Financial Regime Governance: Its role in an IFC and a comparative perspective

chapter 8

1. The intrinsic value of regulation for IFS production

The fundamental difference between the pre- and post-1991 approaches to development strategy in India – i.e. the themes of outward orientation and openness to enhance technology, efficiency, productivity, quality and competitiveness throughout the economy – apply with equal force when it comes to providing IFS. An inward-looking policy aimed at protecting the domestic market for financial services (e.g. protecting financial firms from the force of competition from other domestic and foreign competitors) exacerbates and prolongs: intermediation inefficiency, over-staffing, cost-ineffectiveness, higher intermediation margins, poor management, poor service quality, sub-optimal technology, and inability to capture fully a number of economies of size and scale.

In establishing an appropriate context for the discussion on Indian financial regulation that follows, it is essential to underline that, since 1991, India has made a belated but fundamental shift from an import-substituting development model to an outward oriented strategy emphasising greater openness and trade (particularly exports). In the process, India has discovered that achieving export-competitiveness requires a combination of: (a) cost-effective human capital inputs; (b) good management and corporate governance; (c) the use of cutting-edge technology that is continuously updated; and (d) the application of best global practices. A side-effect has been that export-orientation has improved the productivity and efficiency of production, as well as the quality/quantity of goods and services available, for the domestic market. In addition, competing in global markets has proved to be useful in sidestepping problems of domestic competition policy, reducing rent-seeking impulses in local political economy, and thus accelerating growth.

However, it is important to take note of a fundamental difference between the export of financial services and the export of goods and non-financial services.

IFS exports are intrinsically different from ordinary exports. When a car is exported from India, its quality/value is measured without regard to the difficulties encountered in its manufacture. Dealers/customers who sell/use the car – anywhere in the world – evaluate/verify its quality and relative value by applying objective tests. An Indian car is accepted by the world market if it passes these tests; it is rejected if it does not.

Production of the car in India might take place in a difficult institutional and operating environment characterised by a number of weaknesses such as: poor infrastructure, restrictive labour laws, high real costs of capital, inefficient taxation, a weak legal system, difficult trade unions, poor public governance, poor standards of regulation (e.g. health and safety standards, factory hygiene, conformity with local planning rules, etc.).

These difficulties induce additional ‘coping costs’ for firms manufacturing cars in India. For example, an industrial process that consumes tap water in an OECD country might require a special purification plant in an India; or the unreliability of power supply may require investment in a captive power plant; or a car manufacturer may need to have special infrastructure for effluent discharge and sewage. However, once the car is made, these problems do not affect either the reality or user perceptions of its quality. An objective technical assessment of the finished car is '*ahistorical*'; it has no links to the policy, regulatory or physical environment under which it was produced. This applies for a wide range of ordinary goods and services – ranging from motorcycles to steel to computer programmes. For this reason, India has made considerable progress in exporting a variety of goods and services, even though the underlying institutional environment continues to be deficient in many respects. High coping costs induce lower wages, yielding globally competitive prices for finished goods in most industries.

But this separation between final product and the institutional/policy and regulatory environment in which it was produced (i.e. the regime that governed its production) does not hold for IFS. Finance is about the fulfilment of contingent contracts that specify performance of stated actions by stated parties at future dates. The quality, performance, and value of a financial product or service depends critically on ***confidence*** in the mind of the customer, and ***trust*** on his/her part, that stated actions/obligations at future dates will be performed/fulfilled as promised. Given their very nature, the implicit obligations that underlie all financial contracts, and the regulatory regime that governs their fulfilment, become an intrinsic part of such contracts – represented operationally as financial products and services.

Financial Regime Governance: i.e. the framework of laws, rules and regulations governing financial products/services (and the way in which authorised regulatory institutions specify, apply and enforce them) is therefore ***intrinsic*** to the value of financial services in a way that governance is not intrinsic to the value of a car or a ball bearing. For example, a simple deposit at a bank involves the performance of an action or fulfilment of an obligation by the bank to the customer at a future date: i.e. when one buys or invests in a CD for Rs. 1,000 at an interest of 10% for 12 months, one expects the bank to return Rs. 1,100 at the end of that period with even thinking about it. The thought process of the customer involves the financial regime governance at two levels. First, *is the bank well regulated and supervised, so as to induce a low probability of failure?* And, *if the bank goes bankrupt, is there an effective bankruptcy procedure with a high and predictable recovery rate, on a highly predictable time horizon?* If Mumbai is to become an IFC, and attract global customers who place deposits in banks in Mumbai, then an intrinsic part of the product offering would be to have answers to these questions that instil confidence in the global customer that in these and other respects an IFC in Mumbai operates with world-class standards.

