the total cost to parties for proceedings before it, compliance cost for financial firms and time-periods for each step of the redress process. The redress agency will be accountable for meeting these targets with a requirement to explain any failure to do so. These measures will compel the redress agency to strive towards maximum efficiency in its processes and functioning.

The draft Code allows the redress agency the discretion to open offices anywhere in the country. The Commission intends that the redress agency will use this power to set up

Table of Recommendations 5.11 Outline of the redress agency's proceedings

The redress agency will follow the following steps while assessing complaints made to it by retail consumers:

1. *Receipt of complaint:* Complaints against financial service providers may either be submitted directly to the redress agency (at any of its offices) or be submitted to the regulator, which will then forward it to the redress agency.
 2. *Screening of complaints:* The redress agency will screen all received complaints and may dismiss a complaint during the screening process if the consumer has not made a complaint to the financial service provider before approaching the redress agency; the complaint is *prima facie* frivolous, malicious or vexatious; or if the matter is pending before, or has been adjudicated upon by, another competent authority.
 3. *Mediation:* A complaint that is not dismissed during screening will be referred to a mediator who will assist the parties to arrive at a voluntary settlement. If the mediation process fails, the complaint will proceed to the adjudication stage, unless it is withdrawn by the retail consumer.
 4. *Adjudication:* The redress agency will appoint independent skilled and qualified adjudicators, who will be responsible for investigating, considering and determining complaints. Unless an appeal is made, the decision of the adjudicator will be final and binding on the parties.
 5. *Appeals:* Appeals from a decision of the redress agency's adjudicators will go to the FSAT and appeals from the appellate tribunal will go to the Supreme Court.
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front-end offices throughout the country where retail consumers of all financial products and services will be able to submit their complaints. Modern technology would then be used to connect these front-ends into a centralised mediation and adjudication system (see Table 5.11).

The redress agency will endeavour to arrive at an amicable settlement in a majority of the complaints through its mediation process. In cases where a settlement is not achieved, the consumer may choose to withdraw the complaint from the redress agency, failing which, it will be referred for adjudication. The adjudicator will hear the parties, examine the claim and pass a final order on the complaint after taking into account:

- the provisions of the draft Code on consumer protection and regulations made under it;
- the terms of the financial contract between the parties;
- any code of conduct applicable to the financial service provider; and
- prior determinations made by the redress agency on similar matters.

An order made by the adjudicator may provide for an award of compensation to the retail consumer, subject to limits that will be specified by the regulators, or issue any other directions that the adjudicator considers just and appropriate. A party that is dissatisfied with the adjudicator's orders will have the right to bring an appeal before the FSAT and appeals from FSAT will lie before the Supreme Court.

The Commission sees strong complementarities in the roles of the redress agency (curing grievances) and the regulators (preventing grievances). The complaints received by the redress agency will shed light on areas where the problems of consumer protection are most prominent, and thus suggest areas for improvement in subordinated legislations. Hence, the draft Code seeks to ensure a feedback loop through which the redress agency will use the FDMC to share information on complaints with the regulators on an ongoing basis and the regulators will analyse the information received from the redress agency and utilise it for improved regulation-making and systemic improvement.

Specifically, the information technology systems within the redress agency must create a high quality database about all aspects of all complaints that are filed with it. This database must be analysed in order to shed light on the areas where there are difficulties and thus feed back into better regulation and supervision. The research program which studies this database should be a joint effort between the redress agency, regulators and academic scholars, with release of datasets and research into the public domain. Over the years, there should be a visible feedback loop where the hot spots of grievance that are identified lead to modifications of regulation and supervision.

Several provisions of the draft Code, specifically those relating to the creation and operation of the redress agency, require co-ordination and co-operation between multiple regulators. In the event that the regulators are unable to arrive at a consensus on such matters, within a reasonable period, the matter will be addressed through the FSDC.

5.9. Competition law and policy

The Commission recognises the major role of healthy competition in financial markets for ensuring the best interests of consumers. While perfect competition alone will not protect the interests of consumers, greater competition, in tandem with a sound and well-functioning consumer protection framework, is undoubtedly a powerful tool to enhance consumer welfare. The cci is the leading, non-sectoral authority responsible for competition policy issues in India. The cci has overlapping jurisdiction with many independent regulators as it is charged with the duty of fostering greater competition in all areas of the economy.

The Commission recommends a structured mechanism for interaction and co-operation between the cci and financial regulators in the following ways:

1. *Consultation for draft regulations*

The cci should review draft regulations issued by the regulator for public comments and provide its inputs on the potential competition implications, if any. The regulator must consider the representation made by cci before finalising the regulations. If the regulator disagrees with cci's views, it must provide written reasons.

2. *Review of regulatory provisions*

cci must be empowered to monitor the effects on competition of any regulatory actions and practices on an ongoing basis. If it determines that a regulatory action is unduly detrimental to competition in a financial market, the cci must submit a report on the issue to the regulator. The regulator will be obliged to consider and respond to the report.

If the regulator and the cci disagree on the course of action to be taken, the cci will have the power to direct the regulator to take specified actions to address the negative effects on competition identified by the cci.

3. *Reference by cci*

The cci must make a reference to the regulator if it initiates any proceedings involving a financial service provider, and the regulator must respond with its views on the referred issue, within an agreed period. In such cases, if the regulator believes that an action taken by the cci may interfere with the regulator's objectives, the regulator may choose to nominate one non-voting member on to the cci's board to participate in proceedings relating to that matter.

4. *Reference by the regulator*

The regulator must report to the cci about any conduct of financial service providers that appears to it to be in violation of the Competition Act, 2002 so that appropriate proceedings may be initiated under that law.

5. *Memorandum of understanding*

The draft Code requires the cci and the regulator to enter into a memorandum of understanding to establish the procedures for co-operation between them, which may be modified by them from time to time.

There is also a need for organised interaction between the cci and the resolution corporation in the context of non-voluntary mergers and acquisitions. The mechanisms to address the likely effects of the resolution corporation's actions on competition in the relevant market is addressed in the draft Code under the part on resolution of financial service providers.

Micro-prudential regulation

Micro-prudential regulation refers to the regulation that governs safety and soundness of certain financial service providers. The rationale, scope and extent of micro-prudential regulation are primarily motivated by consumer protection concerns. Additionally, the possibility of large numbers of financial service providers failing at the same time, or a systemically important financial institution failing, can raise concerns about the stability and resilience of the financial system as a whole. Sound micro-prudential regulation then, plays a role in mitigating systemic risk as well.

6.1. Rationale for micro-prudential regulation

Financial service providers have a vested interest in their health. However, their financial health is not simply a matter of private concern, for a variety of reasons:

1. *Governance failures within firms:* Managers of a firm may not work in the best interests of shareholders - pursuant to the compensation structures of many organisations, managers may stand to make huge profits if the firm does well and walk away if the firm collapses. In particular, high-powered incentives created by share ownership, stock options, or profit-linked bonuses are likely to promote excessive risk-taking. Micro-prudential regulation is then a way of addressing the public good concerns raised by compensation structures and governance failures within a firm.
2. *Moral hazard:* Government rescue of failing financial service providers is inequitable because excessive risks taken by managers impose costs on tax payers at large. The possibility of such rescues induces 'moral hazard': managers have an incentive to increase risk knowing that tax payers will bear the burden of any significant losses that arise. As such, micro-prudential regulation is justified to constrain excessive risk-taking by financial service providers.

Market discipline, understood here as the process by which informed consumers identify and avoid dealing with unacceptably risky financial service providers, can work to prevent some financial firms from managing their risks badly, but even such discipline is somewhat constrained by the following:

- *Information asymmetry:* It is often difficult for consumers to evaluate, before or after entering a contract, how well a financial service provider is performing. There is noise in the information available to consumers, and there are significant limitations to the ability of most consumers to process and react to market information. While markets generate signals of financial soundness in the prices of stocks and bonds, many consumers are not in a position to access and act on such information. This is particularly the case with unsophisticated consumers. Most households will not be involved in transactions of a size that would warrant large financial investments in monitoring.

Table of Recommendations 6.1 Objectives

The objectives of micro-prudential regulation are:

1. To promote the safety and soundness of regulated persons; and
 2. To thereby contribute to the stability and resilience of the Indian financial system.
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This problem is most prominent in institutions that make balance sheet-based obligations to consumers, and have opaque balance sheets, since the cost of information processing is highest. With banks, due to information asymmetries, depositors may not know a bank is failing until it is too late. Conversely, depositors may react to false alarms and trigger bank runs.

Weaknesses of market discipline exacerbate the governance problems of financial service providers. Managers are, then, more able to make decisions that yield short-term gains while reducing the health of the financial service provider in the long run.

- *Co-ordination problems:* Consumers with low-volume transactions could ostensibly join forces and develop mechanisms for monitoring while sharing costs. In practice, the likelihood of such mechanisms emerging is low to the extent that those monitoring financial service providers incur costs that all market participants benefit from. These public good problems create co-ordination problems for consumers which, in turn, lead to inadequate monitoring of financial service providers.
- *Market power:* Financial service providers usually enjoy significant market power compared to their consumers, and the latter's ability to enforce corrective actions on the former is limited.

Market discipline does play an important role in ensuring safety and soundness of many financial service providers, but it is often not enough. This inadequacy of self-regulation and market discipline becomes particularly problematic for financial service providers making certain kinds of obligations, and financial service providers of systemic importance.

The Commission notes that certain obligations are inherently more difficult to fulfil than other obligations. Debt repayment obligations - obligations that make specified payments at specified times - are inherently more difficult to fulfil than obligations linked to equity prices or firm profitability. Insurance obligations - which are contingent upon external events and which require payment, regardless of the financial health of the promising institution - also pose problems of fulfilment.

The Commission also notes that for certain kinds of financial service providers, if obligations are not fulfilled, there are adverse consequences for specific consumers. If bank deposits are lost due to a bank failure, the consequences for consumers, whose savings are deposited with the bank, will be quite adverse. If a large financial service provider fails, the entire financial system, and the larger economy, may be adversely affected.

This combination of harsh consequences of failure, problems limiting self-regulation and the ability of markets to ensure safety and soundness, and inherent difficulty of fulfilling certain obligations, creates a case for regulation organised around securing the safety and soundness of certain financial service providers.

Fragile financial service providers, whether those taking bank deposits, issuing insurance contracts or otherwise, limit participation of households in the financial system in line with the possibility of non-performance. This, in turn, diminishes the participation of households in the financial system.

These challenges motivate micro-prudential regulation. The State needs to establish regulatory and supervisory mechanisms that intervene in the behaviour of firms, and improve their safety and soundness. These mechanisms, if designed and implemented properly, would act on behalf of consumers and society to reduce, though not eliminate, the probability of firm failure. The objectives of micro-prudential regulation, as enunciated in the draft Code, are enumerated in Table 6.1.

The phrase *safety and soundness* needs to be interpreted in terms of the *consequences* of failure rather than failure itself. If it is efficient to let the regulated persons fail or become insolvent, while the obligations to consumers' are protected, the regulator should

let that happen. For example, if consumers' funds are kept in a bankruptcy remote vehicle, it should be possible to let the regulated person fail, without significantly affecting the interests of consumers. In the stock market, the success of clearing arrangements has made possible a regulatory stance where many securities firms have failed with no adverse consequences to consumers. The construction of the resolution corporation thus greatly changes how regulators would view failure.

For systemically important financial institutions, *safety and soundness* should be taken to mean reducing the probability of *firm failure*, and for all other micro-prudentially regulated persons, it should mean reducing the probability of *the event of regulated person failing to meet the obligations made to consumers*. The Commission recognises that the acceptable probability of failure for regulated persons is not zero. However, if regulators are conferred with the objective of trying to *minimise* the probability of failure of regulated persons, they may adopt an excessively restrictive approach that could result in an adverse effect on competition or innovation in financial markets. This is not good, particularly given the resolution mechanism being enshrined in the draft Code. Therefore, the Commission recommends that the regulators should work with the objective of *reducing the probability of failure of regulated persons and maintaining it at below an acceptable level*. This *acceptable level* should be determined based on due consideration of the principles enunciated in the draft Code.

Micro-prudential regulation must be distinguished from 'systemic risk regulation', also called macro-prudential regulation (see Chapter 9). Sound micro-prudential regulation is, of course, an essential ingredient of reducing systemic risk. Yet micro-prudential regulation focuses on one firm at a time, while systemic risk regulation involves the financial system as a whole. Micro-prudential regulation sees the proverbial trees to the forest surveyed by systemic risk regulation.

6.2. A non-sector-specific micro-prudential framework

Micro-prudential regulation has often been a sector-wise concern. Some countries have sector-specific laws, focusing on issues and instruments in the respective sectors. For example, micro-prudential regulation in India is conducted by various financial regulators, operating in different sectors, through an array of relevant laws. In this context, the Commission recommends non-sector-specific micro-prudential provisions in the draft Code, for the following reasons:

1. There is underlying similarity in financial contracts- they are all built from a small number of contingent claims or obligations. There are common principles that underpin the micro-prudential regulation framework in different sectors, though specific risk-types to be addressed and the way instruments are to be used may differ. For example, there is significant convergence between the Basel II framework for banks and the European Union's Solvency II framework for insurance companies. Unification of the law will yield more consistent treatment across apparently diverse activities, which are actually constructed from a small set of core ideas.
2. As the financial system develops further, it will become increasingly difficult to draw sector-specific lines on financial products and services being offered. A common set of principles guiding the regulation of the entire financial system will help minimise the potential for regulatory gaps.
3. Once problems of competition policy are addressed, and competition in the financial system heats up, easy sources of profit will be competed away. This will give firms a strong incentive to pursue regulatory arbitrage. The use of a single set of principles, consistently applied across different kinds of activities, will reduce the extent to which regulatory arbitrage might arise.
4. Sector-specific regulators administering different sets of provisions create the possibility of a *race to the bottom*, where a sector regulator favours lax regulation in the interest of increasing the growth of the sector. The presence of non-sector-specific provisions will help curtail such destructive regulatory competition.

Table of Recommendations 6.2 Scope of micro-prudential regulation

Micro-prudential regulation will apply to financial service providers that carry out specified activities or have been determined to be systemically important. Those financial service providers that are deemed to be micro-prudentially regulated are called *regulated persons* in the draft Code. The draft Code lays down the following tests for the regulator to determine which activities should be subject to micro-prudential regulation, and to what extent:

1. The nature of the relationship between the regulated person and its consumers, including:
 - (a) the detriment caused to consumers if obligations are not fulfilled by the regulated person,
 - (b) the ability of consumers to access and process information relating to the regulated person's safety and soundness, and
 - (c) the ability of consumers to co-ordinate among themselves to monitor the regulated person's safety and soundness.
 2. Inherent difficulties in fulfilling the obligations owed by a regulated person to its consumers.
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5. Conversely, multiple regulators interpreting a single set of non-sector-specific provisions, can generate healthy public debates. Such comparative discussions, across sectors, would not occur in a climate conditioned by separate regulatory ecosystems. If there were separate laws, then this comparative law discourse would not arise.

A unified set of non-sector-specific micro-prudential regulation provisions in the draft Code will help create a consistent framework across the financial system. This would, in turn, help in efficient allocation of capital owing to the substantial mitigation of regulatory gaps or arbitrage.

6.3. Scope of micro-prudential regulation

Since micro-prudential regulation is an expensive and intrusive form of regulation, the Commission considers it important to ensure that micro-prudential regulation applies only where it is required, and with intrusiveness that is proportional to the problem that is sought to be addressed. All persons providing financial services, termed as *financial service providers*, will require permission from the regulator to carry on the relevant financial activity. From this set of financial service providers, only a subset will be subjected to some or all micro-prudential provisions of the draft Code. This subset of micro-prudentially regulated financial service providers, referred to as *regulated persons*, will be determined by the regulator based on the tests given in the draft Code. The tests provided in the draft Code will also guide the regulator in deciding the extent to which micro-prudential regulation should apply to different regulated persons (see Table 6.2).

The Commission recommends that financial service providers deemed to be systemically important should be subject to micro-prudential regulation. Though identification of systemically important financial institutions will be made by the systemic risk regulator (FSDC), micro-prudential regulation of designated institutions will reside with their respective regulators.

Usually the obligations intermediated and backed by the provider's balance sheet, where the provider carries market risk, would be micro-prudentially regulated with high intensity, though not always. For example, for a provider with only a small number of consumers, balance sheet-based obligations may often not attract high intensity regulation, to the extent that the ability of individual clients to assess the credit-worthiness of that provider may be high. Providers making market-linked obligations, where the consumers are expected to hold the market risk, should typically not be micro-prudentially regulated with high intensity, because the inherent difficulty of fulfilling the obligations is low and the ability to assess credit-worthiness is high. Here also, retirement financing funds offering defined contribution schemes, may be an exception on the basis of the high level of adversity caused if the expectations are not met, and information asymmetries for investors at the time of purchase. Regulators will have to take positions on the

Table of Recommendations 6.3 Instruments of regulation

The powers of micro-prudential regulation are classified into the following functional categories:

1. Regulation of entry;
 2. Regulation of risk-taking;
 3. Regulation of loss absorption;
 4. Regulation of governance, management and internal controls; and
 5. Monitoring and supervision.
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basis of comprehensive analysis of obligations made, relative levels of accountability to markets and institutional health.

Certain financial service providers are not likely to come under micro-prudential regulation:

- ▶ Investment funds with a small number of typically large value investors, such as hedge funds, venture capital funds, private equity funds, may not be subject to micro-prudential regulation, unless they are systemically important. Though the adversity caused by failure of some of these funds may be significant, information asymmetries and co-ordination failures are likely to be low given the small number of investors, who are likely to be sophisticated.
- ▶ Small, semi-formal arrangements at local level, such as mutual savings arrangements, may not be micro-prudentially regulated. Here, the local nature of the institutions should reduce information asymmetry and co-ordination failure, and make enforcement relatively easy for consumers, even though the adversity caused in case of failure to meet the obligation may be quite high, since many of these may be accepting members' deposits.

6.4. Powers of micro-prudential regulation

Micro-prudential regulation has evolved significantly in recent decades. Internationally accepted frameworks have undergone significant change over this period, and continue to evolve. The Commission recommends a set of principles-based provisions to allow regulation to adapt to changing circumstances and evolving scholarly and policy consensus on optimal structures of regulation.

The Commission has reviewed the range of micro-prudential powers used in India, along with prominent international comparators, and suggests a functional categorisation as suggested below (see Table 6.3). The Commission recommends that the precise mix of powers used, and that the manner of usage, evolve over time.

The regulator would only allow entry to those financial service providers that are likely to be prudently managed. The regulator would also work to ensure that regulated persons continue to be prudently governed and managed. Regulated persons would be regulated in terms of their risk-taking and risk avoiding practices, as well as the loss absorbing buffers they put in place. The regulator could also impose requirements to ensure business continuity and failure management in these persons. Regulated persons would be monitored and supervised to ensure compliance, and to respond to issues specific to any regulated person. Taken together, these components create the basis and framework of the Commission's approach to micro-prudential regulation.

6.4.1. Regulation of entry

The creation of micro-prudentially regulated persons should proceed on the basis of conditions consistent with the micro-prudential framework (see Table 6.4), so that on day one itself, an institution has low probability of failure. But there is a risk of excessive restrictions on entry that may impede competition and innovation.

Table of Recommendations 6.4 Regulation of entry

The regulator will have the following powers in connection with restricting entry:

1. Notifying pre-conditions for authorisation to carry on regulated activities;
 2. Authorising to carry on regulated activities, which may include a process of automatic authorisation; and
 3. Approving changes in the controlling interest of regulated persons.
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If new firms can be created, existing firms can launch new products or services, and entirely new business models can come about, the environment will be competitive and dynamic. The pursuit of these objectives presents two puzzles: the legal framework should allow only reliable and competent persons to deal with financial consumers, and lack of existing regulations on a particular area should not hold back the emergence of new business models.

The Commission, therefore, recommends a balanced approach, which is enshrined in the draft Code.

1. *Requirement for authorisation*: Any person who seeks to carry out a financial service for the first time will need to be authorised by the regulator. This will not apply to a new product or service launched by existing financial service providers, if the person is already authorised for that line of business. All new products can be launched after following the *file and use process*.
2. *Exemption*: Representatives of authorised financial service providers need not seek authorisation for the services for their principal has been given authorisation, as long as the representative is only carrying out the activity with regards to those services on behalf of the principal. Through regulations, the regulator will have the power to exempt, from the authorisation process, certain agencies of the government. The intent here is to exempt only those agencies that have a unique character, such as EPFO. This power should only be used as an exception, and does not mean that other regulations will not apply to an agency exempt from the authorisation process.
3. *Authorisation process*: The manner and process of obtaining authorisation for financial services will vary depending on the type of activity that is proposed to be carried out. A comprehensive authorisation process will apply to persons who want to carry out *regulated activities* which are to be micro-prudentially regulated with high intensity.

The need to promote innovation in the Indian financial system has been embedded thus: where a person proposes to carry out a financial service that is not a regulated activity, a simplified authorisation process will be applicable. Here, the regulator has the flexibility to specify that the authorisation requirement may be satisfied through an automatic process.

In either case, whether an activity is regulated or non-regulated, the authorisation process will not allow the regulator to refuse authorisation merely on grounds that the regulator does not have in place appropriate regulations to govern the proposed activity.

6.4.2. Regulation of risk-taking

This category of powers will empower the regulator to prescribe ways in which the regulated persons can avoid or reduce the risks they take (see Table 6.5). Regulator may impose restrictions on how the regulated persons invests the funds - their own funds and those of the consumers. In some cases, they may also impose restrictions on claims that may be placed from the regulated person's over business on consumers' funds. Regulator may also require adherence to certain business processes that reduce risks to the

Table of Recommendations 6.5 Regulation of risk-taking

The regulator will have the following powers in connection with reducing risks:

1. Regulating investments of own funds and consumers' funds;
 2. Regulating claims on consumers' funds;
 3. Regulating to foster business processes that reduce risks;
 4. Regulating the valuation standards for assets and liabilities of regulated persons;
 5. Regulating transactions with related persons; and
 6. Regulating liquidity management.
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Table of Recommendations 6.6 Regulation of loss absorption

The regulator will have the following powers in connection with absorbing losses:

1. Defining categories of capital resources, based loss absorbing capacities;
 2. Prescribing the amount of different types of capital resources required to be held, and the solvency requirements;
 3. Defining criteria for assessing compliance with capital resource requirements;
 4. Defining how regulated persons should manage the capital resources, including the requirement to notify the regulator while issuing certain capital instruments;
 5. Regulating how the changes in values of assets and liabilities will be recognised; and
 6. Mandating purchase of insurance from Resolution Corporation.
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regulated persons. The draft Code also empowers the regulator to impose liquidity requirements on the regulated persons.

6.4.3. Regulation of loss absorption

These powers allow the regulator to require the regulated persons to keep capital resources and/or purchase insurance from resolution corporation for *absorbing losses*. Capital resources act as buffers that are typically used for covering unexpected losses arising from under-performing investments or under-valuation of liabilities.

In conventional thinking, equity capital is thought to play this role. Loss absorption functions can be provided by a variety of instruments not limited to equity capital. Different instruments have different loss absorption capacities, and these capacities may also vary with time. Contingent capital has debt-like features, but can become equity-like loss absorber depending on certain conditions. If there are instruments that require deep and liquid markets, during times of crisis, this loss absorption capacity may be constrained. The regulator will need to think about loss absorption capacities across different times, and ensure that there are adequate buffers in place for normal times as well as for times of crisis (see Table 6.6).

A mechanism of loss absorption being built in this framework recommended by the Commission is the resolution mechanism, which presently does not exist in India. For certain financial service providers, the regulator should mandate purchase of insurance from resolution corporation, as a pre-condition for undertaking the activities they propose to undertake. For example, for banking service providers, the regulator may impose a condition of getting their deposits insured upto a limit determined by the resolution corporation.

6.4.4. Regulation of governance, management and internal controls

These instruments empower the regulator to prescribe standards for good governance. Since the regulator shares the responsibility for achieving micro-prudential objectives with the board and management of the regulated person, it is important that these persons are prudently governed and managed (see Table 6.7).

Table of Recommendations 6.7 Regulation of governance, management and internal controls

The regulator will have the following powers in connection with improving governance and management:

1. Regulating norms of corporate governance;
 2. Regulating the structure of management incentives;
 3. Regulating risk management systems;
 4. Regulating internal controls and internal audit;
 5. Regulating appointment of qualified auditors and actuaries; and
 6. Regulating outsourcing and appointment of agents.
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Table of Recommendations 6.8 Monitoring and supervision

The regulator will have the following powers in connection with monitoring and supervision:

1. Mandating disclosures to consumers and the market;
 2. Mandating reporting to the regulator;
 3. Conducting on-site supervision;
 4. Investigating powers; and
 5. Developing the capability to conduct analytics on the information received from regulated persons and other resources.
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6.4.5. Monitoring and supervision of regulated persons

These instruments can be used to improve monitoring and supervision by regulators, as well as, by market participants. The role of monitoring by market participants is complex. Since monitoring has a public good nature, the Commission proposes an approach that not only allows regulators to facilitate monitoring by market participants, but also empowers regulators to fulfil monitoring and supervisory functions on their own.

Monitoring and supervision can take many forms. Monitoring can involve disclosure of annual statements and other reporting. Regulated persons may also be required to obtain, maintain and disclose a current credit rating from an approved credit rating agency (see Table 6.8).

For regulated persons that are under the regulatory purview of more than one regulator, there should be a requirement for the regulators to co-operate to ensure optimal supervision. This may entail conglomerate supervision or supervision of a single regulated person undertaking multiple activities. The Commission does not prescribe any specific mode of co-operation, and the regulators will be expected to develop co-operation through mutual understanding and agreement.

6.5. Principles to guide the use of powers

Micro-prudential regulation, like all forms of regulation, imposes costs on the economy. Regulation is optimal when it achieves a desired objective while imposing the smallest possible distortion. As such, the draft Code enunciates principles that guide the use of powers instead of being a simple grant of powers. (see Table 6.9).

Distortions can take various forms. For example, regulations that focus excessively on products rather than underlying functions could encourage regulatory arbitrage between various products. Two different products that achieve similar payoffs between risks and rewards should be regulated in similar ways.

PRINCIPLE 1. *Any obligation imposed on regulated persons should be proportionate to-*

Table of Recommendations 6.9 Principles of micro-prudential regulation

The regulator must consider the following principles in discharging its functions and exercising its powers:

1. Any obligation imposed on regulated persons should be proportionate to-
 - ▶ the nature, scale and complexity of the risks in the regulated activity being carried out; and
 - ▶ the manner in which the regulated activity ranks on the factors stated in Table 6.2
 2. Regulatory approach needs to take into account the feasibility of implementation by regulated persons and supervision by the Regulator;
 3. The need to minimise inconsistencies in the regulatory approach towards regulated activities that are similar in nature or pose similar risks to the fulfilment of the Regulator's objectives under this Act;
 4. Any obligation imposed on regulated persons should be consistent with the benefits, considered in general terms, which are expected to result from the imposition of that obligation;
 5. The desirability of facilitating competition in the markets for financial products and financial services and minimising the adverse effects of regulatory actions on competition in the financial sector;
 6. The desirability of facilitating access to financial products and financial services;
 7. The desirability of facilitating innovation in financial products and financial services;
 8. The need to ensure that regulatory actions are carried out in a manner that is least detrimental to competitiveness of India's financial system;
 9. The need to take into account the long-term implications of regulatory actions, which will include a period of at least five years following a regulatory action;
 10. The need to minimise the pro-cyclical effects of regulatory actions; and
 11. The requirement that persons who control and manage the affairs of regulated persons must share the responsibility of ensuring the safety and soundness of the regulated persons.
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- ▶ *the nature, scale and complexity of the risks in the regulated activity being carried out; and*
- ▶ *the manner in which the regulated activity ranks on the factors stated in Table 6.2*

This principle requires that regulatory instruments are used in a manner that is risk sensitive; the intensity of regulation should be proportional to risk held by the regulated person. For example, compare two banks with the same balance sheet size. One of them is investing only in low risk assets, while the other is investing in high risk assets. A regulatory approach that is sensitive to the risks will impose different micro-prudential requirements on these two regulated persons, because they have different levels of risks to their safety and soundness. Similarly, the factors listed in Table 6.2 translate the market failures providing the rationale for micro-prudential regulation into tangible tests. These tests can be used not just to determine where micro-prudential regulation will apply, but also to decide the extent to which such regulation are to be applied. Regulation ought to be proportional to the risks and market failures.

PRINCIPLE 2. *Regulatory approach needs to take into account the feasibility of implementation by regulated persons and supervision by the Regulator.*

The Commission notes that the regulatory approach should be modulated in light of questions of feasibility for regulated entities and the capacity of regulators to supervise.

For example, consider buffers to absorb losses. Risk-weighted capital based on internal models is potentially the most sensitive to risk though also the most opaque from the perspective of regulatory supervision. Simple leverage ratios are likely to be the least risk sensitive though easiest for regulators to monitor and enforce. While laws should not be constructed for regulatory convenience, the possibility of frustration of regulatory objectives should be kept in mind.

Alternatively, consider institutional capability, including questions of regulated persons manipulating regulatory frameworks to their advantage. A regulated person using the right internal models, and having access to sufficient data, could achieve fairly risk sensitive capital buffers. Conversely, a regulated person using poor models or insufficient data could fail to do so. Opacity raises the possibility of manipulation though regulation

cannot be designed with extreme examples in mind. Regulations framed from the perspective of malign institutions could lead to over-regulation just as the same framed with only the most benign institutions in mind could lead to under-regulation.

Regulators will also need to take into account the possibility of developing robust models, given data sufficiency constraints. Faulty modelling is a possible consequence of poor data, drawn from illiquid or opaque markets. As such, the draft Code authorises the regulator to consider alternative pathways and/or impose overall or risk-weighted capital requirements.

The micro-prudential provisions in the draft Code will ask regulators to confront the tradeoffs, and make wise decisions about the optimal regulation that is reasonably feasible for regulated persons to implement, and for the Regulator to monitor and supervise. Over the years, accumulation of datasets and academic research will give feedback about how certain initiatives have worked. Over the years, the financial system itself will evolve. The combination of these factors will give a healthy evolution of the appropriate trade-offs.

PRINCIPLE 3. *The need to minimise inconsistencies in the regulatory approach towards regulated activities that are similar in nature or pose similar risks to the fulfilment of the Regulator's objectives under this Act.*

In the financial system, there are many ways of achieving the same objective. Products looking very different can be constructed that essentially fulfil the same function. The only difference would be the way these products look, and the specific contracts they comprise of. As an example, consider the number of ways of taking a levered position in shares of companies in the index, all of which fulfil the same function:

1. Buy each stock individually on margin in the cash stock market.
2. Invest in an index fund and borrow from a bank to finance it.
3. Go long a future contracts on the index futures.
4. Go long an over-the-counter forward contract on the index.
5. Enter into a swap contract to receive the total return on the index and pay a fixed interest rate.
6. Go long exchange-traded calls and short puts on the index.
7. Go long Over The Counter (otc) calls and short puts.
8. Purchase an equity-linked note that pays based on returns on the index, and finance it by a repo.
9. Purchase, from a bank, a certificate of deposit with its payments linked to returns on the index.
10. Borrow to buy a variable-rate annuity contract that has its return linked to the index.

Since these are functionally equivalent, each of these mechanisms would add the same risk to the regulated person. Regulators need not treat this diverse array of possibilities with a sense of alarm, neither should they be blind to these possibilities. The choice of a certain mechanism for fulfilling a function may depend on various factors, such as differences in financial systems, constraints imposed by institutional form, technological constraints, various types of transaction costs, and so on. An institution should be able to choose the best possible mechanism, given all the factors it chooses to consider. However, with a healthy financial regulatory structure, differences in micro-prudential regulation should not favour any one of these mechanisms over another.

If the regulators take a functional perspective towards risk, treating similar risks in a similar manner, it would help reduce regulatory inconsistencies across products and markets. This principle is likely to lead to efficient regulation, because it allows innovation and encourage competitive neutrality. It is also necessary because as system evolves and opportunities to earn supernormal returns become difficult to find, regulatory arbitrage could be used to destabilise the system. Capital will flow towards sectors with less expensive regulations and this can often involve inappropriate risk-taking.

PRINCIPLE 4. *Any obligation imposed on regulated persons should be consistent with the benefits, considered in general terms, which are expected to result from the imposition of that obligation.*

The incentives of regulators are usually asymmetric in favour of excessive caution; regulators may not get much credit for maintaining the safety and soundness, but are likely to be subjected to much criticism if the number of failures cross an acceptable level. Consequently, regulators may tend to be too cautious and impose excessive costs on regulated persons and the economy.

PRINCIPLE 5. *The desirability of promoting competition, access and innovation, and minimising the adverse effects of regulatory actions on competition, access and innovation.*

Competition in financial markets is likely to have a significant positive impact on growth. Competition and innovation often go hand in hand, since competition creates the incentive for innovation. The strength of competition is likely to influence the efficiency of financial intermediation and the quality of financial products.

Certain instruments of micro-prudential regulation, such as licensing, may have a direct impact on competition, innovation and access in the system. As an example, it is possible to use rules for entry in ways that close down entry altogether for years on end. Going beyond entry barriers, instruments such as capital requirements, if not properly used, could impede innovation and access.

The Commission believes that competition and high quality micro-prudential regulation can go hand in hand. Indeed, the Commission's reading of research of international contexts suggest that high quality supervision in banking enhances stability and competition. The Commission emphasises the pursuit of both goals: of high competition and high quality micro-prudential regulation. A sound approach to regulation and supervision is an integral part of a pro-competitive stance, through which there is no adverse impact on competition.

The Commission also asserts that safety and soundness can be pursued in a manner that minimises impact on access, innovation and competition. For example, hypothetical situations could be imagined where simple leverage limits and risk-based systems of capital adequacy achieve similar regulatory results though having a differential impact on innovation and competition. The Commission recommends that concerns of stability and impact on access, innovation and competition be considered in tandem.

PRINCIPLE 6. *The need to ensure that regulatory actions are carried out in a manner that is least detrimental to competitiveness of India's financial system.*

The Commission does not take a position on financial globalisation as such. The financial system provides the pathways through which foreign capital gets infused in the economy. The Commission simply notes that if policy makers continue to look to foreign capital for assistance in meeting the development and financing needs of the economy, micro-prudential regulation should be assessed in part by how such regulation affects the ability of the country to attract such capital.

Regulations enhancing safety and soundness of institutions should help the country attract financial capital, because investors are averse to losing capital due to instability in the financial system. But if micro-prudential regulation over-reaches, then this can negatively affect the return on capital. There is some evidence that global banks transfer resources away from markets with highly restrictive financial regulation.

The Commission also notes that the viability of an onshore financial system is an important measure of international competitiveness. Difficulties in regulation can lead to financial intermediation involving India to move offshore. The Commission recommends balancing two competing concerns. On the one hand, rules preventing the use

of offshore trading venues deny users of markets the lowest cost products and services. Conversely, a regulatory race to the bottom where economic stability is sacrificed to increase competitiveness is equally problematic.

PRINCIPLE 7. *The need to take into account the long term implications of regulatory actions, which will include a period of at least five years following a regulatory action.*

Numerous examples illustrate how micro-prudential regulation can be used in a manner that reduces failure over a short period of time, though with much worse consequences over a longer period of time. For example, regulations that allow conversion of a pool of illiquid, poorly rated assets into liquid tranches of differentially rated securities (some of them highly rated), may reduce the total capital obligations for the institutions originating these assets, while also seeming to maintain safety and soundness. Such regulation, if not conducted properly with sound alignment of incentives, requirement of buffers at different levels, and other checks and balances, may encourage creation of risks that may have consequences years later, perhaps going beyond the regulatory cycle in which the regulation was notified.

PRINCIPLE 8. *The need to minimise the pro-cyclical effects of regulatory actions.*

Micro-prudential regulation can often be pro-cyclical, that is, it can amplify business cycle fluctuations, and possibly cause or exacerbate financial instability. In a contraction, regulatory constraints may bite well before the bankruptcy law does, as financial institutions regard violating minimum capital requirements as extremely costly. Depending on how the instruments of micro-prudential regulation are used, the extent of pro-cyclicality may vary.

In the framework proposed by the Commission, the primary function of micro-prudential regulation is to think about one financial firm at a time. The task of thinking about overall systemic risk has been placed separately from micro-prudential regulation, precisely because micro-prudential regulation requires a different perspective. This principle requires micro-prudential regulators to be aware of the extent to which their rules are pro-cyclical and to seek alternative mechanisms which minimise this phenomenon.

PRINCIPLE 9. *The requirement that persons who control and manage the affairs of regulated persons must share the responsibility of ensuring the safety and soundness of the regulated persons.*

Though the main objective of micro-prudential regulation is to maintain safety and soundness for regulated persons, the regulator is not the one ultimately responsible for the safety and soundness of the regulated persons. That responsibility should stay with the board and management of the regulated person. Once a financial service provider is identified for micro-prudential regulation, consumers, investors and other stake-holders should not perceive themselves to be absolved from responsibility for the safety and soundness of that institution. Regulation is only an additional set of measures that do not replace the efforts of the board and management of the regulated person. The regulator should lay out frameworks, which the board and management would be responsible for implementing.

In addition to these principles enshrined in the draft Code, the Commission also recommends that micro-prudential regulation be conducted in such a manner that there is *balance between a structured and a responsive regulatory approach*. A very structured, rules-based approach may bring clarity and certainty for regulated institutions, but may limit the ability of the regulator to see risks arising from areas they may not have thought about sufficiently in time. Also, if an institution is able to find a way to game the rules, the regulator may not be able to see the problems at all. Regulators could miss the big picture while being overly dependent on minutiae of the framework they have put in place. On



the other hand, a principles-based, more discretionary approach may reduce certainty for the regulated institutions but give the regulator greater flexibility to pursue the micro-prudential objective. A balance needs to be struck between these two possibilities.

