

The HPEC's recommendations

chapter 15

Throughout the chapters of this report a series of suggestions have been made either implicitly (*i.e.*, arising from the logic of the arguments made) or explicitly in the form of a specific change. These recommendations/suggestions have been arrived at bearing in mind that the ToR of the HPEC outlined a broad remit requiring the Committee to raise any issue that, in its view, impinged upon the success of an IFC in Mumbai. In some areas, the recommendations of the HPEC concern formulating an appropriate approach. In other situations, the Committee has crafted specific recommendations. In some situations, the Committee proposes a re-examination of certain issues by the Ministry of Finance, recognising their bearing upon the issues of achieving an IFC in Mumbai, but at the same time recognising that their resolution requires more detailed treatment, which impinges upon many other issues in economic policy. Putting both together, the HPEC believes it has articulated a set of immediate and medium term goals in the form of a roadmap to put Mumbai on a trajectory for becoming an IFC.

The HPEC is mindful that it has not been tasked specifically with looking into detailed matters concerning macroeconomic policies (ie fiscal, monetary, exchange rate, convertibility *etc.*) financial regulation and regulatory architecture or, for that matter, the prevailing legal or educational systems. Nevertheless all these areas exert a considerable influence upon whether an IFC can be established in Mumbai and upon its prospects for success. Therefore they have attracted our attention and comment. Other Committees have looked into some of these issues. The HPEC has taken their findings and suggestions fully into account in its deliberations. That does not necessarily mean that it agrees with what has been suggested by others in every instance.

In most cases the focus of other Committees has not taken into account the possibility of Mumbai becoming an IFC. Their recommendations were crafted mainly in a domestic context. Therefore it should not be surprising that in some instances their findings may (implicitly) militate against the establishment and successful operation of an IFC. In many instances the HPEC recommendations may require further detailed scrutiny by specialists to convert broad ideas and suggestions for change into specific 'actionables'. With this background in mind, the HPEC has attempted to draw an appropriate balance in making its recommendations in terms of their width, specificity and depth. These are pulled together in coherent form below.

In recommending that policy makers opt for creating an Indian IFC in Mumbai, for a variety of strategic reasons of national interest, this chapter explicates what is implicit. It collates and clusters its recommendations under the following three pillars on which an IFC has to be supported:

1. The general **macroeconomic environment** in which an IFC operates and the policy framework that affects its operations and credibility in the global financial system.
2. The agenda for further **financial system reform** that needs to be carried through so that an IFC can operate on a viable basis. Such reforms include changes that need to be made in: (a) financial regime governance and regulation; (b) the development of 'missing' or weak markets; (c) the development of globally competitive institutions and financial firms; and (d) other policies concerning the financial system and ensuring that its growing need for qualified human capital are met.
3. The agenda for **urban infrastructure**

and governance in Mumbai, particularly in the context of making it a hospitable global city for a large and demanding expatriate population that will be indispensable in the successful operation of an IFC.

1. The general macroeconomic environment

This report traces the origins of a tendency toward financial repression in India, given its development trajectory since independence, and the policy choices made under governing political economy pressures and constraints at different points in time. To a significant degree, the present problems of Indian finance, and therefore the future prospects of an Indian IFC, are rooted in legacies created by the size of the public deficit and how it has been financed over the last three decades. This assertion demands a digressive preamble.

India has run a high gross consolidated fiscal deficit (for the centre, states and contingent liabilities) – three to four times the size generally regarded as prudent as a percentage of GDP – for too long; particularly since the 1980s. That has resulted in expedient strategic and tactical options being resorted to for financing such a public deficit. These options, which perhaps were necessary at that point in time, in turn, have affected the evolution of the Indian financial system. They have bolstered public sector ownership of financial firms through ‘balance sheet and profit-loss protection’ as well as high barriers to entry and competition and the resultant suppression of financial innovation. A distorted INR yield curve – determined by the government rather than the market – accompanied by a reliance on captive bank rather than bond market financing, have been seen as pre-requisites for financing public debt at low cost. These tendencies are, axiomatically, anathema to markets and therefore to the prospects for establishing an IFC – which by definition requires a liquid bond market with undistorted interest rates.

The persistence and pervasiveness of *direct* rather than *indirect* forms of public intervention in the financial system (from ownership to directed lending) has compromised the early and smooth development of various financial markets and concomitant institutional structures in different financial sub-segments. It has prolonged the existence of too many inefficient, small, undercapitalised financial firms (public and private) that are incapable of withstanding the heat of global competition in almost every financial market segment. Thus the domestic institutional and market infrastructure that is needed for an IFC to operate is deficient in many important respects at the present time in India. So is the range of financial products and services that are offered and traded in Indian financial markets relative to those available in global markets. An IFC cannot function when the domestic-global gap is quite so wide.

With the policy choices made in the past it is no surprise that natural market discipline has been prevented from operating as it usually does in the financial system to induce efficiency and competition – *i.e.*, through time-tested processes of adjustment, adaptation, acquisition, merger, takeover and bankruptcy. Direct public intervention in the financial system (through ownership) has influenced, if not compromised, the policy objectives of *financial regulation* by inclining them toward the goal of protecting certain types of financial firms for social or political, rather than economic or commercial, reasons.

Regulatory objectives aimed at the *primary goals* of fostering prudence, soundness and stability of the financial system, have become inextricably intertwined with the *secondary goals* of protecting (implicitly or explicitly) the legitimate vested interests of the State as the largest single borrower from, as well as the largest single owner of, financial firms and markets in India. That multiplicity of objectives makes any system of financial regulation imbalanced and opaque; if not occasionally confused and contradictory, in attempting to accommodate too many irreconcilable but inherent conflicts-of-interest. Such a cocktail of multiple ingredients be-

comes even more potently dangerous when the conduct of an independent monetary policy is fused with the exercise of regulatory responsibility under circumstances in which the state as the ultimate regulator is implicitly protecting its own interests as a privileged economic agent as much as it is protecting the wider interests of a market financial system.

It is important for us to stress at the outset that, in tracing this history as a matter of fact, the HPEC does not question the legitimacy or propriety of what has happened and why. Nor is it advocating any particular ideological line. It is simply establishing the links between historical impulses, policy choices and market/institutional outcomes in the evolution of Indian finance since 1947. In opting, through a democratic process of choice, for a command-and-control type of economy between 1947 and 1992, the State had the legitimacy and the right to arrogate unto itself a special privileged position as a superior economic agent and driver of development; as well as the prime protector of wider social interests. That public choice was supported by successive electoral mandates.

But in shifting gears and transiting toward a market oriented economy – which is what the reforms of 1991 onwards were all about – the legitimacy and ‘appropriateness’ of that privileged position for the state as an economic agent, over other types of economic agents, has come into question. It causes systemic discomfort and dysfunction when the prerogatives and privileges of the State *as an economic agent* are maintained in a market economy which, by definition, does not recognise such prerogatives or privileges as legitimate or functional. Markets – whether financial or real – and market economies do not function as they are intended to when economic agents are differentiated in this fashion and when one type of agent (the State) maintains a privileged position over other economic agents in terms of access to natural or financial resources, pre-emption in the ownership of productive or institutional assets, or in access to factors that determine a firm's competitive abilities. That kind

of differentiation and privilege of one economic agent over another strikes at the roots of what makes a market economy tick – *i.e.*, a level playing field, equality of opportunity, application of the same rules to all players across the board regardless of their ownership, no barriers to entry or exit, competition, innovation and adaptation through unfettered freedom.

The inescapable result of the accumulated legacy of pre-emptive and repressive policies in Indian finance has resulted in a ‘lowest common denominator’ approach influencing the outlook and mindset of financial policy and financial regime governance. These deficiencies began to be corrected with the onset of ‘serious’ reforms in 1991–92. Those reforms have gone far, wide and deep in the real economy resulting in a transformation of Indian manufacturing and of service industries such as IT services. But those reforms have not yet penetrated India's financial system to the same extent. Considerable progress has since been made; especially on public finance, with tax reforms and the passage of the FRBM Act. But key issues and concerns remain that HPEC is obliged to illuminate and adumbrate in the context of establishing an IFC:

1.1. On Economic Strategy, Fiscal Policy and Deficit Financing

1. An IFC in Mumbai would become credible and successful more quickly if India's overall economic strategy was aimed at **achieving and maintaining an average growth rate of 9% to 10% between now and 2025**. With 10% growth, India's nominal GDP expressed in US dollars is likely to double every 5–6 years. In terms of crude approximations, that would imply India's nominal dollar GDP increasing from \$725 billion in 2005 to \$1.3 trillion in 2010. It would increase again to \$2.5 trillion by 2015, and \$10 trillion by 2025. Such growth would create a favourable environment for an IFC in Mumbai to capture a huge hinterland advantage. These rates of growth are achievable. Indeed they may be the only way of generating sufficient public resources to deal with poverty, fiscal

deficit, and public debt reduction all at the same time. When GDP is \$10 trillion, a government that spends 2% of GDP on welfare programs puts itself in a position to transfer about Rs. 4,000 per person per month to the poorest one-sixth of the country's population. Clearly, a 10% real rate of growth cannot be achieved unless extant, binding infrastructure and governance constraints are relieved. Those key objectives would be facilitated by India having its own IFC in Mumbai.