When an Austrian customer buys an Indian car, he is concerned with its quality, performance, reliability and functionality. He is blithely unaware of the Indian policy framework for auto manufacturing, the legal regime, the infirmities of physical infrastructure, or the capability and competence of the regulatory institutions that governed its production. Once the car is produced and used, those connections cease to matter. In contrast, when an Austrian customer places an order on an Indian USD-CNY futures market, or buys an Indian bond or share, he is inextricably and inexorably affected by Indian law and regulation. Indian law and regulation are an intrinsic part of the financial product/service purchased. They cannot be stripped out.

For that reason, one of the key elements in judging the technical merits and relative safety of a USD-CNY futures position on an Indian exchange, in the eyes of a foreign customer, are the strengths and weaknesses of Indian law and regulation; as well as the credibility and capability of its regulatory institutions and exchanges. Hence, achieving success in the export of IFS such as currency futures trading, or involving global investor participation in Indian bond, equity, derivatives or commodity markets, is not just about having good issuers, attractive products that are liquid and tradable, or globally competitive entities in the private sector, such as exchanges or brokerage firms. It is equally about having foundations, institutions and practices of law and regulation or, more holistically, of ***financial regime governance*** that is also globally competitive in meeting the best standards of regulatory practice applied around the world. In this sense, Mumbai's seeking to become a globally competitive IFC requires Indian law, regulation and overall financial regime governance to be as good as the best 'state-of-the-art' equivalents at other IFCs.

Financial regulation is thus an intrinsic, inseparable component of any financial service/product; whether it is sold domestically or internationally. But, when sold internationally, the regulatory component of that financial service/product must conform to the best international norms/practices for it to be acceptable to global markets and the financial firms and players operating in them. This is a key premise that must be appreciated at policy-making levels.

When a financial product is sold or a service is provided *across borders*, issues of confidence and trust in the fulfilment of obligations by counterparties become more acute. This has two implications for an IFC in Mumbai. *First*, India as a newcomer in the global IFC space must aspire to higher standards than those in London and New York, in order to attract global IFS business. The same infirmities embedded in London and New York for historical reasons may not be acceptable to global customers operating in a new Indian IFC. Second, India will not be able to make rapid inroads into the global customer base without IFS provision in Mumbai by *global financial firms* that are recognised brand-names to global IFS customers. For Mumbai to develop as a credible IFC it will not be sufficient for IFS to be provided only or mainly by Indian financial firms that are not as yet globally recognised brand-names.

2. Three levels of international competition on regulation and law

International competition on issues of financial regulation and law, which shapes competition in IFS provision, occurs at three levels:

1. ***Banning products or markets; banning export:*** At the simplest level, one IFC can lose out to others because it is blocked from competing with them in the provision of particular financial products/services or of a wide range of them. At present, most products and services in the global IFS space are not exported from India because their production (even for the domestic financial system), or sale to foreigners, is prohibited.
2. ***Rules limiting the success of products or markets when they are permitted:*** Even when provision of a certain kind of IFS is permitted, restrictive regulation can limit the success of an IFC in providing IFS. Limitations on participation by certain types of firms in certain markets (e.g. banks being prohibited from operating in derivatives markets or foreign banks being prohibited from doing government business) or on proscribing certain kinds of trading strategies (e.g. algorithmic trading and DMA), can decisively influence the success of a product or a market by circumscribing its use to the point where the market becomes too small, fractured and illiquid with virtually no market-making. What are ostensibly 'prudential' requirements can limit product/service success when there is overstretch beyond a technically sound notion of prudence.
3. ***Intangible issues of trust and level playing field:*** Finally, the export of IFS is influenced by intangible concerns about legal/regulatory impartiality, fairness and trust as seen by private players (whether domestic or foreign) and global customers. Global customers have a choice of placing orders in competing IFCs for their IFS transactions. That choice is influenced by perceptions about

the soundness, stability and fairness of the legal/regulatory environment which an IFC has; i.e. the extent to which it is felt by customers that a particular IFC has fair processes of enforcement, and treats non-residents fairly.

3. Where does India stand? An illustrative bird's eye view

To obtain a bird's eye view on issues concerning regulation and the legal system, as they influence global competition on IFS, this report examines them in comparison against existing and emerging IFCs through a scoring scheme from 0 (worst) to 10 (best) on a list of crude but useful illustrative indicators. This is applied to groups of existing and of emerging IFCs. The indicators, and the numerical values for scoring shown below, are admittedly subjective. There is an inevitable cross-over where different indicators pertain to overlapping, and yet distinct, issues. Much time has been spent debating the choice of indicators, and the numerical values for each city and each indicator to obtain a more objective picture. But we should stress that there is no objective methodology underlying these numerical values.