While there is merit in having primarily a structured approach to regulation, the nature of micro-prudential regulation is such that the regulator should not get overly dependent on a structured framework and specific rules, and should have capabilities to scope and monitor the risks being built, and through due process, respond to these risks pro-actively. This requires a mix of rules and judgement.

Resolution

7.1. The problem

The failure of large private financial firms can be highly disruptive for households that were customers of the failing firm, and for the economy as a whole. This might have been less important 20 years ago when the Indian financial system was dominated by PSUs that rely on implicit financial support from the tax payer. As India has increasingly opened up entry into finance, and several large private financial firms have arisen, it becomes important to create mechanisms to deal with failing firms.

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.

This requires a specialised ‘resolution mechanism’. A ‘resolution corporation’ would watch all financial firms that 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. As an example, in India, customers of a failed bank are guaranteed the first Rs.1 lakh of their deposits as ‘deposit insurance’.

At present, India has a deposit insurance corporation, the DICGC. However, the DICGC is not a resolution corporation; it deals only with banks; 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 will be placed upon customers, tax payers, and the shareholders of public sector financial firms. This is an unfair arrangement.

Establishing a sophisticated resolution corporation is thus essential to strong responses to the possible failure of a large financial firm and its consequences for the Indian economy. Drawing on international best practices, the Commission recommends 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. The corporation will concern itself with all financial firms that make highly intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and

payment systems. The corporation will also take responsibility for the graceful resolution of systemically important financial firms, even if they have no direct link to consumers.

The defining feature of the resolution corporation will be its *speed of action*. It must stop a financial firm while the firm is not yet insolvent. International experience has shown that delays in resolution almost always lead to a situation where the net worth becomes negative; a situation where costs are likely to be placed on the tax payer. 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 on the tax payer. Hence, a sophisticated legal apparatus has been designed by the Commission, 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, such as sales, assisted sales, mergers and other arrangements.

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, the capabilities of the resolution corporation are required, and would proceed in a different manner than micro-prudential regulation. The resolution corporation is 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 co-ordination with the micro-prudential regulators. For strong firms, the resolution corporation will lie in the background. As the firm approaches failure, the resolution corporation will assume primacy. The provisions for both micro-prudential regulation and resolution have been drafted in an internally consistent fashion that design for this lockstep.

The first three pillars of the work of the Commission – consumer protection, micro-prudential regulation and resolution – are tightly interconnected. Consumer protection deals with the behaviour of financial firms towards their customers in periods of good health. 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 fail.

7.2. An effective resolution framework

The analysis of the Commission in designing an effective resolution framework reflected a combination of:

1. India's experiences in managing a failing financial firm;
2. The emerging global consensus on the need to have an effective and wider resolution framework that is not limited to banks; and
3. The analysis of the tools of resolution that would protect the interests of the consumer and would incur least cost to the tax payer.

Table 7.1 enunciates the organisational structure of the resolution corporation. In thinking about the design and composition of the board of the resolution corporation, the Commission believes that a formal framework of information-sharing and timely co-ordination between the resolution corporation and the micro-prudential regulators can help achieve orderly and least disruptive resolution.

An effective resolution framework also requires appropriate arrangements for cross-border resolution. Since many SIFIs operate on a global level, an unco-ordinated approach by the home and host countries' authorities would create difficulties in the way of resolution of such institutions in a manner that would protect interests of consumers and prevent the risk of a contagion. Deliberations are underway at international policy forums to devise an optimal approach to cross-border resolution. India must participate in

Table of Recommendations 7.1 Organisation structure of the resolution corporation

The draft Code on resolution establishes a resolution corporation as a statutory body to carry out the resolution of covered service providers. Covered service provider includes:

1. each financial service provider that makes “covered obligations” as discussed in Table 7.2; and
2. each financial service provider designated by the Council as a SIFI.

The resolution corporation must have representation from across the financial regulatory architecture, including the central bank, financial regulators, and the Central Government, and must be headed by a chief executive. The resolution corporation must have representation of independent experts. The resolution corporation must also have an administrative law member on its board. The establishment of the resolution corporation will be carried out in alignment with the principles of legal process identified by the Commission.

Accordingly, the board of the resolution corporation will consist of executive, non-executive and nominee members, to be appointed by the Central Government:

1. the total number of members must not be more than nine (9);
2. the total number of non-executive members must be greater than the total number of executive members; and
3. three (3) members will be nominee members.

The executive members will include –

1. the Chairperson of the corporation; and
2. an administrative law member.

The nominee members will consist of –

1. one nominee of the Reserve Bank;
2. one nominee of the Unified Financial Authority; and
3. one nominee of the Central Government.

The board will appoint a senior officer of the corporation to act as secretary to the board.

Table of Recommendations 7.2 Objectives

Resolution of covered service providers that are approaching failure should be carried out with the objectives of:

1. Protecting the stability and resilience of the financial system;
 2. Enhancing financial market efficiency through efficient pricing and allocation of risk;
 3. Protecting consumers of covered obligations up to a reasonable limit; and
 4. Protecting public funds.
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emerging global arrangements on cross-border resolution. Developments in this regard may well require amendments to the law in the future, such as to require the resolution corporation to co-ordinate with its counterparts in other jurisdictions. In this regard, the Commission recommends that, in five years from now, a committee be set up to review the emerging consensus in this field and suggest amendments in the legal framework on resolution accordingly.

7.3. Objectives of the resolution corporation

Designing an effective resolution mechanism requires clarity of objectives in performing resolution. Table 7.2 outlines the objectives of the resolution corporation that must guide its functioning.

The increasing size of deposit-taking institutions and the emergence of financial conglomerates have increased the risk to financial stability from firm failure. To address this concern, regulatory regimes have tried to redefine the scope of resolution. Internationally, regulators are now moving to broaden the mandate of resolution authorities to include any SIFI including banks, holding companies, non-bank financial corporations, and financial market infrastructure such as payment, settlement and clearing systems. The Code drafted by the Commission envisages a resolution corporation of similar scope.

Commensurately, the corporation must have sufficient resources (financial, organisation and technical), and must have the legal powers for the rapid and orderly liquidation of a wide variety of covered firms – and SIFIs – to avert risk to financial stability.

The resolution corporation regime must enhance financial market efficiency. It must not restrict market participants from innovation or taking calculated risks. Instead, it should facilitate the efficient pricing and allocation of risk, and the internalisation of the costs of firm failure. Market efficiency will be supported and enhanced in the following ways:

1. All covered service providers would pay fees that are proportional to the prospective costs that they may impose upon resolution, which reflects a combination of the probability of failure and the costs borne by the resolution corporation upon firm failure.
2. Allocation of losses to firm owners and unsecured and uninsured creditors will be in a manner that respects hierarchy of claims.

An important aspect of the resolution framework centres around the protection of consumers in proportion to the nature, scale and complexity of obligations owed by the regulated entity; and to prioritise claims according to the hierarchy determined by such obligations.

In determining the nature, scale and complexity of obligations the regulator, in consultation with the resolution corporation, must take into consideration the following factors:

1. the nature and extent of detriment that may be caused to consumers in case of non-fulfilment of obligations owed to them by the covered service provider;
2. the lack of ability of consumers to access and process information relating to the safety and soundness of the covered service provider; and
3. the inherent difficulties that may arise for financial service providers in fulfilling those obligations.

The obligations that score high on the above factors must always be protected by the resolution corporation. Such obligations will be referred to as “covered obligations”. The objective of the resolution corporation will be to protect consumers of covered obligations up to a reasonable limit.

If there is no resolution framework, the Government will be pressured to capitalise distressed firms, leading to high fiscal costs, and losses to tax payers. This is especially true in the case of a SIFI, whose failure could threaten financial stability and the health of the real economy. The other alternative to taxpayer-funded bailout could be bankruptcy. However, as global experience in the aftermath of the financial crisis shows, regular bankruptcy proceedings may not be adequate to prevent financial market instability. Thus, a specialised resolution regime must offer a viable alternative to the financial instability resulting from bankruptcy proceedings, or the fiscal and political consequences of taxpayer-funded bailouts.

The global experience with financial firms that approach failure is that rapid and early action works smoothly, while delayed action places substantial costs upon the exchequer. Hence, the objective of protecting public funds is synonymous with building a capability that monitors covered financial firms, makes an early assessment about a firm that is approaching failure, and undertakes interventions early. This requires a sophisticated risk assessment system, one that works in partnership with micro-prudential regulation but ultimately reaches an independent decision.

7.4. Interaction between agencies

Micro-prudential regulation is closely linked with the resolution framework. They share a common objective, that is, to minimise costs to customers, the financial system at large,

and the tax payer arising from the risk of failure of a financial institution. However, there are important differences between the perspective of micro-prudential and resolution authorities in terms of timing and intensity of intervention. As long as a firm is healthy, the resolution authority does not intervene; and instead, relies on information from the micro-prudential regulator. At best, it conducts periodic reviews.

As the probability of failure increases, the degree of supervision by the resolution corporation will increase. At each stage of greater difficulty, there will be regular interaction between the micro-prudential regulators and the resolution corporation. Micro-prudential regulators and the resolution corporation have a well defined protocol, embedded in the draft Code, for joint work covering:

1. Risk assessment of covered service providers;
2. Actions to be taken with respect to a covered service provider at different stages of risk to the covered service provider; and
3. Identification of emerging regulatory risks, their assessment, quantification and impact on the financial sector.

The task of resolving a failing covered service provider also involves interaction with the competition regulator, cci. One commonly used tool of resolution involves selling the firm to a healthy firm. In the routine business of selling or merging a firm, the effects on competition must be considered. The resolution corporation must consult the cci on the likely effects of its actions on the state of competition in the market. In addition, the resolution corporation must prepare a report detailing the effect that its proposed action is likely to have on competition in the relevant market. The interaction should involve sharing of any relevant information and data at the disposal of the resolution corporation.

However, in times of crisis, concerns of financial stability may outweigh competition concerns. An analysis of global experience shows that post-crisis, national competition authorities recognise that failing firm investigations are too lengthy, as firms in distress may deteriorate rapidly, and cause inefficient liquidations. Procedures need to be amended to facilitate speedy mergers of failing firms. In such an event, the obligation to consult the cci and examine the implications on competition must be exempted.

The resolution corporation must approach the FSDC in two circumstances. Firstly, if there is a difference of opinion between the resolution corporation and the micro-prudential regulator, either entity may approach the FSDC, which must resolve their dispute. Secondly, if the resolution corporation believes that it may be required to take action against a SIFI, it must necessarily inform the FSDC of the measures that it proposes to take thus, and seek permission for taking any such measures. The Commission is of the view that actions by the resolution corporation against a SIFI are likely to have systemic implications. The one entity in the new financial architecture designed by the Commission with a view of the entire system is the FSDC. Therefore, any actions against a SIFI must necessarily be with the knowledge and permission of the FSDC, to preempt any unforeseen systemic consequences from occurring.

Table 7.3 establishes the framework of co-ordinated action with other agencies.

7.5. Powers of the resolution corporation

The Commission believes that the resolution corporation needs to be equipped with wide powers to carry out its functions. To carry out its supervisory reviews, the resolution corporation needs to have a specialised staff of examiners. These examiners will conduct regular examination of covered service providers. When the covered service provider shows unfavourable trends in its risk profile, the resolution corporation can call for special examinations as a measure of enhanced supervision.

Table of Recommendations 7.3 Interaction with other agencies

The draft Code on resolution obliges the resolution corporation, the micro-prudential regulators, the competition regulator and the FSDC to consult and co-ordinate regularly and frequently, achieve regulatory harmonisation, and share information. Accordingly, the draft Code provides for:

1. An appropriate mechanism to address disputes in the event of disagreement between the regulators and the resolution corporation;
2. Where actions are likely to involve a SIFI, the resolution corporation must necessarily obtain the permission of the FSDC;
3. An obligation to consult CCI on the likely effects of the resolution corporation's proposed actions on competition in the relevant market; and
4. Exemption from consultation with the CCI in certain circumstances, if the resolution corporation determines that those actions need to be taken immediately to prevent the probable failure of a covered service provider.

Proactive and timely intervention by the micro-prudential regulator and the resolution corporation is the key to ensure orderly resolution of covered service providers and to prevent losses to the insurance fund. To operationalise this, the Commission envisages a framework of “prompt corrective action” incorporating a series of intervention measures to be undertaken by the micro-prudential regulator and the resolution corporation to restore the financial health of the covered service provider. As a first step, the framework requires determination of certain measures of risk and identification of certain *stages* of the financial condition of covered service providers, based on the direction and magnitude of these risk measures. Once the stages are identified, the micro-prudential regulator and the resolution corporation will seek to address the concerns of firms through their supervisory and regulatory tools.

The Commission believes that the benefits of such a framework would be two-fold:

1. Enhanced regulatory intervention on deteriorating covered service providers would mitigate the risk-taking incentives by imposing more market discipline; and
2. Reduced regulatory forbearance such as “too big to fail”, by linking regulatory response to a covered service provider's financial condition.

Table 7.4 outlines the Commission's recommendations.

7.5.1. Powers of the resolution corporation as receiver

The framework of “prompt corrective action” is designed to identify the risks to a covered service provider's viability at an early stage so that corrective actions can be taken by the covered service provider. However, if the covered service provider fails to implement the corrective actions prescribed by the micro-prudential regulator and the resolution corporation, and its financial condition continues to deteriorate, the covered service provider falls within the receivership domain of the resolution corporation.

Table 7.5 defines the powers of the resolution corporation as the receiver. In thinking about the corporation's role as a receiver, the Commission recommends that the corporation be given wide range of powers and accorded significant legal immunity.

7.6. Resolution tools

The choice and sequencing of the use of a resolution tool must be guided by the objective of minimising direct and financial costs to the system, proportional protection to cover small and less-sophisticated depositors and customers, and minimising contagion risk. The objectives should be prioritised as the resolution corporation determines to be appropriate in each case.

Global experience shows that the tools of resolution can broadly be categorised as:

Table of Recommendations 7.4 Examination and prompt corrective action

The resolution process requires the resolution corporation to undertake a series of activities including the regular monitoring, supervision and evaluation of covered service providers; prompt corrective action; and transferring and disposing assets of failing or failed covered service providers. To carry out these functions, the draft Code enables the resolution corporation to:

1. Conduct regular evaluations at periodic intervals;
2. Conduct “special” evaluations of covered service providers that show unfavourable changes in their risk profile; and
3. Impose monetary penalty if a covered service provider fails to disclose relevant information or co-operate with the corporation.

The resolution corporation and the micro-prudential regulators must together establish a framework for prompt corrective action to identify risks to covered service providers at an early stage, and to ensure their timely resolution. Therefore, the law must provide for the determination of:

1. Indicators or measures of risk assessment by the micro-prudential regulator; and
2. Stages identifying the risk to the viability of covered service providers based on these indicators or measures.

Five such stages – low, moderate, material, imminent and critical risk to viability – must be identified. Each covered service provider, depending on its state of health, will be classified accordingly. In each of the stages, the resolution corporation will implement a series of measures as described below:

1. Low risk to viability: In this stage, the activity of the resolution corporation will be restricted to monitoring the covered service provider based on regulatory data, reports from examinations and inspections, and any other data that may be available to the corporation.
2. Moderate risk to viability: In this stage the resolution corporation will conduct a special examination of the affairs of the covered service provider to assess its health, and communicate its concerns to the covered service provider and may levy a premium surcharge.
3. Material risk to viability: In this stage, in addition to the actions mentioned above, the resolution corporation will require the covered service provider to prepare a resolution plan. The resolution plan will help the resolution corporation in devising optimal resolution strategies for the covered service provider. It will intensify engagement with the covered service provider on the resolution plan, including obtaining all the information related to the plan.
4. Imminent risk to viability: If the covered service provider has imminent risk to viability, within 90 days of such a determination, the corporation will apply for receivership of the covered service provider. The regulator must appoint the corporation as the receiver for such a covered service provider.
5. Critical risk to viability: If a covered service provider reaches this stage, the corporation will cancel or terminate all policies of insurance and apply for liquidation.

In each of these stages the regulator will apply its regulatory tools and will intensify engagement with the covered service provider, till it is placed in the receivership domain of the resolution corporation.

1. Sale to another institution: The most market-oriented tool of resolution involves selling all or part of the business of a covered service provider to a viable commercial purchaser. This tool is useful because it ensures continuity of services, and incurs minimal resolution cost. In the exercise of this tool, the resolution corporation must ensure that thorough diligence is followed in inviting bids, giving accurate information, maximising the number of potential purchasers and exploring multiple transaction structures.
2. Bridge institution: In some cases, it may not be possible to find a willing buyer for a failing covered service provider. In such cases, the resolution corporation can establish a wholly-owned subsidiary to bridge the time lag between the failure of such an institution and the satisfactory transfer to a third party. The management of the bridge institution will try to restore asset quality and arrange for finding a suitable buyer for the covered service provider. This is an interim solution which will culminate in either sale or liquidation or a combination of the two.
3. Temporary public ownership: If the other two tools fail to work, temporary public ownership is the last resort. The law will provide for specific conditions for its application.

Table 7.6 defines the three resolution tools and the conditions for their use.

The Commission recommends that the process of resolving a covered service provider, including the choice of a resolution tool, should not depend on the ownership structure of the service provider. This will result in ‘ownership neutrality’ in the approach of the corporation. In this framework, the treatment of public and private firm; and domestic

Table of Recommendations 7.5 Powers of the resolution corporation as receiver

If a covered service provider fails to implement the instructions of the micro-prudential regulator and the resolution corporation under the prompt corrective action framework, and reaches a stage of “imminent risk to viability,” the regulator will appoint the resolution corporation as receiver of that covered service provider. As a consequence of being appointed as receiver of a covered service provider, the resolution corporation will have the following powers:

1. To act as successor to all rights, titles, powers, and privileges of the covered service provider;
2. To take over the management of the covered service provider;
3. To exercise any of the three major tools to resolve a covered service provider: sale to another financial service provider, the incorporation of a bridge institution, or temporary public ownership (nationalisation);
4. To manage and operate the covered service provider including selling off its assets, arranging for the assumption of its liabilities, and conducting the business of the covered service provider; and
5. The resolution corporation as receiver shall terminate all rights and claims that the shareholders and creditors of the covered service provider may have against the assets of the company, except for the right to payment, resolution, or other satisfaction of their claims.

The resolution process must be allowed to proceed smoothly, with appropriate immunity from legal proceedings pending the completion of resolution. In law, this requires mandating the following:

1. The decision to resolve a covered service provider, as determined by the resolution corporation, is final, conclusive and may not be appealed;
 2. A court will not have jurisdiction over any claim or any action seeking a determination of rights with respect to the assets of the covered service provider, including any assets which the resolution corporation may acquire as receiver; and
 3. Throughout the exercise of its functions, the resolution corporation must be bound by a clearly defined legal process. If it strays from this process, it may be open to challenge before the tribunal.
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Table of Recommendations 7.6 Tools of resolution

The draft Code on resolution enables the resolution corporation to exercise at least three types of resolution tools:

1. Resolution by purchase
 - ▶ The resolution corporation can merge a failing covered service provider with another financial service provider(s), or transfer some of its assets and liabilities to another financial service provider; and
 - ▶ The resolution corporation must ensure that there is thorough due diligence, and there is minimal disruption caused to the consumers of the service providers concerned.
 2. Resolution by bridge service provider
 - ▶ The resolution corporation can create a wholly-owned bridge institution to which all or some of the assets and liabilities of a failing covered service provider may be transferred;
 - ▶ This tool may be exercised if, given the size and complexity of the covered service provider, it is infeasible to sell it to another institution directly; and
 - ▶ This tool may also be exercised if the resolution corporation determines that the continued operation of the covered service provider is essential to provide financial services in the market.
 3. Resolution by temporary public ownership
 - ▶ As a last resort, the resolution corporation may require temporary public ownership of a failing covered service provider in order to maintain financial stability;
 - ▶ This tool should be used only when all other options have been exhausted;
 - ▶ Temporary public ownership should typically be used for a SIFI, including banking service providers, where the risk of firm failure is a threat to the financial system;
 - ▶ The resolution corporation must consult and obtain the permission of the FSOC in the exercise of this tool; and
 - ▶ Since the tool has large fiscal implications, the draft Code must limit the conditions when the tool can be exercised.
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and a wholly owned subsidiary of a foreign firm will be identical from the viewpoint of resolvability.

In the existing legislative landscape, there are certain Acts such as the State Bank of India Act, 1955 and the Life Insurance Corporation Act, 1956, that were enacted to create specific financial institutions. These laws contain provisions that vary or exclude the applicability of general corporate and financial laws to the institutions created under them. For instance, the State Bank of India Act, 1955 exempts the State Bank of India from the

applicability of laws governing winding-up of companies and provides for its liquidation only by an order of the Government. These provisions create unfair competition as it creates a perception of safety in the minds of consumers and an expectation that they will be insulated from the failure of such firms. The Commission recommends that such provisions be amended immediately so that the resolution corporation can engage in orderly and least disruptive resolution of all covered service providers in accordance with its objectives envisaged in Table 7.2.

In an attempt towards enhancing the effectiveness of the resolution framework, the Commission also focussed on the regulatory framework of co-operative societies that carry out banking activities. In the current arrangement, such “co-operative banks” are governed by state legislations and are subject to a dual regulatory framework by the RBI and the Registrars of Co-operative Societies of the States in which the banks are located. This has created difficulties in the regulation of co-operative banks. These difficulties have been attempted to be addressed through memorandums of understanding entered into between the RBI and State Governments. Some States and Union Territories which have amended the local Co-operative Societies Act empowering the RBI to order the Registrar of Co-operative Societies of the State or Union Territory to wind up a co-operative bank or to supersede its committee of management and requiring the Registrar not to take any action regarding winding up, amalgamation or reconstruction of a co-operative bank without prior sanction in writing from the RBI are covered under the Deposit Insurance Scheme. These co-operative banks are designated as “eligible co-operative banks” for the purpose of deposit insurance under the DICGC Act, 1961. This has resulted in an uneven framework where some co-operative banks are eligible to avail the deposit insurance scheme by the DICGC while some others are not part of this arrangement.

The Commission is of the view that when co-operative societies engage in the business of providing financial services, they need to be regulated and supervised by financial regulators in a manner that is commensurate with the nature of their business and the risks undertaken by them and must be resolved in an orderly manner to cause least disruption to the consumers and the financial system. Since co-operatives often cater to the needs of small households, the Commission is of the view that in the event of a deterioration in their risk profile, they should be subject to the prompt resolution framework envisaged by the Commission.

This can be achieved under Article 252 of the Constitution which allows two or more State Legislatures to pass a resolution accepting the authority of the Parliament to make laws for the State on any matter on which it otherwise does not have the capacity to legislate. Using this provision, State Governments could pass resolutions to extend the power to make laws on the regulation, supervision and resolution of co-operative societies carrying on financial services to the Parliament.

The Commission therefore makes the following recommendations with respect to co-operative societies:

1. In consonance with the recommendations on competitive neutrality, co-operative societies carrying on financial services should be subject to similar regulatory and supervisory framework of resolution as other entities carrying on similar activities;
2. Using Article 252 of the Constitution of India, State Governments should accept the authority of the Parliament to legislate on matters relating to the failure resolution of co-operative societies carrying on financial services; and
3. The regulator may impose restrictions on the carrying on of financial services by co-operative societies from States whose Governments have not accepted the authority of the Parliament to legislate on the regulation of co-operatives. These restrictions would entail that co-operative societies in such states would not be covered under the resolution framework envisaged by the Commission.

Table of Recommendations 7.7 Funding of resolution and insurance coverage

Funding the costs of resolution and consequent payouts are incorporated in the draft Code. The resolution corporation must create a resolution fund. The draft Code enables the resolution corporation to:

1. Expand the coverage of traditional deposit insurance to include payment of compensation to specified consumers of covered service providers;
2. Collect premia from covered service providers to cover the likely costs of resolution; and
3. Terminate insurance in specific circumstances.

For the purpose of calculating premia, the draft Code provides for:

1. the manner of classification of covered service providers into different categories;
2. the manner and methodology of assessment of premia payable by different categories of covered service providers;
3. the process of collection of premia from covered service providers; and
4. the manner and mode of payment of premia by covered service providers to the Corporation.

The resolution corporation must be able to revise insurance limits, in accordance with the principle of proportionality to the risk to viability of covered service providers.

The draft Code on resolution allows for persons or institutions who have been reimbursed from the resolution fund to claim for compensation over and above what they have received. Alternately, persons or institutions who are legitimate claimants, but whose claims have not been recognised by the resolution corporation, should also be able to seek such compensation.

In exceptional circumstances, there may be an access to a line of credit from the Central Government for a temporary period.

7.7. Fund for compensation and resolution

Since the scope of resolution runs beyond banks, the Code drafted by the Commission envisages the creation of a resolution fund, to which various premia received from covered service providers will be credited. The premia to be collected from the covered service providers would be proportional to their financial position as envisaged in the prompt corrective action framework.

In certain specified circumstances, the resolution corporation can terminate the policy of insurance issued by the resolution corporation. For example, the resolution corporation will be empowered to terminate the policy if the covered service provider fails to pay the premia for a specified period, or if the covered service provider is engaged in unsafe or unsound practices in conducting their business.

In the context of resolution, the Commission recommends the use of proceeds of the resolution fund for resolution related expenses including administrative expenses as well as for the payment of compensation to specified consumers. This reduces the burden on covered service providers to make separate contributions for different purposes.

The Commission recognises the fact that the resolution corporation may require monetary assistance if it is unable to meet its obligations in times of extreme financial distress in the markets. In such exceptional circumstances, the resolution corporation would be allowed to avail a line of credit from the Central Government for a specified period. The Central Government will determine and review the terms of the line of credit. Any extension, renewal or increase of credit under the line of credit sought by the resolution corporation must be accompanied by a detailed report stating the reasons for additional borrowing and its intended uses.

Table 7.7 summarises the recommendations of the Commission on insurance coverage and the scheme of funding resolution that must be embedded in the draft Code on resolution.

Table of Recommendations 7.8 Winding-up proceedings

If a covered service provider has failed and needs to be liquidated or wound up, the draft Code on resolution must allow for:

1. The process of liquidation to be carried out in accordance with the law of incorporation of the covered service provider;
 2. The resolution corporation to be appointed as the official liquidator by the court concerned; and
 3. The resolution corporation to be the creditor of the first priority if the resolution corporation has utilised proceeds from the fund towards meeting the expenses of liquidation.
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7.8. Consequences of resolution

A resolution action by the resolution corporation may include the following:

1. Transfer of shares, property, rights and obligations in contracts;
2. Change in the management of the firm, even resulting in removal of certain workforce;
3. Compensation; and
4. Liquidation of the covered service provider.

To provide for compensation, the resolution corporation must be empowered to carry out proceedings where persons or institutions to be compensated are identified and awarded monetary compensation.

Compensation proceedings would cover the following process:

1. Identification of the persons or institutions affected by the actions of the corporation who are to be compensated;
2. Evaluation of the amount of compensation to be carried out to each person or institution identified for compensation; and
3. Payment of the award.

As a last recourse, the law would allow dissenting claimants to file appeal to the appellate tribunal, beyond which the compensation proceedings would be final and conclusive. Appeals would be restricted to establishing whether due process was followed in the award of compensation.

An efficient resolution mechanism is one that ensures that those covered service providers that have become unviable are wound up. This ensures that deterioration of the financial health of a covered service provider does not affect other covered service providers in the financial system.

Since the resolution corporation closely monitors the viability of a covered service provider and works towards bringing the institution to a less riskier financial state, it is best suited to determine when a covered service provider should be liquidated. As such, if the resolution corporation determines that a covered service provider has failed, the covered service provider would proceed to liquidation.

The Commission has decided that liquidation of a covered service provider would only happen in accordance with the law under which the institution was incorporated. However, *this* law must stipulate that the resolution corporation would be appointed as the official liquidator of the firm. As mentioned earlier, there are certain special laws governing public sector financial institutions that contain provisions which would restrict the power of the resolution corporation to act as the official liquidator of those institutions. The Commission recommends that such provisions of existing laws be amended immediately to give effect to this power of the resolution corporation.

Table 7.8 states the position of the Commission regarding liquidation proceedings.

Capital controls

Capital controls are restrictions on the movement of capital across borders. The design of controls vary from country to country. Typically, capital controls include a range of measures from reserve requirements to quantitative limits, licensing requirements and outright bans. Controls may be imposed economy-wide or may apply only to specific sectors. In addition, restrictions may apply to all kinds of flows or may differentiate by type or duration of flows.

India's current account is fully liberalised. The Commission has no view on either the timing or the sequencing of capital account liberalisation. These are decisions which should be made by policy makers in the future. The focus of the Commission has been on establishing a sound framework of law and public administration through which capital controls will work.

8.1. Objectives of capital controls

While some nations have used capital controls as part of their policy response to sudden inflows, the International Monetary Fund (IMF) recommends that capital controls be implemented only on a temporary basis, when other macroeconomic policy responses have been exhausted. The Commission notes that empirical studies present mixed evidence on the effectiveness of capital controls in addressing macroeconomic imbalances and systemic risk. The Commission also acknowledges that, in the current Indian context, a distinction must be made between strategic and tactical capital controls. While the former involves defining a 'credible framework of rules of the game which can be used by foreign investors to decide their investment strategy', the latter would be 'situation specific - to be imposed when particular circumstances arise and withdrawn when they abate.' Consequently, the Commission recommends that capital controls be available for policy purposes as a temporary measure during macroeconomic crises.

Even in countries which have achieved full capital account convertibility, the legal framework provides for the imposition of controls for preventing foreign ownership of certain national assets for reasons of national security. The Commission recommends that in the Indian context too, the law should restrict foreign ownership of national assets. Accordingly, the draft Code provides for the pursuit of this objective with clarity on instruments and objectives.

The application of capital controls should be consistent with the principle of competitive neutrality. Controls should only be imposed at the entry level. Once all entry level

requirements are fulfilled, there should be full national treatment of foreign entities, i.e. full symmetry when compared with resident entities. For instance, net worth, capital adequacy norms or investment restrictions should not be different for a foreign entity when compared to a resident entity performing similar functions or investments in India.

8.2. Current framework

The Foreign Exchange Management Act, 1999, codifies the existing approach to capital controls. It differentiates between current account transactions and capital account transactions. The Central Government makes rules in consultation with RBI for current account transactions, and the RBI in consultation with the Central Government makes regulations in relation to capital account transactions. This approach has led to a complex web of rules and regulations on capital controls spread across laws. It has also led to the absence of a clear and consistent framework of policy and translation of policy into law. In studying the current framework, the Commission notes that the deficiencies can be broadly be classified into two categories:

1. Difficulties of multiplicity: These arise due to multiple laws, multiple regulators and multiple artificial investment vehicles created by the regulations; and
2. Difficulties of absence: These arise due to absence of legal process and judicial review, and absence of clear and consistent drafting.

8.2.1. Difficulties of multiplicity

The difficulties of multiplicity involve the following elements:

1. **Multiple laws:** The current framework of controls involves a myriad and complex web of regulations issued by multiple regulators regulating multiple market participants. Regulations are also organised by asset classes such as equity, quasi-equity instruments (such as convertible debentures) and debt instruments, issued by both listed and unlisted entities.
2. **Multiple regulators:** The institutional bodies regulating capital flows include the RBI, SEBI, FMC, IRDA, and the interim PFRDA. Within the Central Government, the Ministry of Finance houses the Department of Revenue, the Department of Economic Affairs, and the Department of Financial Services. The Department of Economic Affairs hosts the Foreign Investment Promotion Board which approves Foreign Direct Investment (FDI) into the country, on a case by case basis for those investments which require prior approval under the regulatory framework. The Ministry of Commerce and Industry hosts the Department of Industrial Policy and Promotion which is responsible for promulgating policy on FDI into the country.
3. **Multiple investment vehicles and unequal treatment:** Various artificial investment vehicles have been created in India to regulate capital inflows. These investment vehicles include the Foreign Institutional Investors (FIIs), the Foreign Venture Capital Investors (FVCIs) and the Qualified Foreign Investors (QFIs). Varied levels of controls are exercised on these vehicles, in accordance with policy considerations. In addition to the artificial vehicles, non-resident Indians and persons of Indian origin are treated differently from other foreign investors, effectively creating a separate 'investment vehicle'.

Additionally, there is also a problem of unequal treatment, as foreign investors are not treated at par with Indian investors.

8.2.2. Difficulties of absence

The difficulties of absence in the field of capital controls comprise the following:

1. **Absence of legal process:** The rule making process in relation to capital controls is devoid of any public consultation. In addition, policy pronouncements and regulations are rarely accompanied by statements of policy and purpose, making it difficult for stakeholders to deduce a regulator's intention.

2. **Absence of judicial review:** Currently, for violations of any regulations, direction or contraventions of 'conditions subject to which any authorisation' is issued by the RBI, administrative hearings are conducted by first, 'adjudication officers' and second, by 'Special Directors (Appeals)'. Adjudication officers can begin inquiry only upon receipt of a complaint from an 'authorised person'. While contravention of conditions of approval of RBI can be a cause of action, 'failure to grant an approval' by the RBI or the Foreign Investment Promotion Board is conspicuous by its absence. Typically, the RBI regulation of capital flows has been seen purely as an act of monetary policy under the discretion of the central bank and not a regulatory action worthy of legal appeals. Appeals from decisions of Special Director (Appeals) lie to a tribunal created by the Central Government. A person aggrieved by a decision or order of the appellate tribunal created by the Central Government must file an appeal to the appropriate High Court.
3. **Absence of clear and consistent drafting:** Capital controls regulations, as currently articulated, are ambiguous and inconsistent which increases the transaction costs for investors. At any given level of convertibility, an ad hoc administrative arrangement of sometimes overlapping, sometimes contradictory and sometimes non-existent rules for different categories of players has created problems of regulatory arbitrage and lack of transparency. These transactions costs increase the cost of capital faced by Indian recipients of foreign equity capital.

8.3. Proposed framework

India now has an open current account. Under the draft Code, there is a liberalised regime where foreign exchange for the purposes of current account transactions can be freely brought into the country or taken out of the country. This will be subject only to tax and money laundering considerations, as currently applicable.

The capital controls framework in India must address the difficulties in the present framework and seek to rationalise and unify rule making. The design of the draft Code on capital controls focuses on accountability and legal process, and leaves the questions of sequencing and timing of capital account liberalisation to policy makers in the future.

The Commission deliberated at length on the proposed framework on capital controls. One view was that the imposition of controls on capital flows are essentially based on political considerations. Hence the rule-making on capital controls must vest with the Central Government. Empowering the regulator to frame regulations on capital controls creates difficulties in articulating the objectives that should guide the regulator while framing regulations on capital controls. Another view was to give the regulator enhanced regulation making powers as it directly interact with market participants. The Commission, however recommends a mixed formulation. The rules governing capital controls on inward flows and consequent outflows i.e. repayment of the principal amount, should be framed by the Central Government, in consultation with the RBI. The regulations governing capital controls on outward flows should be framed by the RBI, in consultation with the Central Government.

Table 8.1 enunciates the design of the proposed framework on capital controls.

8.3.1. Rules and regulations on capital controls

The rules on inward flows will be made by the Central Government and the RBI will make regulations on outward flows. The rule making and regulation making will be a consultative process between the Central Government and the RBI. The consultations will be documented and may also be guided by national security considerations. Table 8.2 details the rule and the regulation making process recommended by the Commission. As is the case today, the oversight of reporting and supervisory powers over intermediaries in capital controls, the authorised dealers, will be placed with the RBI, till such time capital account convertibility is not achieved. As is the case currently, the Financial Intelligence Unit would have a role in monitoring these flows for purposes of addressing money-laundering and related matters.

Table of Recommendations 8.1 Objectives

The draft Code addresses fundamental concerns in the framework of capital controls, and provides for the following:

1. The rules on capital account transactions for all inbound flows including outflows that arise as a consequence of these inflows, will be made by the Central Government in consultation with the RBI. The regulations on capital account transactions for all outbound flows will be made by the RBI in consultation with the Central Government.
 2. A single investment vehicle for investment in India i.e., qualified foreign investors (those foreign investors who meet the customer due diligence criteria prescribed by the Central Government);
 3. A sound legal process while making rules for capital account transactions and while granting approvals;
 4. A framework for imposition of controls in emergency situations (such as war, natural calamity and balance of payment crises);
 5. Review or restrictions on capital account transactions on national security considerations, by the Central Government or the RBI for inbound and outbound flows, respectively;
 6. Review of decisions of the Central Government and the RBI; and
 7. The principle that once controls are imposed at the entry level there must be equal treatment for Indian investors and foreign investors.
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8.3.2. Single investment vehicle

The Commission believes that there must be an unified QFI framework to address unequal treatment of foreign investors. This recommendation is not new; the UK Sinha Report also recommended the removal of artificial and multiple classification of foreign investors. In adopting those recommendations, regulators created an additional investor class of QFI without subsuming existing investor classes. This has unnecessarily increased complexity in regulation. The Commission therefore recommends combining regulation of all investment vehicles and individuals into a single, unified framework, the QFI regime. Any non-resident should be eligible to become a QFI provided it meets the customer due diligence norms prescribed by the Central Government. Creating a single investor class for foreign investments would offer a clear investment regime, and would considerably reduce uncertainty, compliance costs and the time taken to make investments without in any way altering the domestic investment framework. At the same time, this would ensure that India complies with the treaty obligations associated with the FATF.

8.3.3. Legal process

Legal process broadly refers to the processes, procedural rights and institutions through which law is made and applied. Legal process includes principles of transparency and accountability, fairness in application, equality before the law and participation in decision making. The Commission proposes the deepening of legal process guarantees in the country's framework on capital controls. Legal process principles will be applicable at the levels of policy formulation, rule making, regulation making and implementation.

With rule/regulation making, the responsibilities are split between the Central Government and RBI. For regulations issued by RBI (for outbound flows), the usual regulation-making process detailed in the draft Code should be applied. For rules issued by the Central Government, the conventional regulation-making process cannot be applied as the Central Government is not a regulatory agency. The Commission recommends that a process that is similar in most respects should be utilised.

