Working Paper 324

Financial Sector Legislative Reforms Commission (FSLRC)
&
Financial Sector Regulation in India

Jaimini Bhagwati

M. Shuheb Khan

Ramakrishna Reddy Bogathi

June 2016

INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS

Table of Contents

List of Tables

List of Figures

Abstract

The Financial Sector Reforms Commission (FSLRC) which was set up in 2011 by the Ministry of Finance was mandated to study existing legislation and financial sector regulatory practices in India and to propose improvements. The FSLRC submitted its report in 2013 and four of its members recorded dissenting notes. This paper examines the changes in regulation in four G7 countries post the financial sector breakdown of 2008 and suggestions made by the Financial Stability Board with respect to e.g. capital adequacy, shadow banking and accounting. The paper also reviews the current levels of development of the Indian banking, capital markets, pensions and insurance sub-sectors and past episodes of egregious wrong-doing. The last section of the paper examines and comments on the principal FSLRC proposals to further develop India's financial sector, regulate it better and protect consumers. The dissenting notes of four FSLRC members are also covered in this section followed by conclusions.

Keywords: *Financial Sector Regulation, non- performing assets, capital adequacy, systemic risk, insurance coverage, regulatory gaps, Financial Sector Reforms Commission, Indian Financial Code,*

JEL Classification: *G10, G20, G21, G22, G23, G28, G100*

Authors' Email: *j.bhagwati@gmail.com, shuhebkhan01@gmail.com, ramedge37@gmail.com*

Financial Sector Legislative Reforms Commission (FSLRC)
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Financial Sector Regulation in India[1]

Jaimini Bhagwati, M. Shuheb Khan and Ramakrishna Reddy Bogathi

Introduction

The Financial Sector Legislative Reforms Commission (FSLRC) was constituted in 2011 during the United Progressive Alliance (UPA) government's second term. The FSLRC was headed by Justice (retired) B. N. Srikrishna[2] and its terms of reference were broadly speaking to[3] "examine/study the following:

- The current financial regulatory and legislative architecture in India, which includes reviewing current Acts, gaps in regulation, departments in each regulatory body and their roles and the procedures related to selection of senior officers who head these regulatory bodies and their tenure etc.;

- The need to make statement of principles behind every subordinate legislation to show the purpose ….and whether feedback from the public on every subordinate legislation should be mandatory or not;

- Pre-requisites for giving emergency powers to regulators to take action on an ex-parte basis;

- The ways to monitor regulators and their independence from government;

- The need to redefine existing laws and abolish out dated laws based on the policy shift after liberalisation;

- The current consumer protection structure and legislation related to the role of information technology in the financial sector;

- Various expert committee recommendations and the role of state governments in regulating the financial sector."

The FSLRC's report was submitted in March 2013. Thereafter, it was placed in the public domain by the Ministry of Finance and comments received are expected to be included in a

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1 This paper has been written as part of Research Studies conducted under the 'ICRIER-RBI Chair' headed by Professor Jaimini Bhagwati. We are thankful to Mr. Abheek Barua (Chief Economist HDFC Bank), Dr. Thomas Richardson (IMF's Senior Resident Representative for India) and Dr. Samiran Chakraborty (Chief Economist for Citigroup Global Markets India, Private Ltd.) for their valuable comments.

2 The members of this Commission were Justice (Retd.) Debi Prasad Pal, Dr. P.J. Nayak, Smt. K.J. Udeshi, Shri Yezdi H.Malegam, Prof. Jayant Varma, Prof. M. Govinda Rao and Shri C. Achuthan. Member convenor was Shri Dhirendra Swarup and Shri C. K. G. Nair was Secretary to the Commission.

3 No. 18/1/2011-RE. Department of Economic Affairs, Ministry of Finance, Government of India

revised Indian Financial Code (IFC). Based on comments in the media, it appears that the Reserve Bank of India and other regulators may have substantive reservations about the FSLRC's recommendations. Four out of the FSLRC's eight members submitted dissenting notes.

The FSLRC report is in two volumes[4]. The first volume elaborates on: (i) the current norms and prevailing practices in the Indian financial sector: (ii) the gaps and shortcomings; and (iii) how these should be corrected. The second volume called the Indian Financial Code (IFC) provides for overarching legislation to cover the four sub-sectors: banking, capital markets, insurance and pensions. In overall terms, the FSLRC has covered a wide range of issues and proposed one piece of legislation, namely the IFC, to correct shortcomings in the Indian financial sector including regulation, consumer protection and development of the four sub-sectors.