These tables should be cautiously utilised as an *illustrative* input for insights and for policy analysis, rather than as precise numerical values that should be argued *ad infinitum*. Also it has to be recognised that in most of the comparator cities scores are based on subjective judgements about regulatory regimes for IFS and IFCs that are already in place. In most IFCs there is some overlap between regulation of the overall financial system *per se*, and regulation of IFS provided through an IFC. In the case of Mumbai there is no specific regime for IFS or an IFC in place yet. Its scores therefore reflect judgements about its current governance regime for financial services as a whole, including those for a limited range of IFS involving foreign institutional investors FIIs and the IFS activities of foreign banks.

Thirteen aspects of the quality and impact of the regulatory regime for the financial sector, from the viewpoint of global competitiveness in IFS production, are scored. The first measure is that of ensuring systemic stability (E1), the task of avoiding crises that engulf the financial system and the macro-economy at large. One part of this concerns the protection of the integrity and soundness of financial institutions (E2). But equally, recognising that firm failure is an inherent feature and a learning mechanism in any market economy, a sound regulatory regime has effective coping mechanisms when market and institutional failures do take place (E3) so that failures are handled in a manner that does not induce panic. A sound regulatory regime is one where good quality risk management occurs at the level of firms, markets and the system at large (E4). Failures to achieve this can arise from faulty rules, in a rules-based regulatory environment, or from moral hazard with finance firms which believe they will be bailed out in distress.

A key test of a sound regulatory regime is whether it assures consumer protection (E5). What matters is the degree of genuine protection that consumers get as opposed to a regime that is strong on rhetoric about the importance of consumers while failing to uphold the interests of the consumer in reality. As an example, financial repression is inimical to the interests of all households. It is inconsistent with consumer protection, regardless of rhetorical claims made by policy makers about the importance of the consumer. Another aspect of consumer protection is the distinction between notions of what consumer protection actually is, as opposed to making it synonymous with adherence with an intricate system of rules specified by regulators. As is now understood from global experience, financial firms often have clever compliance departments to ensure adherence with complex rules, while violating the spirit and reality of consumer protection in the conduct of business.

One of the strongest tools for consumer protection is competition policy (E6). A sound regulatory regime is one in which there is full and effective competition and where every market is genuinely contestable. This applies in two ways:

Box 8.1: *Case Study - The Nikkei 225 futures*

The newspaper Nihon Keizai Shimbun has computed the Nikkei 225 index, a price-weighted stock market index of large Japanese firms since 7th September 1950 (Azarmi, 2002).

The first index futures contract was the S&P 500 index futures, which started trading at the Chicago Mercantile Exchange (CME) in 1982. It was only a matter of time before a Japanese index futures contract started trading.

CME was interested in this market, as was the Singapore International Monetary Exchange (SIMEX). SIMEX was established in 1984, as a part of Singapore's plan to become a centre for international finance. It offered an open outcry trading system for investors across the Asia Pacific and European regions and to interested parties in the US through the mutual offset system. The time difference between Singapore and Tokyo made it convenient for Japanese traders to trade on SIMEX. Three factors affected the evolution of this market:

1. Japan had wagering restrictions that hindered cash-settled index futures contracts. An effort was made to launch a physically settled contract which quickly failed. This legal hurdle needed to be resolved in order to enable index futures trading.
2. Nihon Keisai Shimbun Inc. had to choose how it would license the index.
3. Japanese regulators had to setup a regulatory regime for the product.

Nihon Keisai Shimbun chose to license the index to three exchanges: CME (May 1985), Simex and Osaka. CME and SIMEX had the option of linking their Nikkei 225 contracts. These exchanges were already linked through a mutual offset arrangement in a number of futures contracts offered at both markets, such as the Eurodollar futures. Positions taken in these contracts at CME could be transferred to or liquidated at SIMEX and vice versa.

With a fungible contract, the risk that one market would grow at the other's expense was low. However, the rewards of offering a successful Nikkei contract exclusively were high. SIMEX chose independently to offer a non-fungible Nikkei 225 futures contract in September 1986 – thus it decided to compete and not cooperate with CME on this product.

Osaka Securities Exchange started trading Nikkei 225 futures in 1988 followed by CME in 1990. From the onset, trading in Nikkei 225 futures at Osaka was very successful. Chicago has a 14 hour time difference with Tokyo. That ensured Japanese traders could not access CME during business hours in Japan. However despite the Osaka market, there was much Japanese interest in trading the Nikkei Futures in Chicago. At the time, some traders seemed to prefer the open outcry trading mechanism of CME to the computerised trading at Osaka.

Now three different exchanges were trading the same product. Since all three markets were, to a large degree, targeting the same clients, there was a chance that one or more of these markets would not attract enough clients and suffer a liquidity problem. During these initial years, trading at SIMEX was not very active.