The grant of approvals presents unique problems. At the implementation level, denials of approvals and registrations must be done with transparency and must provide explicit reasoning. For instance, registrations must not be denied to meet broad policy objectives and policy decisions must not be implemented in an ad hoc manner or be targeted at individual participants. The Central Government and the RBI will be obliged to

Table of Recommendations 8.2 Rule and regulation making process

While making rules on inbound flows, the Central Government must first consult the RBI and then publish draft rules. The draft rules must be released for public consultation along with an analysis of the costs and benefits of the proposed rule. All other provisions of regulatory governance which apply to regulators while making draft regulations will apply to the Central Government as well.

For outbound flows, the RBI must first consult the Central Government and then utilise the usual regulation-making process.

In emergency circumstances, the Central Government or the RBI, as the case may be, need not follow the detailed rule making process. However, consultation between the Central Government and the RBI must precede the rule making. Additional controls on capital account transactions may be imposed in emergency circumstances.

The emergency rules and regulations will remain valid for only three months, and are required to be notified and placed before both the Houses of the Parliament.

The emergency rules and regulations will remain valid for only three months, and are required to be notified and placed before both the Houses of the Parliament.

Emergency situations include:

1. Outbreak of a natural calamity;
 2. Grave and sudden changes in domestic and foreign economic conditions;
 3. Serious difficulties or expectation of serious difficulties in international payments and international finance;
 4. Proclamation of national emergency under Article 352 of the Constitution of India; or
 5. Proclamation of financial emergency under Article 360 of the Constitution of India.
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Table of Recommendations 8.3 Grant of approval

The Central Government, in relation to inbound flows, and the RBI, in relation to outbound flows, will have the authority to grant approvals or dispose off applications by following a time-bound due process. Reasoned decision in this regard must be provided. If approval is granted, it must clearly specify the scope, effective period and any conditions subject to which it is granted.

While deciding on an application, the principles of proportionality between the costs imposed and the benefits expected to be achieved must be considered, and similarly situated persons must be treated in a similar manner i.e. full national treatment must be followed.

However, the Central Government and the RBI may impose conditions or reject applications on national security considerations such as:

1. Ownership of critical infrastructure by foreign investors;
 2. Ownership of critical technologies by foreign investors;
 3. Control or ownership of assets in India by foreign governments;
 4. Involvement of a non-resident or foreign government which presents a threat to peaceful coexistence of India with other nations;
 5. Involvement of a non-resident or foreign government which presents a threat or a major disruption to foreign relations of India; or
 6. Any other matter prescribed by the Central Government or specified by the RBI.
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provide decisions within specific and reasonable time limits. However, the Central Government and RBI may deny approvals or impose conditions where there are national security considerations.

Table 8.3 establishes the Commission's recommended framework regarding the granting of approvals that is embedded in the draft Code.

8.3.4. Review

The decisions of the Central Government and the RBI will be subject to a two-tier review. A senior officer in the Central Government will hear the matters relating to denial of approvals or imposition of unnecessary conditions by the Central Government. Appeals from orders of such senior officers would lie to the appellate tribunal. The administrative

Table of Recommendations 8.4 Review

The decision of the Central Government on granting or rejection of approvals on inbound flows will be subject to a review by a senior officer in the Central Government. The decision of the RBI on granting or rejection of approvals on outbound flows will be subject to a review by the administrative law member of the RBI. Matters relating to violations

of the capital controls rules, regulations or conditions of any approval by any person will be subject to review of the administrative law officer in the RBI. The administrative law officer may initiate inquiry upon receipt of report by investigation officers. The administrative law officer must follow principles of natural justice, conduct an inquiry in a fair, transparent and time-bound manner and provide reasoned orders in writing. Appeals from the orders of the administrative law officer will lie to the administrative law member of the RBI. Appeals from the orders of the senior officer and the administrative law member will lie to the appellate tribunal.

Table of Recommendations 8.5 Reporting and Supervision

1. Supervision would be conducted by the RBI through its oversight of authorised dealers.
 2. The authorised dealers will conduct continuous monitoring of qualified foreign investors.
 3. The persons undertaking transactions and the authorised dealers will file reports with the RBI through FDMC.
 4. The Central Government will have access to the reports filed with the FDMC.
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law member of the RBI will hear the matters relating to denial of approvals or imposition of unnecessary conditions by RBI. Appeals from orders of such administrative law member will lie to the appellate tribunal.

Cases of violations of the provisions on capital controls under the draft Code, any rules or regulations on capital controls, or conditions subject to which approvals are granted, would be subject to review by an administrative law officer in the RBI. Appeals from the orders of the administrative law officer will lie to the administrative law member of the RBI. Appeals from the orders of such administrative law member will lie to the appellate tribunal.

Thus, this process would include first and second levels of administrative appeals, as well as the provision for awarding remedies. The Central Government, the RBI, and the appellate tribunal would be obliged to provide reasoned decisions involving interpretations of law. Such decisions would also be published. Appeals from the appellate tribunal would go directly to the Supreme Court, bypassing the High Courts, though writ jurisdiction of the High Courts would not be precluded.

Table 8.4 outlines the recommendations of the Commission that are embedded in the draft Code.

8.3.5. Reporting, supervision and enforcement

Ensuring compliance of provisions on capital controls in the draft Code, rules and regulations in relation to the capital controls is placed with the RBI in the draft Code. This would include oversight of reporting of foreign exchange transactions with the FDMC and ensuring compliance of the law, rules and regulations. Under conditions of full capital account convertibility, these functions will be placed with the Central Government.

The RBI will supervise authorised dealers (such as banking service providers) for the purpose of ensuring compliance with the law, rules and regulations. Certain supervisory activities would be delegated to these authorised dealers who will use their discretion on the basis of certain guiding principles (see Table 8.5 generally). All reports made to authorised dealers will be shared with RBI through the FDMC. FDMC will be able to share this information with the Central Government, as required.

8.3.6. Guidance and compounding

The transparent and easily accessible framework for guidance and compounding provided in the draft Code extends to the capital controls framework as well. The RBI will

Table of Recommendations 8.6 Compounding and guidance

1. Compounding of offences will be carried out by the RBI.
 2. General and specific guidance will also be provided by the RBI.
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provide guidance and compound matters in relation to capital controls under the draft Code.

Table 8.6 outlines the recommendations of the Commission on guidance and compounding.

Systemic risk

9.1. The problem of systemic risk

The field of financial regulation has traditionally focused on consumer protection, micro-prudential regulation and resolution. However, the 2008 financial crisis highlighted systemic risk as another important dimension of financial regulatory governance. Subsequently, governments and lawmakers worldwide have pursued regulatory strategies to avoid such systemic crises and reduce the costs to the exchequer, and ultimately society, of resolving the crises that do occur.

Systemic risk is the risk of a collapse in the functioning of the financial system, largely due to its interconnectedness to other parts of the economy, leading to an adverse impact on the real economy. Thinking about systemic risk oversight requires an integrated and comprehensive view of the entire financial system. In comparison, conventional financial regulation leans towards analysing consumers, financial products, financial firms or financial markets, one at a time.

The Commission recommends the IMF-FSB-BIS definition of systemic risk:

[a] risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.

The primary regulatory mandate of regulators and agencies defines their perspective and information access, so an individual *sectoral* regulator is likely to focus its gaze or have a viewpoint on the operations of that sector alone, and not on the overall financial system of the country. For example, a resolution corporation tends to look at firms from the narrow perspective of how an individual firm would be resolved when in distress and this perspective informs its approach to the financial system. Systemic risk analysis, in contrast, requires a comprehensive system-wide perspective on the impact of the failure of an individual firm or sector.

The analysis of the Commission regarding systemic risk reflects a combination of:

1. India's experiences with several systemic crises from 1992 onwards;
2. The emerging global consensus on methods for avoiding systemic crises that have come into focus after the 2008 financial crisis; and
3. The analysis of scenarios involving potential systemic crises in coming decades in India.

To some extent, systemic crises are the manifestation of failures in the core tasks of financial regulation – consumer protection, micro-prudential regulation and resolution.

Table of Recommendations 9.1 Objectives

The Commission notes that even if individual institutions appear sound and are well-monitored, system-wide risks may build up in the aggregate. Such risks need to be monitored, identified and addressed - with a system-wide perspective and not a sectoral perspective. Hence there is a need for an agency to:

1. Foster the stability and resilience of the financial system by identifying, monitoring and mitigating systemic risk; and
2. Improve co-ordination between multiple regulatory agencies (such as the micro-prudential regulators, the resolution corporation and other agencies within the financial system) by bringing diverse perspectives into the discussion, engaging with the regulatory stake-holders, identifying and reducing regulatory uncertainty (including regulatory arbitrage), and addressing unregulated areas. When a systemic crisis materialises, the agency must assist the Ministry of Finance and regulatory agencies in their efforts relating to resolving the crisis.

Many of the crises of the past, and hypothetical crisis scenarios of the future, are indictments of the limits of such regulation, standing alone. Increasing institutional capacity to address the problems of consumer protection, micro-prudential regulation and resolution will certainly work to diminish systemic risk, however, such risk will not be eliminated.

The Commission notes that despite well-intentioned implementation, flaws in institutional design, and errors of operation in existing institutional arrangements are inevitable. Additionally, even if extant consumer protection, micro-prudential regulation and resolution regimes work perfectly, some systemic crises may not be prevented, and measures to contain such crises will need to be developed. These dimensions of concern call for urgent and thorough work in the field of systemic risk oversight, as a fourth pillar of financial regulation.

9.2. Objectives and principles

While there is a clear case for establishing institutional capacity in these areas, it is also important to be specific in the enunciation of its implementation. Unless systemic risk regulation is envisioned as a precise set of functions, demarcated by clear and concrete rules as specified by the draft Code, systemic risk law could easily devolve into a set of vaguely specified sweeping powers, and there could be a danger of sacrificing the goals of development and efficiency in favour of avoiding potential systemic risk. Therefore, the Commission has taken care to precisely articulate the strategy for systemic risk oversight, seeking to avoid any draconian control of regulatory powers and emphasising on inter-regulatory agency co-ordination. The Commission's recommendations also emphasise broad principles of regulatory governance so as to ensure that the operations of an agency charged with such functions are guided by an appropriate set of checks and balances.

Table 9.1 enunciates the objectives of systemic risk oversight.

Table 9.2 lists the principles that should guide the functioning of the agency designated to monitor and address systemic risk concerns.

9.3. Institutional arrangement

The monitoring of systemic risk across the world, in varying capacities, has resulted in countries adopting differing structural frameworks for this purpose. For example, the UK has envisaged a Financial Policy Committee, located within the Bank of England, that functions in a manner analogous to its Monetary Policy Committee. The US has established a statutory body called the Financial Stability Oversight Council which comprises the heads of various regulatory agencies and government representatives. Similarly, the

Table of Recommendations 9.2 Principles

The agency must be subject to regulatory governance norms, including the obligation to report on its activities at frequent intervals. The agency's decisions can significantly impact financial market participants, including by way of increasing costs of micro-prudential regulation. Such decisions can also have unintended consequences, causing regulatory arbitrage and otherwise generally affecting the competitive nature of financial markets. Therefore, the draft Code requires that the agency:

1. Performs actions proportionate to the benefits expected from those actions;
 2. Ensures that its actions seek to reduce the potential for regulatory inconsistency;
 3. Does not cause a significant adverse effect on the competitiveness or growth of the financial sector;
 4. Acts in a transparent manner; and
 5. Be subject to the "Duty to explain" principle: Whenever there is a conflict between principles, the agency must explain the rationale for acting in contravention of a principle, subject to the caveat that the agency's actions must always further its overall objective under the draft Code.
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European Union has established a European Systemic Risk Board consisting of central bank representatives from member-states, as well as European Union financial regulators.

The regulatory architecture envisaged by the Commission consists of a resolution corporation tasked with managing the resolution of regulated entities, while regulators will pursue consumer protection and micro-prudential regulation within certain sectors of the financial system. None of these agencies will be able to monitor the financial system as a whole, on a constant basis. Hence, the Commission believes that monitoring and addressing of systemic risk concerns is best executed by a 'council of regulatory agencies', which allow it to combine the expertise of the multiple agencies involved in regulation, consumer protection and resolution. The board of the council will include the Minister of Finance, Central Government as the chairperson and would be served by an executive committee comprising the heads of the regulators and agencies of the financial sector. The Commission also envisages a secretariat to assist the executive committee with administrative matters. Except in circumstances of dispute resolution and implementation of system-wide measures, the managerial and administrative responsibilities of the council would vest in the executive committee. Where the executive committee is unable to reach consensus on a proposed decision or action of the council, the board will step in to resolve the issue, thus facilitating efficient functioning of the agency.

In the consultative processes of the Commission, the RBI expressed the view that it should be charged with the overall systemic risk oversight function. This view was debated extensively within the meetings of the Commission, however, there were several constraints in pursuing this institutional arrangement. In the architecture proposed by the Commission, the RBI would perform consumer protection and micro-prudential regulation only for the banking and payments sector. This implied that the RBI would be able to generate knowledge in these sectors alone – from the viewpoint of the safety and soundness of such financial firms and the protection of the consumer in relation to these firms. This is distinct from the nature of information and access that would be required from the entire financial system for the purpose of addressing systemic risk.

The Commission notes that its recommendation is in keeping with that of the Raghuram Rajan report (2008), which led to the establishment of the Financial Stability and Development Council (FSDC) by the Ministry of Finance. The proposals of the Commission aim to place the FSDC on a sound legal footing by sharply defining its powers and tasking it with achieving objectives in relation to monitoring and addressing systemic risk concerns.

Another key decision of the Commission involved the question of whether to structure the FSDC as a statutory body or as a unit within the Ministry of Finance. The analysis of the Commission emphasises the former for two reasons. First, the FSDC would require operational and financial autonomy in order to build a technically sophisticated staff to

Table of Recommendations 9.3 Establishment of the Agency

The following characteristics will apply to the FSDC:

1. It will be a statutory body;
 2. It will have operational and financial autonomy, and endeavour to build up a technically sophisticated staff;
 3. The chairperson of its board will be the Minister of Finance, Central Government;
 4. Other members of the board will be the head of the regulator for banking and payments, the head of the regulator for other financial sectors, the chief executive of the resolution corporation, the chief executive of the FSDC and an administrative law member to fulfill the requirements of regulatory governance; and
 5. It will be served by an executive committee chaired by the regulator for banking and payments. Managerial and administrative control will vest in the executive committee, which will refer decisions to the board when it is unable to reach consensus. There will also be a secretariat which will assist the board and the executive committee.
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Table of Recommendations 9.4 The systemic risk regulation process

Systemic risk regulation is envisioned as a five-element process. The first four would be performed by the FSDC exclusively and the fifth would be carried out under the supervision of the Ministry of Finance, Central Government.

1. Data, research and analysis;
 2. Identification and designation of SIFIs, including conglomerates;
 3. Formulation and implementation of system-wide measures for mitigation of systemic risk;
 4. Inter-regulatory agency co-ordination; and
 5. Crisis management.
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undertake vigorous oversight. Second, where the FSDC's actions might adversely affect financial firms, enshrining the FSDC as a statutory body with adequate mechanisms for accountability will fulfill the requirements of regulatory governance.

The FSDC will have a compact membership of five persons, thus facilitating efficient discussions and decision making. The FSDC will be headed by a Chief Executive who will lead a high quality, full-time professional staff.

The Commission's recommendations are listed in Table 9.3.

9.4. The five elements of the systemic risk regulation process

Systemic risk regulation is a five-element process, as shown in Table 9.4. The first element is a data collection and research function. It involves constructing a measurement system through which the FSDC can study the entire financial system. The analysis of system-wide data collected by the FSDC on an ongoing basis will generate areas for discussion by the FSDC. The consensus of the FSDC executive committee and board will then be implemented by the respective agencies where areas of systemic risk concern have been identified. The FSDC will also be empowered to collect, warehouse and disseminate all financial sector data through a system-wide database.

The second element is that of utilising this system-wide database to identify SIFIs, including conglomerates. These will then be placed under enhanced supervision by the respective regulators and the resolution corporation. The FSDC will also be a forum for discussion about what this enhanced supervision will constitute, so as to ensure coherence in perspectives across the financial system.

The third element is that of taking the decision to impose system-wide measures on the financial system. The implementation of the system-wide measure chosen by the FSDC will be done by the regulatory agencies, in accordance with their primary legislative mandate. These measures can include capital buffers that work to diminish systemic risk, for example, by building up capital – across the financial system – in good times and drawing on that capital when the system is under stress. As with everything else in the

field of systemic risk, it is essential that system-wide measures are implemented on the scale of the financial system or a large part of the financial system. For example, raising capital requirements for the banking sector alone may lead to an increase in systemic risk relating to bank substitutes, or the non-banking sector, which may defeat the purpose of imposing the system-wide measure. For a system-wide measure such as capital requirements to matter on the scale of the entire financial system, the formulation and operation of such measures would have to take place in a co-ordinated fashion.

The fourth element requires promotion of inter-regulatory co-ordination amongst the member of the FSDC. Effective co-ordination across a wide range of policy areas is a key element of designing an appropriate institutional framework to monitor systemic risk. Since co-ordination is an inherent part of the FSDC's work, the performance of this function may not be visible as a stand alone process with separate tangible goals. Nonetheless, the FSDC would focus on facilitating co-ordination which will aim to reduce regulatory uncertainty, thus promoting the overall coherence of the financial system.

Finally, the fifth element involves assisting the Central Government with crisis management. In the event that any systemic crises occur, the draft Code emphasises a more formal and cohesive approach to crisis management. The Ministry of Finance, Central Government will lead the crisis management function, with assistance from the FSDC. The FSDC will also provide assistance to members and other agencies in their efforts to resolve the crisis.

9.5. Constructing and analysing a system-wide database

The process of systemic risk oversight begins with the gathering of information from all sectors of the financial system, collating the same and analysing it from the viewpoint of identifying system-wide trends which may be areas of concern. This requires inter-regulatory agency co-ordination, through which the data gathering, as well as discussion leads to informed decision making. The Commission envisages the construction of a unified database, located at the FSDC which will hold all data relating to the entire financial system.

The FSDC will be a forum for the construction of a sophisticated database leading to the assimilation and transmission of system-wide financial data (Table 9.5). This database will serve to assist the FSDC in conducting research on systemic risk and system-wide trends, and facilitate a *discussion* about policy alternatives between the members of the FSDC. It will not have any power to give directions to financial regulatory agencies, which would be governed only by their respective legislation. The reporting requirements will be stipulated by the respective regulatory agency in relation to its respective financial entities. The latter will be required to route the data only through the FSDC's database. All regulatory agencies will have instantaneous and continuous access to the data of financial entities which they regulate.

Once this database is in place, and maintained regularly, the FSDC would conduct research, in co-operation with all regulatory institutions and with several academic institutions in order to analyse this data and identify potential systemic risks. These areas of concern would be brought up for discussion at the FSDC. Based on the consensus achieved at the FSDC, actions would be undertaken by all regulatory agencies in a co-ordinated fashion.

Towards this end, the FSDC will operate a data centre called the Financial Data Management Centre (FDMC) that will obtain data from regulated entities and other financial firms. All supervisory information supplied by a regulated entity to any regulator will be routed through and held by this database; there will be no other physical or electronic

filings by financial firms. It must be noted however that regulators and agencies will continue to collect any data that they require until the FDMC is fully functional. The FDMC will also contain public domain data from the economy at large, as appropriate.

Once the FDMC is operationalised each regulated entity will only submit all regulatory data through the database. Further, each regulatory agency will only be allowed to access the data it is authorised to collect from the entities that it regulates, to ensure that there is no widespread access by all regulatory agencies to a regulated entity's data. This access will be governed by memoranda of understanding that the members will enter into with the FSDC and the FDMC.

Table of Recommendations 9.5 The Financial Data Management Centre

- ▶ The FDMC will work within the FSDC as the sole electronic system for the collection of data from financial entities for regulatory reporting and supervision;
 - ▶ All decisions on the nature of information to be collected will be entirely within the domain of individual regulatory agencies;
 - ▶ The FDMC staff will merely aggregate the data and provide access to the regulators. All vetting and review of such data, and requests for additional information will continue to be done by the individual regulators; and
 - ▶ The FSDC would be empowered to enter into memoranda of understanding with other regulators such as the CCI or other statutory agencies associated with the financial system for increasing the ambit of a centralised data collection, transmission and warehousing function.
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To preserve data confidentiality, the FSDC's use of the data in the FDMC will be governed by the draft Code. It is envisaged that where the FSDC is required to obtain information from unregulated financial entities, it will be able to do so; however requests for data by the FSDC must necessarily be in consonance with its objectives. There will be legal procedures, grounded in principles of due process and regulatory governance that will guide the request for such data by the FSDC.

It is envisaged that anonymised data from the FDMC (which will not contravene confidentiality or privacy concerns or other law) may be made available for access to research bodies and members of the public to foster greater analysis and research relating to the financial system.

The FDMC would represent the first accretion of information on a financial system scale in India. With this data in hand, the FSDC would conduct a research programme on the problems of monitoring and mitigating systemic risk, through the identification of system-wide trends. In addition, the FDMC would also reduce the burden of multiple filings by financial firms, and promote a more efficient system of regulatory information gathering. Many benefits accrue from creating an FDMC, including de-duplication of regulatory filings, lower costs of compliance for firms, and standardisation of regulatory data standards. Members of the public and research bodies will also be able to access anonymised data to foster greater analysis and research of the financial system.

The operations of the FDMC are defined in Table 9.5.

It is evident that there will be considerable challenges that the FSDC would face while trying to conduct this research programme. The patterns of systemic risk in India are likely to differ considerably when compared with the experiences of more developed countries, which limits the portability of knowledge and ideas from those settings. Additionally, policy and scholarly understanding of systemic risk is relatively underdeveloped to the extent that actions to develop these databases have begun as recently as 2010 in countries such as the US. The FSDC would have to undertake special efforts in ensuring that the research programme has adequate capabilities and meets the desired end. The research programme must:

1. Identify the interconnectedness of, and systemic risk concerns in, the financial system;

Table of Recommendations 9.6 Data, research and analysis

- ▶ Effective and informed analysis of systemic risk requires access to a high-quality, system-wide financial database containing data from all regulated and some unregulated entities;
- ▶ The draft Code will provide for a central agency or other mechanism that collects, warehouses and provides access to financial data. Such mechanism must be guided by certain basic principles – to standardise data collection; to reduce duplication of data; and to protect the confidentiality and privacy of data;
- ▶ There will be technological safeguards, as well as legal process to balance the gains from requests for data, and possession of information;
- ▶ The agency will also conduct analysis and research to develop indicators and instruments to monitor and mitigate risk, respectively. Each policy initiative in the field of systemic risk should be associated with data-capture and post-mortem analysis. This research must achieve state of the art capability by world standards. It must recognise the unique features of the Indian financial system (and not mechanically transplant ideas from elsewhere) while featuring rigorous research methodologies that are respected worldwide; and
- ▶ Regular progress reports on the database, and results of the research programme, should be disseminated to the public. Anonymised data may also be released to foster better analysis and research.

2. Provide rapid response analysis when there is a significant financial event;
3. Develop systemic risk indicators;
4. Advise the FSDC on the formal functions of the FSDC (listed ahead) in the field of systemic risk;
5. Analyse the optimal uses of system-wide measures for influencing systemic risk that are embedded in the present law, and envision measures that merit consideration in future amendments to law;
6. Study the impact of regulatory policy on overall financial stability; and
7. Communicate the results of research to market participants and the public on a regular basis.

A summary of the research and analysis function as envisaged by the Commission is provided in Table 9.6.

9.6. Identification of systemically important firms

The draft Code in relation to micro-prudential regulation envisaged by the Commission imposes prudential requirements upon financial firms in accordance with the objectives and principles of the regulator. Some financial firms may present exceptional risks to the system by virtue of their sheer size, interconnectedness or infeasibility of resolution. Some financial firms can generate systemic risk concerns when seen as a conglomerate, though not taken individually. Some financial firms or conglomerates could be systemically important even if they make no promises to consumers, and are thus outside micro-prudential regulation.

The FSDC will analyse the data from the FDMC to obtain information in relation to the overall financial system, and name the firms and conglomerates that are systemically important. The process used to identify SIFIs here will benefit from international standards, but will be rooted in Indian realities. The *methodology* that will be used for this designation will be released into the public domain, go through a notice-and-comment process, and finally be approved by the FSDC.

This methodology will then be applied to the database within the FSDC to generate a checklist of systemically important firms and conglomerates, which will be released into the public domain. These firms will be brought under heightened supervision through micro-prudential supervision and the resolution corporation. The strategies for heightened supervision, that will be applied in micro-prudential supervision and by the resolution corporation, will be discussed at the FSDC so as to induce consistency in treatment across the financial system. This information will also be released into the public domain.

Table of Recommendations 9.7 Designation as Systemically Important Financial Institutions

- ▶ The FSDC will agree on the methodology for identifying SIFIs, which will embrace global standards to the extent possible for the Indian financial system. All the recommendations for the regulation-making process put forth by the Commission will be enforced on the construction of the methodology;
- ▶ Using this methodology, the FSDC will identify SIFIs. The list of such institutions will be released into the public domain annually;
- ▶ SIFIs will have the choice of appealing their designation at the appellate tribunal;
- ▶ This designation will be used by micro-prudential regulators, and by the resolution corporation, to exercise a higher standard of regulation and supervision; and
- ▶ The FSDC will monitor the higher standard of regulation and supervision by the regulatory agencies.

Financial firms can be adversely affected by being designated systemically important and being called upon to face higher regulatory standards and supervisory focus. The Commission therefore believes that financial firms must have an opportunity to appeal this designation to ensure that the FSDC's decisions comport with basic principles of regulatory governance.

The process followed in this field must, hence, follow a carefully structured set of steps, as detailed in Table 9.7.

9.7. System-wide measures

Financial regulators worldwide are gradually evolving measures for regulation which apply at a system scale. For example, measures that seek to resolve the problems caused by systemic cyclicity include the increase of capital requirements – across the financial system – in good times, and vice versa. This area also requires co-ordinated movement by all financial regulatory agencies. If, for example, capital requirements are raised in the banking sector alone, but not in other parts of the financial system, business will simply move away from banks, leading to regulatory arbitrage.

Therefore, there is considerable interest worldwide in identifying appropriate measures for counter-cyclical capital variation that are applicable to the entire financial system, or large parts of the financial system. At the same time, systemic risk as a body of professional, scholarly and policy knowledge is relatively underdeveloped. Therefore the Commission proposes laying the legal foundations for one measure - the counter-cyclical capital buffer.

The FSDC must conduct research and formulate a mechanism for the implementation of a counter-cyclical capital buffer such that it is applicable to the entire financial system, or large parts of the financial system - thus preventing concerns of regulatory arbitrage. Once such a measure has been formulated, the members of the FSDC will move in unison to increase or decrease capital requirements in counter-cyclical fashion. It must be noted that the counter-cyclical capital buffer is in addition to each regulator's power to specify capital requirements under its micro-prudential mandate.

Various types of system-wide measures which seek to resolve problems that are not solely cyclical in nature are also being debated internationally, such as sectoral capital requirements and leverage ratio requirements. In the coming decades, as the global consensus on such measures, as well as the experiences of countries in the use of such measures will increase, the FSDC may need to develop and authorise other system-wide measures.

When such a scenario arises, the systemic risk law should be amended to provide the legal foundations of additional measures. The Commission recommends that the FSDC should research the applicability of other system-wide measures to the Indian financial

Table of Recommendations 9.8 Counter-cyclical capital measures

- ▶ The FSDC must conduct research and formulate a mechanism for the implementation of a counter-cyclical capital buffer such that it is applicable to the entire financial system, or large parts of the financial system;
 - ▶ The counter-cyclical capital buffer will be applied at the level of the entire financial system, or to large parts of the financial system, as appropriate;
 - ▶ The FSDC will make the decision to increase capital requirements when systemic risk is building up, and decrease such requirements, and free capital when the system is under stress;
 - ▶ Decisions of the FSDC will translate into action through co-ordinated regulations issued by the respective regulatory agencies with identical effective dates; and
 - ▶ The FSDC will continue to conduct research on other measures. Once the FSDC is satisfied regarding the applicability of a measure, drawing on both international experience and original research in Indian settings, the Ministry of Finance will propose amendments to the appropriate sections of the draft Code pertaining to systemic risk, in Parliament.
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Table of Recommendations 9.9 Aspects of inter-regulatory agency co-ordination

- ▶ Promoting formal co-ordination mechanisms amongst regulatory agencies;
 - ▶ Coordinating the conduct of systemic-risk monitoring functions;
 - ▶ Facilitating the adoption of common standards and practices in rule-making and enforcement;
 - ▶ Coordinating with international organisations and multilateral bodies in conjunction with the Ministry of Finance; and
 - ▶ Helping to resolve inter-regulatory agency disputes.
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system and devise new measures (based on international best practices where appropriate). To this end, the Commission recommends that the Central Government should undertake a formal review of this issue in five years.

9.8. Inter-regulatory agency co-ordination

The institutional arrangement of the FSDC brings together multiple regulatory perspectives which are essential to identifying market trends that can result in systemic risk. The Commission believes that the FSDC can further promote co-ordination and consultation by initiating measures like the establishment of joint working groups, cross-staffing initiatives, designated points of contact for inter-regulatory communication, resolution of disputes and other such mechanisms between member-regulators.

The board of the FSDC will engage in resolving regulatory disputes amongst members of the FSDC and between members and other regulatory agencies, if required. The board of the FSDC will be empowered to determine its own procedure for resolution of the dispute, in line with the principles of natural justice.

The FSDC will also work with member-regulators to help in identifying and reducing regulatory uncertainty. In order to reduce regulatory uncertainty, the FSDC will promote consistency in the principles and practices adopted by its member-regulators in the areas of rule-making and enforcement. Such efforts will enable better resolution of conflicts between the policies of the members and promote cohesive oversight of the financial system.

The Commission wishes to emphasise that any action of the FSDC in this regard will not interfere with the functioning or the primary regulatory mandate of the regulators. Table 9.9 summarises the envisioned approach to inter-regulatory co-ordination.

9.9. Crisis management

Despite the best efforts at avoiding systemic crises, there is a possibility that some crises may occur. Crisis management requires extraordinary co-operation between the various

regulatory agencies. In such a situation, the FSDC will:

- ▶ Provide and conduct data analysis and research to seek to understand and resolve the crisis;
- ▶ Assist the regulators and members of the FSDC in their efforts to resolve the crisis;
- ▶ Implement any system-wide measures such as the release of the counter-cyclical capital buffer;
- ▶ Discuss and assist in the implementation of extraordinary methods of resolution for certain entities, such as SIFIs, if required; and
- ▶ Initiate an audit of all actions leading up to, and taken during, a crisis.

For efficient crisis management, the Central Government should have the ability to tap into the data and knowledge at FSDC and particularly, the FDMC. Second, crisis management will be improved by the presence of the resolution corporation and system-wide measures such as the release of the counter-cyclical buffer. Finally, the Ministry of Finance will be required to consult with the FSDC before making any decisions in relation to fiscal assistance, or other extraordinary assistance to financial service providers. The use of these powers should be restricted to emergency situations, and the actions of the FSDC should be subject to a post-crisis audit so as to ensure accountability.

Financial inclusion and market development

In the framework proposed by the Commission, the focus is on regulatory functions, which are meant to address market failures that impede efficient functioning of the financial system. There are certain functions that are present in the existing legal and regulatory framework that are not strictly regulatory in nature, and therefore remain to be addressed. Specifically, these are functions that the state plays in (a) ensuring more equitable distribution of financial services, and (b) in fostering the development or improvement of market infrastructure and market processes. In this chapter, these problems are discussed in terms of the objectives, powers to pursue objectives, principles to guide use of powers, and institutional roles that should be enshrined in the *the draft Code*.

10.1. Objectives

Development concerns within Indian financial markets broadly involve two aspects: (i) financial inclusion: initiatives where certain sectors, income or occupational categories are the beneficiaries of redistribution of financial services, and (ii) market development: fostering the development or improvement of market infrastructure or market process (see Table 10.1).

Financial inclusion comprises certain interventions that impose costs on society as a whole and yield gains to particular groups of citizens. Prominent and well-known initiatives of this nature include restrictions on branch licensing, to require banks to open branches in rural areas, and priority sector lending, to name some more widely known initiatives in banking. Similar initiatives are there in other sectors as well.

Table of Recommendations 10.1 Development functions

The Code should provide for the objective of fostering the development or improvement of market infrastructure or market process. This objective translates into the following:

1. Modernisation of market infrastructure or market process, particularly with regard to the adoption of new technology;
 2. Expanding consumer participation; and
 3. Aligning market infrastructure or market process with international best practices.
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Market development requires information gathering and analysis, which may be at the level of one sector, or on the scale of the full financial system. Inter-regulatory co-ordination is often called for. Market development may also require spending resources on market infrastructure that has public good characteristics. Such resources may be recovered from the financial service providers, and spent on market infrastructure based on a thorough understanding of costs and benefits. Market development may also require notifying regulations to bring market processes in line with international best practices.

Accordingly, the Commission, after much debate on the objectives of regulators in the pursuit of development, recommends that the regulatory objective of development should translate into the following:

1. *Modernisation*: The regulator should undertake measures that are necessary to modernise market infrastructure or market process, particularly measures with regard to the adoption of new technology.
2. *Enlarging consumer participation*: The regulator should be able to pursue certain social goals which contribute to the welfare of the people more broadly. In particular, the regulator should be able to undertake measures that provide for the differentiation of financial products or financial services to specified categories of consumers, or that enlarge consumer participation in financial markets generally.
3. *Best practices*: The regulator may undertake measures to align market infrastructure or market process with international best practices.

Besides the measures that the regulator may undertake to pursue its objective of market development, the Commission recommends that the Central Government should be able to direct a specific regulator to ensure the provision of specified financial services by specified financial service providers or to any consumer or class of consumers. The provision of services in this regard must be with a view to ensure effective and affordable access of financial services to persons who would ordinarily not have such access.

The Commission acknowledges that there may be costs incurred by financial service providers in implementing such directions, and recommends that the Central Government reimburse the cost of granting such access to the financial service providers.

10.2. Institutional architecture

The Commission believes that these questions of development of markets and financial inclusion create certain problems for public administration. As an example, consider an attempt at subsidising credit for agriculture, or an attempt at increasing the flow of credit into certain states. If this is done by a financial regulator, three problems are encountered:

1. *Hidden costs*: When a regulation forces banks to give more loans to open a bank branch in a non-profitable location, this imposes a cost – a tax – upon other branches, and also depositors and shareholders. Questions of institutional design are raised when the power to impose such costs on certain parts in society is given to unelected officials. Therefore, the Commission recommends that where there is a cost incurred by financial service providers in granting effective and affordable access to financial services, such financial service providers should be reimbursed in some form (for example, cash, cash equivalents or tax benefits).
2. *Dilution of accountability*: There is considerable policy knowledge and experience worldwide about embedding principles of accountability into systems of consumer protection and micro-prudential regulation. There is less experience and information available with regard to accountability principles for market development or inclusion initiatives. For example, the number of households that participate in a given financial product may be increased quickly by reducing the burden of consumer protection. Similarly, the function of redistribution to exporters, by requiring banks to give loans to exporters, is in direct conflict with the function of protecting consumers who deposit money with banks. Competing objectives can hinder accountability.
3. *Inefficiency*: When a transfer is achieved by taxing some consumers in order to deliver gains to others, this is a form of taxation. The Commission believes such implicit and selective taxation of different categories of consumers is inefficient.

Table of Recommendations 10.2 Implementing market development

The implementation of the objectives of development should be as follows:

1. Regulators should pursue a developmental strategy that fosters the *development and improvement of market-wide infrastructure and processes*:
 - ▶ This should include measures to modernise market infrastructure or market process, including in particular, the adoption of new technology; measures to provide for product differentiation, or enlarging consumer participation; or measures to align market infrastructure or market process with international best practices.
 - ▶ This goal should be subordinate to the goals of consumer protection and micro-prudential regulation, and should only be pursued where there is evidence of co-ordination failures in the market impeding the development of such infrastructure and processes.
 - ▶ A high-quality rule-making process should be applied and should involve features such as cost-benefit analysis and notice-and-comment periods.
 - ▶ There should be ex-post evaluation of the initiatives, to assess the costs of these initiatives and compare them with the benefits.
 2. In addition, the Central Government should be able to direct specific regulators to ensure certain practices in the financial markets:
 - ▶ These directions should be in the form of an order in writing issued by the Central Government and notified in the Official Gazette, to any specific Regulator to ensure the provision of any specific financial service by any specific category of financial service provider or to any consumer or classes of consumers on such conditions as may be prescribed, with a view to ensure effective and affordable access of financial services to any category of persons who would ordinarily not have such access; and
 - ▶ The Central Government should reimburse the cost of granting such access by providing either cash or cash equivalents, or tax benefits to the financial service provider.
 3. For initiatives involving multiple regulators, FSDC would play a think-tank role: In this instance, FSDC would perform a research and analytic role - measuring the state of play and the rate of progress of initiatives, undertaking post-facto analysis of past initiatives, formulating new ideas for reform and raising them before the Council.
 4. Where the issue is cross-sectoral and there is a need for co-ordination among regulators, this co-ordination should be done through FSDC.
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The Commission believes that there is a danger of reaching suboptimal outcomes when goals, powers and accountability are not clearly defined. Accordingly, the Commission recommends efforts to measure the efficacy of given development initiatives and evaluate alternative paths.