Four task forces are reported to be studying specific recommendations of the FSLRC. These are on the proposed; (a) Financial Sector Appellate Tribunal (FSAT); (b) Public Debt Management Authority (PDMA); (c) Resolution Corporation (RC); and (d) Financial Data Management Centre (FDMC). Reports, if any were finalised, by these four task forces have not been made public. It is understood that the Ministry of Finance may engage an expert body, to be selected through competitive bidding, to assess the reports of the task forces if and when these are completed.

Section I of this paper covers the regulatory framework and recent experience in four G7 countries, namely, USA, Germany, Japan and the UK. UK and USA have been chosen because they have been at the forefront of financial sector innovation and the long standing of their regulatory institutions. India has borrowed a number of its regulatory structures and practices from the UK and USA. The financial sectors in Germany and Japan are comparatively less innovative but they have been less prone to regulatory capture. Plus the Euro and Yen are widely traded international currencies and India's financial sector has relatively closer linkages with Germany and Japan than for example South Korea. Netherlands has a banking regulator and one other regulator for the rest of the financial sector. The FSLRC has suggested a similar model for India. An argument can be made that there are fixed costs to setting up separate regulators for these three sub-sectors and India has a shortage of qualified staff. Hence India would be better off merging these three regulators into a Unified Financial Agency (UFA) as in the Netherlands. These three regulators currently exist with their respective sets of personnel and separate Acts of parliament. In our opinion the political-economy barriers in India to the merging of SEBI, PFRDA and IRDA into one regulator are so high that far too much of government's efforts would go into achieving this goal rather than improving regulatory supervision over India's capital, pensions and insurance markets.

[4] The executive summary of the FSLRC report is at pages xiii – xxviii. It would be easier for readers if they are familiar with the FSLRC report or at least the executive summary. Table 19 at the beginning of Section III provides a summary of the current and proposed financial sector regulatory functions and allocation of accountabilities.

Section I also reviews the following in these four developed countries: (a) leverage and adequacy of capital; (b) liquidity and solvency issues; (c) systemically important institutions; (d) Basel II or III for banks and European Union's Solvency II for insurance companies; and (e) regulatory arbitrage. This Section also includes a summary of the work of the Financial Stability Board under the auspices of the G20 to improve regulatory and incentive structures as also how to limit cross-border risks post the financial sector meltdown of 2008.

Section II provides details of a representative sample of liquidity and solvency problems which have afflicted the Indian financial sector in the last three decades. Additionally, Section II examines the extent to which the FSLRC has suggested practical next steps for Indian financial sector regulators to widen and deepen financial inclusion in India not just correct regulatory shortcomings.

Section III examines Part I of the FSLRC report under specific subject headings. This Section also includes analysis of the dissenting notes and to what extent these comments qualify the recommendations made in the report. This paper consciously does not attempt to address all the regulatory, supervisory and attendant implementation issues covered explicitly/implicitly in this wide ranging FSLRC report. For example, whether SEBI, PFRDA, IRDA should be merged into a UFA, the tortured history till now of attempts to set up a Public Debt Management Agency (PDMA), the suggestions to assign greater accountabilities for financial inclusion to regulators and set up of a Financial Redressal Agency (FRA) for consumer protection. It is also not this paper's objective to cover the substantive and political-economy issues which surround the FSLRC's recommendation to repeal most laws pertaining to the financial sector and replace these with the proposed omnibus IFC. The attempt in this paper is to scrutinise the salient features of the report and comment on what would be useful or not. Further, whether the suggestions and prescriptions made in the report are consistent with what could be implemented without over or under-regulating India's financial sector.