2. Despite the FRBM Act and a number of other measures that have been taken, insufficient progress has been made toward **reducing the gross consolidated fiscal deficit (GCFD) to 4–5% of GDP**. More progress needs to be made to underline an unshakeable GoI commitment to establish the fiscal foundations for a rapidly growing – but still ‘developing’ – economy in which a ‘newcomer’ IFC must operate credibly. **No IFC has taken off or thrived in any economy where such sizeable deficits have been incurred for so long.** Global markets are deterred from participating in IFCs whose home economies are fiscally incontinent because of a chronic inability to align public expenditure with public revenue. Large deficits (and the build-up of an overhang of public debt) pose a latent threat to systemic stability in the event of endogenous or exogenous shocks. Confidence in the INR is diminished in such an environment. For that reason, if having an IFC is a strategic objective to be achieved by India (and for other obvious reasons as well), then governments at all levels (central, state and local) need to exert greater political will over the next five years and beyond to reduce their respective fiscal deficits.
3. Related to the deficit reduction target (and contributing to its achievement) **the HPEC would recommend progressive reduction of the total public debt to GDP ratio from the current level of 80% of GDP to significantly less.** That reduction has already begun. It must be sustained. **The HPEC did not reach a consensus on any particular debt/GDP ratio as a ceiling.** It has done no detailed work on the range that would be appropriate; that was not its primary mandate. By way of illustration, however, it does suggest that ratios of 50–65% have been adopted by different countries as being indicative of prudence. India needs to establish its own ratio for a debt/GDP ceiling after careful study, as a natural accompaniment to the FRBM deficit reduction targets. That ceiling should suggest to global markets India's commitment to fiscal prudence at all levels of government. Total public debt in this context would mean the outstanding long and short term debt of central and state governments, as well as the debt of PSUs guaranteed (directly or indirectly) by GoI, and all contingent liabilities of central and state governments incurred through off-balance sheet financing or quasi-fiscal accounts. When these adjustments are made, the true debt/GDP ratio of India is well in excess of 80%. Public debt reduction depends, to a large degree, on fiscal deficit reduction. But it can be accelerated through programmes of public asset sales at all levels of government. Such sales would galvanise capital markets, spur growth and result in more foreign investment (portfolio and direct) to achieve a higher growth rate.
4. In restructuring tax revenues to achieve deficit reduction, particularly in the context of an IFC and the effects that taxes have on influencing financial system evolution, **the HPEC would recommend, broadly, that tax policy should implement the key principles determined by a series of expert committees starting from the mid 1980s, and leading up to the FRBM Task Force Report of 2004.** This involves a simple tax code, with administrative efficiency, low tax rates, removal of exemptions, and a tax system which places the main burden of taxation on consumption rather than income or saving. From an IFS perspective, **the HPEC recommends eliminating transactions taxes in the form of the Securities Transaction Tax (STT) and**

stamp duties. The former requires actions by the Ministry of Finance, while phasing out the latter needs to be synchronised with the shift to the two part Goods and Services Tax (GST) and integration of the real estate sector into the GST. **HPEC does not see the need for a tax haven, or even temporary tax breaks, as concomitants to having an IFC in Mumbai.** But it does recommend **applying GST to the financial services industry.** This will require appointment of a technical committee to work out the mechanics of how this should be achieved.

5. In financing the fiscal deficit, over-dependence on the domestic financial market needs to be reduced. GoI should continue reducing reliance on pre-emption or quasi-pre-emption through the financial system. Public debt should be financed in domestic and global bond markets. Such markets are willing to finance the public deficit by buying **INR denominated** GoI notes and bonds. **The purchase of INR denominated instruments issued by GoI should be open to anyone across the maturity spectrum from 7-days to 30-years.** This opening-up should be done in two steps, so as to postpone foreign investment into short-dated bonds. This would automatically reduce pressures on the domestic financial system and on: (a) crowding out private investment; (b) interest rates; (c) the balance sheets of PSU banks and other financial firms; (d) continued public sector ownership of financial firms; and (e) keeping the capital account partially closed thus thwarting or delaying full convertibility of the INR.
6. **The budgets and 'balance-sheets' of state governments and major metropolitan municipal corporations (and other local authorities as well) need to be restructured.** That would permit sub-sovereign governments to become 'solvent' and resort to market financing rather than depending on GoI support and direct/indirect financial guarantees. Doing so would have the triple effects of:

(a) exposing sub-sovereign governments to the discipline of the market; (b) creating new financial markets in these segments thus adding to the width/depth of a bond market in India that is, at present, lacking in both; (c) expanding the array of IFS that could be provided by an IFC in Mumbai.

7. **Shift the burden of future infrastructure investment from the public to the private sector through PPPs: i.e., public private partnerships** involving private finance – from the domestic and global markets – to provide public goods and services on an appropriately structured basis that avoids the risk of 'privatising profits while socialising costs'. Greater resort to PPPs would: (a) resolve the financing constraint facing infrastructure investment in India which requires staggering amounts of funding; and (b) also provide an opportunity to hone a special competitive edge in the IFS provision capabilities of an IFC in Mumbai.

1.2. On Monetary Policy and its Implementation/Execution

8. The creation of an IFC in the 21st century inevitably requires an open capital account if the IFC is to: (a) function with a modicum of efficiency; (b) provide the full array of IFS; and (c) be viable/successful and globally competitive with other IFCS/GFCs within a conscionable time-span. But, with large fiscal deficits being run, the task of managing monetary policy – with an open capital account in a rapidly growing, developing economy like India – becomes more complicated than it presently is. When faced with such a situation, **the implication for the monetary authority may well be that – in keeping with regimes that characterise economies with successful IFCS – it needs to consider focusing exclusively on the single task of managing a key short-term 'base rate' to maintain price stability (e.g., inflation being kept within a range of 3–4%), consistent with supporting a high growth rate (8–10%).** As global experience with managing monetary regimes in the

more successful economies suggests, achieving that prime objective is critical. It may be so crucial in the Indian 'high-growth requirement' context that all other subsidiary functions now performed by the extant monetary-cum-regulatory authority may need to be divested to agencies that specialise in undertaking them. In particular, **the monetary authority should not be placed in a position where: (a) it is obliged to manage multiple conflicts-of-interest; and (b) runs the risk that managing such conflicts might lead to sub-optimal decisions on adjusting the base rate as evolving internal and external circumstances impinging on the economy might demand.** Confidence in an Indian IFC will be enhanced if the monetary authority is *seen* to be free of these conflicts of interest. As part of this framework, **the HPEC believes that the function of a public debt management office should be either completely independent – in the form of an autonomous agency – or placed in the Ministry of Finance rather than in a regulatory institution to avoid any perceptions of conflicts-of-interest in the eyes of regulated financial firms.**

9. **Managing monetary policy under changed circumstances will require fundamental reconsideration of core issues** such as: (a) the viability of maintaining a 'stable' exchange rate for the INR; (b) whether that rate should be managed around a notional central USD peg or a different trade/investment weighted currency basket; (c) whether official intervention in currency markets to 'stabilise' the INR should occur, except in extreme (market failure) circumstances; (d) ceding a 'stable exchange rate policy' in favour of monetary autonomy, thus putting the burden of adjusting to a more variable exchange rate on private actors and the government, while **creating more risk management possibilities (through currency derivatives) that make such adjustment easier;** (e) a focus on 'inflation targeting' and examining

carefully whether such a focus makes sense in an economy that is still subject to price manipulation of some 'big prices' (e.g., energy price) that feed through the economy and have an impact on all other prices as well; and (f) the gradual evolution of the INR into becoming a global reserve currency by 2025. **These issues, which have also been examined tangentially by the Tarapore-2 Committee on CAC, need to be looked into further by a specialised expert technical committee.**

10. The debate on convertibility is primarily about avoiding the currency crisis and banking crises which came about in countries such as Mexico, Thailand, South Korea and Indonesia in the last decade. These failures are understood to have been caused primarily by flawed currency policies, and these pitfalls need to be carefully avoided. Taking into account the balance of risks evaluated by many previous committees and experts, **the HPEC is of the view that the capital account needs to be liberalised more rapidly and in a time bound fashion than is presently envisaged. CAC needs to be achieved within the next 18–24 months – i.e., by the end of calendar 2008 at the latest – preferably sooner.** That is required partly to ensure that any IFC established in Mumbai has a fighting chance of succeeding. At the same time, this policy is what the Indian economy and financial system need at this critical juncture. The capital controls that are now in place: (a) pose a high (if not insuperable) barrier in practice, to Indian financial firms offering IFS in the global market and hobble them in competing against global firms in the context of increasing *de facto* convertibility; (b) deprive these firms from earning significantly higher export revenues; (c) delay the development and acquisition of core IFS-provision competencies; (d) reinforce protectionist barriers to entry in the Indian financial system thus rendering it inefficient, uncompetitive and more costly in terms of basic financial intermediation; and (e) inhibit essential financial system

liberalisation from occurring as swiftly and to the extent that it should.