In the late 1980's, Japanese regulators allowed banks and securities houses in Japan to do brokerage business in futures markets for their customers. The biggest benefits of this decision were realised by the Osaka market. The trading hours, the economy of the host country, and the access to the local market by both foreign and domestic traders were all important to the success of Nikkei futures on each exchange. Most of these factors were in favour of Chicago and Osaka.

Consequently, by the early 1990's, the Chicago and Osaka markets were thriving. SIMEX was not. Since the Chicago and Osaka markets did not trade simultaneously, there were no arbitrage opportunities between the Chicago and SIMEX markets or the Chicago and Osaka markets. However, for most of the trading day, the Osaka and SIMEX trading times overlapped. So a trader could arbitrage between these two markets.

It looked like Japan had successfully captured the Asian day and the Western night business for its Nikkei 225 futures contract. While the Western day business was done in Chicago, Singapore was pushed aside to doing only marginal side business. SIMEX tried hard to attract more business. It offered an award to the brokerage firm that did the most business through it.

In the summer of 1992, the Japanese regulators gave Singapore a big 'omiage' (gift). The Japanese regulators had misdiagnosed the difficulties that had led to the October 1987 stock market crash in the US and had decided that programme trading was to blame.

Osaka imposed stringent rules on the options and futures deals in that market. In order to stymie programme trading, Japanese regulators imposed restraints on index futures trading in the Osaka Futures Exchange. In addition, the price was allowed to move only within tight limits. Osaka let the Nikkei contract move to about 3.3% of current market levels while SIMEX permitted a 10% fluctuation. Because of this the Osaka market was often suspended for most of the day, especially when markets were volatile, leaving traders with no domestic benchmark against which to buy and sell. Traders had to keep high margins with the exchange. Margins were raised four times in 1991 and in 1992, after which margin stood at 30% of the value of the contract, of which 13% was a non-interest bearing cash deposit. In addition, dealers' commissions were required meet a minimum rate that the exchange had specified. This enabled SIMEX dealers to gain a competitive advantage by offering discount commission rates that could not be matched at Osaka.

Within a few weeks of implementing these rules, trading began to move from Osaka to SIMEX. Trading in SIMEX rose from 4,000 to over 20,000 contracts per day. The success with the Nikkei 225 futures put SIMEX and Singapore on the global map. This was bad for Japan's financial industry, which lost fees for brokerage, transactions, research, advisory, etc. However, it was good for users in Japan, who were not locked into using their inferior domestic market: they were able to use the offshore market even when policy makers disrupted the local market.

The Nikkei 225 futures now trade in Chicago, Osaka and Singapore. Japan's regulators have since removed many of their restrictions, but an important Nikkei 225 futures market remains in Singapore. This is partly because liquidity is hard to dislodge once it comes about. In addition, Japan appears to have problems with competition policy, and treatment of foreign firms, which translates to elevated transaction and brokerage fees.

Table: Nikkei 225 futures: an example of three levels of international competition on regulation and law

Aspect		Example: Nikkei 225 futures
I.	Banning of products and markets	Nikkei 225 futures were banned
II.	Rules limiting the success of permitted products and markets	Restrictions on participation, and high margins, in Nikkei 225 futures traded in Japan.
III.	Intangible issues	Trust in Japanese regulatory mechanisms as seen by outsiders.

This case study illustrates all three levels of competition in export of IFS. At first, in the period after 1982, even though it was obvious from the success of the S&P 500 futures in the US that there was a market for the Nikkei 225 futures in Japan, the Nikkei 225 futures could not be launched in Japan owing to legal difficulties with cash settlement. Japan then squandered a head start owing to poor policy analysis in the aftermath of October 1987, which led to restrictions against program trading, high margins and regulated brokerage fees. Finally, SIMEX and CME were more attractive for global order flow in terms of the intangible issues of trust.

competition among firms, and competition across different financial 'technologies'. Competition among firms is impeded by entry barriers in any kind of business. Competition across technologies is best illustrated by an example: Money market mutual funds and checking accounts are alternative technologies through which certain kinds of services can be obtained by customers. Sound competition policy requires that both these sub-industries compete with each other in the marketplace. Any regime that blocks the growth of checking accounts in order to favour mutual funds, or blocks the growth of money market mutual funds in order to favour bank deposits, limits competition and damages consumer interests.

The next question is that of a level playing field (E7). It is related to competition policy. It seeks identical regulatory treatment of all firms. A key feature of an IFC is the treatment of foreign firms. One indicator is the extent of protectionism embedded in the regulatory system (E8). This seeks to measure the treatment of foreign firms in a broad sense. It is like a level playing field question where a domestic firm is compared against a foreign firm.