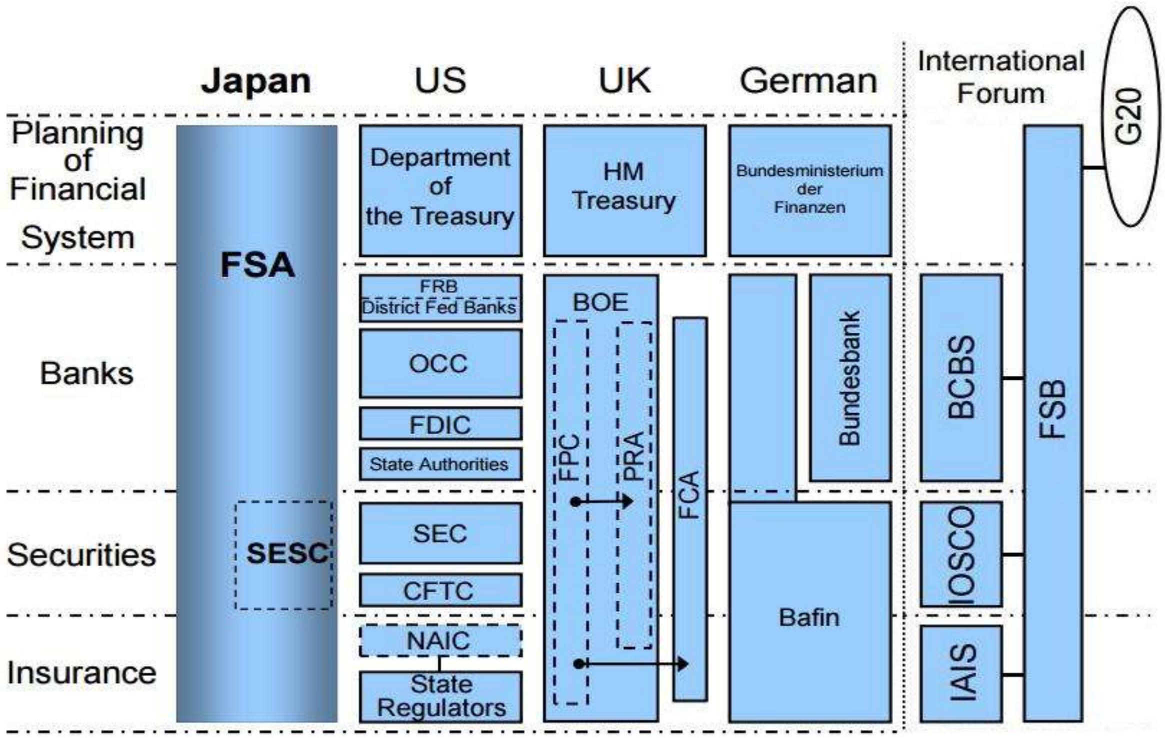
Section IV looks back, in summary format, at the lessons learnt from financial sector crises in developed market countries and the issues that have not received detailed attention in the FSLRC report but require focused attention in India. The Ministry of Finance has taken a topic specific approach and approved some of the FSLRC's recommendations e.g. on setting up the Financial Stability Development Council (FSDC), Financial Data Management Centre (FDMC) and providing a statutory basis for the making of monetary policy. These and other recent developments are covered in the conclusions in Section IV. The conclusions also list what would be the next steps as evidenced from recent government announcements.

This paper does not comment on Part II of the report or the proposed Indian Financial Code. If and when India's financial sector regulators and the government are convinced and agreed about the required changes, the Parliament's Standing Committee on Finance would, with the help of legal experts, examine and debate the feasibility or otherwise of the proposed legislation. This critique of the FSLRC report does not delve into specific and technical aspects of regulation except to comment on what is likely to work in improving regulatory oversight and help in further developing the financial sector in India.

Section I: Financial sector regulation in select advanced economies and multilateral coordination of regulatory efforts

After the mega-financial sector crisis in 2008, the shortcomings in several countries and the international regulatory framework were quite evident. The regulatory architecture, particularly in developed countries, has undergone substantial transformation since the financial crisis. The following Figure 1 outlines the current regulatory structure in the US, UK, Germany and Japan after the 2008 crisis. The changes in regulation in these four countries are discussed below under country specific headings.