The Commission recommends:

1. Initiatives for development should be pursued by the regulators.
2. Additionally, the Central Government may direct a specific regulator to ensure the provision of specified financial services either by specified financial service providers or to any consumers or classes of consumers. The provision of such services must be with a view to ensure effective and affordable access to such services by persons who would ordinarily not have such access.
3. Where a financial service provider incurs costs in implementing such directions, the Central Government will reimburse the cost of granting such access by providing either cash or cash equivalents, or tax benefits to the financial service provider.
4. Wherever an initiative involves multiple regulators, the overall process of development should be analysed and measured by the FSDC. Similarly, if there is a need for co-ordination between regulators, it should be done through FSDC (see Table 10.2)

10.3. Principles that guide the use of measures

The Commission suggests a cluster of principles to guide the use of measures by the regulator and the government. In particular the Commission believes that the law must provide for the following balancing principles:

1. *Minimising any potential adverse impact on the ability of the financial system to achieve an efficient allocation of resources*: For a given improvement in financial

inclusion, the instruments should be used in a manner that is least distorting for capital allocation decisions of institutions.

2. *Minimising any potential adverse impact on the ability of a consumer to take responsibility for transactional decisions:* Consumers should take responsibility for their informed decisions. Instruments of development should be used in such a manner that lead to the least distortion of incentives for consumers.
3. *Minimising detriment to objectives of consumer protection, micro prudential regulation, and systemic risk regulation:* Instruments should be used in a manner least likely to cause detriment to achievement of objectives of the main financial regulation laws.
4. *Ensuring that any obligation imposed on a financial service provider is commensurate and consistent with the benefits expected to result from the imposition of obligations under such measures.*

Monetary policy

In the long run, the prime determinant of price stability in a country is the conduct of monetary policy. While price fluctuations on a horizon of a few months may be influenced by other considerations, such as a monsoon failure, these considerations do not explain sustained inflation over multi-year horizons. Advanced and emerging economies have achieved price stability by establishing appropriate institutional arrangements for monetary policy.

Price stability is a desirable goal in its own right, particularly in India where inflation is known to hurt the poor. A focus on price stability is also associated with macroeconomic stabilisation. When an economy is overheating, inflation tends to rise; and a central bank that focuses on price stability tightens monetary policy. Similar effects would be found in a downturn, with a drop in inflation and monetary easing. Through this, a central bank that focuses on price stability tends to stabilise the economy.

In the 1970s, many countries experienced stagflation: a combination of low GDP growth and high inflation rate. To a large extent, these problems were related to the conduct of monetary policy. From the late 1970s onwards, the shift to a more rules-based monetary policy, and one that was more oriented towards price stability, has helped improve macroeconomic outcomes.

The Commission believes that the central bank must be given a quantitative monitorable objective by the Central Government for its monetary policy function. Whereas the Commission recognises that there is broad consensus at an international scale on the need for a central bank to have a clear focus on price stability, after much discussions, it has decided to not specify such a requirement in the draft Code. Instead, the objective that the central bank must pursue would be defined by a Central Government and could potentially change over the years. If, in the future, the Government felt that the appropriate goal of monetary policy was a fixed exchange rate, or nominal GDP, then it would be able to specify these goals.

The problems of independence and accountability have unique features in the field of monetary policy. In the areas of consumer protection, micro-prudential regulation and resolution, independence and accountability are required in order to reduce the extent to which individual financial firms facing enforcement actions bring pressure on financial regulators. In contrast, in the field of monetary policy, there is no engagement with individual financial firms. The objectives are at the level of the economy; the instruments utilised are at the level of the economy. Monetary policy does not require conducting inspections of financial firms and writing orders at the level of one financial firm.

Table of Recommendations 11.1 Objective of monetary policy

1. The Central Government, in consultation with the central bank Chairperson, would release a Statement establishing the specifics of its predominant objective, as well as other secondary objectives (if any). In addition, if there are multiple secondary objectives, these would be prioritised in the Statement. These would be medium-term objectives.
 2. The Statement would also define what constitutes a substantial failure in achieving the objectives.
 3. The Statement would be released into the public domain.
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At the same time, there is a strong case for independence in making this decision. If a central bank lacks independence, it comes under pressure to cut rates in the period preceding elections. This tends to kick off increased inflation after elections. The lack of independence at a central bank is thus associated with reduced fairness in elections and enhanced macroeconomic fluctuations.

Achieving independence of a central bank requires appropriate institutional design. One key element is a MPC that controls all instruments of monetary policy. Such an arrangement yields improved decisions by pooling the thinking and analysis of multiple members. In addition, it reduces the extent to which the head of a central bank can be pressured to cut rates in accommodating the government. The Ministry of Finance, as a representative of the Central Government, has the right to be heard in MPC meetings, but it should have no voting member in the MPC. This would remove political and electoral considerations from the conduct of monetary policy.

The strongest form of independence, among all the agencies for which bills have been drafted by the Commission, is found with the central bank. This requires a commensurately strong accountability mechanism. Strengthening accountability, alongside enhanced independence, is a core theme of the Commission.

11.1. Objective of monetary policy

The Central Government, in consultation with the head of the central bank (referred to as Chairperson in this chapter), would determine the predominant objective of monetary policy, as well as other secondary objectives (if any) through a formal process shown in Table 11.1. The specifics of the objectives would be articulated in a Statement, which would be released into the public domain. Each objective would be a quantifiable, numerical target. Secondary objectives would be prioritised and could be pursued subject to successful delivery of the predominant objective. These would be medium-term targets. The Statement would also quantitatively define what constitutes a substantial failure in achieving these objectives.

While the Statement would be issued every two years, it is expected that the substance of the Statement would be modified only occasionally, thus giving stability to monetary policy strategy.

11.2. Powers of the central bank

In order to perform its monetary policy functions and play its role as the lender of last resort, the central bank will have the following powers:

1. *Issuance of Legal Tender Currency*: The central bank would be the sole agency authorised to issue currency.
2. *Banker to Banks*: In order to facilitate smooth inter-bank transfer of funds, or to make payments and to receive funds on their behalf, banks need a common banker.

To facilitate smooth operation of this function of banks, an arrangement needs to be in place to transfer money from one bank to another. To fulfil this function, the central bank would act as custodian of specified reserves of commercial banks and as their settlement agent.

3. *Act as banker to the government:* As a banker to the Government, the central bank would perform the same functions for the Government as a commercial bank performs for its customers. It would maintain accounts of the Government; receive deposits from, and make advances to, the Government; provide foreign exchange resources to the Government for repaying external debt or purchasing foreign goods or making other payments. This would not include debt management for the Central Government, which would be undertaken by the debt management agency.
4. *Act as custodian and manager of foreign exchange reserves:* The central bank, as custodian of the country's foreign exchange reserves, would be responsible for managing such reserves. The basic parameters of the central bank's policies for foreign exchange reserves management would be safety, liquidity and returns.
5. *Powers to manage its balance sheet:* The central bank would have the power to undertake market operations, onshore and offshore, in managing its balance sheet. This may include, but would not be limited to, buying and selling of securities, foreign currencies, gold and other precious metals.

11.3. The monetary policy process

Once the Central Government has chosen the objective of monetary policy, the monetary policy process would comprise five elements:

1. Measurement and research foundations;
2. Decisions about the instruments of monetary policy;
3. Operating procedure of monetary policy;
4. Monetary policy transmission; and
5. Accountability mechanisms.

The central bank would establish an internal organisation structure to perform the first step – the economic measurement and economic research foundations that must guide monetary policy.

The Commission recommends the establishment of an executive MPC that would meet on a fixed schedule and vote to determine the course of monetary policy.

Once the MPC has determined the policy action, the central bank would establish an operating procedure through which the operating target would be achieved.

Monetary policy influences the economy through the monetary policy transmission – the array of channels through which monetary policy instruments influence households and firms in the economy.

Finally, there are accountability mechanisms through which the central bank would be held accountable for delivering on the objectives that have been established for it.

When all these five elements work well, the central bank would be able to deliver on the goals established for it. The draft Code has focused on the second ('Decisions about the instruments of monetary policy') and the fifth ('Accountability mechanisms'), which require to be enshrined in the law. The remaining three elements – measurement and research, operating procedure, and monetary policy transmission – would take place through the management process of the central bank, with oversight of the board.

Table of Recommendations 11.2 The monetary policy committee

1. The MPC will be chaired by the Chairperson of the central bank. It will have one executive member of the board of the central bank and five external members.
2. External members will be independent experts in the field of monetary economics and finance. These members will be appointed by the Central Government, where in case of two of these members, the appointment will be in consultation with the Chairperson.
3. The external members will extensively engage with the organisation and have access to data (except data on individual financial firms that is related to the supervisory process), research and other office facilities. However, they will have no management or operational role within the central bank. They will not be members of the board or any of the two advisory councils (described ahead). Their only function in the central bank is to be members of the MPC.
4. The MPC will meet periodically and vote on all instruments of monetary policy. The main briefing report of the central bank's research department to the MPC would be released to the public one day before the MPC meeting.
5. A representative of the Central Government would participate in the MPC meetings, but would not have a vote. The representative would express the views of the Ministry of Finance and these views would be released into the public domain.
6. Decisions of the MPC would be made on a one-person one-vote basis.
7. Each of the seven members will also submit a rationale statement about his/her vote. With a lag of three weeks, the voting record and all seven rationale statements would be released into the public domain.
8. The central bank Chairperson would have the power to override the MPC in exceptional circumstances. However, he/she would be required to release a rationale statement in public, explaining the reasons for disagreeing with the MPC.

11.4. The monetary policy committee

The Commission recommends the creation of an MPC that would determine the policy interest rate. In addition to the Chairperson and one executive member of the board, the MPC would have five external members. Of these five, two would be appointed by the Central Government, in consultation with the Chairperson, while the remaining three would be appointed solely by the Central Government. These members must not be employees of the Government or the central bank or be involved in political activity. They may be permitted to hold other offices or positions during their tenure as MPC members, subject to there being no conflict of interest. In order to avoid conflict of interest, external members should: (a) be restricted from certain activities or affiliations outside the central bank – these may include restrictions on involvement in financial institutions; and (b) not have allied commercial interests that may give them unfair advantage due to access to privileged information obtained in their capacity as members of the MPC.

MPC members would have access to relevant information within the central bank, other than information about individual financial firms that is related to the supervisory process. The members would interact with the research department on an ongoing basis. This would provide the members with a complete information base required to vote on monetary policy decisions.

This arrangement, which has been adopted in the monetary policy process world-wide, has many strengths. A formal voting structure, coupled with the release of the voting record and rationale statement, ensures that each member analyses the questions and arrives at his/her own judgement; and ensures that it diminishes the extent to which an individual can dominate the MPC meeting.

Monetary policy faces a challenge in terms of the dangers of political interference, particularly in the period prior to elections. The political leadership may often try to pressure the head of the central bank, asking for accommodative monetary policy. By placing the decision clearly in the hands of the MPC, there is no one person that can be pressured. A representative of the Central Government, would participate in MPC meetings but would not have a vote.

The staff of the central bank report to the head of the central bank and face obvious conflicts of interest in voting independently. Additionally, having multiple members from one organisation raises the possibility of group-think. These concerns are addressed by having five external members on the MPC. However, ultimately it is the head of the central bank who must be held responsible for delivering on the monetary policy objectives.

The accountability mechanisms (described ahead) would ultimately rest with the head of the central bank. Hence, under extreme circumstances, the head of the central bank has the power to override the MPC. However, this would have to be accompanied by a letter to the Central Government, which would be released into the public domain, explaining why he/she feels that the MPC is exceptionally incorrect in its assessment, thus justifying an exceptional bypassing of the MPC.

Under normal conditions, monetary policy can generally be conducted using only one instrument, the control of the short-term policy rate. Occasionally, there may be a need to use other instruments, such as ‘quantitative easing’, or, trading on the currency market, or, capital controls.¹ The framework envisaged by the Commission is unified in its approach: All powers of monetary policy should be wielded in the pursuit of well defined objectives established by the Central Government, and all exercise of these powers should be done by voting at the MPC.

The structure and functioning of the MPC is summarised in Table 11.2.

11.5. Accountability

Alongside the definition of the monetary policy objectives of the central bank, the Statement of the Central Government that establishes the objective of monetary policy would clearly define what constitutes a substantial failure to achieve monetary policy objectives. If such an event should arise, the head of the central bank would have to: (a) write a document explaining the reasons for these failures; (b) propose a programme of action; (c) demonstrate how this programme addresses the problems that have hindered the achievement of the target(s); and (d) specify a time horizon over which the MPC expects the target to be achieved.

A further check is envisaged in the form of a reserve power granted to the Central Government to issue directions to the central bank on issues of monetary policy under certain extreme circumstances. Given the drastic nature of this power, any direction under this power must be approved by both Houses of Parliament and can be in force only for a period of three months. Such direction may be issued in consultation with the head of the central bank.

11.6. Institutional structure

11.6.1. Board of the central bank

The board of the central bank would oversee the functioning of: (a) monetary policy; (b) micro-prudential and consumer protection functions for banking; and (c) micro-prudential and consumer protection functions for payments. The Chairperson and the board would ultimately be responsible for continually reforming the organisation so as to deliver on its objectives as defined in the draft Code. Decision-making about organisational and institutional arrangements would take place at the board.

¹The Commission envisages that the central bank will frame regulations on outbound capital flows, in consultation with the Government.

Table of Recommendations 11.3 Board of the central bank

1. The board of the central bank would have up to 12 members; the number of executive members should not exceed 50 percent.
2. One of the executive members will be the Chairperson of the Bank (who would be the chair of the board).
3. One executive member will function as the administrative law member.
4. There would also be nominee members of the Central Government.
5. In the exercise of micro-prudential and consumer protection functions, all regulations would be issued by the board.
6. The board would oversee the functions of the central bank and have overall control of its organisation structure. It would continually work towards refashioning the organisation so as to best achieve its goals.
7. The board would be assisted by two advisory councils, in the fields of banking and payments.

Table of Recommendations 11.4 Functioning of the advisory councils for consumer protection and micro-prudential regulation in banking and payments

1. In the regulation-making process, all information associated with a proposed regulation would be placed before the advisory councils, which would draft a memo with its views on the proposed regulation. This memo would be presented to the board of the central bank.
2. Each advisory council would author a report every year, taking stock of progress in their respective fields and making specific recommendations for reform. The reports would be presented to the board of the central bank for decisions and be released to the public.
3. Each council would periodically originate memos on current policy issues that would be presented to the central bank board for decisions and released to the public.

While the board would not be involved in monetary policy decisions, it would, however, watch the extent to which the objectives of monetary policy (as formulated by the Central Government) are being achieved. The structure of the board, proposed by the Commission, reflects these three functions, and is shown in Table 11.3.

11.6.2. Advisory councils for banking and payments

The provisions on regulatory governance in the draft Code envisioned by the Commission involves a well-structured regulation-making process. When this process is completed, each proposed regulation would contain a draft regulation, the associated cost-benefit analysis, the comments received from the public, and the substantive response to each of them. Such information would be placed before the advisory councils and they would issue a statement containing their opinion on draft regulations. In addition, the two advisory councils would publish a report each year, highlighting new developments and areas of concern in their respective fields. The functioning of the two advisory councils for banking and payments is summarised in Table 11.4.

11.7. Temporary Liquidity Assistance

The central bank would operate mechanisms through which liquidity assistance is potentially available to financial service providers, against adequate collateral, to tide over temporary liquidity shortages, or, technical payment problems that may hamper smooth functioning of the financial system. This would involve a distinction between ‘standing facilities’, which are oriented towards resolving problems in payments systems, and ‘emergency lending assistance’, which are somewhat longer term. These processes would involve mechanisms for co-ordination between the central bank and other regulatory agencies. The central bank would issue regulations to determine rules of collateral and the overall rules governing the lending.

Since this facility is intended to provide short-term liquidity support to financial service providers and not meant to be used as a replacement for funding day-to-day oper-



ations, the price structure should be such that the borrowing entity would prefer to first seek regular funding from the market.

The identity of the borrowing entity would be revealed to the public only after an appropriate lag, while the total amount lent through this facility should be part of the daily reporting requirements.

Public debt management

12.1. An independent public debt management agency

In India today, some functions of public debt management are divided between the Central Government and the RBI. The RBI manages the market borrowing programme of Central and State Governments. External debt is managed directly by the Central Government. However, some functions that are crucial to managing public debt are not carried out at present. For instance, no agency undertakes cash and investment management, and information relating to contingent and other liabilities is not consolidated. Most importantly, there is no comprehensive picture of the liabilities of the Central Government, which impedes informed decision making regarding both domestic and foreign borrowing.

For roughly two decades, the solution that has been proposed in order to address this problem has been a specialised agency that manages the liabilities of the Central Government in a holistic manner. Public debt is increasingly obtained from private lenders, including both domestic and foreign entities. Under these conditions, the management of Government liabilities can grow in infinitely complex ways that could only be tackled by a specialised agency.

A number of reports dealing with the issue of reform of public debt management, notably the REPORT OF THE INTERNAL WORKING GROUP ON DEBT MANAGEMENT (2008), have highlighted this gap in Indian financial sector regulation, and have argued for the creation of an independent public debt management office. The Commission also believes that there are other institutional benefits in avoiding conflicting roles for the RBI.

The Commission has considered the views of the RBI in this regard. The RBI believes that “to achieve public policy objectives of ensuring growth, price stability and financial stability, co-ordination between monetary policy, fiscal policy and sovereign debt management is critical”. In the Commission’s formulation, the management of public debt will not be carried out in isolation of an understanding between monetary policy and fiscal policy. This is addressed through the governance arrangements that the Commission recommends for the public debt management agency, where the RBI and the Central Government have a presence and a voice in the agency’s deliberations (see Table 12.2).

Drawing on the consensus of expert committees of the last 20 years, the Commission recommends fast-tracking the setting up of an independent public debt management agency. In this regard, the RBI has put forth the view that “the expert committees that have recommended an independent public debt management agency have made

fiscal consolidation an essential pre-condition” for creating such an agency. However, the Commission is of the view that such a pre-condition is not stated as a requisite in most of the expert committee reports that have recommended an independent public debt management agency, with the REPORT OF THE INTERNAL WORKING GROUP ON DEBT MANAGEMENT being a case in point.

The Commission believes that the main benefit of an independent public debt management agency will come through the integration of public debt management functions and various databases and information, which are currently dispersed. By unifying the public debt management function, and efficiently linking it with the cash and the investment management functions, there will be improved information, analysis and thus decision making. With specialised human resources at its disposal, the public debt management agency can contribute to a more effective interface with the market resulting in cost-efficient management of Government borrowings. A specialised, unified and independent agency will have significant comparative advantage over the existing structure of a fractured and unco-ordinated Government borrowing programme spread across various agencies.

The Commission’s views on public debt management and the creation of the public debt management agency draws significantly from the deliberations of the Working Group on Public Debt Management (see Annex 19.9).

12.2. Structure of the public debt management agency

The governance and operations of the public debt management agency would be handled through a two-tiered arrangement. At the top, there would be an advisory council, comprising of experts in finance, law, and public debt management. The advisory council must advise and issue opinions on any matter related to the objectives and functions of the public debt management agency that is referred to it by the agency or the Central Government. It must also advise and provide its opinion on the financing plans submitted by the public debt management agency to the Central Government, as well as the agency’s annual report, whenever such opinion is sought. The council must meet periodically to review and ratify the borrowing programme for the upcoming months.

The advisory council must issue its opinion by way of a consensus decision. Enforcing a consensus requirement is also a way of ensuring that there is co-ordination between the members of the council. Ideally, the chairperson of the council must be obliged to seek consensus from all members. When no consensus is possible, the council would resort to voting procedures. In such a scenario, opinions of individual dissenting members should be documented and placed on record. The functioning of the advisory council must follow standard governance practices as regards appointments, vacancies, meeting procedures, terms and conditions of appointment, resignation and future employment.

As its title suggests, the advisory council would have no executive control over the day to day management of the public debt management agency. The supervision and control over daily operations and management would vest in the hands of a management committee within the public debt management agency. The composition of the management committee would be similar to that of the advisory council, except that advisory council members would be senior in rank to those of the management committee.

This management committee must exercise general superintendence over, and manage the administration and business of, the public debt management agency. The rules and procedures followed by the committee must follow standard governance practices. The appointment of the chief executive of the public debt management agency should be open and transparent. The management committee should meet more frequently than the advisory council, and take operational decisions, which affect the daily affairs

of the public debt management agency. Table 12.1 and Table 12.2 establish the essential structure of the public debt management agency.

Table of Recommendations 12.1 An independent debt management agency

The draft Code creates a specialised statutory public debt management agency that is equipped to manage the liabilities of the Government in a holistic manner. It will have a two-tiered arrangement as follows:

1. The public debt management agency will be guided by an advisory council and run by a management committee.
 2. The composition of the advisory council and management committee will be broadly similar, with representation from the RBI and the Central Government. The management committee should be headed by the chief executive of the agency, and the advisory council should be headed by an independent chairperson (see Table 12.2).
 3. The public debt management agency should function with independent goals and objectives. However, it remains an agent of the Central Government, to which it will be accountable for its actions and results.
 4. There should be regular and frequent consultation and co-ordination with the Central Government and the RBI, to ensure that all views are taken on record, and there is co-ordination between fiscal policy, monetary policy and public debt management. In part, this will also be achieved through the management committee and advisory council, where both the Central Government and the RBI have representation.
 5. The management committee will seek the opinion of the advisory council in matters of strategy and policy.
 6. The advisory council must provide opinions on any matters that are referred to it. It may also make recommendations, of its own accord, on any activities of the public debt management agency it finds relevant.
 7. The principles of governance, including transparency and accountability, will apply to all functions of the public debt management agency, its committee and council.
 8. The public debt management agency should be lean on staffing, and should have the power to decide staff salaries, and outsource a majority of its non-core activities.
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The public debt management agency should be a lean organisation, with limited staff on its rolls. A larger number of employees may be more challenging to handle, and may affect the organisation's performance. The public debt management agency must also have the authority to recruit staff with specialised skills on the sovereign bond market. Therefore, both selection processes and salary structures must be within the control of the agency itself. All non-core responsibilities should be outsourced to appropriate service providers, and the expertise and functions present within the agency should be limited and focused on the narrow mandate of the organisation.

Table of Recommendations 12.2 The composition of the advisory council and management committee

The composition of the management committee will be as follows:

1. the chief executive of the public debt management agency as its chairperson;
2. a nominee of the Central Government as member;
3. a nominee of the RBI as member;
4. a nominee of the State Governments, only if the agency borrows on behalf of any of them; and
5. experts as members.

In case the agency borrows on behalf of one State Government, such Government would nominate its officer as member. If the agency borrows on behalf of more than one State Government, one of such Governments would nominate that officer as member.

The composition of the advisory council will be as follows:

1. a chairperson;
2. a nominee of the Central Government higher than the rank of its nominee in the management committee;
3. a nominee of the RBI higher than the rank of its nominee in the management committee;
4. experts; and
5. the chief executive of the agency.

With the exception of the chief executive of the agency, the members of the advisory council cannot be the same as the members of the management committee.

Table of Recommendations 12.3 Operationalising agency role with independent objectives

The combination of being an agency with independent objectives and agent of Government has operational implications of the following nature:

1. While the public debt management agency will always act on instructions from the Central Government, the draft Code should allow it to have the discretion to decide on the details of how it implements those instructions in accordance with its objectives.
2. Throughout the process of implementing the instructions it receives, the public debt management agency must ensure that the objectives are met.
3. If, however, the instructions do not enable its objectives to be met, the public debt management agency must have the opportunity to place its objections to the instructions on record.
4. This should be done through mandating a regular consultation and feedback process between the agency and the Central Government, which should take place throughout the agency's exercise of its functions.
5. When issuing instructions, the Central Government must be obliged to consider the views of the public debt management agency, and would have full knowledge of the objectives of the agency as laid down in the draft Code.
6. If there is a disagreement between the two, the public debt management agency would be statutorily bound to meet the instructions, but through the consultation and feedback process, it would have placed on record its inability to meet its objective.
7. The accountability mechanism – routed through the Central Government and eventually to Parliament – would take into consideration all the efforts made by the public debt management agency with regard to achieving its objective, and the objections, if any, it would have already placed on record to this effect.

Table of Recommendations 12.4 Objectives of the public debt management agency

Table 12.1 states that the draft Code must create a public debt management agency that functions with independent goals and objectives, while remaining an agent of the Central Government. Accordingly, the draft Code charges the public debt management agency with the objective of *minimising the cost of raising and servicing public debt over the long-term within an acceptable level of risk at all times*. This will guide all of its key functions, which include managing the public debt, cash and contingent liabilities of Central Government, and related activities.

12.3. Objectives and functions of the public debt management agency

Table 12.4 sets out the objectives of the public debt management agency. It is important to recognise the tension between the short-term and the long-term. A public debt manager can always obtain gains in the short run through tactical decisions which appear to be expedient or immediately yield gains of a few basis points. But these tactics could well be damaging in the long run, if they reduce the confidence of market participants. Hence, the objective of the public debt management agency must be clearly defined in the draft Code as undertaking those actions which minimise the cost of borrowing of the Government in the long run. This should rule out an array of short-sighted tactical actions, such as exploiting informational asymmetry against market participants, exploiting regulatory constraints faced by market participants, and so on.

The key functions of the public debt management agency would be to undertake public debt and cash management for the Central Government. In addition to these, the various functions of the public debt management agency include the management of contingent liabilities, research and information, and the fostering of a liquid and efficient market for Government securities. These functions are summarised in Table 12.5.

12.3.1. Public debt management

The public debt management agency should advise the Central Government on the composition of debt instruments including the proportion of domestic to foreign debt instruments, alongside a thorough debt-sustainability analysis. Given the rising fiscal needs of

State Governments, the public debt management agency should co-ordinate the Central Government borrowing calendar with the borrowings of State Governments to ensure that the auctions of new issues are appropriately spaced.

The operations of the public debt management agency should also keep in mind investor preferences and the ultimate objective of public debt management, i.e., to meet the financial needs of the Central Government in an efficient manner over the long run. However, the final decision will rest with the Central Government. Once the Central Government has made decisions on the key questions, its remit would be executed by the public debt management agency.

Over the medium-term, the public debt management agency's focus is likely to shift towards building voluntary demand for Indian Government paper. It may consider a range of alternatives such as issuing inflation-indexed bonds or issuing in foreign currency, aiming to establish mechanisms that help address market concerns regarding inflation, exchange rate and credit risk, so as to minimise the interest cost paid by the Central Government in the long run.

As things stand today, external debt includes loans received from foreign Governments and multilateral institutions. The foreign currency borrowing of the Central Government takes place through multilateral and bilateral agencies. There is no direct borrowing from international capital markets. Further, State Governments cannot directly borrow from abroad and have to go through the Central Government as the sovereign risk is borne by the latter. Considering all these, both internal and external debt should fall under the scope of the public debt management agency.

Wherever feasible, the public debt management agency should establish limits for various categories of risk and overall risk. It must also seek to insure against these risks inherent in its portfolio. It should also develop a framework that helps identify the risks in the portfolio more efficiently, such as those associated with public debt management operations, refinancing, contingent liabilities, impact of sovereign credit ratings issued by credit rating agencies and global and domestic business cycle risks. It should also co-ordinate with the fiscal and monetary policy functions, and actively engage with credit rating agencies and the private sector and build relationships with market participants.

12.3.2. Cash management

The Central Government has been consistently running large fiscal deficit over the years. In this situation, cash surpluses do not arise except for very short periods of time, due to temporary mismatches between receipts and expenditures within a given financial year. However, the public debt management agency should be tasked with the function of managing and investing surplus cash of the Central Government whenever such a situation arises in future.

There is also a need for the efficient management of cash balances across various departments and ministries of the Central Government. Currently, a large part of the funds received by the various departments and ministries of the Central Government are held as surplus cash. This results in inefficient cash management for the Central Government as a whole. This is because the Central Government might be required to borrow in the market in a deficit situation even while some of its ministries hold on to surplus balances.

The cash balance position of the Central Government is also closely linked to the balances of State Governments, since the latter temporarily place surpluses with the Central Government. The frictional factors that contribute to the unintended liquidity crunch from time to time can be avoided if better cash management practices are introduced by both Central and State Governments in harmony with their public debt management practices.

Therefore, the public debt management agency should also carry out cash management, with a particular focus on its two main components – cash forecasting and cash balancing. Cash forecasting involves participating actively in the forecasting of expenditure and revenue, including long-term annual or half-yearly forecasts and the short-term monthly, fortnightly, weekly or even daily internal forecasts. It also means integrating forecasts of receipts and payments with other information on cash flows, notably those generated by financing decisions - bond issuance and servicing and by the cash manager's own transactions.

Cash balancing involves co-ordinating the matching of day-to-day expenses and revenues. This includes maintaining a regular channel of communication with the Central Government's banker (i.e., RBI) to estimate end-of-day balances. It also requires implementing a remit from the Ministry of Finance regarding managing idle balances. In certain situations, this might also involve management of permanent or structural cash surpluses.

The public debt management agency should also maintain a database (or have access to the database created by the Ministry of Finance for this purpose) of the actual cash balances and the liquidity requirements of various departments and ministries of the Central Government, including forecasts of spending and revenue patterns that gets updated frequently.

12.3.3. Contingent liabilities

Contingent liabilities may be either explicit or implicit, and may be issued by either the Central or State Governments. There are close interconnections between contingent liabilities and debt issuance. The invoking of guarantees can have a substantial impact on the risk assessment of the public debt structure of the Central Government. The Commission is of the view that the public debt management agency must manage and execute implicit and explicit contingent liabilities. It must evaluate the potential risk of these contingent liabilities and advise the Central Government on charging appropriate fees. In addition, the Government should be required to seek the public debt management agency's advice before issuing any fresh guarantees since this has implications for the overall stability of the public debt portfolio.

The realisation of contingent liabilities is counter-cyclical and adds to the financial burden of the Central Government especially at a time when it is in a crisis situation. Given this, the public debt management agency should advise the Central Government on making provisions for contingent credit lines with bilateral and multi-lateral agreements and establish similar credit lines with international agencies.

The management of contingent liabilities is a specialised function that involves undertaking the risk assessment of clients. Therefore, the public debt management agency should be allowed to contract out in part or in entirety the management of contingent liabilities to outside agencies if it so chooses.

12.3.4. Research and information

The public debt management agency must adopt a holistic approach that encompasses the entire liability structure of the Central Government. This includes not just marketable debt but also contractual liabilities from public accounts (such as small savings, provident fund receipts) and any other internal liabilities. While these liabilities are part of public accounts and not a part of consolidated funds, they influence the cost of raising debt and provide indirect support to the Governments.

It is also useful for the public debt management agency to maintain a comprehensive database of State Government debt, including information on Consolidated Funds

Table of Recommendations 12.5 Functions of the public debt management agency

1. *Managing public debt:*
 - ▶ The public debt management agency must design and recommend an annual calendar for the Central Government to manage its public debt;
 - ▶ The calendar will advise on all aspects of the composition of the borrowing and repayment of public debt;
 - ▶ This must be designed in consultation with Central Government and other key stake-holders;
 - ▶ The public debt management agency will eventually act on instructions received from the Central Government, but they must be empowered to make recommendations, even on a daily basis, if necessary; and
 - ▶ To ensure that there is an integrated approach to debt management, the public debt management agency must also manage the external debt for the Central Government.
 2. *Cash management:*
 - ▶ The public debt management agency must co-ordinate with the departments, ministries and agencies of the Central Government and RBI to estimate, monitor and manage daily cash balances. It must advise Government on measures to promote efficient cash management practices and to deal with surpluses and deficits.
 3. *Contingent liabilities:*
 - ▶ The public debt management agency must manage and execute implicit and explicit contingent liabilities;
 - ▶ It must evaluate the potential risk of these contingent liabilities and advise the Central Government on charging appropriate fees; and
 - ▶ The Central Government must seek the public debt management agency's advice before issuing any fresh guarantees since this affects the overall stability of the public debt portfolio.
 4. *Research and information:* The public debt management agency must have a view of the entire liability structure of the Central Government. Accordingly, it must develop, maintain and manage information systems; disseminate information and data; and conduct and foster research relating to its functions.
 5. *Fostering the market for Government securities:* A liquid and efficient Government bond market enables low-cost financing in the long run. Hence, the public debt management agency must take steps to foster a liquid and efficient market for Government securities, including advising the regulators and the Central Government on the policy and design of the market. In this role, the public debt management agency must work towards:
 - ▶ Growth and diversity in investors and intermediaries;
 - ▶ Fairplay;
 - ▶ Competition in intermediation;
 - ▶ Cost-minimising mechanisms for issuance and trading; and
 - ▶ Measurement of liquidity and market efficiency, and presentation of an annual report on the progress of the Government of India sovereign bond market.
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of States, public accounts of States, Contingency Funds of States and any additional explicit or implicit guarantees and contingent liabilities not covered in these accounts.

The public debt management agency must, therefore, develop, maintain and manage information systems, disseminate information and data. It must release comprehensive transaction-level data, and actively foster academic research in the public domain. Beyond merely collating and disseminating data, the public debt management agency must identify gaps in existing sources of data and work with public and private institutions to fill them. Where necessary and relevant, it must synthesise data for market participants. The public debt management agency must also regularly collect and disseminate data and information on its own performance and operations.

12.3.5. Fostering the market for Government securities

Fostering a liquid and efficient market for Government securities should be an integral function of the public debt management agency given the importance of a well functioning securities market in carrying out its primary functions of debt and cash management. This becomes all the more important as the market for Government securities has not as yet substantially developed in India.

The function of developing the Government securities market should not be con-

Table of Recommendations 12.6 Scope of the public debt management agency

There are limitations on the public debt management agency's functions, particularly in expanding it to States, as the management of State debt is a State subject under the Constitution of India. Accordingly, the draft Code must provide for the following:

1. While the public debt management agency acts as a Central Government agency obliged to manage only Central Government debt, it must undertake those functions related to State Government debt, which have implications for the Central Government's debt portfolio.
 2. This involves maintaining a comprehensive database of State Government debt and co-ordinating the Central Government's borrowing calendar with the market borrowings of State Governments.
 3. However, the public debt management agency may provide the option to the States of managing their public debt, subject to the State Governments entering into agreements with the agency to this effect.
 4. Additionally, the public debt management agency should be empowered to offer technical assistance to State Governments to set up their own debt management offices.
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fused with financial regulation. The functions of consumer protection and micro-prudential regulation, for the Government securities market, do not rest with the public debt management agency. However, as a specialised body that understands the market for Government securities, the public debt management agency should be an important voice on legal and institutional reforms that are necessary to achieve its objectives.

Going beyond this, public debt management agency must run a continuous effort of measuring market efficiency and liquidity, and asking how these can be improved, so as to cater to the goal of achieving low-cost financing for the Central Government in the long run. It must undertake initiatives to continually broaden access and participation in the market for bonds issued by the Indian Government, in terms of both investors and financial intermediaries, since this would yield improved market efficiency and liquidity.

12.4. Scope

Imposing the services of the public debt management agency on State Governments is not possible since the management of State debt is a State subject under the Constitution. The public debt management agency must be a Central Government agency obliged to manage only Central Government debt. It must, however, undertake functions related to State Government debt, which have implications for the Central Government's debt portfolio. This involves maintaining a comprehensive database of State Government debt and co-ordinating the Central Government's borrowing calendar with State Governments' market borrowings. However, at a later stage, the public debt management agency may provide the option to the States of managing their public debt (see Table 12.6), subject to the State Governments entering into agreements with the agency to this effect. This will not oblige State Governments to deal with the public debt management agency, as State Governments will also be able to enter into similar agreements with any entity offering such services for managing their public debt. Additionally, the Commission recommends that the public debt management agency should be empowered to offer technical assistance to State Governments to set up their own debt management offices.

Foundations of contracts and property

13.1. The interaction of financial laws with other laws

Financial laws do not operate in a vacuum. They interact with other laws in numerous ways. The Commission recognises that managing the interactions of the financial sector laws and regulations with other areas of law is of great significance. In this chapter the Commission addresses the following issues of interaction of financial laws and their operation in the financial markets:

1. **Interaction with other laws:** For the operation of financial markets and services, certain modification of the applicability of general laws of contracts, property and corporations are required. Some examples of these are the good faith principle in insurance, legal certainty of derivatives, requirement of corporations to make disclosures for publicly traded securities. Public policy concerns, and the regulatory stance, need to be unified for a broad array of traded securities in contrast with the present sectoral laws.
2. **Infrastructure Institutions:** Financial markets and services operate on a special set of institutions like exchanges, clearing houses, depositories, trade repositories, etc. Regulations governing these institutions, and the actions of these institutions, are integral to achieving objectives of consumer protection, micro-prudential regulation, systemic risk, and competition policy. In addition, a unique feature of some Infrastructure Institutions lies in the production of information that has a public goods character. This calls for transparency-enhancing measures and blocking market abuse.
3. **Special provisions for Infrastructure Institutions:** Financial market institutions also require certain levels of protection from the operation of normal legal principles of areas of laws like evidence, property, bankruptcy, etc. These are mainly related to the certainty of the transactions carried out by financial parties on these institutions. For example, settlements carried out in a clearing house cannot be undone when a participant goes bankrupt.
4. **Public issue and trade of securities:** Issuing of securities to the larger public requires financial laws to govern entities outside the financial sector with respect to the securities they have issued. The objective of these regulations is not to regulate non-financial firms but to ensure that obligations incorporated in the securities created by them are fairly applied and the financial markets have adequate information about these non-financial entities which have issued the securities to make informed decisions about investments in such securities.
5. **Issues pertaining to the market abuse:** Financial markets operate based on the information generated by the issuers of securities and the integrity of transactions and information of Infrastructure Institutions. This requires the law to criminalise actions which undermine the integrity and fairness of trading of securities.

As they do not fit within the standard system of consumer protection and prudential regulation, the Commission has decided to consolidate its recommendations with respect to these issues in this chapter.

13.2. Principles relating to certain contracts

The financial sector requires modification of general principles of laws. These pertain mainly to:

1. Insurance laws where certain legal principles presently used are required to be legislated to provide greater clarity.
2. Securities laws where legal enforceability and contractual obligations are required to be protected.

13.2.1. Insurance

Insurance principles are governed by various principles of case law along with statute. The Commission examined these positions as a part of its comprehensive review of India's financial law. The Commission recommends legislative clarifications in the following areas to ensure the smooth functioning of insurance contracts.