A key indicator affecting the performance of the regulatory system is the problem of conflicts-of-interest. Financial regulators tasked with various functions in financial regulation need to have clear goals that do not conflict with each other (E9). For example, around the world, an increasing number of monetary authorities are tasked with achieving the single goal of price stability. Separate institutions undertake regulation and supervision of the financial system.

But, in India, in addition to the core goals of monetary policy, the central bank as a regulator has other subsidiary roles. These include: protecting banks, enabling the provision of subsidised credit in some sectors, running a bond exchange and a depository, and financing the public deficit at lower than real market cost. Can a central bank that: is not constitutionally independent of government, has multiple roles, and is asked to achieve multiple non-monetary goals, possibly avoid multiple conflicts-of-interest from arising on a day-to-day basis? Can it do so when the government that is its apex authority, is also the country's largest owner of banks, owns other financial firms and is its largest borrower?

In the globally competitive game of IFS, innovation is the main source of competitive advantage. The impact of the regulatory regime on financial innovation (E10) directly affects success in establishing an IFC. This issue is also related to the extent of regulatory intrusiveness and micro-management of markets and institutions (E11). It is inimical to succeeding in the global competition for IFS. The ideal framework is one that is principles-based, open, market-friendly and competition inducing (E12). IFCs with rules-based regulation, entry barriers, low competition and opposed to the open internationalisation of their financial systems would score poorly on E12.

Finally, the overall value of a regulatory regime for finance is the extent to which it is conducive to efficient/effective resource mobilisation and allocation (E13). As emphasised above, the choice of these thirteen indicators, and the numerical scores of each city, are necessarily subjective. Yet, these tables yield useful comparative insights. First, they permit an understanding of the strengths and weaknesses of established and emerging IFCs on these 13 dimensions. But equally important, for the present purpose, they put the spotlight on the weakest links that will inhibit Mumbai from emerging as an IFC when compared with its global competitors.

An examination of the values in these two tables is revealing. As far as the overall score for the quality and impact of financial system regulatory regime is concerned, Mumbai lags behind both established and emerging IFCs. London, with a score of 9, is the benchmark that every IFC seeks to emulate. New York and Singapore both score an overall 7 along with Sydney and Dubai. Hong Kong fares better at 8. Seoul and Labuan follow up with 6 and 4 respectively. Mumbai lags at 3. Regulation is clearly an area where much needs to be done if Mumbai's aspirations to become an IFC are to be realised.

Table 8.1: Comparing Mumbai against established IFCs on the quality and impact of the financial system regulatory regime

		London	New York	Tokyo	Singapore	Frankfurt	Mumbai
Quality and Impact of Financial System Regulatory Regime		9	7	6	7	5	3
E1:	Ensuring Systemic Stability	10	8	8	8	8	7
E2:	Protecting Integrity and Soundness of financial institutions	9	8	9	9	8	6
E3:	Capacity to Cope with Market and Institutional failures	10	8	8	8	7	7
E4:	Sound risk management at all levels: systemic, market, institutional	10	10	8	8	8	5
E5:	Effective consumer protection	8	7	7	8	9	5
E6:	Encouraging full and effective competition across firms/segments	10	6	5	7	5	2
E7:	Ensuring level playing field for all players in all market segments	9	7	5	7	6	2
E8:	Extent of Protectionism embedded in regulatory system	9	6	5	5	4	1
E9:	Avoidance of conflicts-of-interest	8	7	5	6	5	1
E10:	Impact on Financial Innovation	10	10	5	5	4	1
E11:	Intrusiveness and micro-management of markets/institutions	10	7	7	6	5	1
E12:	Principles-based, open, market-friendly and competition inducing	10	7	7	6	6	1
E13:	Conducive to efficient resource Mobilisation and allocation	8	7	6	7	6	2

Table 8.2: Comparing Mumbai against emerging IFCs on the quality and impact of the financial system regulatory regime

		Mumbai	Hong Kong	Labuan	Seoul	Sydney	DIFC
Quality and Impact of Financial System Regulatory Regime		3	8	4	6	7	7
E1:	Ensuring Systemic Stability	7	7	3	7	8	5
E2:	Protecting Integrity and Soundness of financial instituions	6	7	5	7	8	6
E3:	Capacity to Cope with Market and Institutional failures	7	9	3	7	8	6
E4:	Sound risk management at all levels: systemic, market, institutional	6	7	5	7	8	5
E5:	Effective consumer protection	5	6	4	7	8	5
E6:	Encouraging full and effective competition across firms/segments	2	8	5	7	8	9
E7:	Ensuring level playing field for all players in all market segments	2	8	4	5	6	8
E8:	Extent of Protectionism embedded in regulatory system	1	7	5	5	7	8
E9:	Avoidance of conflicts-of-interest	1	6	4	5	8	4
E10:	Impact on Financial Innovation	1	7	2	5	7	5
E11:	Intrusiveness and micro-management of markets/institutions	1	8	5	5	7	5
E12:	Principles-based, open, market-friendly and competition inducing	1	7	2	5	6	8
E13:	Conducive to efficient resource allocation	2	7	3	6	6	5