2. Further Financial System Liberalisation and Reform

The HPEC's recommendations and suggestions under this heading fall into four broad categories: (a) financial regime governance and regulation; (b) the development of 'missing' or weak markets; (c) the development of globally competitive institutions and financial firms; and (d) other policies concerning the financial system and ensuring that its growing need for qualified human capital are met.

2.1. On Financial Regime Governance and Regulation

11. Financial regime governance in India must now be transformed in the same way that governance of the 'real' economy was transformed through the 1990s to make Indian manufacturing firms more efficient and globally competitive. Indian financial firms and the financial system need to be exposed to the same discipline, in order to adjust in the same way, to achieve the same goals. **There is an immediate need for the Indian financial system to become more open and outward-orientated to enhance its technology, efficiency, productivity, competitiveness and quality.** Without such transformation the emergence of a credible IFC in Mumbai could not be contemplated.
12. **Such a transformation is essential** not just to enable the export of IFS from an IFC in Mumbai. It is essential **to make the entire financial system more efficient so that it can provide world-class financial services to the domestic market and intermediate financial resources more efficiently for use in the real economy as well.** At present the Indian consumer of financial services is poorly treated, and served at a higher price than his counterpart in more developed financial systems. Similarly

the Indian economy, in attempting to achieve higher growth rates (9–10%) than it has proven capable of over the last four years (8%) needs a financial system that mobilises resources more efficiently, and does not waste or divert scarce financial resources through sub-optimal allocation.

13. **Financial regime governance needs to change fundamentally across the board** if an IFC is to be allowed to emerge in Mumbai for two reasons:

* The quality, flexibility, adaptability and 'lightness-of-touch' of *financial regime governance*, is an integral feature of a country's ability to provide and export IFS successfully and to establish a successful IFC for doing so. The importance of that assertion is brought home with particular force when even a well regulated (by world standards) jurisdiction like New York is faced with becoming less competitive by the day in the face of regulatory competition from a better, more responsively regulated regime in London. By the same token, IFCs like Paris, Frankfurt and Tokyo that are perceived by global markets as over- or unpredictably-regulated, do not make the frame when it comes to competing globally. Financial regulation is not, therefore, a feature that can be treated independently and 'left alone' when it comes to considering what a new IFC needs in order to compete effectively in the global arena.

* A financial regulatory regime is counterproductive for an IFC, or for encouraging the emergence of a dynamic domestic financial system, if it: (a) is too risk averse; (b) is prepared to erect severe roadblocks to 'financial traffic' or even stop it in order to avoid any probability of an 'accident' occurring; (c) reacts negatively to financial innovation or new proposals for products or services; (d) tends to ban financial products, services, players or markets; (e) issues rules that limit

the success of products/services even when they are not banned; (f) discriminates in its treatment of firms based on their ownership or origin; (g) is protectionist in its rules and regulations and in the manner of their application in practice: *i.e.*, effectively or implicitly favouring certain firms while disfavouring others; (h) discourages – through a policy of intervention, intrusion and regulatory micro-management – voluntary, self-induced risk-management, and corporate governance of high standards, on the part of the financial firms being regulated; (j) discourages vibrant competition and financial innovation from occurring in the financial marketplace; and (k) artificially compartmentalises different segments of financial markets while forcing them to remain apart – for regulatory convenience rather than market efficiency – thus reducing liquidity and trading opportunity in each segment as well as diminishing arbitrage and risk-transformation opportunities than enable financial markets to innovate.

14. But financial system regulation in India (which is of a high technical quality if more contentious in terms of its overall orientation, policy and approach) is not the only issue. Other aspects of financial regime governance – especially **the functioning of the legal system** – leave much to be desired. They **must be improved to increase the prospect of establishing an IFC in Mumbai**. If they are left unattended, some glaring deficiencies in the capacities, knowledge-base, and the administrative functioning of these critical systems for dispute settlement and conflict-resolution (especially given the way in which civil cases proceed through the legal system with interminable delays) will prevent an IFC in India from ever emerging or competing effectively in the global marketplace.
15. **HPEC therefore recommends that urgent action be taken to remedy these**

short-comings with suitable reform of the legal system. If that cannot be done relatively quickly then, in the interim, consideration should be given by policy-makers to establishing a special system of fast-track ‘financial’ courts and special arbitration mechanisms to deal with the legal and regulatory complexities that an IFC and the provision of IFS will create. **This could mean creating an International Financial Services Appellate Tribunal (IFSAT), covering all parts of finance. IFSAT should offer a comprehensive appeals procedure against all actions of all financial regulators, where judges have specialised financial domain knowledge.** The specific measures needed to effect improvements in this area will require scrutiny by other experts and specialists before this broad recommendation can be translated into a series of specific actions and remedial measures.

16. To improve the knowledge-base and professional competencies that an IFC in Mumbai will need to function and compete effectively, **the HPEC recommends that domestic space be opened up without any restrictions (such as insistence on domestic partnerships or joint ventures) to permit immediate entry into Mumbai of: (a) well-known global legal firms (corporate or partnerships) that operate in other IFCs and especially the three GFCs; as well as (b) all global accounting firms, tax advisory, information technology, business consulting and education firms that support the IFS industry.**
17. From the ‘wall-chart’ that has been derived for this report, to depict illustratively the barriers and impediments that operate on Indian financial firms of various types, effectively preventing them from providing IFS to a global clientele, three sets of issues emerge regarding the financial sector in India. They include: (a) implications for **competition policy** that governs activity in the financial system; (b) artificially tight **compartmentalisation** of financial markets with

little 'crossover' being permitted across boundaries; and (c) the impact that both these influences have on suppressing *financial innovation* in India.

18. **In each of these areas the HPEC recommends that policy-makers revisit carefully the nature of the financial regime governance so as to make it more competitive, less fragmented, and more innovative.** Operating together, these three factors prevent Indian financial firms from realising the economies of size, scale and scope they need to exploit to compete globally.
19. **The HPEC further recommends that this regime be opened up** to permit a greater degree of competition (domestic and foreign) and induce a more rapid rate of innovation that will permit Indian finance to catch up with the rest of the world within the next 5 years and operate along global lines thereafter. **By the same token it recommends that the excessive compartmentalisation that has occurred across different financial market segments be reversed.**
20. In the view of HPEC, the artificial barriers that have been erected between different segments of the financial market – *i.e.*, banking, insurance, capital markets, asset management activities, and derivative markets – so that they can be regulated separately by different regulators should be dismantled. Whether regulators are separated or not, the financial sector needs to operate as a seamless whole in order to achieve global standards of market efficiency, competition and innovation. This may be inconvenient for regulators. **But, in the view of the HPEC, regulatory arrangements and architecture should be rearranged to meet the market's needs; rather than having the market rearranged in order to meet the demands of regulatory convenience.**
21. In the view of HPEC, artificial obstruction to greater competition in the financial sector now needs to cease. A process of 'creative destruction' needs to be unleashed in Indian finance to make it more dynamic, globally competitive, and to let financial firms emerge that are of the right size and scale to take on global competition. That is precisely what was done in the industrial sector during the last decade when over one thousand firms disappeared but were replaced by fewer but larger, more efficient and more competitive industrial firms.
22. But that also means having the Government prepare an 'exit strategy' through reduction in its ownership of financial firms. As a shareholder it is perfectly rational for the government to act in this manner to protect its shareholding interest and the value of its equity stake. But from the viewpoint of the welfare of the Indian market economy, and to a lesser extent of having a credible IFC, that policy is counterproductive and myopic. It results in the inefficient use of public resources at a time when greater efficiency is demanded to attain and sustain a high growth rate. The logic of the argument suggests that the state should withdraw gradually, at a pace dictated by *realpolitik*, from being a shareholder in any financial firm.
23. By doing so it would avoid the serious conflicts of interest. In terms of a possible timeline, **the HPEC would suggest that the legislature contemplate a general policy of reducing the state's present shareholding in all types of financial firms to below 49% by end-2008, below 26% by end-2010, and toward a full exit by 2015.¹** If this trajectory of withdrawal is not put in place the prospects for an IFC in Mumbai emerging as a credible and competitive centre in the eyes of the global financial market will be compromised.
24. **Over the next 3–5 years the HPEC recommends that the Indian financial regulatory regime makes a much needed and overdue transition from:**
 - (a) a rigid, inflexible and overly-

¹A few members disagreed with this recommendation. However, this was the majority view and is hence retained as the HPEC position.