1. The term 'contract of insurance' has been used in the Insurance Act, 1938 in the definitions of life insurance, general insurance, fire insurance, marine insurance and miscellaneous insurance businesses but the term 'contract of insurance' is not defined in any legislation.
2. Insurance contracts are governed by the principle of *uberrimae fidei*, where all parties to an insurance contract must deal in good faith, making a full declaration of all material facts in a given insurance proposal. In addition to the insurer's obligation to the insured consumer under the consumer protection laws, the Commission recommends that the law must require the insured to disclose all material facts to the insurer.
3. There is no specific statutory requirement to have an insurable interest to enforce insurance contracts (other than marine insurance contracts) though courts have always treated the presence of such an interest as a prerequisite for enforcing the same. The Commission recommends that primary law should not require an insurable interest at the time of entering into an insurance contract though the regulator should have the authority to require an insurable interest for certain types of insurance contracts through regulations.
4. Currently, Section 38 of the Insurance Act of 1938 does not allow insurers the option to refuse an assignment of life insurance policies. The Insurance (Amendment) Bill, 2000 proposes that an insurer may refuse an assignment if it finds that such an assignment is not *bona fide* and not in the interest of the policy holder or the public interest. The Commission recommends that the regulator should have the power to specify the types of permitted assignments and restricted assignments of insurance policies, though insurers should not have the discretion to refuse any assignment.
5. Currently, if an insurance policy mentions the options available to a policyholder upon the lapse of a policy, no further notice needs to be given to the policyholder. The Commission recommends that insurers should serve notice to the policyholders in the event a policy lapses for non-payment of premium. Policyholders should be informed of the consequences of a lapse in the policy and the options available to them in the event of such lapse.
6. In indemnity insurance contracts, the law of subrogation, where an insurance company tries to recoup payments for claims made which another party should have been responsible for paying, is governed by case law. The Commission recommends that the law of subrogation be clearly defined in statute, drawing from directions provided by the Supreme Court in relevant case law.

Table 13.1 offers a brief summary of the specific recommendations of the Commission pertaining to the principles of insurance contracts.

Table of Recommendations 13.1 Insurance contracts

With respect to insurance law, the Commission recommends:

1. Consumers must have a duty of good faith obligation towards the insurer;
 2. The regulator should be able to make an *insurable interest* mandatory for only specified types of insurance contracts;
 3. The law should allow free assignment of insurance contracts subject to anti-fraud restrictions placed by the regulator;
 4. Adequate consumer protection regulations should be placed in the law requiring notice of impending default of insurance contracts due to non-payment of premium; and
 5. The duties of the insured and the insurer in the various events arising out of subrogation must be clearly stated in law, in accordance with relevant Supreme Court rulings.
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Table of Recommendations 13.2 Defining securities

To define securities, the Commission recommends:

1. Securities must be defined in two parts;
 2. The first part is the test of a freely transferable financial interest.
 3. The second part is an illustrative list of securities;
 4. The government should be allowed to add more securities to the illustrative list and financial markets develop and the innovation creates new securities.
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13.2.2. Securities

Defining what constitutes securities has been a challenge in many jurisdictions. The Commission found that the test depends on the free transferability of the instrument which leads to the creation of markets. Table 13.2 provides the recommendations of the Commission on defining securities.

Financial derivatives contracts are transactions, where parties agree that one party will pay the other a sum determined by the outcome of an underlying financial event such as an asset price, interest rate, currency exchange ratio or credit rating. Such contracts help in raising and allocating capital as well as in shifting and managing risks. Derivative contracts may be exchange traded or non-exchange traded, the latter being referred to as OTC. They may be standardised or non-standardised.

At the moment, there are certain complexities in enforcing derivative contracts. Section 30 of the Indian Contract Act, 1872 renders all wagering contracts void. Financial derivatives may be rendered unenforceable because of this provision. Exceptions to this rule have therefore been carved out through special legal provisions. Section 18A of the Securities Contracts (Regulations) Act, 1956 and Chapter III-D of the Reserve Bank of India Act, 1934 (introduced by the RBI Amendment Act, 2006) are examples of such special provisions. The Commission is of the view that for legal certainty in the enforceability of financial derivatives, an exception to the general application of section 30 of the Indian Contract Act, 1872 must be clearly specified in the law in a more general way.

The Commission has reviewed the question of requiring central clearing of OTC derivatives. Internationally, after the financial crisis in 2008, there has been a marked shift in favour of centrally cleared OTC derivative trading. In light of the positions taken by the G-20, both the European Union and the United States (US) have moved towards a regulatory framework for OTC derivatives trading that encourages central clearance. The Commission recommends that the regulator should have sufficient discretion to authorise such a position as and when required.

The Commission also reviewed the issue of inheritance of securities and other financial products. It found that the issues of inheritance should not create undue burdens on intermediaries who hold securities on behalf of the deceased. For example, property

Table of Recommendations 13.3 Exemption for derivative contracts

1. Notwithstanding section 30 of the Contract Act, 1872, a derivative contract is enforceable if it is exchange traded or entered into between sophisticated counterparties;
 2. If a financial service firm is able to prove that it transferred any security, deposit or obligation to a legally recognised nominee or to an executor or liquidator, it should be immune from being made a party to any dispute about the inheritance or bankruptcy of a person.
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disputes over securities should not involve the depository where a deceased person had kept securities. Similar issues are found in bank accounts and insurance contracts. This requires the laws to create a clear ‘safe-harbour’ for financial service firms as long as they transfer the securities to a nominee, or a court appointed executor, liquidator. The Commission states that this does not change any substantive provision in the inheritance laws of any person but merely clarifies the duties of financial firms in specified event.

The detailed recommendations of the Commission on securities are summarised in Table 13.3.

13.3. Infrastructure Institutions

There are certain activities associated with organised financial trading which are unique and different from the usual activities rendered by any other financial service provider in the financial market.

13.3.1. Different types of Infrastructure Institutions

Infrastructure Institutions are a product of the historical development of the financial sector markets. As use of technology and complexity of the financial sector increases new types of Infrastructure Institutions will develop within the financial sector. The Commission reviewed the requirement for designation as Infrastructure Institutions and listed the following activities in the financial sector at present:

1. *Multilateral Payment Clearing System*: Which is a mechanism to transfer value between a payer and a beneficiary by which the payer discharges the payment obligations to the beneficiary. Payments enable two-way flows of payments in exchange for goods and services in the economy;
2. *Exchanges*: Exchanges are organisations which allow a number of parties to trade securities amongst themselves. They create rules for trading, monitor parties to prevent abuse, ensure declaration of relevant information, keep record of transactions and manage risks arising out of the transactions;
3. *Clearing and settlement*: Clearing is the calculation of the obligations of counterparties to make deliveries or make payments on the settlement date. The final transfer of securities (delivery) in exchange for the final transfer of funds (payment) in order to settle the obligations is referred to as settlement. Once delivery and payment are completed, the settlement is complete;
4. *Title storage*: Securities be kept in physical or de-materialised form. Securities accounts are maintained to reduce the costs and risks associated with the safekeeping and transfer of securities;
5. *Counter party default management*: The risk that the counter party to a financial transaction may default on its promise and thereby jeopardise the entire transaction is minimised by imposing a Central Counter Party (CCP). This CCP acts as a buyer to the seller and a seller to the buyer only for the purpose of settlement;

6. *Storage of transaction data*: The last financial crisis has highlighted the interconnected nature of finance. When a financial market player fails, the unmet obligations to other parties may spread risk across the financial system. While it is not possible to move all transactions to an exchange, trade repositories for OTC transactions have become an important infrastructure system to monitor risks during normal times and improve interventions in times of emergency.

The Commission recommends that the Government be provided with the power to add more services to the list of Infrastructure Institutions.

13.4. Regulatory issues of Infrastructure Institutions

The Commission found that the regulation of Infrastructure Institutions requires the regulator to address the following six primary issues about their functioning.

1. An Infrastructure Institution must be governed in a manner which is compliant with the principles of prudential regulation;
2. An Infrastructure Institution must also protect the interests of the persons using its services in compliance with the principles of consumer protection;
3. Infrastructure Institutions are usually systemically important as they connect other financial service providers and therefore systemic risk concerns require to be addressed;
4. Infrastructure Institutions sometimes enjoy considerable market influence as they provide 'infrastructure' services to all players and this requires the regulator to ensure that this market influence is not used to discriminate between users;
5. Certain Infrastructure Institutions produce information which is used by the larger economy. The release and integrity of the information needs to be maintained;
6. Certain Infrastructure Institutions should be obliged to track market abuse and enforce against it, without diluting the requirement upon the regulator for this purpose.

The Commission recommends that Infrastructure Institutions be obliged to pursue these six objectives alongside the regulators. Regulators must have oversight over this rule-making process and ensure that rules are made by Infrastructure Institutions that are consonant with the above six objectives of regulators.

13.4.1. Prudential regulation

The general micro-prudential law mandates the regulator to monitor the promises made by financial firms in the securities sector. The Infrastructure Institutions make important promises to the consumers like delivering securities at an agreed price, keeping record of ownership, transferring money for financial and non-financial activities and extinguishing claims. The failure to keep these promises will have repercussions upon consumers and the financial system at large. Hence, regulators must enforce prudential regulation requirements upon Infrastructure Institutions.

13.4.2. Consumer protection law

While Infrastructure Institutions may themselves not directly deal with consumers, financial service providers usually act as intermediaries between such institutions and retail consumers. This requires that regulators ensure that Infrastructure Institutions apply the principles of consumer protection law. These principles will operate in a number of ways to protect the interests of the consumer:

1. It will require the market design, that is embedded in the rules created by Infrastructure Institutions, to be fair to consumers;
2. It will require securities advisors to judge the appropriateness of the security to the needs of the retail consumer; and

3. It will require sellers of securities to provide adequate information about the securities being sold and the terms and conditions of the security to retail consumers.

13.4.3. Systemic risk

Infrastructure Institutions are usually systemically important financial institutions. Their failure has negative consequence on the entire financial system due to the connection services they provide between financial service providers. The rules made by Infrastructure Institutions must thus pursue high levels of safety, and regulators must monitor such institutions from this perspective.

13.4.4. Monopoly abuse

Contracting has taken place for millennia without the intervention of these Infrastructure Institutions. The economic purpose of such institutions may be classified into two parts. The first is that of *reduced cost in contracting*. The search cost for a counterparty goes down by going to an exchange. Standardisation of processes is essential for the use of electronics in securities trading, settlement, and payments.

The market power that Infrastructure Institutions enjoy are amenable to abuse. This may arise in areas like refusing to list securities, preventing access to connections or preventing access on neutral terms. Hence the regulator has to monitor the terms on which the Infrastructure Institution operates. An essential element of this is the requirement that all Infrastructure Institutions operate on predetermined rules which are approved by the regulator so that there is no arbitrary treatment of any party accessing the services.

13.4.5. Information as a public good

The information produced by Infrastructure Institutions has wide ramifications for the market economy. The prices of securities are utilised by the wider economy as a vital input for making decisions about resource allocation. Hence, Infrastructure Institutions should be required to release high quality information that will support such applications.

13.4.6. Market abuse supervision

Information produced by Infrastructure Institutions is vital to the functioning of the financial system. It is also an input into decision making across the economy. When this information is incorrect, it reduces the quality of decision-making across the economy, often involving persons who are not direct participants in the financial markets. Hence, regulators and Infrastructure Institutions must undertake initiatives that ensure the integrity of this information. This requires blocking market abuse.

Further, Infrastructure Institutions are at the front-line of supervision on the problems of market abuse. While the prime responsibility for enforcement against market abuse lies with regulators, the front-line tasks of watching markets and conducting the early stages of an investigation lie with Infrastructure Institutions. In the modern environment with high-speed computerised trading and complex trading strategies, Infrastructure Institutions are required to build sophisticated supervisory staff of a kind that is not easily assembled in governmental agencies.

Product development at Infrastructure Institutions will often lead to innovative new products being developed. While this is desirable, such institutions will also be required to build the commensurate supervisory capacity to understand and detect abuse in tracking billions of transactions in fast-paced information technology systems. The regulatory

Table of Recommendations 13.4 Depositories

The Commission recommends:

- ▶ Allowing depositories to store securities, including Government securities and records of other financial services in electronic format only;
 - ▶ Recognising the title of the consumer and the custody of the depositary from such electronic records;
 - ▶ Allowing depositories to making records of pledge or hypothecation which are legally recognised; and
 - ▶ Allowing depositories to communicate with trading platforms and making changes to records accordingly.
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structure in this field consists of regulators focusing on the goal of market integrity and ensuring that Infrastructure Institutions are performing their functions in this regard adequately.

The requirements placed upon Infrastructure Institutions would have adverse implications for the costs of setting up new Infrastructure Institutions and the costs incurred by users of such institutions. Hence, the draft Code envisages a review, conducted by the Regulator every five years, that examines the balance that has been obtained between the regulatory objectives and competitive dynamics.

13.5. Special provisions for Infrastructure Institutions

Infrastructure Institutions require special protection in the laws to ensure transactions to be final. This requires certain classes of such institutions to have certain privileges in law not available to private parties. The Commission found that the privileges should only be given to such institutions if they are regulated. These privileges are applicable in the areas of:

1. Acting as depositories;
2. Settlement;
3. Clearing

13.5.1. Depositories

Securities are intangible property. The only proof of the property is the contract (which is a written obligation). This creates unique challenges in relation to establishing ownership of such securities because:

1. Transfer of various types of financial products like shares or debentures can be easily forged (if they are paper based);
2. Paper based contracts are prone to destruction or loss; and
3. Modern financial systems operate on electronic systems.

The depository system for securities has been an efficient solution to the problems of securities and their title. Table 13.4 sets out the detailed recommendations of the Commission in relation to depositories.

13.5.2. Finality of settlements

A multitude of trades result in a multitude of obligations among the members. In an organised financial system, these are netted to result in consolidated obligations of each member to the CCP. The settlement so arrived at, must be final as against any claim by any creditor (including liquidator) of a member outside the closed system of the trading. In other words, legal certainty of transactions in organised financial trading is achieved only by making the netted obligations bankruptcy remote to the members of the organised financial system. Table 13.5 sets out the recommendation of the Commission to protect settlements on exchanges.

Table of Recommendations 13.5 Finality of settlements

The Commission recommends the creation of an exception to normal priority of claims in the following instance:

When a trading member of a clearing house is declared as insolvent or bankrupt, the transactions and obligations of the member will be outside the jurisdiction of any liquidator or receiver. The claims of the clearing house over assets earmarked for settlement of claims will be the property of such clearing house till the claims are settled and cannot form part of the liquidation process.

Table of Recommendations 13.6 Finality of transactions

The Commission recommends:

1. An Infrastructure Institution which does netting and settlements should operate on rules which are approved by the regulator;
 2. The final set of transactions created by the Infrastructure Institution would be enforceable in law and would be recognised as a settlement for all the trades carried out;
 3. The Infrastructure Institution would be allowed to replace contractual obligations between trading parties with the obligations arising out of settlement system; and
 4. Even in the event of a bankruptcy of a person all the collateral of the person which have been deposited to the Infrastructure Institution must be outside the jurisdiction of a receiver or liquidator. The collateral should be used to complete the transactions already initiated on the Infrastructure Institution and then any surplus may be garnered by the liquidator.
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13.5.3. Finality of financial transactions

The Commission noted that transactions on an Infrastructure Institution cannot be easily undone. In netting and settling systems, if any individual transaction is undone, all dependant transactions will also have to be undone. This would create uncertainty for all persons using such institutions. Problems could also arise on exchanges where trades are executed at one point of time but the exchange of securities and money happens at a later point of time. If a person refuses to uphold the trade or goes bankrupt after making a trade but before completing it, a transaction may fail. Failure of a transaction in the exchange may have domino effect on other transactions.

The Commission is of the view that transactions on an Infrastructure Institution should be final and not undone under any circumstances. Recommendations of the Commission in relation to finality of transactions are given in Table 13.6.

13.6. Public issue and trade of securities

The Commission found that the public issue and trade of securities have three important regulatory objectives:

1. The public issue of securities should be done in a manner that adequate information about the issuer and the security is available (on a continuous basis) to the public to make informed decisions about investments.
2. The entity issuing the securities must have governance system which ensures that the issuer treats all purchasers of a specific class of securities in the same way and prevent illegitimate transfer of any funds from the issuer.
3. The trade of securities require that the rules governing the trading of different securities have common underlying principles which should apply to all trading of securities. These are required to prevent regulatory arbitrage between trading different securities and should be based on mitigating and managing the risk of transactions.

13.6.1. Public issue of securities

An incorporated or unincorporated entity may pool capital from an investor base by issuing securities. While doing so, the investor relies on the ability of the entity's manage-

Table of Recommendations 13.7 Issuance of securities

With respect to issuance of securities the Commission recommends:

1. Mandating the Government to publish a list of financial instruments which will be governed under securities law;
 2. That once an instrument is included in the list of securities, the trading of such instruments should be carried out under general principles of organised financial trading;
 3. Stipulating registration of the securities irrespective of the nature of the entity issuing them with specific requirements;
 4. Creating statutory basis for disclosure obligations on the issuer (which must be done through regulations), instead of being completely reliant on the listing agreement;
 5. Giving the regulator jurisdiction over issuers of securities when they approach a certain size or number of purchasers;
 6. Creating exemptions from registration requirement of issues which are below a certain size;
 7. Empowering the regulator to regulate minimum corporate governance standards for issuers irrespective of their legal structure; and
 8. Empowering the regulator to frame regulations requiring disclosure of any change in ownership of the issuer entity (take over) and give investors a reasonable exit option in such event.
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ment, which is in turn reliant on the disclosures made by the entity as well as the transparency of its governance processes.

The law must ensure that whenever any entity is raising capital from a fairly large pool of investors, it is properly managed and monitored. If such an entity is not managed and monitored, unscrupulous persons may use such entities to commit fraud. This, in turn, may detrimentally affect investor confidence and the smooth functioning of markets.

Accordingly, the Commission recommends that issuance of ‘security’ by any person must comply with certain registration requirements unless exempted by law. However, the Commission understands that such a broad definition may impose a prohibitive compliance cost on issuers. High compliance costs may limit the growth of small entrepreneurs. As such, broad exemptions need to be granted from the registration requirement for a limited number of issues to a limited number of people.

Presently, various continuous obligations and corporate governance norms are embedded in the Companies Act, 1956. These naturally apply only to companies issuing ‘securities’. Various obligations applicable to issuers, such as corporate governance norms, arise from the listing agreement. The Commission is of the view that since ‘securities’ may be issued by entities other than companies, the disclosure and governance norms of the issuer should be independent of the legal structure of the issuer. The Commission believes that obligations imposed on issuers of securities must be codified in statute and elaborated by subordinate legislation or regulations.

13.6.2. Trading of securities

The Commission noted that while each type of securities may have specific legal issues related to creation, the organised trading of securities faces similar concerns about integrity. The Commission recommends that the law takes a unified approach to regulate the *trading* of securities. This would include exchanges, brokers, clearing houses and payment systems. This would require a generalised definition of securities. The Commission found that there is no fixed definition of securities. Therefore it recommends that the Central Government should create a list of securities based on the understanding of the financial sector.

Table 13.7 gives a detailed summary of the specific recommendations of the Commission pertaining to disclosure and governance obligations to be applied to issuers of securities.

Table of Recommendations 13.8 Listing of securities

With respect to listing of securities the Commission recommends:

1. Ensuring that exchanges do not arbitrarily refuse to list securities;
 2. That persons in control of the issuer of securities do not discriminate against persons who have bought securities through the exchange;
 3. That in the event the securities are de-listed or cease to be traded, persons who have bought the securities from the exchange should be able to sell the securities at a fair price; and
 4. That in the event the issuer changes fundamentally through a takeover, persons who do not agree to the change are able to sell the securities at a fair price.
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Exchanges play a central role in the organised trading of securities. Table 13.8 provides the recommendations of the Commission with respect to the actions of exchanges in the course of listing and trading.

13.7. Market abuse

The Commission noted that the underlying principles of securities market requires *integrity* of the information produced by markets and *fairness* of the terms in trading in securities. These can be distorted through various ways which can be classified into the following categories:

1. **Market Manipulation:** Organised financial trading produces a stream of *information*, about prices, spreads or turnover. This information has important ramifications for the economy. Millions of individuals and firms make economic decisions as a consequences of the trading value of the securities. Any action which generates an artificial modification in these numerical values has an adverse impact on the market. Hence the law and regulatory processes that protect the integrity of information flow in the market. The regulator either on its own or through the Infrastructure Institution must establish rules, and exercise supervision, to identify and penalise attempts by market participants to induce artificial values of prices, spreads or turnover.
2. **Insider trading:** Concerns itself with trading based on non-public information that is availed through some special relationships and is considered an *unfair* advantage in such markets.

The Commission proposes that the law governing these concerns should be clubbed together under a general legal principle of *market abuse*. Market abuse can be classified into:

1. abuse of information;
2. abuse of securities; and
3. securities market abuse.

Table of Recommendations 13.9 Types of market abuse

The law governing market abuse must cover the following circumstances:

1. **Abuse of information:** Occurs under three circumstances:
 - ▶ When a person under a legal duty to disclose information does not do so or discloses false or deceptive information;
 - ▶ When any person uses information gained from sources which are not supposed to disclose information for purposes of trading; and
 - ▶ When any person circulates false or deceptive information with the objective of changing the price of a security and then trading such security for profit.
 Example: Insider trading, spreading false information.
 2. **Insider trading:** Concerns itself with trading based on non-public information that is availed through some special relationships and is considered an *unfair* advantage in such markets.
 3. **Securities market abuse:** Occurs when a person, with the intention of making a financial gain, artificially affects the price, liquidity, demand, supply or trading of securities or gives a false impression of the same. This may be done by dealing in securities or employing manipulative, deceptive or artificial means.
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Table of Recommendations 13.10 Market abuse

1. Market abuse means insider trading, abuse of information and securities market abuse.
 2. Dealing in securities through market infrastructure, with abusing the same, must be treated as an offence.
 3. Insider trading means dealing in securities or disclosing unpublished price sensitive information to any other person while in possession of unpublished price sensitive information, when such information was achieved through the breach of a fiduciary duty or other relationship of trust or confidence.
 4. The law must categorise attempting and abetting market abuse as an offence, albeit with lesser penalties.
 5. The law should prescribe a penalty on the offender, which would be capped at three times the illegitimate gains made or losses caused. The maximum imprisonment as in the present law should be retained.
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The Commission recommends that the law governing market abuse cover the circumstances mentioned in Table 13.9.

Market abuse invites civil penalties as well as criminal sanctions in major jurisdictions across the world. The recommendations of the Commission in relation to market abuse are captured in Table 13.10.

Financial regulatory architecture

We now turn to the financial regulatory architecture, or the division of the overall work of financial regulation across a set of regulatory agencies. In the international experience, there are three main choices (Table 14.1): A single financial regulator; a ‘twin peaks model’, where one agency focuses on consumer protection and the other on micro-prudential regulation; and a fragmented approach, where there are multiple agencies.

14.1. Financial regulatory architecture as a distinct feature of financial law

Many alternative structures can be envisioned for the financial regulatory architecture. Parliament must evaluate alternative block diagrams through which a suitable group of statutory agencies is handed out the work associated with the law. These decisions could conceivably change over the years.

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 draft Code does not provide for such integration. This is to ensure that from the outset, and over coming decades, decisions about the legal framework governing finance can proceed separately from decisions about the financial regulatory architecture. Changes in the work allocation of agencies would not require changes to the underlying law itself. This will yield greater legal certainty, while facilitating rational choices about financial regulatory architecture motivated by considerations in public administration and public economics.

Table of Recommendations 14.1 Alternative structures

Single regulator

All financial regulation can be placed with one agency. In this case, this one agency will enforce micro-prudential and consumer protection provisions in the draft Code for all financial activities.

Twin peaks

Some countries have constructed two regulators: one focused on micro-prudential regulation and the other on consumer protection.

Complex structures

The us has a highly fragmented regulatory model. As an example, the Commodities Futures Trading Commission (CFTC) regulates derivatives trading, while the U.S. Securities and Exchange Commission (SEC) regulates the spot market. The us also has state level regulators in some areas.

14.2. Problems of the present arrangements

At present, India has a legacy financial regulatory architecture. The present work allocation – between RBI, SEBI, IRDA, PFRDA, and 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 for which no regulator is in charge – such as the diverse kinds of ponzi schemes that periodically surface in India, which are not regulated by any of the existing agencies. It also contains overlaps where conflicts between regulators has consumed the energy of top economic policy makers and held back market development.

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

An approach of multiple sectoral regulators that construct ‘silos’ induces economic inefficiency. At present, many activities that naturally sit together in one financial firm are forcibly spread across multiple financial firms, in order to suit the contours of the Indian financial regulatory architecture. Financial regulatory architecture should be conducive to greater economies of scale and scope in the financial system. In addition, when the true activities of a financial firm are split across many entities, each of which has oversight of a different supervisor, no single supervisor has a full picture of the risks that are present. Fragmentation of financial firms, which responds to fragmentation of financial regulation, leads to a reduced ability to understand risk.

When a regulator focuses on one *sector*, certain unique problems of public administration tend to arise. Assisted by lobbying of financial firms, the regulator tends to share the aspirations of the regulated financial firms, such as low competition, preventing financial innovation in other sectors, high profitability, and high growth. These objectives often conflict with the core economic goals of financial regulation such as consumer protection and swift resolution.

Reflecting these difficulties, the present Indian financial regulatory architecture has, over the years, been universally criticised by all expert committee reports. The Commission has analysed the recommendations for reform of financial regulatory architecture of all these expert committee reports and weighed the arguments presented by each of them.

14.3. Considerations that guide alternative architecture choices

In order to analyse alternative proposals in financial regulatory architecture, the 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 unsatisfactory.

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.

Table of Recommendations 14.2 Financial regulatory architecture envisaged by the Commission

Present	Proposed
(1) RBI	(1) RBI
(2) SEBI	
(3) FMC	
(4) IRDA	(2) Unified Financial Authority (UFA)
(5) PFRDA	
(6) SAT	(3) FSAT
(7) DICGC	(4) Resolution Corporation
	(5) FRA
	(6) Public Debt Management Agency (PDMA)
(8) FSDC	(7) FSDC

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 that are conducive for the growth of its sector, which might be at the cost of overall consumer protection. 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 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.

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

14.4. A financial regulatory architecture suited for Indian conditions

The Commission proposes the following structure, featuring seven agencies.

Agency #1: The RBI, which formulates and implements monetary policy, and enforces consumer protection and micro-prudential provisions of the draft Code in the fields of banking and payment systems.

Agency #2: The UFA, which enforces the consumer protection and micro-prudential provisions of the draft Code across the financial sector, other than in banking and payment systems.

Agency #3: A resolution corporation, which implements the provisions on resolution of financial firms in the draft Code.

Agency #4: The FSAT, which hears appeals against all financial regulatory agencies.

Agency #5: The FRA, which addresses consumer complaints across the entire financial system.

Agency #6: The FSDC, which will be responsible for systemic risk oversight.

Agency #7: The PDMA, an independent public debt management agency.

The table 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.

This 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 RBI will continue to exist, although with modified functions;
2. The existing SEBI, FMC, IRDA, and PFRDA will be merged into a new UFA;
3. The existing SAT will be subsumed into the FSAT;
4. The existing DICGC will be subsumed into the Resolution Corporation;
5. A new FRA will be created;
6. A new PDMA will be created; and
7. The existing FSDC will become a full-fledged statutory agency, with modified functions.

14.4.1. Draft Indian Financial Code

The Commission has drafted a consolidated Indian Financial Code, which embeds the creation of the seven agencies and their responsibilities and functions. The draft Code consists of the following fifteen Parts:

1. Preliminary and definitions
2. Establishment of financial regulatory agencies
3. Regulatory governance
4. Financial consumer protection
5. Prudential regulation
6. Contracts, trading and market abuse
7. Resolution of financial service providers
8. Financial Stability and Development Council
9. Development
10. Reserve Bank of India
11. Capital controls
12. Public Debt Management Agency
13. Investigations, enforcement actions and offences
14. Functions, powers and duties of the Tribunal
15. Miscellaneous

The part on establishment of financial regulatory agencies provides for the creation of five new statutory bodies - UFA, Resolution Corporation, FRA, PDMA and FSAT. This part also provides for the allocation of regulatory responsibilities between the two financial sector regulators - UFA and RBI.

In case of RBI, the Commission recommends the continuance of the existing arrangement, with RBI as the country’s monetary authority. The draft Code however revisits the functions and powers of RBI, and sets out the manner in which it must be operated and governed. This includes provisions for the creation of an MPC and the powers of the committee in connection with the discharge of RBI’s monetary policy functions. Similarly, in case of FSDC, the existing FSDC is to be recast as a statutory body.

The remaining provisions of the draft Code lay down the powers and functions of these statutory bodies and the principles and processes to govern the exercise of their powers.

In the process of achieving the financial regulatory architecture proposed by the Commission, several amendments and repeals are also required to be made to the current financial sector laws that create the existing regulators and lay down their powers and functions.

14.4.2. Functions of the proposed agencies

We now review the functions of each of these seven proposed agencies:

RBI	It is proposed that RBI will perform three functions: monetary policy; regulation and supervision of banking in enforcing the proposed consumer protection provisions and the proposed micro-prudential provisions; and regulation and supervision of payment systems.
UFA	The unified financial authority will implement the consumer protection provisions and micro-prudential provisions for the entire financial system, apart from 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; and it would help address the difficulties of finding the appropriate talent in Government agencies. This proposed unified financial authority 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 securities, currencies, commodity futures, corporate bonds, and so on. The unification of regulation and supervision of financial firms such as mutual funds, insurance companies, and a diverse array of firms that are not banks or payment systems, would yield consistent treatment in consumer protection and micro-prudential regulation across all of them.
FSAT	The present SAT will be subsumed in FSAT, which will hear appeals against RBI for its regulatory functions, the unified financial authority, decisions of the FRA, against the Central Government in its capital control functions and some elements of the work of the FSDC and the Resolution Corporation.
Resolution Corporation	The present DICGC will be subsumed into the Resolution Corporation, which will work across the financial system.
FRA	The FRA is a new agency which will have to be created in implementing this financial regulatory architecture. It will set up a nationwide machinery to become a one-stop shop, where consumers can carry complaints against all financial firms.
PDMA	An independent public debt management agency is envisioned.
FSDC	Finally, the existing FSDC will become a statutory agency and have modified functions.

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 draft Code comes 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 UFA 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 provisions across the entire financial system and a second Prudential Regulation Agency, which enforces the micro-prudential provisions across the entire financial system. In either of these paths, RBI would focus on monetary policy.

These changes in the financial regulatory architecture would be relatively conveniently achieved, given the strategy of emphasising separability between laws that 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.

Transition issues

Once the government decides to move forward with the Indian Financial Code, transitioning from the existing setup to the framework proposed by the Commission will require planning and co-ordination. If not managed well, regulatory uncertainty could introduce considerable difficulties in the system. The Commission recommends that the Central Government should consider establishing a focused project team within the Ministry of Finance to facilitate the overall transition process. This team must be provided adequate staff and resources to enable effective discharge of its functions. The Commission suggests that the tasks of the project team would be to:

1. Create and implement an overall blueprint for the transition to the new legal framework;
2. Steer the draft Code through the entire legislative process;
3. Facilitate information flows and co-ordinate with relevant departments or agencies of the government, including existing regulators;
4. Determine the manner in which existing regulations will be phased out and the timing of the draft Code coming into effect; and
5. Identify the steps to be taken to ease the transition process for regulated entities, such as one-time exemptions from capital gains tax or stamp duty requirements.

To ensure that the transition is achieved in a timely and organised manner, the project team must devote significant efforts towards laying the groundwork for the actual creation and operation of new or modified agencies. In this context, the Commission suggests:

1. **Aligning ongoing work with project plan:** The project team must examine pending bills or draft regulations relevant to the financial sector in order to assess whether they are aligned with the key ideas of the proposed framework, as accepted by the Government. In the event of any material deviation, the project team may recommend that the Government consider the withdrawal of any bill that has been placed before Parliament.
2. **Introducing some elements into existing practice:** The Commission is of the view that many of its recommendations, particularly in the field of regulatory governance, build upon or formalise existing regulatory practices and procedures. Therefore, to the extent possible, the Commission's recommendations on regulatory governance can be implemented by the existing regulators with immediate effect. For example, many regulators already invite public comment on draft regulations. A requirement that all public comments received must be published can be enforced with immediate effect. Such steps will not only ease the transition process, but also allow the regulators more time to modify their internal processes.
3. **Preparation for creation of new agencies:** With FRA, PDMA, FDMC and FSAT, there is a particularly important role for the development of information technology (IT) systems. The development of these systems can commence ahead of time. The second ingredient is the physical facilities to house the new group of agencies. This would also benefit from advance work.

On the functional side, certain preparatory steps can be taken. The Commission recommends the creation of an “Interim Co-ordination Council” of existing regulators, namely, SEBI, FMC, PFRDA and IRDA, that are to be merged to create the UFA.

The following are the recommendations of the Commission on how the implementation of each of the agency may take place:

1. UFA

- (a) **On acceptance:** An interim Board, without any powers, should be set up using an executive order. This Board will evaluate existing regulations and prepare for the eventual setting up of the UFA. Further, a co-ordination committee will be set up between all regulators that will be subsumed under UFA.
- (b) **On passage of draft Code:** The Board will be appointed as the official board under the law. All financial sector regulators other than RBI shall be subsumed under UFA. All the subsumed regulators will change letter heads and continue to function. Employees will be transferred. The Board will begin consultation on new regulations. Existing regulations will transition to new regulations over time.
- (c) **Law + 2 years:** Regulations existing before the passage of the draft Code will lapse. By this time, the Board must have replaced the entire subsidiary legislation and consolidated all subsumed agencies.

2. RBI

- (a) **On acceptance:** The RBI Board will evaluate existing regulations and prepare for the eventual transformation of the RBI. The Board will start taking steps to shift out functions of the PDMA and plan the establishment of the MPC process.
- (b) **On passage of draft Code:** The Board will need to be reconstituted reflecting the provisions of the law. The Board will begin consultation on new regulations. Existing regulations will transition to new regulations over time. PDMA and MPC will come into existence.
- (c) **Law + 2 years:** Regulations existing before the passage of draft Code will lapse. By this time, the Board must have replaced the entire subsidiary legislation.

3. Resolution Corporation

- (a) **On acceptance:** An interim Board, without any powers, should be set up using an executive order. This Board will evaluate existing rules and prepare for the eventual setting up of the Resolution Corporation.
- (b) **On passage of draft Code:** The Board will be appointed as the official board under the law. DICGC will cease to exist and its obligations will be subsumed by the Resolution Corporation till the new rules are put in place. Employees will be transferred or reverted. The Board will begin consultation on new regulations. Existing regulations will transition to the new regulations over time.
- (c) **Law + 2 years:** By this time, the Resolution Corporation will be fully functional and the new set of rules will be in place.

4. FRA

- (a) **On acceptance:** An interim Board, without any powers, should be set up using an executive order. This Board will evaluate existing rules and prepare for the eventual setting up of the FRA.
- (b) **On passage of draft Code:** The Board will be appointed as the official board under the law. Existing rules and ombudsmen will transition to new rules and agency over time.

- (c) **Law + 2 years:** By this time, the FRA will be fully functional and the new set of rules will be in place. Ombudsmen will cease to exist and all pending cases will be transferred to FRA.

5. FSAT

- (a) **On acceptance:** Preparation for expanding of physical and IT infrastructure, and benches. Drafting of new procedural laws should begin.
- (b) **On passage of draft Code:** SAT will be subsumed into the FSAT. The letter-head will change. New procedural laws will be passed and come into effect.

6. FSDC

- (a) **On acceptance:** The process of creating the financial system database will begin. Regulations specifying the technical specifications, as well as frequency of upgrading capabilities will be made. An interim Board and Sub-Committee will begin the process of preparing for the creation of research, analysis and process for SIFI designation.
- (b) **On passage of draft Code:** FSDC will come into existence as a statutory entity; and will implement all the existing research and continue capacity building.
- (c) **Law + 2 years:** FDMC will become operational.

7. PDMA

- (a) **On acceptance:** An interim Board, without any powers, should be set up using an executive order. This Board will prepare for the eventual setting up of the PDMA.
- (b) **On passage of draft Code:** PDMA will come into existence as a statutory entity; will implement all functions except cash management, contingent liabilities and services to others.
- (c) **Law + 2 years:** PDMA will become fully operational.

The draft Indian Financial Code is expected to replace a number of existing legislations, and necessitate amendments in most other such legislations. The legislations expected to be replaced will have to be repealed. Many issues addressed by provisions of these legislations are directly addressed in the draft Code, albeit in a principles-based manner. For some other issues, subordinate legislation is expected to be issued, but the draft Code provides the general power to the regulator and the corresponding principles to guide the regulators.

In this shift from a largely rules-based legal framework to a principles-based one, principles in the draft Code are expected to provide regulators with the independence to respond to problems within the financial system, using the enumerated powers given to them in the draft Code. The use of these powers is to be guided by principles in the draft Code, a requirement for benefits of a regulation to outweigh its costs, and a general requirement for consultations and research. For example, instruments such as the Statutory Liquidity Ratio (SLR) for banks and investment restrictions for insurance companies are not directly enshrined in the draft Code, but the draft Code empowers the regulators to make regulations on such requirements, guided by a set of principles, including one that requires them to be risk-based.

There are also issues on which shift to a new approach is recommended, which means that certain provisions in the existing legislations or certain legislations on the whole will not find corresponding provisions in the draft Code, nor are they expected to be addressed through subordinate legislation. On these issues, the Commission has taken a considered view to recommend a move to a different approach towards regulation. For example, in the interest of competitive neutrality and regulatory clarity, the Commission recommends repealing all legislations that give special status to certain financial

service providers that are functionally the same as other financial service providers created through regulatory authorisation. Such financial service providers will have to seek authorisation just like other financial service providers, and will be subjected to the same regulatory framework. For example, certain banks and insurance companies in India enjoy a statutory status, which should be replaced by a regulatory authorisation to do these businesses.

