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India sets path for reform of financial sector

By Kunal Kumar Kundu

NEW DELHI - As the global financial crisis left a trail of destruction, it was felt that although India weathered the storm, the financial sector needed a major overhaul to respond to the challenges engendered by the globalized world and its dynamic financial system.

India's financial sector has been slow in responding to the needs of a growing economy, save for initiatives in the equity market, which started with the enactment of The Securities and Exchange Board of India Act in 1992. Most of the changes in financial regulation framework were merely reactions to the changing needs of the system, which resulted in amendments of the various existing laws. Not surprisingly, the financial sector continues to be burdened with several archaic laws that are not suitable for India of the 21st century.

It is against this background that the Financial Sector Legislative Reforms Commission (FSLRC) was set up in early 2011. Led by Justice BN Srikrishna, the nine-member commission was tasked with the target of preparing a single comprehensive law of Indian finance. The commission not only examined multiple pieces of legislation, it also employed more than a 100 people for research, learning lessons from the global crisis and consulting regulators, market participants and various stakeholders.

In its report submitted last week, the commission opted for a single or super regulator (Unified Financial Regulatory Agency, or UFRA) to replace those in equity (the Securities & Exchange Board of India), commodities (Forward Markets), pensions (the Pension Fund Regulatory and Development Authority) and insurance (the Insurance Regulatory and Development Authority) sectors.

However, banks being distinct and specialized financial entities, the Reserve Bank of India (RBI) has been kept out of the purview of the UFRA. As the central bank, it will continue to have regulatory control over banks though its wings are aimed to be clipped. The commission noted that a multiplicity of regulatory agencies has created scope for regulatory arbitrage, as well as making it difficult to protect consumer interest. It also observed that certain market players try to take advantage of multiple regulators by operating in grey areas not covered by regulation.

The stated intent of unification is to move from sectoral regulation to a broader framework of rules and principles. This does make sense, as the history of Indian financial regulation is replete with incidences of turf war between various regulatory agencies that has resulted in an inefficient market failing to address the problems. The cornerstone of the proposed framework is that consumer satisfaction and protection is at the core.

The FSLRC has pointed out a number of benefits of the proposed UFRA:

By dealing with all financial transactions other than banking and payments it would help in realizing regulatory economies of scale and scope;

It will promote efficiency, by providing a common platform for a proposed organized financial trading in instruments across equities, bonds, currencies and commodity futures;

Unification of regulation and supervision of financial firms such as mutual funds and insurance companies would yield to consistency in consumer protection and micro-prudential regulation.

While these definitely are suggestions that are worth considering, the important point that is being missed out is that not all suggestions are actually worth implementing.

Out of the five members of the FSLRC, who have long experience in the financial sector, as many four are dissenters on various counts, though not necessarily on same issues. This itself brings to question the quality of recommendations or lack of rigor that has gone into some of the final recommendations.

One questionable suggestion, for example, of the commission is to shift to ''principles-based'' regulation. The suggestion that firms must conduct their business ''ethically'' is as bizarre as it gets, given that a complex world requires a complex set of rules and appropriate deterrents and not just an expectation of ethical business practice.

Unless the rules are clearly laid down, different interpretations would lead to disputes and hence open up the possibilities multiple court cases. In fact, this was the same model that was tried by the Financial Services Authority of the UK, which has not covered itself in glory.

What is more disturbing is the proposal that seeks to overhaul India's central banking practice by recommending the formation of an empowered monetary policy committee (MPC). The committee believes that handing over monetary policy to a committee reduces the possibility of political interference. It also suggests that objectives of monetary policy will be decided in consultation with the government.

It recommends that the Reserve Bank of India be responsible only for overseeing the banking industry and for monetary policy while the management of the government's debt and of foreign remittances (thus far under the exclusive domain of the RBI) would be directly under the supervision of the government. One fails to understand how a monetary policy can be carried out effectively when the RBI is responsible for a part of it while the government has the say on the other.

For quite some time now the RBI and the government have not been seeing eye to eye in regard to the conduct of monetary policy. While the government is clearly unable to control the fiscal deficit, an essential pre-requisite of the RBI to be able to cut the policy rate, the RBI has been fending off immense pressure from the government to cut rates even further than it has.

This recommendation, which would significantly erode the independence of the RBI, seems to be a direct fallout of this tussle. The RBI stands out as one of the few regulators to have done a commendable job. Any intent to curb its independence and increase government influence in monetary policy decision is fraught with danger, particularly as good governance has not been India's forte.

Overall, while the committee has made plenty of sensible suggestions, these recommendations should be considered as a building block that needs to be discussed and improved upon, rather than being zealously implemented as suggested.

It is important that the wisdom of the dissenters, who are stalwarts in their own right, are given due consideration. If India is to focus on financial legislation that will act as a template for the future, prudence

is the key to ensure the building of strong institutions.

Kunal Kumar Kundu *is a New Delhi-based economist. His website kunalsthoughts.weebly.com*

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