Figure 1: Regulatory Structure in select advanced economies



Source: Financial Services Agency, Japan[5]

1.1 United States

The financial sector crisis of 2008, which impacted the US economy adversely, has had long lasting negative consequences for the global economy. After the bursting of the housing bubble in the US, liquidity in international financial markets dried up and several

[5] **Japan**: FSA - Financial Services Agency, SESC - Securities and Exchange Surveillance Commission
United States: FRB - Federal Reserve Board, OCC - Office of the Comptroller of the Currency, FDIC - Federal Deposit Insurance Corporation, SEC - Securities and Exchange Commission, CFTC - Commodities Futures Trading Commission, NAIC - National Association of Insurance Commissioners
United Kingdom: BoE – Bank of England, FPC - Financial Policy Committee, PRA - Prudential Regulation Authority, FCA - Financial Conduct Authority
Germany: BaFin - Federal Financial Supervisory Authority
International Forum: FSB – Financial Stability Board, BCBS - Basel Committee on Banking Supervision, IOSCO - International Organization of Securities Commissions, IAIS - International Association of Insurance Supervisors

internationally significant financial sector firms were on the brink of collapse. A US Senate report has commented that this crisis was avoidable but for the excessive leverage of financial institutions, failure of regulators to curb and monitor complex financial products and that of credit rating agencies, excess risk taking by market participants etc.[6] In Europe too many financial firms were excessively leveraged and post-crisis governments support resulted in the worsening of public finances of several countries.[7] Government in Greece, Ireland, Portugal and Spain needed third party help to service their debt. The regulatory changes following the 2008 crisis in four G7 countries are discussed below.

In the United States, there are multiple regulators in terms of sub-sectors and geographical jurisdictions. Periodically, shortcomings in effective regulatory oversight brings forth calls for strengthening the regulatory system (Edward V. Murphy 2015).[8] Historically, financial regulation in the US has been rule-based and there are separate laws for banking, capital markets, insurance and pensions instead of a single overarching law. In the aftermath of the 2008 crisis, financial sector regulation in the United States has undergone major changes. After widespread consultation across regulators and market practitioners, the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) was passed on July 21, 2010. This law attempts to address gaps and weaknesses in regulation and to make future shocks to the system less damaging (US Treasury).[9] It seeks to achieve those objectives by:

- putting in place a devoted supervisory body for consumers;
- mitigating risks in the derivatives markets through increased transparency, marking to market and posting of collateral;
- making provisions for the winding down of failing firms.

One of the achievements of the Dodd Frank legislation is the creation of the Consumer Financial Protection Bureau (CFPB) and bringing over-the-counter derivatives such as credit default swaps under the lens of regulators. Another suggestion under discussion was the proposed Volcker rule which would separate commercial deposit-taking banking from investment banking. As of now, this proposal has not been accepted by the US Treasury.

Overview of US financial sector regulation

After the Great Depression, the **Glass-Steagall Act,** which separated commercial banking from investment banking, was passed in the United States. During 1932-33, more than 5000 commercial banks suspended their operations and many subsequently failed (Milton

6 "The Financial Crisis Inquiry Report", US Senate
7 "Political Economy of Debt Accumulation and Fiscal Adjustment in a Financial Crisis", Parthasarathi Shome, Reserve Bank of India
8 Edward V. Murphy, "Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Market", Page 10, Congressional Research Service (CRS) Report, January 2015.
9 http://www.treasury.gov/initiatives/wsr/Pages/wall-street-reform.aspx

Friedman et al., 1980).[10] The Federal Deposit Insurance Corporation (FDIC) was also established under the Glass-Steagall Act.

Since the late 1970s and the early 1980s, commercial banks were hard pressed to compete with non-deposit taking financial firms as the latter offered higher returns. The US government deregulated banking further in 1999 through the **Gramm-Leach-Bliley Act** (Financial Services Modernization Act), which erased the distinctions between commercial and investment banks. Concurrently, this Act required financial institutions – companies that offer consumers financial products or services such as loans, financial or investment advice or insurance – to explain their information-sharing practices to their customers (FTC).[11] However, there were several over-the-counter (OTC) derivatives for which regulatory coverage was uncertain. The Commodity Futures Modernization Act of 2000 stated that OTC derivatives would not be regulated as either futures under the Commodity Exchange Act or as securities under securities laws.

Changes in financial sector regulation post 2008 crisis

Among the major changes brought about by the Dodd Frank Act are the creation of the Financial Stability Oversight Council (FSOC) and Office of Financial Research (OFR) to address systemic risks and to maintain financial stability. OFR was established to support the FSOC. OFR's mission is to "promote financial stability by delivering high-quality financial data, standards and analysis for the Financial Stability Oversight Council and public" (OFR).[12] FSOC is empowered to suggest steps required to be taken by regulatory bodies. The principal aim of creating the OFR was to have a comprehensive database on financial institutions and their activities at one place.