From existing legislations affecting India's financial system that are not to be repealed, most will require amendments. Some will have to be substantially amended, and others will require only minor amendments.

Following is a list of legislations to be repealed:

1. The Securities Contracts (Regulation) Act, 1956
2. The Securities and Exchange Board of India Act, 1992
3. The Depositories Act, 1996
4. The Public Debt Act, 1944
5. The Government Securities Act, 2006
6. The Reserve Bank of India Act, 1934
7. The Insurance Act, 1938
8. The Banking Regulation Act, 1949
9. The Forward Contracts (Regulation) Act, 1952
10. The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
11. The Deposit Insurance and Credit Guarantee Corporation Act, 1961
12. The Foreign Exchange Management Act, 1999
13. The Insurance Regulatory and Development Authority Act, 1999
14. The Payment and Settlement Systems Act, 2007
15. The Acts establishing bodies corporate involved in the financial sector (e.g. The State Bank of India Act, 1955 and The Life Insurance Corporation Act, 1956)

Summary of recommendations not embedded in the draft Code

This chapter lists the recommendations from chapters in this report that have not been translated into specific provisions in the draft Code.

16.1. Ownership neutrality and competition

The Commission envisages a regulatory framework where governance standards for regulated entities will not depend on the form of organisation of the financial firm or its ownership structure. The Commission hence recommends the repeal of all special legislations listed in Table 2.1 that (a) establish statutory financial institutions; or (b) lay down specific provisions to govern any aspect of the operation or functioning of public sector financial institutions. The undertakings of all such statutory institutions should be transferred to ordinary companies incorporated under the Companies Act, 1956 and their regulatory treatment should be identical as that applicable to all other financial companies.

The Commission also recommends proportional regulation of certain financial activities that are owned and managed by Government agencies and which presently fall outside the sphere of financial regulation. This includes fund management services offered by the EPFO and other statutory provident funds, insurance services of postal life insurance and the ESIC and the various small savings products issued by the Government. This requires examination of the legislative foundations of these programs and clarification of regulatory jurisdiction.

The principle that financial services should be regulated and supervised in a proportionate manner should apply equally to co-operatives created under laws made by State Governments. Since the subject of co-operative societies falls within the legislative domain of State Governments under the Constitution of India, the Commission recommends the following measures to ensure that regulators have adequate statutory control over the regulation and supervision of financial co-operatives:

1. Using Article 252 of the Constitution of India, State Governments should accept the authority of Parliament to legislate on matters relating to the regulation and supervision of co-operative societies carrying on financial services; and
2. The regulator may impose restrictions on the carrying on of specified financial services by co-operative societies belonging to States whose Governments have not accepted the authority of the Parliament to legislate on the regulation of co-operative societies carrying on financial services.

16.2. Parliamentary review of subordinate legislation

In order to strengthen the oversight of regulators who are empowered by Parliament to issue subordinated legislation, it is recommended that the subordinate legislations made by regulators should be reviewed by the same parliamentary committee which reviews primary legislation for the financial sector.

16.3. Recommendations of Working Groups

The Commission began by an in-depth examination of sectors within the financial system through the establishment of five wgs. Once this sector-level understanding was in hand, the non-sectoral draft Code was constructed by generalising from the recommendations produced by the five wgs. The legal effects of the non-sectoral draft Code have been evaluated in terms of implications for each of the recommendations of all the wgs.

The wg reports embed a rich and contemporary knowledge of the policy problems faced in the five sectors. They add up to the largest-scale synchronised expert committee process in the history of Indian finance. Under the principles based and non-sectoral legal framework adopted by the Commission, several of the provisions that currently appear in the financial sector laws and have been discussed by wgs, and many of the recommendations of wgs, should feature in the subordinated legislations framed by the regulators. Therefore, the Commission recommends that the respective regulators should take into account the recommendations of the wgs while formulating subordinated legislation to implement the draft Code.

The recommendations of five wgs setup by the Commission can be found in Annex 19.6, 19.7, 19.8, 19.9 and 19.10. The full reports of all wgs are on the FSLRC website.

16.4. Cross-border resolution

An effective resolution framework requires appropriate arrangements for cross-border resolution. Since many SIFIs operate on a global level, an unco-ordinated approach by the home and host countries' authorities would create difficulties in the way of resolution of such institutions in a manner that would protect interests of consumers and prevent the risk of a contagion. Deliberations are underway at international policy forums to devise an optimal approach to cross-border resolution. India must participate in emerging global arrangements on cross-border resolution. The developments in this regard, in the coming years, may well require amendments to the draft Code on resolution - such as to require the resolution corporation to co-ordinate with its counterparts in other jurisdictions. The Commission recommends that in five years from now, a committee be set up to review the emerging consensus in the field of cross-border resolution and to suggest amendments in the legal framework on resolution accordingly.

The Commission recommends that the process of resolving a covered service provider including the choice of a resolution tool should not depend on the ownership structure of the service provider. This will result in 'ownership neutrality' in the approach of the corporation. In this framework, thus, the treatment of public and private firm; and domestic and a wholly owned subsidiary of a foreign firm will be identical from the viewpoint of resolvability.

16.5. Systemic risk

The FSDC has been given the power to formulate and implement certain system-wide measures which seek to mitigate systemic risk in the financial system. Regardless of any independent action of the FSDC in relation to research on new system-wide measures, the Commission recommends that the Central Government should undertake a formal review in relation to this issue in five years.

16.6. Transition issues

The Commission recommends that the Central Government should consider establishing a focused project team within the Ministry of Finance to manage the overall transition process.

In the view of the Commission, the tasks of the project team would be to:

1. Create and implement an overall blueprint for the transition to the new legal framework;
2. Support the legislative process in the analysis and processing of the draft Code;
3. Undertake research and capacity building that is required prior to the new activities of regulatory agencies;
4. Undertake systems analysis, design and prototyping for the IT systems that would be required in establishing new functionality and new agencies;
5. Enable information flows and co-ordinate with all relevant departments or agencies of the government, including existing regulators;
6. Determine the manner in which pending bills and existing regulations will be phased out and the timing and sequencing of the draft Code coming into effect;
7. Incorporate, to the extent possible, the Commission's recommendations on regulatory governance within the existing regulators;
8. Create an "Interim Co-ordination Council" of the existing agencies that are to be merged to create the UFA; and
9. Identify the steps to be taken to ease the transition process for regulated entities, such as exemptions from capital gains tax or stamp duty requirements.

Conclusion

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 triad of objectives, powers and accountability mechanisms. The Commission has focused itself upon this task. The draft Code features substantial improvements upon present Indian practice in terms of clarity of objectives, precise statement of enumerated powers, and an array of accountability mechanisms.

The motivation for the establishment of the Commission was rooted in a series of expert committee reports which identified important difficulties in the prevailing Indian financial economic policy framework. The Commission has absorbed these areas of concern. Most of the shortcomings lie in the subordinated legislation, which is drafted by financial regulatory agencies. The work of the Commission, therefore, does not directly engage with these problems. The work of the Commission 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 does not directly address them.

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 US GDP of 2012. 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.

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

The Commission has endeavoured to draft a body of law that will stand the test of time. Hence, it has 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, and serve the country well in coming decades.

Notes of dissent

18.1. Note of dissent by J.R. Varma

In my view, the authorization requirement (Section 142) for providing any financial service (which is defined very broadly in Section 2(75)) creates the risk of regulatory overreach. Many activities carried out by accountants, lawyers, actuaries, academics and other professionals as part of their normal profession could attract the registration requirement because these activities could be construed as provision of a financial service. Similarly, investors who rebalance their own portfolios regularly and day traders who routinely place limit orders on a stock exchange could also be deemed to require authorization. An expansive reading of Section 2(75)(k) could require even a messenger boy who delivers a mutual fund application form to obtain authorization. All this creates scope for needless harassment of innocent people without providing any worthwhile benefits.

The UK law by contrast requires authorization only for a narrow list of regulated activities and there is an explicit carve out for any activity which is carried on in the course of carrying on any profession or business which does not otherwise consist of regulated activities. Similarly, newspaper columns and a variety of information services are excluded from the definition of regulated activities under UK law.

The draft Indian Financial Code (Section 150(3)) does allow regulators to exclude any activities from the definition of financial service. However, this does not solve the problem of regulatory overreach because it relies entirely on regulatory self-restraint (which is often a scarce commodity). By contrast, under the UK law, the list of regulated activities is defined by the government and not by the regulator itself.

In my view, the authorization requirement under Section 142 should be restricted to a narrower subset of financial service providers.

18.2. Note of dissent by K.J. Udeshi

While I am in agreement with the recommendations of the Report, I have reservation on the recommendations relating to Capital Controls. The Commission recommends the following formulation:

“The regulations governing capital controls on inward flows should be framed by the Government, in consultation with the RBI. The regulations governing capital controls on outward flows should be framed by the RBI, in consultation with the Government.” (See Chapter 8.3)

Consultation does not imply a consensus and when the RBI is in disagreement with the Government, the Government has the unquestionable powers to issue directions to the RBI. When the rule-making vests with the Government, the RBI may be consulted, but if there is a disagreement, the RBI would willy-nilly have to deal with a *fait accompli* and be accountable for the actions it would be required to take in the light of the Government's decisions.

In India, the forex reserves accretion is invariably on account of a capital account surplus and not due to a current account surplus and hence the composition of the inward flows assumes importance. Inward capital flows into India comprise FDI as also debt/portfolio equity flows and the latter are not only volatile but can undergo sharp directional shifts. There is widespread concern among several central banks in Emerging Market Economies about the added pressures on monetary management due to the prevailing extraordinarily strong and volatile cross-border capital flows. If the RBI has no say in initiating policy relating to these volatile flows, the RBI would be constrained to take monetary policy measures, both direct and indirect and administrative actions to deal with the consequences of such flows; such measures may not be what the Government or industry and the business community seek, leading to overall dissatisfaction.

If the RBI is to be accountable for the performance on its Balance Sheet, it has to be enabled to decide on the timing, quantity and quality of inward capital flows so that it can calibrate its forex interventions and sterilisation measures.

To the extent that inward capital flows impact liquidity conditions, it becomes necessary for the RBI to impose a burden on the banking system through imposition of reserve requirements and open market sales of securities. Such measures can impinge on the banking system and may not be in consonance with the medium/long-term policy object.

Both, financial markets and Governments have short time horizons and when initiating policy relating to debt/ portfolio equity flows is with the Government, it makes the task of the RBI as Monetary Authority and the Regulator much more difficult.

I am, therefore, not in agreement with the Commission's recommendation to place the policy and rule-making relating to all inward capital flows with the Government.

One of the TOR of the Commission is:

“V. Examine the interplay of exchange controls under FEMA and FDI Policy with other regulatory regimes within the financial sector.”

The formulation of the FDI policy in many jurisdictions is statutorily the prerogative of the Central Governments, since the policy has implications for the macroeconomy, employment, security issues, social and political considerations etc. The Government's concerns in evolving FDI policies need to be recognised and therefore, my suggestion to the Commission has been that: (a) the Government may be entrusted with the policymaking relating to FDI, in consultation with the RBI, and the framing of the Rules relating thereto and (b) the RBI may be entrusted with the policymaking relating to all other transactions on the capital account, both inward and outward, in consultation with the Government and the framing of the regulations relating thereto.

Since the management of capital flows, excluding FDI is required to be with the RBI and the foreign exchange reserves management function is with the RBI, it is imperative that the policy on exchange rate management should remain with the RBI.

The handling of the foreign exchange crisis of the pre-liberalisation period (1990s) as also the handling of the exchange rate policy and cycles of ebb and flow of forex inflows has shown that such arrangements have worked well.

18.3. Note of dissent by P.J. Nayak

While the Commission's Report strives to break fresh ground in several directions, and particularly in respect of Consumer Protection and Resolution, there are two approaches adopted with which I disagree, while otherwise being supportive of the Commission's recommendations. As both approaches affect significantly the structure and conclusions of the Report, I believe their importance necessitates this Note of Dissent.

18.3.1. The Finance Ministry as a Financial Sector Regulator

The last 25 years of the evolution of financial sector regulation in India has seen a continual empowerment of regulatory agencies. This began with the transfer of powers for capital markets regulation from the Government to a new regulator, SEBI; led subsequently to the establishment of other regulators for commodities, insurance and pension funds; and has coincided with the increasing empowerment of the two principal regulators, RBI and SEBI, through periodic amendments to Acts of Parliament under which they draw their powers. This directional thrust in the empowerment of regulators established outside of the Government has brought expertise into financial regulation. It is also now generally accepted that when the Government did regulate directly, as it did for the primary capital market through the Controller of Capital Issues, or the secondary capital market through the stock exchange division of the Finance Ministry, the consequences were sometimes unfortunate: new capital issues were continually grossly mis-priced, and malpractices in the functioning of brokerage firms were commonplace.

The Commission now arrests and partly reverses this directional movement, and it is with apprehension that one must view the very substantial statutory powers recommended to be moved from the regulators (primarily RBI) to the Finance Ministry and to a statutory FSDC, the latter being chaired by the Finance Minister. The Commission has recommended that direct statutory powers be vested in the Government in matters of (i) Capital Controls and (ii) Development. The statutory empowerment of the FSDC encompasses (iii) Inter-Regulatory Co-Ordination; (iv) Identification and Monitoring of SIFIs; and (v) Crisis Management.

This transfer of powers collectively constitutes a profound shift in the exercise of regulatory powers away from (primarily) RBI to the Finance Ministry. The Finance Ministry thereby becomes a new dominant regulator. To rearrange the regulatory architecture in this manner, requiring new institution-building while emasculating the existing tradition of regulators working independently of the Government, appears unwise. There is no convincing evidence which confirms that regulatory agencies have under performed on account of their very distance from the Government; indeed, many would argue that this distance is desirable and has helped to bring skills (and a fluctuating level of independence) into financial regulation.

The concept of a statutory FSDC, and the functions sought to be vested in it, are sensible provisions and will provide much needed co-ordination between regulators, as also the ability to steer the financial sector through periods of systemic risk. What is worrisome is that the chairmanship of FSDC is with the Finance Ministry, as this could lead to a government creep into the micro-prudential powers of other regulators. At present, without statutory powers, such a creep is difficult. As an uneasy compromise, the Commission has recommended (in Table 9.3) that an Executive Committee of the board of FSDC be constituted which will be chaired by the regulator for banking and payments [read Governor RBI], with managerial and administrative control, which will refer decisions to the board of FSDC when the Committee is unable to reach a consensus. It is unlikely that this would constitute an adequate buffer against Government creep. A superior way of combining the needs of efficient co-ordination, the management of systemic risk

and regulatory independence, would be to have the Governor RBI (as the senior of the two micro-prudential regulators) chair the FSDC, with Finance Ministry officials also being represented on its board. The Chairmanship of FSDC is therefore critical. In any case, with the Commission proposing just two micro-prudential regulators, co-ordination becomes easier, and the case for the Finance Ministry exercising FSDC leadership weakens.

The Commission's recommendation (Chapter 8.3) of transferring from RBI to the Central Government rule-making powers on capital account transactions for all inward flows has even more alarming implications. Regulations influencing the quantity and structure of India's external liabilities, the management of the balance of payments, and the conduct of monetary policy have a close and intricate synergy. For the Commission to recommend regulatory scatter, wherein capital controls regulation is with the Government, monetary policy is conducted by RBI and the balance of payments is wedged in between the conduct of monetary policy and the impact of capital controls regulation is likely to prove damaging to the conduct of monetary policy and of fluent macroeconomic co-ordination.

The present law under FEMA vests powers of capital account regulation with RBI. It is true that since the economic reforms of 1991, FDI Policy governing inward equity investments has been authored by the Central Government, on the argument that it constitutes an adjunct of Industrial Policy. ECB policy has however evolved through consultation between the Finance Ministry and RBI, and has invariably required the assent of RBI, even where it may have been initiated by the Government. At best this *de facto* position could be formalised as *de jure*, with regulations on inward equity and equity-related investment being authored by the Central Government, and with external debt regulation vested in RBI. To move formal regulatory powers governing external debt policy away from RBI would be damaging to the maintenance of macroeconomic balances.

18.3.2. Principles as the Basis of Financial Sector Law

The Commission strives to choose an imaginative and bold approach in adopting a principles-based approach towards formulating law for the financial sector. It is necessary however to also put this approach to the test of pragmatism in the Indian context, particularly as most financial sector law has hitherto been rules-based.

Rules-based legislation brings greater certainty to financial sector participants in the understanding of whether a financial product or sales behaviour are legal, but this understanding is necessarily contextual. Rules therefore need to be elaborate in order to cover a plurality of situations which could arise in practice and, where there are gaps in these, participants could potentially exploit these to their advantage. Where rules-based law has achieved adequate comprehensiveness, it provides greater certainty to financial sector participants in understanding whether contracts and behaviour are lawful. Principles-based law does not provide such certainty, but by focusing on more generalised principles, covers the gaps by providing meaning to situations not presently contemplated but which could arise in future.

There are two difficulties which a principles-based approach could create. The first, recognised in the Commission's Report, is that participants are more reliant on courts in interpreting the law in a specific context. As the Commission's Report notes (See Chapter 2.2) "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 finance and technology".

Such an approach works well when court processes are speedy and decisions of courts are dispensed quickly. In the Indian context, with an accumulating backlog of cases, the position is more problematic.

A second difficulty arises on account of the specific principles adopted for the legislative law. In the case of micro-prudential regulation, for instance, 11 principles are listed in Table 6.9 and constitute principles of administrative and economic rationality. The resulting law, applicable to the entire financial sector and embodying these 11 principles, is proposed in Section 141 of the draft Indian Financial Code. If the legislative basis of a micro-prudential law for banking (for instance) is to be restricted to these 11 principles, the burden on regulatory law to bring greater specificity in respect of banking increases very substantially. A mammoth superstructure of regulatory law will thus sit atop a slender base of legislative law. Aside from the issue of whether Parliament would be comfortable with this balance between legislative and regulatory law, such a legal structure imposes a high burden on the quality of regulation-writing. As each regulation can be challenged on grounds of being in violation of the principles, uncertainty about regulatory law will persist until the courts have ruled.

This double whammy of uncertainty will be detrimental to financial contracting, including new product design and sales behaviour across the financial sector. Financial sector contracts gain in strength when the interpretation of contracts is understood by general consensus *ex-ante*, before the contract is entered into, rather than *ex-post*, after interpretation by courts. While it may be true that a principles-based system will settle into its own equilibrium over a period of years, the likely travails associated with that until then appear disproportionate to the benefits. A more rules-based approach to the writing of financial sector law would have been preferable.

18.4. Note of dissent by Y.H. Malegam

I regret I am unable to agree with my colleagues on the following proposals in the Report.

18.4.1. Capital Controls

1. The Report recommends (Chapter 8.3) that: *“The rules on capital account transactions for all inward flows will be made by the Central Government in consultation with the regulators. The rules on capital account transactions for all outward flows will be made by the RBI in consultation with the Central Government”*
2. I believe that rules should be made by the Central Government only in respect of FDI inward flows and rules in respect of all other flows, both inward and outward should be made by RBI. My reasons for this belief are as under.
3. The distinction made in the Report between inward and outward flows is not as relevant as a distinction between inward FDI flows and other inward flows. The latter distinction is necessary for the following reasons:
 - ▶ Inward FDI flows result in the acquisition of assets by non-residents in India which can have policy implications e.g., retail, insurance etc.
 - ▶ While inward FDI flows do carry the right of repatriation of capital, in actual fact very little repatriation takes place and in the short-term FDI flows are largely stable.
 - ▶ On the other hand, non-FDI inward flows e.g., portfolio investment, external commercial borrowing, NRI deposits etc. are essentially short-term and volatile in nature.
 - ▶ Even non-FDI inward flows, on repayment result in outward flows.
4. The Report states (See Chapter 8.1) that IMF “recommends that capital controls be implemented only on a temporary basis where other macro-economic policy responses have been exhausted”. While this is true, in a more recent Staff Paper (November 14, 2012) IMF has modified its stand and made the following statements:
 - ▶ “Capital flow liberalisation is generally more beneficial and less risky if countries have reached certain levels of “thresholds” of financial and institutional development”
 - ▶ “Rapid capital inflow surges or disruptive outflows can create policy challenges”
 - ▶ “In certain circumstances, capital flow management measures can be useful”

These comments have to be viewed in the context of India’s persistent current account deficit which is financed largely by net non-FDI inward flows.

5. As the Report mentions (section 11.2) RBI “in order to perform its monetary policy functions and play the role as lender of the last resort needs certain powers “which include the power to” Act as custodian and manager of foreign exchange reserves”. There is strong linkage between capital controls and monetary policy. Capital flows have a natural tendency to affect monetary aggregates by increasing or decreasing the effective money supply and liquidity in the economy. Hence, in the Indian context, capital controls have been actively used as an additional monetary policy tool. To do this effectively, it is necessary that all capital flows, other than FDI inward flows should be monitored and controlled by RBI. Further as the IMF has pointed out, rapid capital inflow surges or disruptive outflows can destabilise the exchange and create volatility. For this reason also, capital controls need to be calibrated by RBI which has the responsibility for exchange rate management.

6. The present arrangement is that while the Central Government determines the policy for FDI, RBI, in consultation with the Central Government makes rules in relation to other capital flows. This arrangement has worked well and even the U.K. Sinha Working Group has not suggested any change to this basic arrangement. For the reasons enumerated above, this basic arrangement must be allowed to continue.

18.4.2. Financial Regulatory Architecture

1. The Report proposes (See Chapter 14.4) that: “the financial regulatory architecture suited for Indian conditions should consist of seven agencies” which will include:
 - ▶ “Agency #1: A central bank that does monetary policy and enforces the consumer protection and micro-prudential provisions of draft Code in the fields of banking and payments”
 - ▶ “Agency #2: UFA which enforces the consumer protection and micro-prudential provisions of the draft Code in all finance other than banking and payments”

The proposal therefore is that RBI will only regulate and supervise banks and payment system and that NBFCs and Housing Finance Companies (HFCs) will be regulated and supervised by UFA.

2. I believe that it is essential that NBFCs and HFCs should be regulated by the same regulator as regulates the banks i.e., RBI. My reasons are as under.
3. NBFCs are currently regulated and supervised by RBI. HFCs are currently regulated and supervised by National Housing Bank (NHB) which is a 100% subsidiary of RBI. Under the National Housing Bank (Amendment) Bill 2012 which is before the Standing Committee on Finance of the Parliament, it is proposed that the ownership of NHB will pass to Government and that regulation will pass to RBI with supervision remaining with NHB. The transfer of regulation is considered necessary since banks also do housing finance activity, the relative portfolio sizes being banks – 64% and HFCs – 36%. There are currently 54 HFCs with a total asset size of Rupees 335,000 crores which represents roughly 4.1% of the total asset size of all scheduled commercial banks.
4. NBFCs are also engaged in substantially the same activity as banks. They are asset finance companies, infrastructure finance companies, micro-finance companies and investment companies. They rely upon bank finance and are significant competitors of banks, particularly in the retail banking sector. Individually and collectively they are significant players in the financial system as shown below:
 - ▶ There are 12,348 NBFCs registered with RBI of which only 265 accept public deposits.
 - ▶ The total assets of NBFCs aggregate to Rupees 1,038,000 crores which represents roughly 12.7% of the total assets of all scheduled commercial banks.
 - ▶ There are 376 systemically important NBFCs with assets which aggregate to Rupees 923,000 crores, representing roughly 11.3% of the total assets of all scheduled commercial banks.
 - ▶ There are 42 NBFCs which have total assets in excess of the smallest scheduled commercial bank and 2 NBFCs which have total assets in excess of the smallest Public Sector bank.
5. As the Report points, (See Chapter 1.5.2) difficulties are created in addressing finance regulation on a holistic basis, when there is the rise of a rapidly growing shadow banking sector. As most knowledgeable commentators have pointed out,

one of the major causes of the 2008 financial crisis was the fact that credit intermediation activities were conducted by non-banks outside the regulatory environment. This has raised serious concerns of regulatory arbitrage, requirements for similar regulation of entities performing similar activities and issues of commonality of risks and synergies of unified regulation.

6. The concern for “shadow banking” has also resulted in a number of international initiatives as under:

- ▶ At the November 2010 Seoul Summit, the G-20 leaders highlighted the fact that Basel III is strengthening the regulation and supervision of shadow banking and requested the Financial Stability Board (FSB) to make recommendations in the matter.
- ▶ FSB identified “shadow banking” as non-banks carrying on bank-like activities such as credit intermediation, maturity transformation and credit facilitation.
- ▶ Even before the crisis IMF has prescribed that similar risks and functions should be supervised similarly to minimise the risk of regulatory arbitrage.
- ▶ In many countries, HFCs are regulated by bank regulators e.g., MAS in Singapore, HKMA in Hong Kong. In the U.S. the Dodd Frank Act provides for regulatory and supervisory oversight of both systemically important banks and non-banks by the Fed.

7. All the above considerations support the view that:

- ▶ NBFCs and HFCs are engaged in activities which can be termed shadow banking.
- ▶ They are of a size individually and collectively which can pose a serious challenge to the efficient regulation of banks.
- ▶ All the considerations mentioned in the Report to support the need for a single unified regulation support a single unified regulation of banks, NBFCs and HFCs.
- ▶ The Commission having decided that there would be two micro-prudential regulators with a separate regulator for banking must recognise that NBFCs and HFCs have greater synergy with banks than with the activities regulated by UFA.
- ▶ Consequently it is imperative that NBFCs and HFCs be regulated and supervised by RBI

Annexes

19.1. Formation of the FSLRC

**GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
RESOLUTION**

No.18/1/2011-RE.

New Delhi, the 24 March, 2011

The Government in its budget 2010-11 had, inter alia, announced the setting up of a Financial Sector Legislative Reforms Commission (FSLRC) with a view to re-writing and cleaning up the financial sector laws to bring them in tune with current requirements. Accordingly, it has been decided to constitute the Financial Sector Legislative Reforms Commission comprising the following:

i)	Chairman	Justice (Retd.) B.N. Srikrishna
ii)	Member	Justice (Retd.) Debi Prasad Pal
iii)	Member	Dr. P.J. Nayak
iv)	Member	Smt. K.J. Udeshi
v)	Member	Shri Yezdi H. Malegam
vi)	Member	Prof Jayanth R. Varma
vii)	Member	Prof. M. Govinda Rao
viii)	Member	Shri C. Achuthan
ix)	Member Convenor	Shri Dharendra Swarup
x)	Member, Nominee	Joint Secretary (Capital Markets)
xi)	Secretary	Shri C.K.G. Nair

2. The Terms of Reference of the Commission will be as follows:

- I. Examining the architecture of the legislative and regulatory system governing the financial sector in India, including:
 - a. Review of existing legislation including the RBI Act, the SEBI Act, the IRDA Act, the PFRDA Act, FCRA, SCRA and FEMA, which govern the financial sector;
 - b. Review of administration of such legislation, including internal structures and external structures (departments and ministries of government), if required;

- c. Review of inter-play of jurisdictions occupied by various regulators;
 - d. Review of jurisdiction of departments within each regulator, and consider need for segregation / combination, and such other streamlining;
 - e. Review of issues relating to conflict of interest of regulators in the market;
 - f. Review of the manner in which subordinate legislation is drafted and implemented;
 - g. Review of eligibility criteria for senior officers in regulatory authorities and issues relating to tenure, continuity, and means of tapping and retaining lessons learnt by each authority;
 - h. Examine a combined appellate oversight over all issues concerning users of financial sector;
- II. Examine if legislation should mandate statement of principles of legislative intent behind every piece of subordinate legislation in order to make the purposive intent of the legislation clear and transparent to users of the law and to courts.
 - III. Examine if public feedback for draft subordinate legislation should be made mandatory, with exception for emergency measures.
 - IV. Examine prescription of parameters for invocation of emergency powers where regulatory action may be taken on an ex parte basis.
 - V. Examine the interplay of exchange controls under FEMA and FDI Policy with other regulatory regimes within the financial sector.
 - VI. Examine the most appropriate means of oversight over regulators and their autonomy from government.
 - VII. Examine the need for re-statement of the law and immediate repeal of any out-dated legislation on the basis of judicial decisions and policy shifts in the last two decades of the financial sector post-liberalisation.
 - VIII. Examination of issues of data privacy and protection of consumer of financial services in the Indian market.
 - IX. Examination of legislation relating to the role of information technology in the delivery of financial services in India, and their effectiveness.
 - X. Examination of all recommendations already made by various expert committees set up by the government and by regulators and to implement measures that can be easily accepted.
 - XI. Examine the role of state governments and legislatures in ensuring a smooth inter-state financial services infrastructure in India.
 - XII. Examination of any other related issues.
3. The Commission will devise its own procedure and may appoint consultants, advisors and experts and outsource research work to institutions of repute and expertise in the relevant area for the purpose for which the Commission has been set up. It may recall for such information and take such evidence as it may consider necessary. Ministries and Departments of the Government of India will furnish such information and documents and other assistance as may be required by the Commission. The Government of India trusts that State Governments and others concerned will extend to the Commission their fullest co-operation and assistance.
 4. The Commission will have its headquarters in Delhi.
 5. The Commission will make its recommendations within 24 months of the date of this Gazette Notification. It may consider, if necessary, sending reports on any of the matters as and when the recommendations are finalised.

Sd/-
(R. Gopalan)

Secretary to the Government of India

19.2. List of consultants, researchers and other officials who assisted the Commission

► Consultants

1. Somasekhar Sundaresan
2. Bobby Parikh
3. Rajshekhar Rao

► Research team

1. Prof. Ajay Shah
2. Prof. Ila Patnaik
3. Prof. Sunder Ram Korivi
4. Amol Kulkarni
5. Ankur Narain Saxena
6. Apoorva Ankur Mishra
7. Bhavna Jaisingh
8. K. Aishwarya
9. Kaushalya Venkataraman
10. Neena Jacob
11. Pratik Datta
12. Radhika Pandey
13. Shubho Roy
14. Smriti Parsheera
15. Sowmya Rao
16. Sumathi Chandrashekar
17. Suyash Rai
18. Aakriti Mathur
19. Aishwarya Kumar
20. Akhil Dua
21. Apoorva Gupta
22. Karan Anand
23. Kumar Anand
24. Parikshit Kabra
25. Shekhar Hari Kumar
26. Shreya Kashyap
27. Vikram Bahure
28. Abhishek Gupta
29. Alex Etra
30. Ambarish Mohanty
31. Chirag Anand
32. Darshika Singh
33. Devika Das
34. Madhavi Pundit
35. Meeta Ganguly

36. Neeraj Singh
37. Sudarshan Bhattacharjee
38. Varsha Agrawal
39. Vimal Balasubramaniam
40. Dr. Poonam Mehra
41. Shobana B
42. Kavitha Ranganathan

► Other officials

1. A.K. Sinha
2. Uday P. Apsingekar
3. Vishvesh Bhagat
4. Dipak Banerjee
5. D.P. Hura
6. Ram Rattan
7. R.S. Tyagi

19.3. List of invitees for interaction with FSLRC

S.No	Name of Official/ Expert / Organisation
1	Mr. R. Gopalan
2	FICCI
3	Dr. C. Rangarajan
4 *	Dr. Montek Singh Ahluwalia
5	Dr. Shankar Acharya
6	Dr. Bimal Jalan
7 *	Confederation of India Industry
8 *	National Council of Applied Economic Research
9 *	Centre for Policy Research
10*	ASSOCHAM
11	PHDCCI
12	Dr. Vijay Kelkar
13	Dr. Percy S. Mistry
14	Dr. Raghuram G. Rajan
15	FSDC Sub-Committee
16	Forward Markets Commission
17	Indian Banks' Association
18	Prof. Viral Acharya
19	Mr. Deepak S. Parekh
20	National Stock Exchange of India Ltd.
21	Multi Commodity Exchange of India Ltd.
22	National Commodity & Derivatives Exchange
23	BSE Limited
24 *	Dr. Y.V. Reddy
25	Mr. Ashok Chawla
26	Mr. Rajiv Agarwal
27	Dr. Avinash Persaud



** Did not participate in the interaction*

External Agencies/Experts called on the Commission

1. City of London
2. Minister for Financial Services, Australia - Mr. Bill Shorten
3. Indo-us Business Council
4. us Federal Reserve Board Governor - Mr. Jerome H. Powell
5. Federal Reserve Bank of San Francisco - Mr. John C. Williams
6. Financial Services Authority, UK - Mr. Hector Sants

19.4. Issues for discussion with experts and stake-holders

General

- ▶ Strengths and limitations of the existing statutory framework of financial sector regulation and development
- ▶ Strengths and limitations of the current regulatory-organisational structures
- ▶ Capability of the Indian institutional architecture to address issues emerging from financial sector developments globally
- ▶ Adequacy of the consumer protection and investor grievances mechanisms embedded in the current framework
- ▶ Relevance of regulatory-architectural changes in advanced jurisdictions post-global crisis to India
- ▶ Mechanism for removing/reducing conflicts of interests in the current financial structure
- ▶ Any other suggestions

Additional questions/issues on the basis of domain expertise of the invitee

- ▶ Can regulation reduce the growing disenchantment with financial market adventures?
- ▶ Specific issues relating to the banking sector.
- ▶ Is a principle based approach (PBA) still a way forward? If so, is it possible to implement a PBA with limited regulatory capabilities? How to negotiate the transition phase in case of adopting a new institutional architecture?
- ▶ How does and how far the Competition Act address issues relating to customer grievances at the micro level? What are the institutional linkages available in the current customer/investor grievance redressal mechanism (including Consumer Protection Act) in promoting micro level customer satisfaction?
- ▶ What is the extent of institutionalised interface between the Competition Commission and the sectoral regulators? What mechanisms are in place or proposed to enhance the co-operation mechanism?
- ▶ How to balance the provisions in the Competition Act in respect of mergers vis a vis financial sector regulatory decisions based on expedient financial stability reasons?
- ▶ What is the experience with respect to implementation of Consumer Protection Act in achieving customer satisfaction? How far is it successful in resolving customer / investor grievances arising from the financial sector?
- ▶ What are the constraints for developing a national common market for commodities and spreading commodity derivatives throughout the country?
- ▶ How do you visualise the linkages between commodity derivatives market and other financial sector markets? Can they function independently in a completely integrated, globalised financial framework?

19.5. Interactions with authorities overseas

Australia

Treasury	- Mr. Bill Shorten, Minister Mr. Mike Callaghan, Executive Director Mr. Rob Nicholl, CEO, Debt Management Office
Australian Prudential Regulatory Authority (APRA)	- Dr. John Laker, Chairman Dr. Jeff Carmichael, Wallis Inquiry Member and In- augural Chairman of APRA
Financial Sector Advisory Council (FSAC)	- Mr. Paul Binsted, Chairman
Reserve Bank of Australia (RBA)	- Mr. Glenn Stevens, Governor
ASIC	- Mr. Greg Medcraft, Chairman

Singapore

Monetary Authority of Singapore	- Mr. Ravi Menon, Managing Director and senior management team
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United Kingdom

The Treasury	- Mr. Mark Hoban, Financial Secretary
Financial Services Authority (FSA)	- Mr. Hector Sants, CEO Mr. Lyndon Nelson, Director
Prudential Regulatory Authority (PRA) Transition Team	- Ms. Sarah Breeden, & Mr. Gregory Stevens
Financial Markets Law Committee (FMLC)	- Lord Hoffman, Chairman
British Bankers' Association (BBA)	- Ms. Sally Scutt, Deputy CEO
Prof. Charles Goodhart	- LSE Prof. and Director of Financial Regulation Re- search Programme
Financial Sector Practitioners' Panel	- Chairman Russell Collins
UK Debt Management Office	- Mr. Robert Stheeman, CEO and Mr. James Knight
International Centre for Financial Regulation	- Ms. Barbara Ridpath, CEO
City of London Roundtable	- Stuart Fraser, Mark Boleat and Representatives from financial markets

Canada

Department of Finance	- Mr. Jeremy Rudin, Assistant Deputy Minister
Financial Consumer Agency of Canada (FCAC)	- Mr. Ursula Menke, Commissioner Ms. Lucie Tedesco, Deputy Commissioner
Canada Deposit Insurance Corporation (CDIC)	- Ms. Michele Bourque, President
Bank of Canada	- Mr. Tiff Macklem, Sr. Dy. Governor Mr. Timothy Lane, Dy. Governor
Office of the Superintendent of Financial Institutions (OSFI)	- Mr. Mark Zelmer, Asstt. Supdt. Ms. Patty Evanoff, Senior Director
Ontario Securities Commission (OSC)	- Prof. Mary Condon, Vice-Chair

19.6. Working Group on insurance, retirement financing, and small savings

19.6.1. Composition

Composition:

Shri Dhirendra Swarup	- Chairman
Shri C.S. Rao	- Senior Adviser
Shri Tarun Bajaj	- Member
Ms. Anuradha Prasad	- Member
Shri Rajendra Chitale	- Special Invitee

19.6.2. Terms of Reference:

1. Insurance

- (a) Review the consumer protection aspects of insurance and recommend principles for legal framework for the same. Some specific issues to be examined in this regard are:
 - i. Review distribution models and sales practices in the insurance industry.
 - ii. Review the present grievance redressal mechanisms.
 - iii. Review the manner in which special aspects of insurance contracts, such as, dealing with misstatements, insurance fraud, assignment of policy and appointment of nominees, should be addressed.
 - iv. Review the competition laws suitable for the insurance sector.
 - v. Review general market conduct laws suitable for the insurance sector.
- (b) Examine the role of the regulator in pursuing the goal of 'development' and the manner in which the development of products in various areas, including, rural and social sector, micro insurance, agriculture insurance, health insurance, should be specified in laws and regulations.