- prescriptive ‘rules-based’ regime under which the regulator and regulated adopt adversarial and antagonistic postures vis-à-vis one another; to (b) the more flexible and state-of-the-art ‘principles-based’ regime or PBR pioneered in the UK by the Bank of England and embraced and applied enthusiastically by its supervisory successor, the FSA. PBR is becoming more popular around the world. A decade’s experience with it in the UK and elsewhere suggests that it is more effective. The PBR regime is more open, flexible and user-friendly. It does not expect regulators to perceive ‘non-compliance’ as the natural default setting of regulated firms. It is non-adversarial and more co-operative. It expects regulated firms not only to obey and comply with the letter-of-the-law (*i.e.*, what is codified) but also with its spirit (*i.e.*, compliance with what may be uncoded because it was not anticipated, but was intended in any event). For financial firms, PBR is much more demanding, since they are required to adhere to the spirit of the law, and not just the letter. Such a transition will require a major mental adjustment on the part of both Indian regulators and financial firms for many of which ‘beating-the-rules-of-the-regulator’ has become an essential game in order to secure marginal competitive advantage over rival firms.
25. Adopting practice that is now normal in almost all OECD countries, **the HPEC would recommend that GoI conducts** – using independent, impartial interlocutors, including regulators from other IFCs – **a periodic (3–5 yearly) Regulatory Impact Assessment of the financial regulatory regime.** The RIA would aim to evaluate, using enhanced cost-benefit methodology, how efficient and cost-effective extant regulation (policy, practice, application, and institutional arrangements) is in meeting the main regulatory objectives, and to understand what modifications are needed to improve it.
 26. Finally, in keeping with the recommendations made above for improving regulatory approaches and practices, there may be a corresponding need for an accompanying change in **regulatory architecture and arrangements** governing the financial system as a whole and, less importantly, to permit a credible IFC to emerge. Such a change, if made only to satisfy the needs of an IFC, would be akin to “a very small tail wagging a very large dog”. The change has to be made for the sake of the financial system as whole and not just for the sake of having an IFC. But, in suggesting this, the HPEC observes that the interests of the financial system as a whole, and those of an IFC, happily coincide.
 27. When it comes to reconsidering regulatory architecture – whose foundations were set as early as 1934 with the original RBI Act, although many amendments have been made since – India has three options, *i.e.*:
 - a. Keeping the extant architecture in place but with improved co-ordination and co-operation to reduce regulatory conflict, turf-protection, and achieve coherent, consistent regulation across the entire financial system
 - b. Partial consolidation of extant regulators into a tightly knit quartet covering: (a) banking; (b) insurance; (c) pensions; and (d) capital, derivatives and commodities markets. Any area of activity that did not fall neatly or obviously into these four categories would be regulated automatically by the capital markets regulator. In other words activities such as asset management and mutual funds would fall under the purview of the capital markets regulator, as would regulation of the sovereign and corporate bond market. Under such an arrangement, regulators of specific types of institutions (*e.g.*, banks or insurance companies) would not have the right to regulate other domains/market segments (*e.g.*, capital markets) in which banks or insurance companies

(and/or their subsidiaries/affiliates) might operate. Domain regulation would be the responsibility of the functional domain regulator regardless of the institution that wanted to operate in that domain; whether directly or through another corporate arrangement. The regulatory quartet would be presided over by a regulatory co-ordination committee chaired by the regulatory agency that regulates the largest part of the financial system.

- c. Evolve rapidly toward unified regulation with a single regulator for all financial services to avoid problems of co-ordination or of matters falling between regulatory cracks when regulation is more fragmented.
28. **The HPEC is mindful that** in large federal countries like India and the US with a legacy of multiple regulators **policy-makers must consider the pros and cons of these different options and tread carefully.** The evidence being generated from the twenty odd countries that have adopted UK style unified regulation on a 'principles-based platform' is that it works well. But many regulators more firmly wedded to tradition argue that one decade is not a sufficient period to be conclusive about its unquestioned superiority. The quality of a regulatory system can only be tested when it comes under severe strain. The counter-argument is that the UK model actually works toward minimising the risk of such strains appearing in the first place. Moreover, in an imperfect world, there may be as many problems with having a regulatory monopoly (the lack of regulatory competition may also impede innovative thinking) as with a regulatory oligopoly differentiated by activity or market segment.
29. For that reason, while conceptually attracted to the unified, principles-based regulatory approach as the model for the future – *i.e.*, the ideal that India should strive for in the long run – **the HPEC's view is that movement in that direction should proceed at a pace that reflects the regulatory system's absorptive capacity for such change.** Such a move may trigger legitimate concerns about technical and other problems that may be caused by changes in the long-established operating domains of extant regulatory agencies. But, after careful consideration of all the pros and cons, policy-makers may still conclude that rapidly changing circumstances – of the kind that are impelling the next phase of financial system development and calling for the creation of an IFC in Mumbai – require swift changes in regulatory architecture. They may wish to expend the political capital needed to move toward more unified regulation now rather than later. In that event, the HPEC would concur with movement toward more rapid reform. But, whatever is decided by policy-makers on reforming regulatory architecture, the HPEC would **recommend an early, if not immediate, migration from 'rules-based regulation' to 'principles based regulation' even under the extant architecture.**
30. As far as financial system regulation is concerned two key priorities need to be addressed and enshrined in new legislation: (a) the regulatory approach and mindset adopted; and (b) regulatory architecture. **The present series of disparate legislation governing the Indian financial regime needs to be revamped and redrafted into a new Financial Services Modernisation Act that embraces a 'Principles Based Regulation' approach,** as articulated in Chapter 11.
31. **A key task in reforming regulatory architecture is to place all regulatory and supervisory functions connected with all organised financial trading (currencies, bonds, equities, corporate bonds, commodity derivatives; whether exchange-traded or OTC) into SEBI.** This requires collecting together elements of law that are presently dispersed across many other acts, including the RBI Act, the FC (R)A, the Companies Act, *etc.*. The objectives of SEBI,

under the new law, should replicate the objectives and approach of the UK-FSA. This requires closely studying the UK FSA and the FSMA, the US CFMA and the regulatory and legal foundations used in Ireland. **The new law governing financial system regulation should articulate broad principles, and provide sufficient flexibility for more rapid financial innovation. It should embed the distinction between wholesale markets and retail markets, where a much lighter regulatory touch is applied to wholesale markets.**

32. **The proposed new Act should also embed a redrafting of the Banking Regulation Act (BRA), shifting towards principles-based regulation, and giving banks greater flexibility in operations and management than is presently the case.** There is considerable merit in merging the new securities law and the new banking law into a unified financial sector law (the Financial Services Modernisation Act), even if the two regulatory agencies continue to be distinct. This would underline the unity of finance, and increase the extent of coherence found in different parts of finance. As an example, the creation of the proposed International Financial Services Appellate Tribunal (IFSAT) which would provide an appeals procedure covering all aspects of finance is best done within an Act which covers both banking and securities.
33. Finally, when it comes to financial regime governance, the HPEC believes that **India should immediately open up to Direct Market Access (DMA) on Indian exchanges to match the situation with foreign exchanges in other IFCs that provide a hospitable environment for algorithmic trading.** That would enable India to compete as an IFC venue for global firms in this important market segment.

2.2. On 'Missing Markets'

34. As has been elaborated upon at some length in the report, an Indian IFC is handicapped by three key markets that

are 'missing' in India's financial system: *i.e.*, (i) a properly functioning, liquid corporate and sovereign **bond market**; (ii) a spot **currency trading market**; and (iii) a broad **derivatives markets** that includes exchange traded as well as tailored derivatives for the management of **currency, interest rate, and credit default risk**.