The Financial Stability Oversight Council (FSOC), comprising ten voting members and five non-voting members,[13] is chaired by the Treasury Secretary (FSOC).[14] The Dodd Frank Act requires that the FSOC meet at least once in a quarter. However, the council could and does meet more often to discuss emerging risks, financial stability and recommends stricter financial standards as necessary. It also acts as a co-ordinator among the sub-sector specific regulators and facilitates information sharing and collection.

The FSOC primary responsibilities include the following (FSOC Annual Report):[15]

- identifying risks to the US financial system that may arise from the financial sector or from outside the financial system;
- maintaining market discipline;

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10 Milton Friedman, Anna Jacobson Schwartz, "New Deal Changes in the Banking Structure and Monetary Standard", New Deal Banking Reform to World War II Inflation (1980), (p. 3-75), Princeton University Press

11 https://www.ftc.gov/tips-advice/business-center/privacy-and-security/gramm-leach-bliley-act

12 http://financialresearch.gov/about/

13 Refer Annex I for details

14 https://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx

15 FSOC (2015), "Annual Report 2015", Financial Stability Oversight Council

- responding to emerging risks to the financial system.

However, DFA does not give rights to the FSOC to address regulatory shortcomings. FSOC can make regulatory recommendations to make the financial system more stable. If and when the Federal Reserve recommends shutdown of a failing firm, it would require the support of two-thirds of FSOC (Edward V. Murphy 2015).[16]

The DFA consolidated all agencies related to consumer protection and created the new Bureau of Consumer Financial Protection (CFPB). The primary responsibilities of CFPB are to:

- write rules, regulate companies and enforce consumer laws;
- curb illegal, unfair and deceptive practices;
- recognise consumer complaints;
- promote financial education;
- monitor financial markets for emerging risks to consumers.

DFA also consolidated regulation of the banking sector from five agencies to four by eliminating the Office of Thrift Supervision and merging it with the Office of the Comptroller of the currency (OCC) effective July 21, 2011 (OCC)[17]. DFA could have merged these five regulators into just one body. Multiplicity of regulators at times results in disputes between them about overlapping of areas of jurisdiction. This in turn enables market participants to look for arbitrage opportunities created by overlaps and gaps in regulation.

The DFA has brought swaps markets more closely under the purview of regulators. The Commodity Futures Trading Commission (CFTC), which was entrusted with the task of regulating these derivatives, finalised rules in 2013 for swap execution facilities (SEFs). In the first quarter of 2015, 54 per cent of interest rate swaps and 71 per cent of credit default swap (CDS) index trades involving US citizens were traded on these SEFs. There are still several shortcomings in the regulation of derivatives, the responsibility for which was earlier mainly in the hands of the CFTC. However, under the Dodd Frank Act, both CFTC and SEC are responsible for regulating over-the-counter derivatives. For instance, SEC is accountable for regulating some of the riskier derivatives such as security-based swaps (SBS). However, SEC is yet to start the process of making these derivatives transactions more transparent. Although SEC has come up with the proposed rules, these are not yet effective.

Achievements and Shortcomings of Dodd Frank Act

The creation of CFPB was one of the important elements of the Dodd Frank Act. This consumer protection bureau was formed by consolidating existing consumer forums. Until

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16 Edward V. Murphy, "Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Market", Page 13, Congressional Research Service (CRS) Report, January 2015.

17 http://www.occ.gov/about/who-we-are/occ-for-you/bankers/ots-integration.html

July 21, 2015, CFPB has secured over $10.8 billion in relief for more than 25 million consumers, who incurred losses due to illegal practices in the financial industry (CFPB).[18] However, that is only $432 per person.

CFPB supervises consumer credit reporting and non-bank debt collectors whose functioning was opaque prior to the existence of CFPB. The setting up of CFPB has been controversial as some argue that it is inhibiting competition and innovation in the financial industry. The Volcker rule, which proposed separating commercial and investment bank activities, has not been approved for implementation as yet. Implementation of the Volcker rule will be delayed until 2019 if recently passed Promoting Job Creation and Reducing Small Businesses Burden Act by the House of Representatives with a margin of 271-154 becomes law; this law would also weaken the Dodd Frank Act. The other provisions of this law are to exempt select private equity firms from SEC oversight, loosening of derivatives regulation and permitting small publicly traded companies to leave out past financial activities data from their financial filings (US Congress).[19] The White House has said that it would veto such a bill even if it were passed by the Senate as this bill would weaken the Dodd Frank Act[20] (The National Law Review January 2015).