A closer look at the numerical scores shows that Mumbai has better scores – such as 5, 6 and 7 – for indicators E1 through E5. Mumbai appears to match Frankfurt on one indicator (coping with market and institutional failures) with a score of 7. Mumbai may have a slight edge over DIFC on these measures, though this partly reflects the relative age of DIFC; there is little doubt that Dubai will strengthen these features as time passes and experience is gained with episodes of failure.

Where Mumbai fares badly is on indicators E6 through E11 concerning competition, level playing field, protectionism, conflicts of interest, innovation, regulatory intrusiveness, micro-management, and rules-based regulation. Mumbai has to make progress on E1 through E5, where it lags emerging IFCs by a small extent. But fundamental rethinking is required on factors E6 through E11 where both established and other *emerging* IFCs out-perform the Indian financial regime governance.

On balance, these constraints hamper the ability of the financial system to perform its core task: that of supporting efficient resource mobilisation and allocation (E13). Here Mumbai fares poorly when compared with both established and emerging IFCs. An interesting feature of indicators E6 to E11 is that these are the areas in which London appears to fare better than New York. A deeper understanding of the task facing the Indian authorities in making Mumbai is an IFC is illuminated by the international debate about the UK approach to financial regulation as opposed to the US approach. Concerns in the US that New York is falling behind London in these respects are reflected in recent speeches made by the US Treasury Secretary and by the Committee on Capital Market Regulation that has been set up to see what can be done.

4. The overall legal regime governing finance

Underlying the key, but specific, question of financial regulation are a broader set of issues concerning the extent to which an IFC jurisdiction adheres in principle to globally accepted standards for the 'rule-of-law' as well as how such notions are applied in practice. Specifically, where the provision of IFS is concerned, global financial firms and investors place considerable emphasis on: (a) respect for property rights; (b) enforcement of creditor and shareholder rights; (c) the efficiency, cost and 'fairness' of recourse to the legal system; and (d) the integrity and competence of the legal system as a whole and all its components for resolving civil conflicts and disputes and assuring the enforcement of contracts through recourse in real time.

IFS invariably involve multiple instruments (underlying contracts accompanied by a variety of risk management instruments) bundled under a single financial structure (such as a syndicated loan or a sovereign bond with features and conditions attached). IFS also involves complex financial structures such as those involved with privatisations involving the participation of global investors and lenders, or PPP arrangements involving municipal, state and central governments acting in concert with private contractors, domestic and foreign, but with distinct performance obligations (and penalties in the event of default or breach) for each. These complex contractual structures require commensurately sophisticated contract enforcement mechanisms.

An illustrative approach, using indicators and scores in the same way as above, is brought to bear on understanding the quality, efficiency, effectiveness and supportiveness of the legal system insofar as it affects finance in general and IFS in particular. The quality, efficiency and effectiveness of legal recourse for redressing non-performance under contracts, is a fundamental ingredient in the globally competitive provision of IFS. In attempting that task, eight indicators are relied upon. The first (F1) concerns the knowledge base ('know-how') that exists in a particular IFC; i.e. in terms of having law firms, specialist lawyers and judges who understand and are experienced in the intricacies of dealing with complex financial contracts.

Most established IFCs are characterised by the presence of *global* accounting, law and tax advisory firms employing professional staff at all levels who have worked in several IFCs over many years. These institutions are familiar with not just the laws and regulations of the IFC jurisdictions concerned but of other IFCs and the source countries of global investors.

Though it does not yet have an IFC in Mumbai, India's legal system is widely perceived as adhering *in principle* to the rule of law, underpinned by a time-tested constitution and a durable, resilient legislative democracy that has been time-tested for six decades. At its apex, India is perceived as having a paradoxical combination of: (a) world-class knowledge, competence and sagacity about global finance, reposed in a few accomplished individuals with technocratic backgrounds and relevant practical experience; coupled with (b) a lack of similar knowledge, and ideological opposition, at other levels as to how the global economy and financial system function.

The legal system – in terms of its ability to understand and deal with issues of international finance – is perceived as capable at the apex level, but weaker at intermediate and lower levels. The legal system in India/Mumbai is perceived by practitioners abroad as adequate by international standards but not as knowledgeable about global finance simply because it has not had the opportunity to acquire such expertise. The absence of recognised global legal firms in India, with specific expertise and experience in dealing with IFS, provides some cause for concern. That deficit represents a serious institutional handicap if Mumbai is to become an IFC.