35. These three markets, termed the ***bond-currency-derivatives (BCD) nexus*** in this report, are inter-woven by currency and interest rate arbitrage. In an efficient market, the currency forward is only a reflection of current and expected interest rate differentials across currencies. A number of sophisticated trading strategies employed by global financial firms (using sophisticated quantitative finance models to drive algorithmic trading) bind together all traded products of the BCD nexus. No IFC can function (or even become an IFC) in the absence of any of these BCD markets. If India is to have an IFC in Mumbai, the **HPEC would place emphasis on having these 'missing' BCD markets develop rapidly.**
36. A domestic bond market, in which global investors can participate on the same basis as in other IFCs, cannot operate without having an established INR yield curve that is arbitrage free, liquid and well-traded along maturities ranging from the very short (7-days) to the very long (30 or 50 years). A bond market operating along global lines is propelled by the monetary authority setting the short (base) interest rate at which banks can borrow from it. The market arbitrage process in a free and liquid bond market translates such base rate changes into changes in long rates over different maturities; based on expectations about policy stability, the market view about the monetary policy rules in operation, expectations of the future direction of domestic interest rates, inflation and external conditions.
37. In India, the INR bond market is limited and stunted. It is a market in which the monopoly trading platform for bonds is

managed and governed by the monetary authority rather than by a securities exchange. This is a sharp departure from global practice. The framework of existing regulations permits neither liquidity nor arbitrage. Nor does it have bond issues reflecting a wide spectrum of credit risks through the inclusion of corporate issuers. The bond market is dominated by sovereign issues that have no credit risk given the government's right to print money in INR. Moreover, the market's institutional structures are weak, participation is artificially constrained by a number of eligibility and origin barriers, speculative price-discovery is lacking because of the absence of arbitrageurs, option-writers and speculative risk-takers who are barred from operating in this market.

38. But a bond market in an Indian IFC needs to also issue and trade bonds in currencies other than the INR. Indian and foreign corporate borrowers may wish to choose, in an Indian IFC (as they could in any other IFC), to issue bonds in a wide range of globally traded or even exotic currencies to optimise their borrowing costs using derivatives to cover future currency and interest rate risk. They may want to issue a long-term bond in INR and immediately swap it into another currency with built-in provisions for a reverse swap when repayment is due on maturity. At present they can do none of these things.
39. The R.H. Patil Committee Report on domestic debt markets made a number of far-reaching policy, operational, and technical recommendations. In the view of HPEC, these should be implemented as soon as possible to make domestic bond markets function more efficiently and to perform the important economic role that such markets play. To the Patil Committee's many recommendations, and from the viewpoint of internationalising the Indian debt market as a key building block for creating a viable IFC in Mumbai, **the HPEC would add the need to: (a) bring all securities trading**

markets (including those for sovereign debt) under the regulatory purview of the regulator responsible for securities trading, ie SEBI; and (b) to ensure that the platforms for trading all such debt instruments are transferred to the NSE and BSE.

40. **Short selling of bonds is of fundamental importance for obtaining an arbitrage-free yield curve. This requires the ability to borrow bonds. A borrowing mechanism needs to be setup by exchanges, to enable short selling in government bonds, corporate bonds and equities.** This needs to be done in an integrated way, for all three kinds of securities, so as to harness economies of scope and scale.
41. At present INR bond purchases by FIIs are constrained by quantitative restrictions whereas equity purchases are not. **An essential step for increasing the presence of INR denominated bonds (and the INR yield curve) in global investment portfolios (e.g., of globally managed pension funds) is to remove the existing quantitative restrictions so as to put INR bond purchases by FIIs and other foreign buyers wishing to purchase INR denominated bonds in global markets on a par with their equity purchases.**
42. At present, there is a small currency derivatives market and a small interest rate derivatives market where trading of primarily vanilla products takes place over-the-counter (OTC). However, there is a considerable advantage in transparent trading of vanilla products on the exchange platform, particularly given the dramatic progress of electronic exchanges and algorithmic trading. Electronic trading and transparency assist liquidity, and it is easier for India to compete in the global IFS market by emphasising order flow into electronic exchanges – where objective characteristics of liquidity matter more than human relationships and counterparty risk. Hence, **there is a need to shift trading in vanilla products (futures, options, swaps) to exchanges**

- while retaining and expanding the OTC trading of transactions for exotic and tailor-made products.
43. Vibrant trading, on exchanges, of interest rate derivatives is a fundamental part of the BCD nexus. India's experience with interest rate futures has been an unfortunate one, with banks being prohibited from participating in the market except as short sellers of interest rate futures. **The Ministry of Finance needs rapidly to take stock of the constraints that hold back exchange-traded interest rate derivatives, including futures, options and swaps, and obtain the requisite modifications of regulations of insurance companies, banks, mutual funds and FIIs so as to get this critical component of the BCD nexus off the ground immediately.**
 44. By the same token, markets for trading global currencies (spot and derivatives) are the lifeblood of an IFC. Every customer buying IFS generates a series of immediate transactions on the currency spot market and covers exchange risk with currency derivatives. That is true whether a global investor operating in a Mumbai-based IFC wants to buy Indian equities, bonds, index funds, or index derivatives. As India's growth continues over the next decade the INR will join the global club of major currencies. By 2015 these will comprise the USD, EUR, JPY, GBP, CNY and INR: the reserve currencies of the world. **That requires establishing immediately a currency trading exchange in Mumbai, with a minimum transaction size of INR 10 million (or roughly US\$ 225,000 at present exchange rates). Initially, this market should be open to domestic and foreign financial firms including FIIs; opening to individual traders should be deferred until the INR becomes fully convertible. Establishing a wholesale but fully-fledged currency market will require removing those capital controls that presently disallow financial firms from holding multicurrency deposits with banks.**
 45. **This wholesale currency spot market needs to be accompanied by an INR cash settled currency derivatives market, offering products such as currency futures, currency options and currency swaps, traded on India's established exchanges. The currency derivatives market should be open to all (including FIIs).** It must aspire to replace the trading that presently takes place on the INR-NDF market. Regulatory responsibility of the suggested currency market – spot and derivatives, exchange and OTC – needs to be shifted to SEBI.
 46. Contracts involving the four major globally traded currencies (ie USD, EUR, JPY and GBP) are well established and account for the bulk of global trading in spot and derivatives markets. A number of smaller countries in OECD with open capital accounts offer traded contracts in their own currencies against these four global currencies. The INR trading market could be networked into and piggy-back off trades in these markets. An INR market could quickly dominate trading in INR vs. the four global currency contracts. But it should seek to also establish a first-mover advantage in trading new contracts involving: (a) the INR vs. other tradable but exotic currencies such as the Australian, Canadian, Hong Kong, New Zealand and Singapore dollars, the various Scandinavian kroners, and Swiss franc; as well as (b) emerging market currencies (under special arrangements with their central banks) of countries with which India is likely to have growing trade and investment links such as the Malaysian dollar, the Thai baht, South African rand, the Russian new rouble and the Brazilian real. It could develop pass-through contracts between the INR and currencies that are loosely or firmly pegged to the USD (e.g., the HKD and SGD as well as a range of Gulf currencies) but lacking in formal arrangements to protect the peg. The possibilities are limitless and must be left to the ingenuity of indigenous and global market operators and arbitrageurs

to develop and exploit. Some contracts will fail to attract trading volumes and die a natural death. Others (like the INR/CNY contract) may trade in volumes that, in a decade, could rival the volumes of traded contracts across the four global currencies.

2.3. On Weak Institutions

47. Side-by-side with weak or missing markets, the Indian financial system has a number of weaknesses in the make-up, diversity, skill sets, competitiveness and size of its financial firms. India's equity and limited derivatives markets are dominated by trading done by private firms and FIIs although public institutions in the insurance and mutual funds industries are also large players in these markets. That bias in institutional structure, in all financial markets other than the equity market, gives Indian financial firms an excessive 'home bias' in their operational orientation and handicaps them from developing global reach beyond the NRI community.
48. That feature also disables Indian financial firms from competing on level terms with foreign counterparts in global IFS markets. It will constrain the development of an IFC in Mumbai. For example, the ten largest global financial conglomerates (comprising, under a single brand umbrella like Citigroup or HSBC, subsidiaries or affiliates that are commercial banks, investment banks, insurance companies, securities brokerages, global fund managers, hedge funds and derivatives operations) all have a balance sheet size exceeding US\$1 trillion. The top four or five now have a balance sheet size approaching or exceeding US\$2 trillion. In India, the largest financial group (SBI) has a balance sheet size of around US\$160 billion; or less than a fifth that of its 'smaller' foreign counterparts when India is the fourth largest economy in the world in PPP terms and the seventh largest in nominal terms.
49. Such a large relative difference in the size of Indian vs. global financial firms, when the relative difference in the size of their respective home economies is smaller, deprives Indian financial firms of the ability to realise greater economies of scale and competitiveness within their internal structures. It reflects the in-built advantage that foreign financial firms have established in operating globally in an unfettered manner for several decades when Indian financial firms have been constrained from doing so. International financial firms have a presence in all aspects of finance, while Indian financial firms are hemmed into slots defined by over-compartmentalised financial system architecture. This increases the risks of Indian financial firms. They have less diversified sources of profit. It results in Indian financial firms requiring intermediation spreads to cover costs that are higher than international norms. It disables them from operating successfully in a global marketplace where substantial resources have to be expended to establish a globally accepted brand identity, and to invest capital in globally sized operations for: commercial banking, investment banking, securities broking, derivatives trading or insurance.
50. The same is true of Indian investment banks. At present, they are anaemic replicas of their global counterparts, despite their considerable reserves of human capital and their core competencies. Earlier a number of joint-ventures were created (largely to accommodate Indian entry barriers at the time) between established and reputable Indian financial houses and nearly all the major global investment banks. These joint ventures are now coming apart. That raises questions of how the Indian partner 'divorcees' from these 'arranged marriages' will evolve in the future. While they may have the human capital, they certainly do not yet have the size of financial capital they need.
51. What is said about commercial and investment banks above applies even more to the indigenous securities

brokerage industry. It is a far cry from achieving the size, efficiency, capability or capital of its foreign equivalents. The Indian brokerage industry exhibits many of the same symptoms and malaise as India's retail sector in general. It is dominated by a landscape of 'mom-and-pop' shops and single proprietorships masquerading as companies. They do not have the capital or knowledge required to service their investor-clients on a basis that remotely approaches global brokerage service standards; although they do provide a limited array of brokerage services at a fraction of global costs for a securities account.