- (c) Examine whether information should be treated as a public good that can be shared through appropriate data warehousing and data mining infrastructure, subject to customer privacy and confidentiality requirements.
- (d) Identify the prudential regulation and supervision aspects of insurance regulation and recommend a model legal framework for the same. This may include:
 - i. review of the ownership and capital structure of insurance companies.
 - ii. review of the laws governing investment norms for insurance companies - examining how the regulators can be empowered to adjust the regulatory framework with time.
 - iii. review of the prudent man principle approach versus prescription of investment guidelines.
- (e) Review the legal framework relating to re-insurance and examine the changes that might be required to promote more robust participation in the sector.
- (f) Review the systemic risks that can arise from the failure of insurance firms, and the legal framework for dealing with such risks.
- (g) Examine the appropriate resolution mechanisms that need to be adopted to deal with the failure of any insurance firm, keeping in view the interests of policyholders and financial stability. Also review whether this process should differ in any manner for life and non life insurance firms.
- (h) Review the design and implementation of the Employees' State Insurance Act, 1948 and examine the possibility of allowing employers covered by that legislation to opt for group medical insurance offered by the private insurance industry.
- (i) Review the regulation and structure of State owned insurers, in particular the special status of Life Insurance Corporation.
- (j) Examine the manner in which life insurance policies offered by the Department of Posts can be brought within the regulatory ambit in order to ensure the protection of consumers and provide a level playing field.
- (k) Review the role of self regulatory organisation and industry associations in the insurance sector and examine whether there is a need for a re-assessment of their functions.
- (l) Review the insurance related provisions contained in the Motor Vehicles Act, 1988 and identify any changes required to be made to the existing legal regime.
- (m) Examine the mechanisms that need to be put in place for resolution of disputes between market players-insurers and intermediaries
- (n) In this context, review which powers should be given to regulators under law, how should the powers be used, how should the supervisory function be structured, and what punitive actions can be taken.

2. Pensions

- (a) The present retirement income framework in India consists of many components, such as, EPFO, New Pension System (NPS), Public Provident Fund (PPF), provident fund trusts and superannuation trusts, and is regulated in a very fragment manner. Examine the manner in which these components can be brought within the regulatory ambit of financial sector laws and the means for achieving coherence among the different components of the system?
- (b) Identify the consumer protection, prudential regulation and systemic risk aspects of pension regulation, which includes NPS, EPFO, provident fund trusts and superannuation trusts.

- (c) Review the 'development' role of PFRDA and examine whether a developmental mandate is essential for ensuring widespread participation in voluntary NPS?
- (d) Review of NPS and examine if there are any changes required to its present features to promote the interests of consumers. This would include, reviewing the mandatory annuity requirement prescribed under NPS and examining the feasibility and desirability of providing minimum guaranteed returns to subscribers.
- (e) Review the laws governing investment norms for NPS, EPFO, provident fund trusts and superannuation trusts, and recommend a model legal framework that gives the requisite powers to the regulators.
- (f) Review the existing administered interest rate mechanism followed by EPFO and examine the problems that might arise on account of unfunded liabilities under the Employees Pension Scheme.
- (g) In this context, review which powers should be given to regulators under law, how should the powers be used, how should the supervisory function be structured, and what punitive actions can be taken.

3. Small Savings

- (a) Review the existing legal framework governing small savings schemes and identify any changes required to be made to it.
- (b) At present the Government acts as both the operator of small savings schemes as well as its regulator. Examine the issues that might arise on this account and whether there is a case for bringing these schemes under the same regulatory framework as the larger financial system.
- (c) Examine the legal framework required for the regulation of small savings distribution agents, including post offices and banks and review their incentive structures.
- (d) Review whether the financial activities of the Department of Posts may be brought within the regulatory ambit - can narrow banking, corporatisation be considered as options?
- (e) Examine the possibility of separating the investment function from the savings mobilisation function of small savings schemes and the potential implications of the same.
- (f) Identify the consumer protection and prudential regulation aspects of small savings schemes. The consumer protection aspects would include reviewing the need for preventive measures to deal with issues of excessive churning as well as the need for an appropriate grievance redressal mechanism. Issues to be considered in connection with the prudential regulation of National Small Savings Fund would include, capital requirements, liquidity regulations and norms on governance and internal controls.
- (g) In this context, review which powers should be given to regulators under law, how should the powers be used, how should the supervisory function be structured, and what punitive actions can be taken.

19.6.3. Recommendations on insurance

Development goals

1. The development of insurance markets should not be a regulatory objective. Market forces should ordinarily be able to achieve an adequate level of development in the sector. Towards this end, the law should specify that the need for pursuing competitive neutrality and fair competition should be basic principles to be followed by the regulator.

2. General development of markets has to be distinguished from specific measures that need to be taken to achieve the financial inclusion agenda. The mechanisms for achieving financial inclusion in the field of insurance should be aligned with the decisions that the Commission may take for promoting inclusion in the banking sector.

Prudential regulation

3. Capital regulation
 - (a) The capital resources maintained by insurance companies should be commensurate with the specific risks arising from their business activities. To achieve this, the primary law should provide that the prescribed capital requirements should be determined in a risk-based manner. Subject to this principle, the regulator will frame subordinate legislations to lay down the actual capital requirements and the process for computation of capital.
 - (b) The regulator should also be permitted to prescribe the minimum capital requirement for the setting up of an insurance company, instead of having the rupees 100 crores requirement laid down in the primary law. This will allow the entry conditions to be revised from time to time without requiring an amendment to the law.
4. The law should provide that insurance companies are permitted to hold different classes of capital. The classification of capital into different tiers will be done by the regulator through subordinate legislation. The regulator will also be empowered to restrict the extent to which insurers may rely on different tiers of capital for satisfying their capital requirements.
5. Insurance law should not specify foreign investment limits for investments in the sector. As in all other sectors, this power should be with the Central Government. In making its determination, the government may consider adopting different FDI limits for different types of insurance activities. In particular, a higher limit may be considered for the health insurance sector to promote more robust growth in the sector.
6. High-level principles relating to sound governance and management of insurance firms need to be enshrined in the law. The law should also mandate self-assessment of solvency and risk profile by insurers. The regulator should then use its supervisory powers to assess the adequacy and effectiveness of the measures adopted by the insurance company.
7. The law should specify that investments are to be made as per the prudent person principle and quantitative investment requirements and restrictions should be removed from the primary law. To the extent necessary, the regulator should be empowered to specify appropriate investment norms through subordinate legislation. This power would be subject to certain restrictions to be specified under the law. Specifically, the regulator will not be able to prescribe the composition of the investment portfolio or the minimum levels of investment for any given category of investment.
8. The law should not prohibit insurance companies from investing overseas. Insurers may choose to globally diversify their portfolio in accordance with the prudent person principle and risk-based capital requirements. The regulator may, however, choose to set out reasonable limits on the currency mismatch risks that may be held by an insurer.

Consumer Protection

9. The law should set out the principles of consumer protection to be observed by the insurance service providers and the framework within which these principles may be implemented by the regulator.

10. All individuals, who may be individual agents or employees of corporate agents, brokers, advisers, banks and insurance companies, who are involved in the sale of insurance services to consumers must be registered with the regulator. This registration process will be based on certain objective criteria, such as minimum qualifications, training and certification requirements, which will be prescribed by the regulator. The responsibility of verifying the individual's compliance with the specified requirements should be left to the insurance company, in respect of its employees and agents. In case of independent advisors and brokers, who are not aligned with any particular insurer, the relevant service provider would be responsible for the registration of its employees.
11. No minimum or maximum cap on commission or fee should be mentioned in the primary legislation. The law should allow the regulator to prescribe incentive structures for the sale of insurance services, keeping in view consumer interests.
12. In case a policy lapses due to the non payment of premium, there should be an obligation placed on the insurer to issue a notice to the policyholder. However, these details need not be specified in the primary law. The primary law should only provide that the regulator may frame specific regulations for dealing with the lapsation on insurance policies, with a view to protecting policyholders.
13. The scope of the present insurance ombudsman system needs to be expanded to allow complaints against insurance intermediaries, other than agents of the insurance company for whom the insurer will be directly liable. The ombudsman awards should be made enforceable against the complainant as well as the service provider, subject to the right to appeal before a specialised appellate forum.
14. The law should specify the duty of parties to an insurance contract to act in good faith. It should also set out the meaning and consequences of insurance fraud.
15. The collection and sharing of insurance information can help insurers make better pricing and underwriting decisions. It can also help insurers combat instances of insurance fraud. The law should enable the sharing of insurance information while specifically providing the data protection and confidentiality requirements applicable to any person, including the regulator, that holds information belonging to others.
16. The primary legislation must empower the regulator to act in a manner that promotes better access to micro insurance. This should be done by stating that 'promoting innovation and access to insurance services' is one of the key principles to be followed by the regulator.
17. There is a need for reforms in the health care sector to provide for the codification of ailments, procedures and protocols followed by health providers. This will help in promoting better underwriting by insurance companies by reducing the moral hazard problems in the supply of health care services to insured persons.
18. Motor insurance:
 - (a) In order to minimise inconvenience and costs, the law should provide the accident victim, insurer and insured an opportunity to arrive at a voluntary settlement of the claim without having to go through the adjudication process. If the parties fail to arrive at a settlement, the compensation should be decided on a fast track basis by a specialised tribunal.
 - (b) The law should lay down the minimum amount of insurance coverage that must be obtained by every vehicle owner. This will ensure that accident victims are assured of receiving compensation of up to the insured amount. It will also provide insurers with more certainty on their potential liabilities. In order to achieve this, the regulator will have to discontinue the practice of fixing the premium for third party motor insurance policies.

19. Role of surveyors:
 - (a) The Indian Institute of Insurance Surveyors and Loss Assessors should be given statutory recognition as a professional body responsible for the licensing and supervision of surveyors and loss assessors.
 - (b) In order to protect the interests of consumers, the legal framework should allow them to appoint a surveyor in addition to the surveyor required to be appointed by the insurer. The insurer will be required to consider both reports before making a decision on the claim.
20. The law should empower the regulator to specify the types of permitted and restricted assignments of insurance policies. The insurer will not have the discretion to refuse to record an assignment that is made in accordance with the regulations.

Competition issues

21. The legal framework governing LIC should be at par with the laws applicable to all other life insurance companies. In particular, there should be no sovereign guarantee for the policies of LIC. The status of LIC should be changed from a statutory corporation to a Government company governed under standard company law provisions.
22. There is a need for encouraging competition in the reinsurance sector by adopting the following measures:
 - (a) do away with the mandatory requirement placed upon general insurance companies to reinsure a portion of their business with General Insurance Council (GIC);
 - (b) remove barriers which prevent Indian insurance companies from doing business with global reinsurers, subject only to prudential regulation requirements; and
 - (c) create an enabling framework for the entry of global reinsurance firms, including Lloyds, in the Indian reinsurance sector.
23. Competition policy should play an effective role in ensuring that government schemes do not create an uneven playing field between state-owned and private insurance companies.

Resolution and systemic relevance

24. The law should contain appropriate resolution mechanisms to deal with failing insurance firms, including provisions for enhanced supervision and the option of transferring the business of the failing insurer to a solvent insurer. These mechanisms should be applicable to both life and non-life insurers.
25. There is a need to create a compensation scheme to protect policyholders from the inability of an insurer to meet its financial obligations and to minimise the taxpayer's exposure to the failure of insurance firms. The design of the policyholder compensation scheme should be decided under the resolution framework being designed by the Commission.
26. It should be the regulator's responsibility to assess the systemic importance of individual insurance firms. Additional supervisory and resolution tools will need to be employed in respect of those insurance companies that are found to be systemically important.

Unregulated areas of insurance

27. Establishments covered by ESIC should have the option to opt out of the medical benefit facilities provided under the scheme and obtain group health insurance coverage offered by an insurance company, if they are able to obtain similar benefits at a similar cost. In such cases, a proportionate amount of the total contribution payable to ESIC that relates to the medical benefits provided under the scheme will be used as the premium for obtaining the insurance policy.

28. Being a social security scheme administered by the government, ESIC should not be subjected to the entire gamut of insurance laws and regulations. However, the law should allow the insurance regulator to identify certain specific principles, such as those relating to corporate governance, investment management and consumer protection, that would have to be complied with by ESIC.
29. In case of government-sponsored schemes that are administered through insurance companies, the general provisions of insurance laws would be applicable. However, the law should allow the regulator to vary the applicability of certain provisions of law, particularly in respect of the pre-sale obligations of insurers.
30. In case of schemes where the insurance coverage is contemplated to be provided directly by the government and the scheme is not funded through a complete or substantial fiscal transfer, the law will identify certain specific provisions, such as those relating to corporate governance, investment management and consumer protection, that would have to be complied with by the government body implementing the scheme. In order for these provisions to be effectively implemented, the law should mandate that any insurance business carried out by the government, which is eligible for limited regulation under insurance law, should be carried out through a separate corporate entity.
31. Life insurance schemes operated by the Department of Post (DOP) should be corporatised and brought within the purview of the insurance regulator to ensure effective prudential management, protect the interests of policyholders and create a level playing field.

19.6.4. Recommendations on retirement financing

Scope of retirement financing regulation

1. There should be common regulation and supervision for all retirement financing schemes, including various types of pension and provident fund schemes, but not including the unfunded, tax-financed schemes (such as Old Age Pension Schemes), or those that are largely tax-financed. This would mean that the mandates that are presently divided between PFRDA and EPFO must be brought under one regulatory agency.
2. EPFO should only manage and not regulate retirement financing schemes. EPFO itself should be regulated in the same manner like any other retirement financing entity, and the entire range of regulations should apply to it. Similar approach should be taken towards PPF.
3. Smaller exempt and excluded funds should integrate with Employees' Provident Fund (EPF) or NPS. The tax treatment should continue if the fund chooses to integrate with either of the two. The law should not make reference to the possibility of exemption or exclusion, and it should mandate all existing funds that fall under these categories to opt for either NPS or EPFO.
4. The primary objective of retirement financing regulation should be to correct market failures in the retirement financing sector. Development of the sector or inclusion should not be mandates given to the regulator, though the regulator should have the flexibility to customise the regulation according to the profile of the consumers and the kind of the product being offered, based on cost-benefit analysis of the regulation.

Prudential regulation

5. Prudential regulation and supervision of retirement financing should be largely risk-based. Regulator should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated.

6. The law must provide for licensing of retirement finance entities and retirement finance funds, but there should be no licensing of individual plans. The regulator may prescribe conditions to be fulfilled by each plan to be launched by the licensed fund. In addition to the entity's licensing, each of the trustees of the entity should be registered with the regulator.
7. The law should define principles-based criteria for awarding licenses to retirement financing entities and funds. Licensing should be on the basis of demonstration by the trustees/promoters that they have the required legal, managerial and ownership structures, capability (human, technology and financial), risk management systems, investment policy, financial strength and capital to manage the entity and/or the fund. The process of awarding the licenses should be transparent, and the applicants should be given a detailed response in a reasonable amount of time. The regulator should also have the power to modify or withdraw the licenses after due process, and such decisions should be appealable in a court of law.
8. The law should provide that the "prudent person standard" be followed for investment management by those managing the retirement financing funds, such as pension funds, EPFO, etc. The regulators should also have the powers to impose some broad portfolio restrictions to prevent excessive risk-taking by the funds. These restrictions should be imposed only as exceptions, and must not take the form of the regulators prescribing investment management strategies for the funds.
9. All retirement financing funds must be required to set forth and actively pursue an overall "investment policy". The law should empower the regulator to define the minimum requirements for the policy.
10. The law should empower the regulator to set standards for valuation of retirement financing assets in a transparent manner, informed by prevailing standards in other parts of the domestic financial system or in other jurisdictions. The regulator may, if it so chooses, delegate the task of setting standards to a standard setting body, but the regulator would continue to be responsible for the standards.
11. For defined contribution schemes with administered interest rates, such as EPF and PPF, the regulators should have the power to regulate and supervise them for sound investment management practices.
12. The law must empower the regulator to regulate and supervise the risk management systems of retirement finance entities and funds, to ensure the adequacy of risk management systems in place. These powers must cover all the key elements of risk management systems, and must always be used in a risk-based manner. The regulations must be principles-based, should focus on supervision rather than ex-ante rules, and the regulator should not impose any one risk management model on the entities and funds. For small funds with poor in-house capability, the regulator may mandate seeking external support in developing sound risk management practices.
13. The regulators must be given the power to impose risk-based capital and liquidity requirements on retirement finance funds.
14. The law should give the regulator the power to regulate and supervise all the key elements of corporate governance of retirement finance entities and funds, in a risk-based manner.

Consumer Protection

15. The law should provide protection to consumers from being misled or deceived, subjected to unfair terms of contract, or unduly penalised by the fund. Consumers should have access to a reasonable mechanism of grievance redressal. Consumers should also be given the right to get support to take the right decisions, and receive reasonable quality of service.

16. Consumer protection regulation must be proportional to the risk held by the consumer, and the extent to which the consumer is responsible for taking decisions about the plan on issues such as investment.
17. All individuals dealing with retirement financing must be registered with the regulator, who must stipulate significant training requirements on the individuals involved in the process of helping the consumers decide about retirement financing.
18. The structure of various types of charges on retirement financing schemes should be regulated by the regulator.
19. The regulator must be given the powers to ensure inter-operability, portability and exit options in retirement financing plans.
20. The regulator must have the power to mandate suitability analysis and advice to be given by the provider to the consumer regarding the asset allocation decision. The regulator must also have the power to recommend modifications to schemes and processes to ensure that consumers are given suitable solutions.

Failure of retirement finance funds

21. The law should provide for an efficient resolution mechanism for funds offering defined benefit retirement financing plans. This should be modelled on the resolution process for banking and insurance, but with more time for the funds to improve their financial position. There should be an agency responsible for the resolution function.
22. There should be a process to move the consumers' funds from one defined contribution fund to another smoothly, if the retirement finance entity sponsoring the defined contribution fund goes bankrupt.
23. The agency responsible for resolution should have access to comprehensive information about retirement finance entities and funds. The agency should have access to auditors' reports and the powers to ask for information on any fund and conduct on-site investigation of a fund.
24. The resolution process should start with a quantitative trigger.
25. The resolution process should start with giving the fund a notice to improve its financial position. If the fund fails to do so, the process should focus on transfer of the assets to another fund, or under the management of another fund. Liquidation of fund should be the last option in the resolution process. When resolution process starts, the fund should be prevented from collecting contributions
26. Establishing a retirement finance protection fund, which would guarantee payouts from all defined benefit schemes, may be considered. The fund could also provide some guarantees to defined contribution schemes, to help them hedge certain investment risks.
27. If the retirement finance protection fund is established, it should charge risk-based levy from the participating funds; participation should be mandatory for funds offering defined benefit plans; and the fund could be managed by the agency that is responsible for resolution of failing funds.

Special topics

28. Only insurance companies that have proven capability in offering life insurance should be allowed to do the business of issuing annuities.
29. Compared to pension funds, for insurance firms issuing annuities, there should be greater flexibility given to the regulator in law to stipulate restrictions on investment choices. This should be in line with the regulations of life insurance companies.
30. The regulators should work to ensure that consumers take the optimal annuitisation decision, by mandating partial annuitisation and providing active support to consumers to take the right decision.

31. Resolution of insurance firms issuing annuities should be considered along the lines of resolution of any life insurance firm. This issue has been discussed in detail in this report's chapter on insurance firms.
32. Just as in the PFRDA Bill, NPS should be acknowledged as a unique object in the law, and its various components should be regulated at par with their respective categories.
33. The law should acknowledge the unique status of NPS as a government intervention to address market failures in the retirement financing market, and the market power is commands to meet its objectives. If NPS exerts anti-competitive pressures over and above its basic objectives, it should be regulated from a competition standpoint. NPS should be separated from the retirement financing regulator, because there is conflict of interest in managing such a system and regulating the retirement financing sector. This can be achieved by making the NPS Trust an independent entity. The retirement financing regulator should regulate and supervise the NPS Trust.
34. The law should give the regulator the powers to regulate infrastructure for retirement financing sector. Sections from PFRDA Bill on regulation of infrastructure for retirement financing can be considered for drafting these provisions in legislation. These sections provide for regulation and supervision of infrastructure services such as record keeping.

19.6.5. Recommendations on small savings

Legal framework

1. There is a need to consolidate and modernise the laws on small savings. Accordingly, the GSB Act, GSC Act and PPF Act should be replaced with a consolidated law that should, inter alia, contain provisions relating to manner of collection and investment of funds, consumer protection, grievance redressal and, to the extent relevant, prudential regulation.

Structure and regulatory framework

2. All functions related to the operation and management of small savings should be performed by an independent entity that should be brought within the limited purview of the financial regulator. However, prudential regulation of the proposed small savings entity should not extend to changing the manner in which the funds held by National Small Savings Fund (NSSF) are invested since that constitutes a fiscal decision.
3. To address concerns that corporatisation of the scheme would lead to loss of public confidence, it should be ensured that upon the transfer of the management of small savings to an independent entity, the law effecting such transfer should explicitly clarify that these schemes are guaranteed by the government.

Consumer protection

4. Requisite changes may be made in the laws governing small savings to include provisions on investor protection, compensation and grievance redressal.
5. To minimise operational risks on account of agent defaults and to protect the interests of investors, the law should lay down the framework for the licensing, qualifications and training of agents.

19.6.6. List of Acts to be reviewed

1. Insurance Act, 1938
2. Insurance Regulatory Development Authority Act, 1999

3. Insurance Laws Amendment Bill, 2008
4. Life Insurance Corporation Act, 1956
5. Life Insurance Corporation (Amendment) Bill, 2009
6. General Insurance Business (Nationalisation) Act, 1972
7. Marine Insurance Act, 1963
8. Motor Vehicles Act, 1988
9. The Actuaries Act, 2006
10. Employees' State Insurance Act, 1948
11. Companies Act, 1956 (to a limited extent)
12. Indian Contract Act, 1872 (to a limited extent)
13. The Pension Fund Regulatory and Development Authority Bill, 2011
14. Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (Employees' Provident Fund Scheme, 1952, Employees' Pension Scheme, 1995, Employees' Deposit-Linked Insurance Scheme, 1976)
15. Income Tax Act, 1961 (to the extent relevant for recognised provident and superannuation funds)
16. Public Provident Fund Act, 1968
17. Government Savings Bank Act, 1873
18. Government Savings Certificates Act, 1959

19.7. Working Group on payments

19.7.1. Composition

Dr. P.J. Nayak	- Chairman
Shri Ranjit Tinaikar	- Member
Shri Uttam Nayak	- Member
Shri Bharat Poddar	- Member
Shri A.P. Singh	- Member
Shri Abhishek Sinha	- Member

19.7.2. Terms of reference

1. To identify what are the systemic risks to the financial system and to the real economy from payment systems. Payment systems can be systemically important, partly because shocks can originate within them, resulting in operational risks, but also because they can act as channels for propagating shocks originating outside their operations, through credit and liquidity markets. An understanding of the potential systemic credit, liquidity and operational risks in payment systems is thus required, so that criteria for identifying systemically important payment participants and systemically important payments systems can be formulated. Finally, to assess whether there are risks to financial stability arising from encouraging competition and innovation in payments.
2. To evaluate whether the regulatory system should cover all payment systems without exception, or instead merely those which are systemically important. Alternatively, to examine whether there should be a separate regulator for retail and small-value payment systems as compared to systemically important payment systems.

3. As shocks can spread through payment systems to other participants and lead to their bankruptcy, to examine the design of a uniform and quick process for handling payment-induced bankruptcy.
4. To review whether independent payment systems should be encouraged, not linked to payment participants, thereby minimising moral hazard through conflicts of interest, and encouraging technology infusion at a faster pace. This would in turn require a review of whether payments should be viewed as an offshoot of banking, or as a distinct industry in its own right. It would also require assessing whether "banks being special" militates against having independent payment systems. To assess whether existing legislation is adequately supportive of the absorption of fast-changing payments technologies.
5. To review whether RBI should remain the regulator of payment systems or whether instead a regulator independent of RBI should be set up. This involves identifying whether there are conflicts of interest and moral hazard, as also whether adequate domain knowledge gets continually upgraded, in the present regulatory structure.
6. To ensure compatibility with the recommendations of the FATF.
7. To suggest regulation to promote transparency, security, efficiency and certainty of payments; and to ensure that regulation is agnostic to ownership structures of the regulated, necessitating treating regulated entities in the public and private sectors on par. To also suggest constructive and creative ways of enforcement of regulations.
8. To develop a quick and clear appeals process when there is conflict, equally fair to both disputants, especially when one of them is the regulator. To frame dynamic laws for penalties and review the stringency of current laws.
9. To promote financial inclusion following the ideals proposed in various reports such as the 'Report of the Inter-Ministerial Group: Framework for delivery of Basic Financial Services Using Mobile Phones'; 'From Exclusion to Inclusion with Micro-payments'; and Unique Identification Authority of India (UIDAI).
10. Any other matter the Working Group may consider relevant.

19.7.3. Recommendations

1. The Payments Regulator should permit self-registration of payment system providers, including through online modalities.
2. The Payments Regulator should permit existing non-payment businesses to extend their business models to cover payments, in order that customer coverage could thereby expand.
3. Empower the payments regulator to ensure that access to infrastructure services is open and free of restrictive practices.
4. In order to foster financial inclusion within payments, the Payments Regulator should encourage the concept that certain categories of small-value payments could dispense with Know Your Customer (KYC) requirements for the entity making payments. Further, the categories of such payments should be clearly identified.
5. The Payments Regulator should permit, and indeed encourage, electronic KYC authentication as a full substitute for paper-based KYC authentication.
6. Regulation must maintain a level playing field within the payments industry between the public sector and the private sector, and between bank and non-bank players. It would need to be neutral to the ownership and category structures of the regulated entity, in the absence of which innovation within the payments industry is liable to be stifled.

7. Regulation should encourage independent payment system providers, which are not linked to payment participants, thereby minimising moral hazard through conflict of interest.
8. Encourage innovation in payments regulation and supervision, by recognising that this is a fast-changing technology-enabled business. Bring in relevant expertise into the regulatory body in order to improve the regulation and supervision of this industry. Restrict representation from within RBI on the Board for Regulation and Supervision of Payment and Settlement Systems to the Governor (as Chairman) and the Deputy Governor in charge of Payments.
9. The Payments Regulator would need actively to sponsor the constitution of a Payments Council, a body which would be representative of payment system providers and users of payment systems. Regulations would be issued by the Payments Regulator which would define the role which the Council would play in advising the payments regulator on industry standards and other related matters. It would be mandatory for the payments regulator to consult with the Payments Council on such matters.
10. All payment system providers should be governed by one consistent legislative framework.
11. A system of 'proportionate regulation' would be helpful, allowing nascent businesses to adapt technology solutions without undue regulatory intervention, while requiring systemically important businesses to submit to stronger regulatory oversight.
12. It is important to infuse a transparent and fair rule of law into regulatory decisions. Legislation needs to provide for a quick appeals process, equally fair to both disputants, especially when one of them is the regulator. Further, all appellate powers presently vested in RBI and the Finance Ministry should be transferred to the appellate body.
13. All regulations made by RBI on payments would need to be consistent with the principles listed above as contained in Recommendations 1-12 above, which would be incorporated into a new enactment on payments. Regulations could thereby be challenged in the appellate body on grounds of violating the new legislative law.
14. Strong legal protection for payment system participants and other customers of payment systems would need to be incorporated in the new legislation. The constitution of a separate Customer Protection Agency to ensure this, backed by laws that require the enforcement of contracts by payment system providers, would facilitate this. Customer protection would no longer be the prime responsibility of RBI as the payments regulator.
15. Introduce a uniform and quick process for handling bankruptcy within the payments sector, with revenue payables of a payment system provider having priority in the context of bankruptcy.

19.8. Working Group on securities

19.8.1. Composition

Prof. Jayanth R. Varma	- Chairman
Shri Ravi Narain	- Member
Shri Madhu Kannan	- Member
Shri Neeraj Gambhir	- Member
Shri Jayesh Mehta	- Member
Shri S.A. Narayan	- Member
Prof. K.G. Sahadevan	- Member

19.8.2. Terms of Reference

The WG on securities will work on all dimensions of organised financial trading. The terms of reference shall be as follows:

1. Review the existing legal framework including SC(R)A, SEBI Act, depositories legislation, RBI Amendment Act of 2006, FC(R)A, etc.
2. Review expert committee recommendations, and identify the legal changes which would implement existing recommendations.
3. Unification and harmonisation of the legal and regulatory treatment of all underlying and all traded products. How would we treat OTC and exchange-traded derivatives in a unified framework? How should the word 'security' be defined, in a way that accommodates all dimensions of organised financial trading, and supports future innovations?

What should be done about commodity spot trading when delivery is done through dematerialised warehouse receipts? This may require examining the Warehouse Development and Regulation Act.

4. Should clearing corporations / clearinghouses be treated as a part of micro-prudential regulation or systemic stability? Are they systemically important components of the payments system?
5. What are the unique features of consumer protection in securities markets?
6. What are the unique features of micro-prudential regulation and systemic stability for securities markets?
7. What does financial law have to do, other than the main paths of consumer protection, micro-prudential regulation and systemic risk? What 'Aspects of Financial Contracts' require legislative attention, over and above these three pillars?

How do we obtain:

- (a) Enforceability of derivative contracts in view of their similarity to wagering contracts
- (b) Enforceability of netting, cross margining and closeout of positions by the clearing corporation especially in the event of bankruptcy of market participants.
- (c) Bankruptcy remoteness of collateral in derivative margining and other contexts
- (d) Securitisation especially of future cash flows
- (e) Inter-linkage of CCPs with the payment system and their ability to settle in central bank money
- (f) Legal protection of exchanges and clearing corporations in respect of actions taken by them after a participant default
- (g) Resolution of clearing corporations and other systemically important securities market intermediaries
8. To review the legal framework through which the regulatory agency would write subordinate legislation on issues of ownership, governance, and compensation policy for critical infrastructure providers.
9. How should the issues of insider trading and fraud be dealt with, in a general way, which applies to all securities?
10. The field of corporate governance is a complex interplay of company law and securities law. What, if anything, should securities law be doing?
11. In the field of fund management, to review the structures used by mutual funds, private equity funds, etc., and examine the need for fundamentally different approaches.

19.8.3. Recommendations

1. The legal framework for securities must recognise the public good nature of financial markets and establish the principles of market integrity and transparency as key regulatory objectives
2. The definition of securities should be entity neutral and should be broad enough to cover new instruments that emerge from the process of financial innovation. It must include a wide range of unlisted tradable instruments for the purpose of market abuse regulations, but must have broad exemptions for the purpose of registration requirements as explained in Recommendations 6 and 8.
3. The registration requirement must be entity neutral and should not therefore be restricted to companies.
4. There is a need to prevent redistribution of shares by the original recipient of shares. Otherwise, indirectly an offer may be made to a large number of persons.
5. There is need for an aggregation requirement whereby offers of the same class of securities by the same issuer over a period of say twelve months are aggregated. Concomitantly, the number of 50 may need to be increased to 100 or 150.
6. It is necessary to exempt offers to qualified institutional investors who do not need as much protection as retail investors.
7. There is a need to impose a registration requirement when the total number of holders of the securities exceeds a threshold (say 500 or 1000) even though only a small number of investors were approached in any given year.
8. It is desirable to have a “crowd funding exemption” for issues that are small in the aggregate even if they tap a large number of investors.
9. The statute must explicitly state that the purpose of the registration requirements is to ensure adequate disclosure and that the registration requirement is not to be used as a form of merit based regulation of public offers.
10. Commodity derivatives should be regulated in the same way as financial derivatives while taking care to exclude genuine commercial transactions in commodities.
11. The obligations to make adequate disclosures (prospectus, annual and quarterly reports and material event disclosures) must be laid down in statute and made applicable to all listed entities regardless of their legal form. The details regarding the content and format of these disclosures can be left to delegated legislation.
12. There must be a statutory provision allowing the regulator(s) to impose corporate governance obligations on listed entities in relation to (a) minimum proportion of independent directors in the Board of Directors (or similar governance organ) and its key committees (b) financial literacy requirements of members of key committees of the board.
13. The scope and objectives of takeover regulations must be laid down in statute. In particular:
 - (a) The regulations should cover all acquisitions of 25% of the voting rights as well as creeping acquisitions by controlling shareholders.
 - (b) Minority shareholders must be treated fairly by giving them an opportunity to sell at the higher of the highest price paid by the acquirers and the undisturbed market price by means of an open offer.
 - (c) While the long term goal is therefore a regime of 100% open offers, taking into account the development of takeover financing and other relevant factors, the regulator may specify a lower size of the open offer. The regulator(s) would be required to publish a report every five years justifying the size of the open offer.

- (d) The Board of the target company should be restricted from alienating material assets, incurring material borrowings, issuing new shares, buying back shares except with the approval of the shareholders by special resolution during the pendency of an open offer.
 - (e) The regulator should impose appropriate disclosure requirements on the acquirer to allow the shareholders of the target company to make an informed decision.
14. Legal certainty of enforceability of derivative transactions must be ensured for (a) exchange traded derivatives and (b) OTC derivative transaction between sophisticated counter parties without reference to whether and by whom they are regulated.
 15. The regulator(s) should be mandated by law to balance the conflicting objectives of safety and efficiency in relation to for-profit Financial Market Intermediaries (FMIs). Moreover, the regulator(s) must be required to publish a report every five years on how it achieved this balance highlighting the emerging competitive landscape and technological developments.
 16. Every clearing house should be able to settle in central bank money. There should be mandatory settlement in central bank money for systemically important clearing houses, which should be stipulated in primary legislation.
 17. Clearing corporations of stock exchanges should be brought within the scope of the Payment Act (2007) to ensure finality of netting and settlement and to allow the clearing corporations to appropriate the collateral of insolvent members towards their settlement and other obligations.
 18. The definition of insider trading should be incorporated into the statute and should cover only cases where the trading was in breach of a fiduciary duty or other relationship of trust and confidence.
 19. The definition of other forms of market abuse like fraud, misrepresentation and the use of deceptive devices must also be part of the statute.
 20. In order to bring consistency in the scope of activities conducted by “market intermediaries”, an activity based approach should be followed to define market intermediaries in primary securities legislation.
 21. A broad set of activities which are intended to be regulated by the securities regulator, whether or not such activities are primary or ancillary functions of the concerned entity must be specified.
 22. In order to ensure that the securities market regulator adequately enforces the provisions in relation to code of conduct of market intermediaries, the principal legislation in relation to securities market should lay down the broad principles of code of conduct of market intermediaries, specifically covering high standard of service, due diligence, disclosure of fees, prompt disbursement of payments, timely and adequate disclosures, confidentiality of client information, avoidance and management of conflicts of interest, sound corporate governance and compliance.
 23. Regulation regarding governance structure of funds should be neutral to the legal structure adopted by the fund. Regulations should not specifically prescribe the legal structure of the fund.
 24. To facilitate more flexible and modern legal forms of organisation, suitable amendments may be required in taxation and other laws.
 25. The primary statute must contain broad provisions on the governance of mutual funds including: the basic principle of unit holder approval for major decisions (or exit opportunity in lieu of such approval); requirements regarding offer documents and periodic disclosures; requirements regarding custodian and auditors. Details regarding these can be left to delegated legislation.

26. The primary statute must also lay down the broad principles of investment restrictions including matters like diversification requirements, borrowing restrictions, and liquidity of underlying investments. Details regarding these can be left to delegated legislation.

19.9. Debt Management Office

19.9.1. Composition

Dr. M. Govinda Rao	- Chairman
Shri Dharendra Swarup	- Member
Shri Kanagasabapathy Kuppuswamy	- Member

19.9.2. Terms of Reference of the Working Group on Debt Management Office

1. Critically evaluate the case for separation of the PDMA from the RBI. In this context, focus on the conflicts of interest between the RBI's monetary policy, supervisory and regulatory objectives and the debt management objectives of minimising the borrowing cost and the development of a Government bond market. This analysis may be carried out in the light of new developments.
2. Determine how to setup the PDMA under the Commission legal architecture, keeping in view Commission's work on independence, transparency and accountability.
3. Specify the work required in the PDMA on databases. This requires consolidation of all information on assets and liabilities along with contingent liabilities into a single centralised database.
4. Specify in greater detail the consolidation of the functions of several dispersed debt management departments within the RBI and Ministry of Finance into a single agency.
5. Issues related to placing the cash management function in the PDMA:
 - (a) Specify the cash management functions of the PDMA.
 - (b) Study international best practices on how PDMA and the Treasury cooperate on cash management.
 - (c) Draft law which places the cash management function in the PDMA.
6. Sub-national debt: As long as states are indebted to the Central Government, the states are required to seek the permission of the Central Government to borrow. The nature of assistance that the PDMA may offer to these sub-national governments in managing their debt needs to be explored.
7. Review the 2008 report and draft Bill on establishing a National Treasury Management Agency chaired by Dr. Jehangir Aziz, from the above perspectives.
8. Any other matter the working group may consider relevant.

19.9.3. Recommendations

1. The WG recommends that implicit and explicit contingent liabilities should be managed and executed by the PDMA. The PDMA should evaluate the potential risk of these contingent liabilities and advise the Government on charging appropriate fees. In addition, the Government should be mandatorily required to seek advice of the PDMA before issuing any fresh guarantees since this has implications for the overall stability of the debt portfolio.