The second indicator (F2) concerns the *efficiency* of the IFC's legal system. It conveys a composite assessment of factors like: the legal requirements and processes involved in getting conflicts/disputes resolved through the legal system; interruptions and delays in the progress of cases through the system; the backlog of cases in the civil system; the quality of decisions and incidence of successive appeals; the overall time taken for dispute resolution; and the cost involved. The World Bank's 'Doing Business' database has come out with numerical measures for the number of days that it takes to settle disputes in various countries. This is related to indicator F2. On this indicator Mumbai would not fare well relative to other IFCs.

Most global investors seem aware that the concept of 'real time' appears to be elusive in Indian legal practice. That was substantiated by the late Nani Palkhiwala who said that: "Anyone who does not believe in eternal life has never litigated in an Indian courtroom". The Indian civil legal system in every city at every level seems beset by frequent interruptions and delays in the way cases proceed. There is a phenomenal backlog of cases (several million) in the pipeline. It can take up to two decades for civil cases to be resolved; often after the demise of the original litigants and their immediate descendants. Such absence of time-consciousness would be a significant deterrent to global investors from using an IFC in Mumbai. Under such circumstances, even if property or creditor rights are respected in principle, they cannot be applied or enforced in practice, simply because of the perception that as many Indian eminent jurists have repeated: "justice delayed is justice denied".

Distinct from the time taken to resolve contractual disputes through legal recourse, an indicator (F3) of some concern to global firms operating in IFCs, and to global investors, is the issue of probity and *effectiveness* of the legal systems in an IFC, especially when it comes to enforcing judgements, and applying the rule of law in practice, as opposed to adhering to it in principle. Again, on this measure, India (Mumbai) would fare poorly when compared with IFCs in OECD countries.[1]

The next indicator (F4) deals with issues of integrity and probity across the legal system. It is an illustrative measure that indicates the degree to which attributes such as fairness, impartiality, and credibility characterise the legal system in an IFC, along with the relative presence or absence of corruption. Global publicity attracted by perceived miscarriages can affect the image of a legal system adversely.

The fifth indicator (F5) focuses on the quality (in purely technical terms i.e. by way of professional competence) and the human and institutional capacity of the legal system

[1]No comparative scores have been provided for Mumbai in these two tables. The HPEC felt that as there was no IFC in Mumbai, the basis for comparison might be misleading and controversial if numerical scoring was attempted to convey a spurious sense of accuracy. However it also felt in qualitative terms that Mumbai was quite far behind other IFCs in these areas and much needed to be done to catch up with best global practices.

Table 8.3: Comparing IFCs on the quality, efficiency and effectiveness of the legal system

		London	New York	Tokyo	Singapore	Frankfurt
Quality, efficiency, effectiveness of legal system						
F1.	Know-how in dealing with complex Financial instruments/arrangements	8	9	6	6	5
F2.	Efficiency of legal system (i.e. time for dispute resolution)	7	8	7	9	6
F3.	Effectiveness of legal systems - enforcement and rule of law	7	8	7	8	6
F4.	Fairness, Credibility, lack of Corruption in civil legal system	7	7	9	10	8
F5.	Human and Institutional Capacity and Quality of the Legal System	7	8	7	8	7
F6.	Adherence to global benchmarks and standards of best practice	8	8	6	7	6
F7.	Use of national law in national, regional and global contracts	8	9	3	5	4
F8.	Overall Assessment of Legal System Functioning	8	9	6	8	6

insofar as its capability for dealing with, and supporting, IFS is concerned. While this indicator may involve a judgemental overlap with the first indicator of 'know-how' (F1) it is different in the sense that it attempts to capture dimensions that go beyond simply the 'know-how' aspect. F5 tries to capture a sense of the quality standards of legal training and expertise in dealing with issues that the provision of IFS raises, the degree of professionalism, quality of jurisprudence, depth and width of human capital, and the professional capabilities of legal firms and advocates in comparison with their global peers. Again a comparison across established and aspirant IFCs would reveal Mumbai as comparatively weak as far as the capacity of the extant legal system for supporting the provision of IFS by financial firms in Mumbai is concerned. But that weakness could be corrected quite swiftly if the will was exerted to accomplish that.