52. None of these institutional categories are inherently or congenitally weak. Their weakness is derived from a legacy of financial policies and strategies that are proving, in retrospect, to have discouraged emergence of the kind of institutional base of financial firms that India needs to compete in global financial markets.
53. The legacy problem inherited by Indian financial firms, and exacerbated by the domination of PSU financial firms in the Indian financial universe, needs to be tackled boldly on two simultaneous tracks: (a) first, India needs to moderate, and eventually dispense with, its legacy of state ownership in the financial universe; (b) second, Indian policy-makers and regulators need to shift away from the artificial over-compartmentalisation of sub-markets. Those two propensities have inhibited the proper development of these markets. They have also prevented larger, more capable financial conglomerates – operating across different market segments – from emerging and competing globally. With reintegration across the extant sub-sectors of finance, and with barriers to expanding into new lines of business being removed, large, sophisticated and competitive Indian financial firms will emerge.
54. **The HPEC believes that the Indian authorities should support the consolidation of Indian firms in the financial sector to permit – through the unconstrained operation of natural market processes – sizeable Indian financial conglomerates to emerge, through acquisitions, mergers and (hostile as well as amenable) takeovers.** The aim should be to create a few (at least five or six) Indian LCFIs – led by the most capable and dynamic financial groups in India – the size of whose consolidated balance sheets exceeds US\$500 billion. No financial firm should be exempt from this consolidation process, regardless of ownership. Furthermore the consolidation of Indian financial conglomerates should be facilitated by foreign equity participation on the part of private equity firms, strategic direct investors, and institutional portfolio investors to augment the limitations of Indian capital resources. The implementation of this strategy does not require government or regulatory direction concerning which firm should acquire which other firm. It requires removing the barriers to reintegration, and impediments to market-driven M&A, that are present today.
55. The end goal should be to have Indian LCFIs that span the entire financial spectrum. Until India achieves FSA style integration of all finance under one regulator, a key tool for achieving this goal might be the 'financial holding company' as described in Chapter 11. HPEC sees the holding company as the logical organisational structure for Indian financial firms that seek to become global players in the period where India uses the proposed four-pillar regulatory architecture. A set of policy measures need to be taken to enable this institutional structure to emerge.
56. In the specific field of asset management, a major organisational innovation to harness scale economies is recommended. At present, banks, insurance companies, mutual funds, pension funds, FIIs, *etc.* all undertake uneconomic asset management operations. Each of these operations is small, lacks economies of scale, and is unable to compete in the global

market for asset management. In this situation, **the government needs to permit the emergence of Wholesale Asset Management businesses, regulated by SEBI, where the minimum size of customer funds is at least Rs. 10 crores.**

57. This initiative should get the benefit of light-touch regulation, given that the protection of retail investors does not arise as an issue under this arrangement. **All impediments to outsourcing of asset management by financial firms in India – banks, insurance companies, mutual funds, pension funds, FIIs, hedge funds, etc.. – should be identified and removed.** Once these artificial barriers to outsourcing are removed, each entity – such as a mutual fund – will make a commercial decision on whether the task of asset management should be in-sourced or outsourced to one of the Wholesale Asset Management firms.
58. Given the immense economies of scale that can be captured by large asset management factories, differentiated front-end entities – such as mutual funds, insurance companies, pension funds, investment banks – may choose to outsource their asset management functions to such Wholesale Asset Managers. This would separate the *front-end* interface with a customer – such as a mutual fund, bank, insurance company or pension fund – from the *back-end factory* undertaking the actual activity of asset management. The front-end financial firms would continue to be regulated by their domain regulator while the factory would be regulated by SEBI using PBR. Undertaken on a wholesale basis, that is blind to the sourcing of assets being managed, such *asset management factories* can achieve much lower costs and much larger economies of scale than the present plethora of fragmented, small asset management units of disparate financial firms. By pooling assets from all parts of the Indian financial system, Wholesale Asset Managers could achieve pricing efficiencies that would make them competitive by global standards.
- India's progress on this score should be measured by comparing the Indian wholesale price for running an index fund for \$1 billion of the S&P 500 against the wholesale price seen in New York or London.
59. In addition, Indian authorities should bring forward their liberalisation plans for the financial sector (*e.g.*, opening up to branch banking by foreign banks) ahead of the commitments to the WTO Agreement on Trade in financial services. In this instance, the HPEC believes that more open foreign entry will be in India's own self-interest in the short, medium and long term.
60. The protectionist arguments that have become so familiar in other sectors – to give Indian financial firms more time to adjust to new global realities – need to be re-examined carefully. Indian financial firms have seen the writing on the wall since 1991. It is true that they have not had the freedom and flexibility as yet to grow organically and diversify as they might have wished. HPEC envisages convertibility within 18–24 months. This gives all Indian financial firms a window of 18–24 months for gearing up to cope with the opportunities and competition that flow from convertibility. Giving firms more time than that will prolong inefficiency rather than enhance competitiveness.
61. **The Indian financial sector now needs to open its doors to face the full force of international competition and adjust accordingly.** As with their counterparts in manufacturing industry some Indian financial firms will perish. Others will strengthen to take their place in the world in the same way that the more robust, competitive Indian manufacturing firms are now doing. **The HPEC sees no convincing argument in favour of delaying this move any further.** It will enable India to rectify its institutional weaknesses and deficiencies faster than it otherwise would. There is little point in being cautious simply for the sake of caution if, given the balance of probabilities, such caution

only ends up in damaging India's ability to compete effectively in the global market for IFS by having a less efficient financial system.

62. The control of branch licensing for banks is an anachronism, at a time when India has moved away from the license-permit raj in most respects. There is no other industry in India, today, where firms have to take permission from the government in order to open branch offices. Simply because they take deposits does not make bank branches any different from other market enterprises. Banks should decide where and when they want to open branches and not the regulator. As part of improving competition policy, **the opening of branches by domestic banks should now be immediately decontrolled.** No domestic bank should have to ask the banking regulator for permission for each ATM or branch. After one year (ie by the beginning of 2008) this policy should be extended to all banks. This will give local banks a one-year head start over foreign rivals on opening branches.
63. Indian banking is afflicted by a weak pace of entry and exit, reflecting poor competition. Entry into domestic banking has been hampered by over-prescriptive and asymmetrical rules about the ownership of banks. Banning banks with ownership patterns that have close relationships with the owners of non-finance companies eases the task of regulators and supervisors. **The time has come to remove these restrictions and permit unrestricted entry by Indian corporates into banking and all other financial services. As the Tarapore-2 Committee has pointed out, and the HPEC concurs, the discriminatory 10% ceiling on investments by corporates in banks is unjustifiable and should be removed immediately.** As a member of the HPEC observed, in a market economy there can be no justification for such a restriction when another economic agent – i.e., the state – can have any level up to 100% ownership of the same types of institutions. While this will increase the workload and complexity of banking regulation and supervision, the benefits through increased competition will be considerable.
64. Banking regulation requires strong features of market discipline to accompany the kinds of competition policies described above. This requires that all banks in India should now raise equity in the capital market and raise a minimum proportion of their liabilities by issuing bonds with no safety net of deposit insurance. In the context of the need for additional equity capital on the part of Indian banks to meet Basel-II requirements, regulators appear to have been tempted to accommodate high asset growth with diluted equity requirements. This temptation needs to be checked, in the interests of controlling the leverage of Indian banks and simultaneously exposing banks to market discipline.
65. **Finally, the Indian financial market should be made fully open to the entry of globally established alternative investment vehicles with a track record as well as to exchange traded funds, arbitrage funds and any financial entity of any sort provided it meets the requisite performance, track record and 'fit-and-proper' tests for entry.** These tests should not be manipulated to bar or delay entry in practice when it has been opened up in principle. Alternative investment vehicles should also be enabled on the domestic market.
66. In Chapter 2, Box 2.8 showed a comparison of the charges for trading index futures in Mumbai versus Chicago. Indian exchanges have charges that are higher by a multiple of 10 or 25 depending upon the size of the customer. The reforms proposed in this report rectify this egregious anomaly through the following measures:
 1. Eliminating all transactions taxes like the STT and stamp duties;
 2. Subsuming into the GST on finance all service taxes on brokerage and refunding the GST applied to foreign

customer transactions (because exports are zero-rated);

3. Adoption of a PBR approach by SEBI that is likely to reform the ad-valorem charge going into the 'Investor Protection Fund';
4. Permitting algorithmic trading, DMA and greater global participation by sophisticated traders such as alternative investment vehicles to increase the number of transactions in India, thus reducing the average charge per transaction;
5. Unifying equity, commodities, currencies and interest rates into a single exchange industry to open the possibility for Indian exchanges to trade additional contracts and obtain economies of scope and scale, thus lowering average charge per transaction;
6. Global benchmarking: *i.e.*, at present the management teams of Indian exchanges do not compare themselves against the Chicago tariff structure. The situation is like that of Indian steel companies in 1992 which thought that the price of Indian steel was distinct from the world price of steel. If the reforms suggested in this report are implemented, global competition would greater pressure on Indian exchanges in favour of efficiency and lower charges, as happened with Indian steel companies.