2. The PDMA should adopt a holistic approach that encompasses the entire liability structure of the Central Government including not just marketable debt but also contractual liabilities from public accounts (such as small savings, provident fund receipts) and any other internal liabilities.
3. The wg believes that imposing the services of the PDMA on State Governments might not be advisable since the management of state debt is a state subject. It recommends that at the present juncture, the PDMA should be a Central Government agency obligated to manage only Central Government debt. The PDMA should, however, undertake functions related to State Government debt, which have implications for the Central Government's debt portfolio. This involves maintaining a comprehensive database of State Government debt and coordinating the Central Government's borrowing calendar with State Government's market borrowings. However, at a later stage, PDMA may provide the option to the states of managing their debt.
4. in regard to external debt, the wg is in favour of an integrated approach and recommends that the PDMA manages the external debt for the Central Government. The wg believes that the current set-up of external borrowings through external assistance needs to evolve over time into the Central Government developing a sovereign benchmark in the external market. This would benefit the corporates approaching international markets. In order to assist the PDMA in performing this role, the wg recommends that the Aid, Accounts and Audits Division (AAA), currently under the Department of Economic Affairs (DEA), Ministry of Finance should be merged with the PDMA once it comes into operation.
5. The Central Government has been consistently running large fiscal deficit over the years. In this situation, cash surpluses do not arise except for very short periods due to temporary mismatches between receipts and expenditures within a given financial year. However, PDMA should be tasked with the function of managing and investing surplus cash of the Government whenever such a situation arises in future.
6. On the structure of the proposed PDMA, the wg after considering various options recommends setting it up as a statutory corporation with representation from both the Central Government and the RBI. Further, the proposed PDMA should function with independent goals and objectives while being accountable to the Central Government for its actions and results. There should be a mechanism for constant consultation and coordination with both the Ministry of Finance and RBI.
7. The wg recommends a two tiered arrangement for the operations and management of the PDMA. It envisions a vertical relationship between the Policy Advisory Board and the Board of Management with the latter seeking opinion of the former in matters of strategy and policy. The Board of Management should have a direct line of communication with the Government. However, it should be required to consider any opinions or recommendations made by the Policy Advisory Board through a documented voting process. The duties of the Policy Advisory Board should be to provide opinions on any matters that may be referred to it by either the Board of Management or the Government. In addition, the Policy Advisory Board may also make recommendations suo motu on any activities of the PDMA it finds relevant.
8. The wg is of the opinion that transparency should be embedded into the organisational structure and the proceedings and other related documents of the meetings, including dissenting opinions, should be made statutorily public, and be open to the jurisdiction of the Right to Information (RTI). Based on the staff size and the activities of PDMA in various countries, the wg recommends that the Indian PDMA should be lean on staffing (approximately 70 staff), and should outsource a majority of its non-core activities.

19.10. Working Group on banking

19.10.1. Composition

Smt. K.J. Udeshi	- Chairperson
Shri Y.H. Malegam	- Member
Shri Janmajeya Sinha	- Member
Shri Aditya Puri	- Member
Ms. Naina Lal Kidwai	- Member
Shri Rajiv Lall	- Member
Shri Harsh Vardhan	- Member
Shri M.G. Bhide	- Member

19.10.2. Terms of Reference

The working group on banking will work on all entities which accept deposits for the purpose of lending or investments, of deposits of money from the public, repayable on demand or otherwise. The Terms of Reference of the Working Group shall be as follows:

1. To review the legal framework of the financial firms that are engaged in banking, such as commercial banks, public sector banks, cooperative banks, SBI and its subsidiaries and Regional Rural Bank (RRB) in India.
2. Unification and harmonisation of the legal and regulatory treatment of these entities.
3. To identify legal mechanisms for obtaining equal treatment, regardless of ownership and nationality on questions of competition policy, mergers, take overs, and governance.
4. The field of creditors rights and debt recovery should ideally be a feature of company law and debt in general. Yet, finance policy makers have embarked on initiatives such as The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI). What is the appropriate balance that Commission should adopt?
5. To review expert committee recommendations, and identify the legal changes which would implement existing recommendations.
6. To review the legal framework through which the regulatory agency would write subordinate legislation on issues of ownership, governance, and compensation of banks.
7. Addressing consumer protection, resolution, systemic risk and prudential regulation in banking.

19.10.3. Recommendations

1. The WG recommends that the definition of banking must be guided by the principle that all deposit taking activities (where the public places deposits with any entity, which are redeemable at par with assured rates of return) must be considered as banking. Consequently entities undertaking such activities must obtain a bank license and /or be subject to the regulatory purview of the banking regulator.
2. On the definition of “banking” the WG recommends that any entity that accepts deposits, has access to clearing and to the RBI repo window is a bank. The primary activity of a bank is to accept deposits. Once an entity accepts deposits, it will have access to clearing and discount window of RBI.

3. On the issue of co-operatives which collect monies from members/ shareholders, this wg recommends that any co-operative society accepting deposits exceeding a specified value must fall within the regulatory purview of the banking regulator. Co-operative banks are currently regulated under Part V of the Banking Regulation Act, 1949 (BR Act), but many provisions in the BR Act are not applicable to them. This wg recommends that such exclusions be removed. Co-operative banks must be treated at par with banking companies. This wg also endorses the policy recommendations of the Malegam Report on Urban Co-operative Banks (2011). To deal with the problem of dual control, the Committee recommends the creation of a new organisation structure for Urban Cooperative Banks (ucbs) consisting of a board of management in addition to the board of directors. The board of directors would be elected in accordance with the provisions of the respective State Co-operative Societies Acts or the Multi-State Co-operative Act, 2002 and would be regulated and controlled by the Registrar of Co-operative Societies. The board of directors would establish a board of management, which shall be entrusted with the responsibility for the control and direction of the affairs of the Bank assisted by a CEO who shall have the responsibility for the management of the Bank. RBI would have powers to control and regulate the functioning of the Bank and of its board of management and of the Chief Executive Officer (CEO) in exactly the same way as it controls and regulates the functioning of the Board and the Chief Executive in the case of a commercial bank.
4. On the issue of companies accepting deposits, the members of the wg deliberated at length. It was pointed out to the wg that the RBI had, in its presentation before the Commission submitted that; "Only banks, statutory corporations, companies and co-operative societies regulated by the RBI should be allowed to accept deposits from public". While some members were of the opinion that the issue of companies accepting deposits is beyond the purview of this wg, other members expressed the opinion that deposit taking activities should be restricted only to banks. On the question of whether this issue falls within the ambit of this wg, the members deliberated that the Reserve Bank of India Act, 1934 (RBI Act) already prohibits partnership firms from accepting deposits. Hence some members of the wg recommended extending this prohibition to corporates accepting deposits as well. This requires amending Section 58A of the Companies Act, 1956. The proposed Companies Bill of 2011 is a step in this direction. It places restrictions on the acceptance of deposits by companies. It lays down the procedure for acceptance of deposits by members. A limited class of companies including banks and non-banking financial companies are allowed to accept deposits from public.
5. On the issue of NBFCs, this wg recommends that deposit taking NBFCs must obtain a license to operate as a bank and will fall within the regulatory purview of the banking regulator. The class of NBFCs that do not accept deposits from public will not be regulated by the banking regulator.
6. This wg also considered and debated the recommendations of Vickers Report (2011) and on the issue of ring fencing:
 - (a) This wg recognises the significant role played by NBFCs in providing finance. However, with a view to systemic risk oversight, this wg recognises that credit linkages between banking and non-bank finance should be subject to appropriate regulatory oversight from the viewpoints of both micro-prudential regulation and systemic risk regulation.
 - (b) Once transition to the Financial Holding Company (FHC) structure, as contained in the recommendation of this wg, is achieved subsidiaries of banks must only do such activities which banks themselves can undertake.

- (c) There must be ring-fencing of banks vis-a-vis other non-bank entities. Further, banks must not lend to intermediaries which are not regulated by a financial sector regulator. However, the operation of certain financial institutions such as mutual funds might require access to short-term funding. Such short-term funding must be within stringent prudential regulations.
7. This wg recommends that laws relating to banking should be ownership neutral and should provide a level playing field for all banks. As a necessary consequence this wg recommends corporatisation of all Public Sector Banks (PSBs).¹
 8. In case of foreign banks having branches in India, this wg recommends that all such foreign banks set up a Wholly Owned Subsidiary (wos) in India. Transition issues will need to be addressed by the Government of India (GOI) so that they do not incur taxation from capital gains, or stamp duty, when they convert from branch operations to wos.
 9. On the issue of deposit taking by co-operative societies this wg recommends that there should be some restriction on deposit taking by co-operative societies and that such activity should fall under the regulatory purview of the relevant legislation. The deliberation was on whether the restriction should be based on number of members or on the value of deposits. While some members expressed the view that restriction should be based on number of members i.e. a co-operative society accepting deposits from more than 50 members should fall within the regulatory ambit of the RBI, the opinion finally weighed in favour of value of deposits. The wg finally concluded by recommending that any co-operative credit society accepting deposits exceeding a specified value must follow the provisions of the relevant legislation.
 10. The wg recommends that there should be no exemption from the jurisdiction of the CCI under the Competition Act, 2002 (Competition Act) for mergers of banks. The wg, however makes a distinction between voluntary and assisted mergers. All voluntary mergers will be subject to the review and approval by the competition regulator. One of the key recommendations of the Commission is the establishment of a resolution corporation to ensure prompt and orderly resolution of weak financial institutions. One of the tools of resolution involves sale or merger of weak firm with a healthy acquirer through appropriate mechanisms of due-diligence. To achieve this framework, the wg recommends that all assisted mergers involving sale of a failing bank to a healthy bank will be done under the supervisory review of the resolution corporation.
 11. This wg recommends corporatisation of all PSBs, such as SBI, its subsidiaries, corresponding new banks within the meaning of the Bank Nationalisation Acts and RRBS by converting them into companies under the Companies Act. This would level the playing field and will also rationalise the merger/ amalgamation provisions by bringing them with a single unified framework under the BR Act. In addition, this wg also endorses the policy approach that co-operative banks accepting “public deposits” must obtain a bank license from the regulator.
 12. Ownership in banks must be dispersed. The wg recommends that the current position of law in this regard be maintained.
 13. Bank supervisors must have powers to comprehensively look at human resource policy documents of a bank and recommend changes to the extent such policies impinge upon excessive risk-taking and soundness. The Board of Directors (BOD) and shareholders of banks must have the power to claw back payments made to the top management in line with the global trend of curbing excessive risk taking by the top management.

¹ In its submission to the Commission, the RBI has made a strong case for integrating the various statutes governing different segments of the banking industry and different dimensions of the banking business into a harmonised law to provide clarity and transparency.

14. Regulators must look at compensation policy and structure and its impact upon incentives and the ability of the bank to perform adequate risk management. The focus of supervisors should be upon the incentive implications of the compensation structure. There is a case for rules that require compensation to be spread over longer horizon, with provisions for claw back of payments in certain cases. While there is some thinking on framework for compensation in private and foreign banks, the same needs to be extended to PSBs. The legal and regulatory framework for compensation should give the BOD and shareholders the ability to push PSBs towards more rational compensation structures, given the deep links between the problems of risk management, operational controls of PSBs, and the flaws of compensation structure.
15. The notion of fit and proper for the boards of banks needs to be reviewed. The wg recommends removing the restriction on directors on Boards of banks also being directors of other enterprises. However, the Managing Director (MD) would not be allowed to occupy a board position in group companies/entities.
16. Further, this wg recommends that Section 20(1)(b) of the BR Act, which places restrictions on loans and advances by the BOD, must be confined to only loans and advances made to private limited companies or to entities where the director has substantial interest. For the purposes of this recommendation, the entities in which the director is deemed to be substantially interested must be in line with standards used for related party transactions under the Companies Act and accounting standards. This recommendation is broadly in line with the recommendations of the Committee on Financial Sector Assessment (CFSA) (2009). Referring to the definition of “substantial interest” in Section 5(ne) of the BR Act, the CFSA was of the view that,

“this quantitative stipulation (Rs. 5 lakhs or 10% of the paid up capital of a company) has proved to be very low because of inflation and also growth in size of banking companies. It is felt that the quantitative ceiling of Rs. 5 lakhs should be removed and an appropriate percent of the paid-up capital be stipulated”

Hence the definition of substantial interest needs to be revised upwards.
17. With respect to PSBs, the BOD, must be given greater powers to nominate members of the appointment committee and the compensation committee of the BOD.
18. On governance arrangements, the wg recommends that uniform rule of law must be followed by banks irrespective of ownership. This includes:
 - (a) Separating the position of chairman and managing director in case of PSBs as well.
 - (b) BODs of PSBs must play the same role as any other BOD, with the same stipulations as any other type of bank.
 - (c) Fully complying with the listing norms (SEBI stock exchange rules) in case of listed entities.
19. This wg recommends that the current mode of operations of banks under Bank Subsidiary Model (BSM) is inadequate and there should be a shift towards the FHC model as a preferred model for financial sector in India. The FHC model mitigates the risks spilling over to the bank from other entities in the group.
20. Subsidiaries of banks should only do business that could have been done purely within the bank. If insurance cannot be done by a bank, it should not be done by the subsidiary of a bank.
21. Further, capital of banks should not be allowed to take any risks apart from banking risks, and mechanisms must be put in place through which resources from the

bank does not flow up into the FHC or to sister subsidiaries in times of crisis, or otherwise. This is consistent with the ring-fencing approach, where micro-prudential regulation and resolution would face clearly defined bank risks, which are engaged in a well defined business of banking (public deposits that are redeemable at par with assured rates of return), with no other complexities of financial structure.

22. To achieve this transition the GOI must provide a one time exemption to capital gains and stamp duty when such conversion happens.
23. With respect to the structure of the holding company, the Percy Mistry Report (2007) states that the holding company must pursue the business strategy of a unified financial conglomerate. In addition this WG endorses the policy recommendations contained in the Percy Mistry Report (2007) which states that the holding company must be required to comply only with the Companies Act with exchange listing requirements, and should be subject only to systemic risk oversight by the appropriate regulator.
24. Considering the issues and gaps in the current legal framework and drawing on the recommendations of standard-setting bodies and international best practises, this WG recommends that a sophisticated resolution corporation be set up that will deal with an array of financial firms including banks and insurance companies. The mandate of this corporation must not just be deposit insurance. It must concern itself with all financial firms which make intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and payment systems. A key feature of the resolution corporation must be its swift operation. It must also effectively supervise firms and intervene to resolve them when they show signs of financial fragility but are still solvent. The legal framework must be so designed to enable the resolution corporation to choose between many tools through which the interests of consumers are protected, including sales, assisted sales and mergers.
25. Prudential regulation should be ownership-neutral. The scope of regulation should be agnostic to the ownership structure of the banks.
26. Quantity and quality of capital should be the core part of prudential regulation of banks.
27. Prudential regulation should cover systemic interconnectedness in the context of the holding company model. As outlined above, one of the core mandates of prudential regulation is to limit the negative externalities arising out of the failure of a systemically important firm. The instruments of prudential regulation should be designed to deal with such kinds of firms.
28. In the proposed regulatory architecture the jurisdiction, approval and enforcement process of regulators is important and needs to be clearly defined in the prudential legislation.
29. There is a need for a comprehensive law on consumer protection and a redressal forum focussed on financial services, which cuts across different sectors such as banking, insurance and securities market.
30. In addition specific consumer protection issues also arise in case of electronic/net banking and lending. The rights and liabilities of parties entering into a net banking transaction is not clearly provided under any law and consumers are not protected by law against unauthorised electronic transfers. In addition liability of lenders towards fair disclosure and treating borrowers fairly is not governed by legislation but through guidelines of RBI. These specific issues are required to be addressed in laws to be written by Commission.

31. The wg recommends the move towards the FHC model as with appropriate accounting and reporting standards, it will help in identification of systemic risk build-up in large financial conglomerates.
With appropriate accounting and reporting standards the move towards the FHC model will help in identification of systemic risk buildup in large financial conglomerates.
32. There are concerns which arise with insolvency proceedings of entities which are systemically important. In this regard the wg endorses the recommendation of CFSA to keep resolution of these entities separate from those relating to ordinary companies.
33. This wg endorses the recommendations of CFSA which recognises the need for a regulatory agency which would conduct periodic assessments of macro-economic risks and risk concentrations. This agency must also monitor functioning of large, systemically important, financial conglomerates anticipating potential risks.
34. While research and academic literature in systemic risk is relatively new, based on the existing experience of the countries and as endorsed by its inclusion in the Basel III report, the wg recognises the need for countercyclical capital buffer as a policy tool for dealing with systemic risk.
35. In our view, the threshold limits for application of Recovery of The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDBFI) must not be stated in the act. The Central Government must have the power to determine the limit through rules. In addition, the capability and efficiency of Debt Recovery Tribunals (DRTs) must be measured on an ongoing basis and limitations must be addressed efficiently. The threshold limit after which cases may be filed before the DRT may be decreased only if the efficiency and capability permit.
36. This wg endorses the recommendations of Malegam Report on Urban Co-operative Banks (2011) and recommends a separation of the ownership of UCBS. In this way the banking business would be separated from the co-operative society. This would ensure that the regulatory treatment of the banking arm of the co-operative society is at par with banks. With the implementation of this recommendation the banking arm of co-operative banks must also be granted the same privileges available to banks under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) and RDBFI.
37. Section 14 of SARFAESI is silent on the time period within which petitions are required to be disposed off by the Chief Metropolitan Magistrate or District Magistrates. Since no time lines are prescribed, these petitions take longer than required to be disposed off leading to unnecessary delays. In *International Asset Reconstruction Company Private Limited through its Authorised Representative of Constituted Attorney Mr. Tushar B. Patel v. Union of India, through the District Magistrate and Others* noting the significant delay caused in enforcing security interests under Section 14 of SARFAESI petitions, the Bombay High Court has prescribed a time line of *two months* for all petitions filed under Section 14 of SARFAESI. This wg recommends that the law should prescribe a time period (perhaps 2 months) within which the District Magistrate or the Chief Metropolitan Magistrate, as the case may be, should dispose off Section 14 petitions. Those who fail to meet the time limit should be required to report the number of cases where they took longer than the prescribed time limit.
38. Neither Section 14 of SARFAESI nor the rules prescribed under SARFAESI, state what documents are required for filing a petition for enforcing a security. This leads to uncertainty in procedure with different courts requiring different documents leading to unnecessary delays. The Debt Laws Amendment Bill (2011), addresses this

issue by providing a list of documents to be filed with a Section 14 petition under SARFAESI. In our view, the proposal in the Debt Laws Amendment Bill (2011) would be sufficient for addressing this issue. This WG recommends the same list of documents to be filed with a Section 14 petition.

39. A petition for enforcing security interest under Section 14 SARFAESI can only be filed with a District Magistrate or a Chief Metropolitan Magistrate. In present day administrative services, the Deputy Commissioner of a particular district also acts as a District Magistrate. A Deputy Commissioner is an administrative officer principally responsible for overseeing revenue collection, such as collection of land revenue and other public dues. A Chief Metropolitan Magistrate on the other hand, does not exercise executive and judicial function but is the administrative head of metropolitan courts in India. Since both District Magistrates and Chief Metropolitan Magistrates are involved more in administrative functions than actual day to day judicial functions, there is considerable delay in addressing petitions under Section 14 of SARFAESI. The Debt Laws Amendment Bill (2011) addresses this issue by allowing the District Magistrate or the Chief Metropolitan Magistrate to authorise any officer subordinate to him to take actions for enforcing the security interest. On this issue, it is the view of this WG that the proposals in the Debt Laws Amendment Bill (2011) is sufficient to address the problem. If the District Magistrate or the Chief Metropolitan Magistrate is allowed to authorise any officer subordinate to him to take actions for enforcing the security interest it would help in reducing delays.
40. In India our laws give preference to crown debt in the form of taxes and statutory dues over the claims of secured creditors during insolvency and bankruptcy proceedings. Though reforms in certain tax laws now provide priority of secured creditors. Tax dues under Customs Act, 1962, Central Excise Act, 1944, and service tax under the Finance Act, 1994 are subject to the claims of secured lenders under RDDBFI and SARFAESI. While these reforms have only partly addressed the issue, the general principle of priority of secured lenders over crown debts and debts under other welfare legislations such as labour laws is not specifically provided for in our laws. This WG endorses the recommendations of the Raghuram Rajan Committee Report (2009) on rationalising insolvency and bankruptcy proceedings:
 - (a) While it is important to protect employee claims such as overdue wages, there must be a limit, say six months, to which such pay is protected. After the expiry of this period employees must also join the ranks of unsecured creditors.
 - (b) The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors.
 - (c) Statutory priorities of a firm should be well disclosed so that creditors can act well in time, before they get crowded out by other claims.
41. The purpose of setting up DRTs was to ensure speedy recovery of debts by setting up a special tribunal system which follows a summary procedure as opposed to a detailed procedure followed by the civil courts. DRTs in India are now plagued with the same problems that afflict civil courts: Huge backlog of cases and insufficient infrastructure. An efficient tribunal system has sufficient resources at its disposal and has well trained and competent staff. If the objective and purpose of setting up DRTs are to be given effect to, one cannot ignore the infrastructure issues that afflict the DRTs.

To address the infrastructure issues that afflict DRTs in India, there is a need to re-think and overhaul the legal framework under RDDBFI:

- (a) **Objective of DRT:** Amend RDDBFI to clearly state the objective of RDDBFI, as a special tribunal for providing a mechanism for recovery of debt that is fair, just, economical and quick.

- (b) **Efficiency of DRT:** Suitably amend RDDBFI to place an obligation on the appropriate entity to ensure efficient and effective functioning of the system.
- (c) **Training of judicial and recovery officers:** Suitably amend RDDBFI and SARFAESI to place a duty on the appropriate entity for training of judicial and recovery officers.
- (d) **Uniform procedures:** Amend RDDBFI to reflect the principle that uniform procedures must be followed by all DRTs.
- (e) **Comprehensive rules on procedures:** Detailed rules of procedure under the Civil Procedure Code, 1908 and rules of evidence under the Indian Evidence Act, 1872 are not required to be followed. Keeping this in mind, the rules of procedure for DRTs under RDDBFI, namely the Debt Recovery Tribunal Rules, 1993, were drafted. The rules of procedure were intended to be light touch by allowing significant liberty to the tribunals to devise their own methods and standards. This has led to inconsistent and differing approaches taken by different DRTs. There is a need to set out comprehensive if not detailed, set of rules of procedure applicable to hearings before DRT to increase certainty of procedure and provide guidance to practitioners.
- (f) **Quantitative measurements of performance:** Amend RDDBFI and SARFAESI to ensure reporting requirements by appropriate authorities for preparing annual reports which detail revenues received through filing fees, resource allocation, steps taken towards efficient functioning of the tribunals, statistical analysis of cases and workload, time taken to dispose cases, and reasons for delay.
- (g) **Funding and resource allocation:** There is a need to rethink the funding and resource allocation for DRTs in India. Tribunals do not function efficiently if they are not well funded and do not have sufficient resources at their disposal. The recommendations are two fold:
 - i. **Independence:** Currently, resource allocation for DRTs is done through the Ministry of Finance, through the budgetary process. Financial sector regulators in India, such as SEBI and IRDA, have the ability to charge fees from regulated entities to cover the cost of their functioning. Independence in funding and resource allocation is important for effective functioning as it allows the entity the operational flexibility. The recommendation is therefore to amend RDDBFI recognising the principle of independent resource allocation.
 - ii. **Quantum of fees:** There is merit in empowering the DRTs to determine the filing fees by keeping in mind the overall costs for their effective functioning. The applicants who file petitions before DRTs are financial institutions which can afford to pay for speedy recovery of loans made by them.² Currently, only the Central Government has the power to make regulations prescribing the fees. Since the recommendation of this wg is to grant more independence to DRTs for allocating resources, deciding the quantum of fees should be their prerogative and is a necessary outcome of such independence.
- (h) **Adopting information technology:** Indian courts have been slow in adopting information technology. While there has been some improvements in communication to the public through websites; there is no movement towards integrating the entire court process into an electronic form. Digitisation of court records and computerisation of registries would be beneficial

²At present, the cost of filing an original application before the DRT is Rs. 12,000 when the amount of debt owed is Rs. 10 lakhs, subject to a maximum cap of Rs. 1.50 lakhs.

in handling the huge backlog of cases. As an example, digitising the registry of the Supreme Court of India has been beneficial in reducing arrears and in facilitating docket management. For efficient functioning of DRTs, adopting information technology would help in overall reduction of case backlog and would lead to greater efficiency.

42. Amend Section 5 of SARFAESI to allow sale of assets from one Asset Reconstruction Company (ARC) to another.
43. Amend Section 9 of SARFAESI to allow the issue of convertible debt by an ARC. The proposals contained in the Debt Laws Amendment Bill (2011) allows converting only a portion of the debt into equity. It does not allow the conversion of all of the debt into equity, and it does not allow issuing convertible debt which may or may not convert into equity.
44. Suitably amend SARFAESI to allow all secured creditors who are regulated entities under the purview of the Act.
45. Amend Section 12 of SARFAESI to list enumerated powers of RBI along with principles that reflect factors which will inform RBI of the choice of powers to be used.
46. While stamp duty laws are not within the purview of laws to be rationalised either under Commission or within the scope of the TOR of this WG, this WG is of the opinion that there must be rationalisation of stamp duty laws in India. A possible solution could be the levy of transaction tax as opposed to stamp duty. The power to levy transaction tax lies with the Parliament and a transaction tax similar to that of goods and services tax may be introduced by abolishing stamp duty.
47. The recommendations in this part are primarily clarifications and standardisation of the process of securitisation, and are not features of the primary law. Reforms in these areas would lead to smoother functioning and greater clarity in the process of securitisation. Some of these also act as a guide to the enumerated powers/principles to be reflected in the powers of the regulator under Section 12 of SARFAESI:
 - (a) **Clarity on sale/lease of business:** Although Section 9(b) of SARFAESI allows securitisation/reconstruction companies to sell or lease a part of the business of the borrower, the exercise of this power is subject to RBI guidelines, which have not been issued by RBI. This WG recommends that since the primary legislation allows sale or lease of a business by an ARC, the regulator must not exercise discretion by not issuing guidelines on substantive rights.
 - (b) **Restructuring support finance:** Borrowers' debts turn into Non Performing Assets (NPAs) on account of their inability to finance the debt. The goal of restructuring is to turn around the profitability of such borrowers. Typically, ARCs fund the purchase of the bad assets by issuing securitisation receipts to Qualified Institutional Buyers (QIBs). ARCs are only allowed to deploy funds to restructure the loan account of the borrower. Deploying of funds by the ARC into the defaulting borrower is not permitted. Given that ARCs are in a better position to restructure and revive failing companies there may be merit in allowing ARCs to also deploy funds into the borrowing company. On the basis of the proposals contained in the Debt Laws Amendment Bill, 2011, which allows partial conversion of loan into equity, deploying funds into the borrower company should be allowed, as this will act as an incentive for the ARC to restructure the company in a holistic manner. This WG is of the opinion that the regulator must prescribe guidelines, subject to prudential regulations, on when ARCs can deploy funds towards restructuring the borrower company along with the process to be followed.

- (c) **Pledged shares and exemptions from the Takeover Code:** When the underlying security, which has been acquired by an ARC, are shares held in dematerialised form, there are no statutory provisions or regulatory guidelines allowing substitution of the ARC in place of the original lender. This leads to complications and excessive procedural requirements. Further, while banks and financial institutions have been exempted from the Securities and Exchange Board of India Substantial Acquisition of Shares and Takeover, Regulations, 2011 (Takeover Code), for pledged shares held by them, similar exemptions have not been made applicable to ARCs. This wg recommends that substitution of ARCs in place of the original lender, and the exemption from the applicability of the Takeover Code must be allowed. This would however require appropriate amendments to sub-ordinate legislation by SEBI and Ministry of Company Affairs, Government of India (MCA), as applicable.
- (d) **Modification of charges:** Companies which mortgage their assets are necessarily required to intimate the Registrar of Companies (ROC) to assist in case of insolvency/winding up. However, currently dormant companies (companies who have not complied with filing of annual returns among other things) are not allowed to change or modify their charge registers in light of recent notifications of the MCA.³ This leads to a situation where if the assets of the dormant company are securitised and transferred to ARCs, the names of ARCs cannot be substituted leading to difficulties in enforcement proceedings/insolvency and winding up cases. This wg is of the opinion that modification of charges and exemptions in case of ARCs acquiring NPAs of dormant companies must be allowed. This would however require appropriate clarifications by the MCA.
- (e) **Central Registry:** The Central Government has set up a central electronic registry under SARFAESI effective from March 31, 2011 to prevent frauds in loan cases involving multiple loans from different banks. The central registry is maintained by Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) under SARFAESI. The registration of charges can be done online and search of the records of the registry can be done by any person online. This wg is of the opinion that the scope of the registry must be expanded to include encumbrance over any property and not just those which are mortgaged to banks or financial institutions. In addition all existing registration systems such as land registry and filings with the registrar of companies, must be integrated with the central registry so that encumbrance on any property (movable or immovable or intangible) is recorded and can be verified by any person dealing with such property.

19.10.4. List of Acts governing the Indian banking sector

1. Banking Regulation Act, 1949
2. Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (applicable to banks nationalised in 1970)
3. Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (applicable to banks nationalised in 1980)
4. Companies Act, 1956 (to a limited extent)
5. Reserve Bank of India Act, 1934, rules, guidelines, master circulars, and regulations made thereunder

³The Ministry of Company Affairs through General Circular 33/ 2001 dated June 1, 2011 notified that unless a company files its updated balance sheet and profit and loss account it will not be able to file any event based compliance forms, including for modification of charges.

6. Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
7. Recovery of Debts Due to Banks and Financial Institutions Act, 1993
8. Foreign Exchange Management Act, 1999 (for foreign currency dealings), guidelines, rules, regulations and master circulars made thereunder
9. Banking Ombudsman Scheme, 2006 (not an Act, but governs resolution of consumer disputes)
10. Payment and Settlement Systems Act, 2007
11. Regional Rural Banks Act, 1976 (for rural banks)
12. Deposit Insurance and Credit Guarantee Corporation Act, 1961
13. Banking Laws (Amendment) Bill, 2011
14. State Co-operative Societies Acts (for each state)
15. Multi State Co-operative Societies Act, 2002
16. State Bank of India Act, 1955
17. State Bank of India (Subsidiary Banks) Act, 1959
18. Competition Act, 2002

19.10.5. List of Committee Reports on Indian banking sector

1. Narasimham Committee I and II
2. Percy Mistry Committee
3. Raghuram Rajan Committee
4. Leeladhar report: Consolidation of Banking Industry in India
5. Umarji Report: Review of the Banking Regulation Act
6. A. Ghosh Committee: Frauds and Malpractices in Banks
7. Adhyarjuna Committee: Changes in NI Act and Stamp Act
8. B. Eradi Committee: Insolvency and winding up
9. Bhide committee: Coordination between commercial banks and SFC's
10. James Raj Committee: Functioning of PSBs
11. K. Madhav Das Committee: Urban Co-operative Banks
12. Marathe Committee: Licensing of New Banks
13. M.L. Dantwala Committee: Regional Rural Banks
14. Thingalaya Committee: Restructuring of RRBS
15. S.S. Nadkarni Committee: Trading in PSBs
16. S.S. Kohli: Rationalising Staff Strength in Banks
17. S. Padmanabhan Committee: Inspection of Banks
18. S. Padmanabhan Committee: Onsite supervision function of Banks
19. R.N. Midgra Committee: Cooperative societies
20. Rajamannar Committee: Changes in banking laws and bouncing of cheques
21. Raghavan Committee: Competition Law
22. R. Jilani: Inspection system of banks
23. Pillai Committee: Pay scales of bank officers
24. Pendarkar committee: Review of the system of inspection of commercial, RRB and urban co-operative banks

19.11. Interactions by the Working Groups

WG on Payments

- ▶ Reserve Bank of India
- ▶ National Payments Corporation of India
- ▶ PayPal
- ▶ Vodafone
- ▶ Bharti Airtel
- ▶ A Little World

WG on Insurance, Pensions & Small Savings

- ▶ General Insurance Council
- ▶ Life Insurance Council
- ▶ Lloyds
- ▶ Indian Institute of Insurance, Surveyors & Loss Assessors
- ▶ Ministry of Labour
- ▶ Insurance Regulatory and Development Authority

WG on Securities

- ▶ Association of Investment Bankers of India
- ▶ Association of National Exchanges Members of India
- ▶ BSE Ltd.
- ▶ Indian Clearing Corporation of India
- ▶ National Stock Exchange of India Ltd.
- ▶ National Securities Clearing Corporation Ltd.
- ▶ MCX-SX
- ▶ Central Depository Service (India) Ltd.
- ▶ The BSE Brokers' Forum

19.12. External Reviewers and Experts who worked with the Research Team

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1	Avinash Persaud	Senior Fellow	Caribbean Policy Research Institute
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3	Bikku Kuruvila	Legal Consultant	New York, USA
4	Bindu Ananth	President	IFMR Trust
5	Chandrasekhar Bhaskar Bhawe	Former Chairman	Securities and Exchange Board of India
6	Jahangir Aziz	Chief Economist	JP Morgan Chase & Co
7	K.N. Vaidyanathan	Chief Risk Officer	Mahindra and Mahindra
8	K.P. Krishnan	Secretary	Economic Advisory Council to Prime Minister
9	Kate McKee	Senior Advisor	CGAP
10	M.S. Sahoo	Former Member	Securities and Exchange Board of India
11	Matt Crooke	Minister-Counsellor	Australian High Commission, New Delhi
12	Molina Asthana	Principal Solicitor (Commercial, Property & Technology)	Victorian Government Solicitor's Office, Melbourne, Australia
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15	Nachiket Mor	Chair	Sugha Vazhvu Health Care Private Ltd
16	O.N. Ravi	Corporate Development Officer	The Clearing Corporation of India Limited
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19	Sanjay Banerji	Professor of Finance	University of Nottingham Business School
20	Sanjiv Shah	Executive Director	Goldman Sachs
21	Subrata Sarkar	Professor	Indira Gandhi Institute of Development Research
22	Sudhamoy Khasnobis	Founder	i-Care Life Pte. Ltd, Singapore
23	T. Koshy	Executive Director, Advisory Services	Ernst & Young Private Ltd.
24	Tarun Ramadorai	Professor of Financial Economics	Saïd Business School & Oxford-Man Institute of Quantitative Finance University of Oxford
25	Vikramaditya Khanna	Professor	University of Michigan Law School
26	Viral V. Acharya	Professor of Economics	New York University Stern School of Business
27	Yesha Yadav	Assistant Professor of Law	Vanderbilt University Law School

19.13. Submissions to FSLRC

A. General Submissions

S.No.	From	Remarks
1.	Mr. Rajiv Ranjan, President & CEO, Reliance Asset Reconstruction Co. Ltd through CM Division of MoF	SARFAESI Act: Legal and Regulatory issues
2.	Mr. S.M. Roy	Funds for investor education - unclaimed monies of investors lying with companies
3.	CM Division, DEA, MoF	Draft National Competition Policy 2011
4.	Mr. B. Veeraswamy	Review of employees' Pension Scheme - 1995
5.	Mr. Dirk Kempthorne, President & CEO of ACLI / CM Division, DEA, MoF	White paper on Benefits of Life Insurance Sector Reforms prepared by American Council of Life Insurers (ACLI)
6.	PHD Chamber of Commerce and Industry	Written submission based on interaction
7.	FICCI	Written submission based on interaction
8.	DFS, through CM Division, DEA, MoF	Suggestions for the consideration of Commission
9.	Indian Banks' Association	Written submission based on interaction
10.	Mr. Charan Lal Sahu, All India Sahu Mahasabha, through DEA, MoF	Amendments in all Laws U/A 39(C) of the Constitution of India in Central Acts to root out corruption
11.	Mr. Sandeep Parekh, FINSEC, Mumbai	Written representation on policy issues to terms of reference of the Commission
12.	Mr. L. Rutten, MD & CEO, MCX, Mumbai	Written submission based on interaction
13.	Mr. Bill Shorten, Minister for Employment and Workplace Relations etc., Canberra ACT	Written submission based on interaction
14.	Mr. Rajiv Agarwal, Secretary, Consumer Affairs	Written submission based on interaction
15.	Mr. R. Gopalan, Secretary (Economic Affairs)	Copy of reply sent to Shri Rajiv Agarwal, Secretary, M/o Consumer Affairs Reg. non acceptance of their request to remove FCRA from the TOR of the Commission
16.	MoF (CM Division)	Withdrawal of Indian Trust Act(Amendment) bill 2009 from the Lok Sabha seeking views/comments of Commission
17.	Mr. H. Jayesh, Juris Corp, Mumbai	
18.	Keith Noyes, Regional Director, Asia Pacific International Swaps and Derivatives Association, Inc., Singapore	
19.	CUTS International	On the need for a dedicated consumer protection agency

B. Feedback on Approach Paper

S.No	Author/Publication
1.	Bureau Report — Economic Times (ET) 02.10.2012
2.	Ila Patnaik — Financial Express 02.10.2012
3.	Monika Halan — MINT 02.10.2012
4.	Editorial — MINT 02.10.2012
5.	Bureau Report — Business Standard 02.10.2012
6.	Asit Ranjan Mishra — MINT 02.10.2012
7.	Editorial — Financial Express 02.10.2012
8.	Bureau Report — Financial Express 02.10.2012
9.	Editorial — ET 04.10.2012
10.	Shaji Vikraman — ET 04.10.2012
11.	Bureau Report — Hindustan Times 05.10.2012
12.	Dhirendra Kumar — ET 08.10.2012
13.	George Mathew — Indian Express 09.10.2012
14.	K.K. Srinivasan (Former Member, IRDA) — email dated 12.10.2012
15.	Bimal Jalan (Ex. RBI Governor) — Moneycontrol.com 13.10.2012
16.	Sucheta Dalal — Moneylife 16.10.2012
17.	Sameer Kochhar — Inclusion.in 17.10.2012
18.	Dr. C. Rangarajan, Chairman, PMEAC — Moneycontrol.com 20.10.2012, MINT 28.10.2012 & Times of India 29.10.2012
19.	Dipankar Chaudhury — MINT 25.10.2012
20.	S.S. Tarapore — Inclusion.in 29.10.2012
21.	Madhoo Pavaskar — e-mail 30.10.2012
22.	Venkat Chary, Chairman, MCX — e-mail/letter 30.10.2012
23.	Joseph Massey, MD, MCX-SX — 31.10.2012
24.	CUTS International — e-mail dated 02.11.2012
25.	Ministry of Corporate Affairs — 05.11.2012
26.	Forbes India — 08.11.2011
27.	Indian Centre for Islamic Banking — 12.11.2012
28.	Alternative Investments and Credits Limited — 15.11.2012
29.	Department of Consumer Affairs — 29.11.2012
30.	Reserve Bank of India — 07.12.2012