In a similar vein, the sixth indicator (F6) attempts to convey a sense of how well extant IFCs adhere to global benchmarks and standards of best practice in matters of law and legal support where the provision of IFS is concerned. The seventh indicator (F7) assesses the extent to which: (a) 'national law' prevailing in an IFC jurisdiction governs the provision of IFS in/from that jurisdiction or whether IFS contracts are governed by the use of foreign law (invariably UK or US) or international codes (UN, BIS, IMF or WB) when they are available; and (b) which foreign jurisdictions are chosen by most IFCs as centres for adjudication and settlement of disputes. Again, on these two indicators, Mumbai would fare poorly but then so do most other IFCs other than the three GFCs and those that use US and UK law for their IFS contracts as a matter of course. An attempt to make Mumbai an IFC will require a substantial improvement in the functioning of its legal system for this purpose.

Under the present circumstances it would be unrealistic to assume – if an IFC were to emerge in Mumbai – that Indian law covering IFS contracts, or Mumbai as a jurisdiction for adjudication concerning IFS, would be immediately acceptable to global participants. It is more likely that, as in most IFCs at present, UK or US law would be chosen to cover IFS contracts. Over time – with experience, expertise and credibility being gained, along with improvements in the operating and quality standards of the Indian legal system – it is more than likely that Indian law could gradually be applied to IFC operations in Mumbai and become acceptable globally.

Finally, the eighth (F8) indicator attempts to encapsulate information contained by all the previous seven indicators into a composite judgement. Unsurprisingly it reflects what has already been alluded to above.

The two tables on the ability of the extant legal system to support the provision of IFS reveal a discouraging picture because in our subjective judgement Mumbai lags in all aspects. The four tables comparing different IFCs on financial regulation and the legal system are particularly illuminating in terms of two comparisons: against Shanghai and DIFC. While Mumbai might be competitive with Shanghai in these aspects, that is not the case with DIFC, whose legal governance and regulation is de-linked from the UAE's legal and regulatory regime for financial services. It is purpose-built for DIFC alone. DIFC has a stated policy of hiring the best available practitioners from abroad to ensure that regulation and dispute settlement at DIFC are of the highest world class standards; i.e. similar to those prevailing in the three GFCs. That could give an edge to DIFC as a competitor to Mumbai (as an IFC) in attracting regional and global customers for IFS. DIFC has a head start over Mumbai in the process of complex institution building required for financial regulation and the legal system governing its IFC. It is willing to be flexible, adopt the best global practices, and has the resources as well as the political will to employ the best people available in the world, as regulators and for administering the special legal framework that has been established for governing the operations of DIFC.

The second interesting comparison is Hong Kong. Here, the traditional argument made in Indian circles is that the Chinese financial and legal systems lag far behind those of India. That is undoubtedly true as far as Mumbai competing with Shanghai as an IFC is concerned. But China has an enormous asset in the form of Hong Kong, a thriving well-established IFC that has been shaped by over a half-century of liberal law and regulation based on the UK model. Hong Kong scores better than Mumbai on financial regulation and its legal system. This affects India in two ways.

First, in the global competition for IFS production, China may have a stronger position than appears to be the case, if the institutional attributes of Hong Kong are taken into account. The caveat lies in whether China will rely more on Hong Kong than on Shanghai as its premier IFC.

Second, if resource allocation in China is influenced by the way in which Hong Kong's financial markets operate, that will certainly improve the quality of capital productivity. This facet of having Hong Kong contradicts the stereotype that Indian finance and law are far superior to Chinese finance and law as far as IFS provision is concerned. A considerable deployment of Chinese savings, and fundraising by Chinese firms, especially for the southern special economic zones and the economic region surrounding Guangdong, is being done in

Table 8.4: Comparing emerging IFCs on the quality, efficiency and effectiveness of the legal system

		Hong Kong	Labuan	Seoul	Sydney	DIFC
Quality, efficiency, effectiveness of legal system						
F1.	Know-how in dealing with complex Financial instruments/arrangements	8	4	5	7	6
F2.	Efficiency of legal system (i.e.time for dispute resolution)	8	5	6	7	10
F3.	Effectiveness of legal systems - enforcement and rule of law	7	5	6	8	5
F4.	Fairness, Credibility, lack of Corruption in civil legal system	7	5	6	9	5
F5.	Human and Institutional Capacity and Quality of the Legal System	6	5	6	8	5
F6.	Adherence to global benchmarks and standards of best practice	8	6	7	8	7
F7.	Use of national law in national, regional and global contracts	6	6	5	6	9
F8.	Overall Assessment of Legal System Functioning	7	5	6	8	6

Hong Kong which outperforms Mumbai by a considerable margin as a financial centre.

5. Summary of cross-country comparisons

In summary, it appears that the weakest links in an Indian effort to compete with other IFCs are issues of financial regulation (E6 to E11) and the overall weakness of its legal system. These are the areas on which this report places great emphasis as needing immediate strengthening if a viable IFC is to emerge in Mumbai.