2.4. Other Policies and Issues affecting the Financial System and an IFC

67. The Indian IT services industry was based on India's exploitation of its advantage in 'purpose-suited' human capital. That will be equally true of India's entry into the export of IFS through a Mumbai based IFC. But **India's human capital resources and their qualifications for this purpose should not be taken for granted.** There are intense competitive pressures across all industries to attract these human resources. Major investments therefore

need to be made simultaneously including *inter alia*:

- Creating a specialised postgraduate programme (M.Sc. in Finance) that combines the teaching of high-level quantitative economics, finance, advanced mathematics and complex modelling, and computer science. Such a programme should be pioneered in an academic centre of excellence close to Mumbai and should result in a steady stream of graduates to populate the IFC and replenish its human capital base regularly.
- For this initiative to have a material impact upon the human capital in Mumbai, the size of the program should be set at 200 students graduating every year. Once a major program is established, it is likely that other graduate schools of business in India will mimic its structure thus further augmenting the supply of numerate staff-persons into the emergent IFC.
- Increasing the output of MBAs majoring in Finance and Quantitative Finance from India's best postgraduate teaching institutions, with a particular focus on strengthening the quality of academic staff and the linkages between their research program and the emergent IFC.
- Increasing the output of qualified professionals and paraprofessionals for the supporting accounting, auditing, business-consulting, and legal professions to ensure that an adequate supply of properly trained and qualified human capital is always available in these areas.

68. In the final analysis, **it would be a grave error to take an 'industrial policy' or planning approach to the emergence of an IFC in Mumbai.** It is tempting for policy-makers to have a laundry check-list to guide what specific actions need to be taken to make an IFC work, or to try and 'pick winners' in terms of firms or areas of business to be

encouraged by government. Clearly, as this report elucidates, a number of critical issues do need to be resolved as far as financial regime governance in India and urban infrastructure and governance in Mumbai are concerned. But, beyond that, the authorities should not attempt to be over-prescriptive.

69. **The role of government should be to set up an enabling framework, and rely on two principles: (a) ensuring that the market for IFS provision in Mumbai works as efficiently as possible; and (b) adopting a policy of total 'openness' in terms of entry into that market by every kind of player that wants to provide any kind of IFS without being bound by capital controls, artificial entry barriers and restrictive rules.**

70. **The IFC in Mumbai should evolve on its own, based on the drive, entrepreneurship and innovation of domestic and foreign financial firms participating in the export of IFS.** Clearly such players need to meet the basic 'fit-and-proper-person' tests of probity, integrity and competence. They need to have an established track record which inspires confidence in their ability to enhance the reputation of the IFC. In short, **the IFC's destiny should be left to market forces and not be determined by government fiat.**

71. The reason for relying on these principles is that it is impossible to predict how the IFS industry will evolve or what products and services will appear five or ten years from now, or who the players will be. Certainly it would have taken an extraordinary insightful if not clairvoyant observer to predict ten years ago what the IFS industry would be doing today. Government should not attempt to go too far beyond that other than doing what is needed and what has already been elaborated upon earlier.

72. Intuitively, the task of bringing Indian finance up to a level of global compet-

itiveness in 2007 is comparable to the task faced in reforms of Indian trade and industry in 1992. At the time, key reform initiatives did not consist of thinking through all steps from 1992 to 2007. They consisted of introducing new elements of competition into the system, after which a continual process of learning and policy evolution took place.

73. In similar fashion, the set of recommendations of this report do not claim to be a fully thought out program of financial sector reform for a multi-year time horizon. However, what is likely to be achieved by implementing this program of reforms is of unleashing new forces of competition and outward orientation into Indian finance. That process would (in turn) have far-reaching consequences; comparable to the removal of industrial licensing and scaling back of trade barriers in the early 1990s.

74. **Once these recommendations are implemented, a dynamic of competition and innovation would come about, which would trigger off new learning and new forces of political economy, which would then influence the future evolution of financial sector policy. However, the immediate priority is to implement the recommendations of this report. They constitute a minimum set of reforms which break free from the present stasis, and unleash competition and outward orientation. India has dismantled an autarkic license-permit raj in industry and trade, and can do it again in finance.**

3. The challenge of urban infrastructure and governance in Mumbai

75. As indicated earlier, the prospects of establishing an IFC in Mumbai and ensuring its commercial viability, global credibility, and operating success, depends as much on financial regime transformation in India as on how well Mum-

bai covers its debilitating infrastructure and urban governance deficits. **The HPEC has more concerns about how and whether these large urban governance challenges in Mumbai will be met than it does about achieving the necessary transformations in Indian financial policies and practices to accommodate an IFC.**

76. For a Mumbai based IFC to be globally competitive, on a par with other IFCs and the three major GFCs, it has to have world class infrastructure that meets global standards in the quality of construction, finish and ongoing maintenance. That applies to: (a) residential and commercial space; (b) shopping and recreational facilities; (c) uninterrupted, high quality electric power supply with minimal fluctuations in voltage and current; (d) water supply with minimal fluctuations of pressure and quality; (e) sewerage and waste disposal as well as storm drainage and flood control during the monsoon season; (f) local gas and utility distribution; (g) global standards in all modes of private and public urban commuter transport – road, rail and water-borne – as well as rapid transport links that connect the Mumbai IFC with the rest of India (ie air links involving airports and airlines as well as high-speed rail and world class motorways) and the rest of the world (mainly air-linkages); and (h) global standards of telecommunications (landline, cellular and broadband) that connect the Mumbai IFC around the clock to the world. Apart from coming close on the last of these requirements, Mumbai does not hit the board on all the others.
77. All these infrastructural requirements have been explicated in several forums before with elaborate plans being drawn up to meet these challenges by a variety of public and private bodies aiming to put 'Mumbai First'. For that reason the HPEC has desisted from going too far down a path trodden too often by too many others (a slew of local city committees as well as national international agencies) in the recent past.
78. In HPEC's considered view (with many members of the Committee having resided in Mumbai for most of their lives) the progress that has been made so far has been more rhetorical than real. The state and civic administrations have made numerous statements of intent in the past but little progress was made until recently. But the scene appears to be changing with new vision and drive on the part of the State's Chief Minister to go on a war footing to improve the urban environment of Mumbai. Excellent staff appointments have been made in Mantralaya to drive the development of infrastructure in the city. The change in the air is palpable. While India was progressing rapidly by way of economic growth, Mumbai seemed until last year, paradoxically, to be decaying and crumbling at almost the same pace. That obviously could not continue. The Chief Minister and his dynamic team have done much to change that state of affairs.
79. If Mumbai is to host an IFC then its infrastructure deficiencies need to be resolved quickly – and not through arabesques such as the Navi Mumbai SEZ. **The HPEC suggests that the impressive and laudable combined efforts now being made by central, state and civic authorities – along with the active support of the private corporate sector – should be enhanced and supported by multilateral financing institutions and PPP arrangements in every sub-sector of infrastructure. The authorities should invite the open participation of foreign construction and development firms alongside their Indian counterparts to ensure that Mumbai's infrastructure deficit is covered in the next 10 years.** If that is not done then the pursuit of an IFC in Mumbai will remain a pipe dream that will be impossible to convert into reality. Locating it in a SEZ is not a viable option.
80. In that connection the HPEC believes that state and civic administrations need to move swiftly but fairly in resolving

the outstanding issues posed by the ULCRA and the Rent Control Act that are blocking access to pipeline funds available from the Centre and multilateral financing institutions.

81. Apart from the present state of its physical infrastructure – that makes Mumbai remote from being world class – the city also confronts a serious ‘governance deficit’. The reasons for that are well-known and have been discussed *ad nauseam* in academic circles, the media, and in policy-making circles at central and state levels of government. Given this backdrop, HPEC believes that it is time for the talking to stop and the action to start. Mumbai needs a City Manager (whether elected or appointed) who is directly accountable

to its citizens and residents. The city needs an administrative apparatus for governance that is under the direct control of such a City Manager – with the support of the state and centre – and that has its own revenue base and financial independence to match. Mumbai has been a ‘milch cow’ for both the Centre and State for some time. It has got very little back for its own urban development. That asymmetry needs to be reversed.

82. Mumbai needs to be seen across India and around the world as a welcoming, cosmopolitan and cultured metropolis capable of accommodating a large number of expatriates. It is only with such an ethos that Mumbai can become an IFC.

HPEC Report on making Mumbai an International Financial Centre: Timelines for Recommended Actions

Recommended Actions																
2007 by Quarter				2008 by Quarter				2009 by Quarter				2010 by Quarter				2011>
1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	Year
A. Actions on Fiscal Deficit, Tax and Public Debt Financing/Management Fronts:																
1. Achieving and maintaining an average growth rate of 9% to 10%																
2. Reduce the gross consolidated fiscal deficit (GCRD) from 8+ to 4–5% of GDP.																
3. Reduce total public debt to GDP ratio from 80% of GDP to significantly less.																
4. Implement the FRBM Task Force Report of 2004.																
5. Eliminate Securities Transaction Tax (STT) and Stamp Duties (SDs).																
6. Apply GST to the financial services industry.																
7. Open up purchase of INR denominated debt instruments issued by Govt to All Buyers																
8. Restructure Budgets/balance-sheets' of states and metropolitan municipal corporations																
9. Shift burden of future infrastructure financing from public to private sector through PPPs																
10. Set up independent public debt management office (or as second-best locate it in MoF)																
B. Actions on Monetary Policies and Monetary Management based on Inflation Targeting																
11. Focus Monetary Authority exclusively on single task of managing key short-term 'base rate'																
12. Full CAC to be achieved in a time-bound manner within the next 18–24 months																
C. Actions on Financial Regime Governance and Financial System Regulation																
13. Improve functioning of Legal System insofar as it affects financial services.																
13A. Improve knowledge-skills and training of judges and arbitrators																
13B. Reduce Case Backlog of cases involving financial contract disputes																
14. Create International Financial Services Appellate Tribunal (IFSAT) covering all of finance.																
15. Permit unrestricted entry of well-known global legal firms operating in other IFCS/GFCs																
16. Permit unrestricted entry of well-known global accounting firms operating in IFCS/GFCs																
17. Dismantle barriers between different financial market segments																
18. Govt to prepare 'exit strategy' for its withdrawal from the ownership of financial firms																
19. Govt to reduce equity stake gradually in all types of public sector financial firms; esp. PSBs																
20. Shift Financial Regulatory Regime from Rules-Based (RBR) to Principles-Based (PBR)																
21. Conduct Periodic Regulatory Impact Assessments of the financial regulatory regime.																
22. Examine Carefully the Need for changing extant Regulatory Architecture																
23. Trading platform for sovereign bonds to be moved to exchanges (NSE and BSE)																
24. Draft new Financial Services Modernisation Act embracing 'Principles Based Regulation'																
24A. FSMA should incorporate redrafted Banking Regulation Act (BRA) giving banks more flexibility																
25. Transfer all regulation/supervision of any type of organised financial trading to SEBI.																
26. Distinguish between wholesale and retail markets and use appropriate regulation for each																
27. Open up immediately to DMA and algorithmic trading																
D. Actions on Filling the Gaps in 'Missing Markets'																
28. Create rapidly the Missing BCD Nexus in Indian Capital Markets:																
A. Bond Market																
B. Establish Currency trading exchange with a minimum transaction size of INR 10 million																
C. Derivatives Market: Shift trading in vanilla products (futures, options, swaps) to exchanges																
D. Retain and Expand OTC trading of exotic and tailor-made derivatives.																
E. MoF to review/remove constraints on any financial firm operating in derivatives																
F. Create INR cash settled currency derivatives on exchanges open to all (FIS).																

HPEC Report on making Mumbai an International Financial Centre: Timelines for Recommended Actions

Recommended Actions																		
E. Actions to Strengthen Institutions operating in Indian Financial Markets																		
29. GoI to support emergence of Indian LCRIs to emerge, through M&A and takeovers.	Technical Studies	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	2011 > Year
30. GoI to permit Wholesale Asset Management regulated by SEBI (minimum account Rs.10 crores)	Technical Study					Remove Restrictions		Encourage M&A Launch		Let market drive consolidation through financial system								
31. Remove all impediments to outsourcing of asset management by banks, insurance companies, mutual funds, pension funds, FIIs, hedge funds, etc.	Technical Study					Remove Restrictions		WAMS Full outsourcing in India		Encourage rapid expansion of WAM with SEBI								
32. GoI to bring forward liberalisation of financial sector in keeping with commitments to WTO Agreement on Trade in Financial Services.	Technical Studies					Accelerated liberalisation Programme in place				Indian financial system fully open to global prudential regulation and fitness tests								
33. Interim adjustment period of two years for Indian institutions to adapt to global competition.						Capacity building by Indian firms				Indian financial sector open to foreign competition								
34. Opening of branches by domestic banks to be decontrolled immediately.						All restrictions on branch opening by domestic banks to be removed immediately												
35. Opening of branches by foreign banks to be decontrolled after one year										All restrictions on branch opening by foreign banks to be removed								
36. Remove immediately all restrictions limiting corporate ownership of banks to 10%						Restrictions limiting private corporate ownership of banks to 10% to be removed												
37. Open up Indian capital markets to entry of hedge funds and alternative investment vehicles						Remove all restrictions on entry of hedge funds and AIVs												
38. Set up range of programmes for development of specialised human capital for the financial industry						Set up MSC in Finance and a range of specialised technical training programmes												
F. Actions to Improve Infrastructure in Mumbai																		
39. Transport Infrastructure:																		
A. Intra-city roads and arterial routes [PPPs]	Technical Feasibility Studies					Tenders		Tenders Preparation		Contracts				Construction				
B. Coastal Highways and Expressways [PPPs]	Technical Feasibility Studies					Tenders		Contracts		Facility Construction and Operations				Construction				
C. Suburban Railways and new Metro System [PPP]	Feasibility					Tenders		Contracts										
D. Water-borne Transport – Ferries/Hydrofoils/Jetfoils [PPPs]						Actions already taken for Santa Cruz and Sahar.				New plans for Navi Mumbai airport and runways								
E. Increase/upgrade airport and runway capacities	Studies					Tenders		Contracts		Power Plant Construction and Operations								
40. PPPs for Power Infrastructure:	Studies					Tenders		Contracts		T&D Line Construction and Operations								
A. Increase in Power Generation Capacity (24 × 7 × 365)																		
B. Increase in Transmission/Distribution Capacity																		
41. Water Supply, Sewerage& Drainage:																		
A. Increase in Storage Capacity and Pipelines [PPP]						Plans and Projects underway to increase and improve water supply quantity/availability												
B. Increase in Filtration and Water Quality [PPP]						Plans and Projects underway to increase and improve water quality												
C. Upgrading/Expansion of Sewerage Capacity						Plans and Projects underway to increase and improve sewerage capacity/treatment												
D. Upgrading of Storm and Flood Drainage						Plans and Projects already underway to increase and improve storm/flood drainage												
42. Increase Waste Disposal Capacity: For solid and liquid waste with environmental protection	Develop PPPs					Contracts		PPP Contracts		Underway and Operating								
43. Telecommunications Infrastructure:																		
A. Substantial Expansion of Cellular Network						TRA to hold cellular operators to service quality commitments to upgrade continuously												
B. Expansion of Landlines and Broadband						MTNL to expand landlines in keeping with demand growth; increase competition												
C. Expansion of International Bandwidth						VSAT, FLAG to increase bandwidth rapidly; introduce greater foreign competition												
44. Accommodation: Residential, Office and Commercial						Drop ULCRA/RCA		Normalise rentals		Disperse with all controls except urban planning								
G. Actions to Improve Urban Governance in Mumbai																		
45. GoM and BMC to appoint or arrange to elect a City Manager accountable for Mumbai	Prepare Groundwork					Appoint/Elect				Place City Administration under full control of City Manager								
46. Bring the existing city governance machinery under the full control of the City Manager	Prepare Groundwork																	
47. Establish independent financial base for the city that is under the control of the City Manager	Study Options					Agree Fund Sources				Place City on mainly independent financial footing								
48. Rationalise and streamline to organisation structure and lines of responsibility in city management	Organisation Study					Transition				Implement Rationalisation/Streamlining Programme								