The Federal Reserve Board has given time to banking entities until July 21, 2016, to confirm investments in and relationships with covered funds and foreign funds that were in place prior to December 31, 2013 ("legacy covered funds"). It also gave an additional one year period for banks until July 21, 2017, to confirm ownership interests in and relationships with legacy covered funds (Federal Reserve).

A basic shortcoming of the Dodd Frank Act (DFA) is that it is too lengthy (848 pages).[21] As the report is too voluminous, it is likely that there would be inconsistencies and ambiguities in interpreting the measures stipulated/proposed in the DFA.

According to the IMF's latest assessment of financial stability in the US, further reforms are needed to make banks more resilient to crisis situations. On balance, although banks are safer and healthier than they were five years ago, they are bigger and more interconnected. There are also new risks that mutual funds and insurance companies are exposed to and IMF has recommended that US regulators create an independent national regulator for insurance companies. IMF's report on this subject, titled 'United States: Financial Stability Assessment' says that although the Dodd Frank Act has made the US financial system more stable, the proposed reforms are yet to be implemented fully. The IMF has also suggested that data on financial transactions needs to be collected more comprehensively to assess

18 CFPB (2012, July 16), "CFPB to Supervise Credit Reporting", http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-to-superivse-credit-reporting/

19 US Congress (2015, January 16), "H.R.37 - Promoting Job Creation and Reducing Small Business Burdens Act", United States Congress

20 "Newly Passed Bill May Impact Dodd Frank Act", The National Law Review January 2015

21 "Chinese officials are reported to have remarked, tongue in cheek, that the mammoth law, let alone its appended rules, seems to have been fully read by no one outside Beijing", The Dodd-Frank act, Too big not to fail, The Economist, February 18, 2012

correlation risks and an explicit mandate should be given to the FOSC to oversee systemic financial stability (IMF, July 2015).[22]

Post the 2008 crisis there was considerable discussion in the US in expert, government and legislative circles that financial sector regulation should be consolidated into fewer regulatory bodies. However, although there have been improvements including DFA the regulatory structure in US continues to be highly fragmented compared to Japan and Germany.

1.2 United Kingdom

Financial sector regulation has undergone major changes in the UK too after the global financial crisis of 2008. Before the crisis, the Financial Services Authority (FSA) was responsible for regulating the financial sector based on the Financial Services and Markets Act 2000 (FSMA). FSA was widely criticised for its failure to detect and prevent the financial crisis. The Financial Services Act of 2012 abolished the FSA and created two new institutions – Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). One major change proposed in the Financial Services Act is separation of retail banking from investment banking as recommended by the Vickers Commission. This Commission also proposed that banks maintain higher capital and loss absorbing reserves than the ratios specified by the current Basel norms (The Vickers Report, December 30, 2013).[23] Banks have been given till 2019 to implement the Vickers Commission recommendations.

The Prudential Regulation Authority (PRA) is a subsidiary of the Bank of England (BoE) and works closely with the Financial Policy Committee and the Special Resolution Unit. It is responsible for the supervision of banks, building societies, credit unions, insurers and major investment firms (Prudential Regulation Authority, Bank of England). It is regulating around 1,700 financial firms. According to the PRA's 2013 annual report, it has three statutory objectives to:

- promote the safety and soundness of the firms it regulates;
- contribute to the securing of protection for insurance policy holders; and
- promote competition in the markets for services.

PRA works towards its objectives by setting standards and through supervision. Major supervisory decisions are taken by its Board, which is accountable to parliament. The Board includes the Chief Executive Officer of PRA, the Governor of the Bank of England (BoE), the Deputy Governor for Financial Stability of the BoE and independent non-executive members.

The Financial Conduct Authority (FCA) supervises the conduct of over 50,000 firms, and sets prudential standards for those firms not covered by the PRA (FCA Annual Report 2013-

22 IMF (2015, July 7), "US Needs to Finish Financial Reforms", International Monetary Fund

23 The Independent Commission on Banking: The Vickers Report & the Parliamentary Commission on banking standards, December 30, 2013

14).[24] FCA's primary objective is to protect consumers, maintain stability and promote competition among service providers. FCA is governed by its board appointed by the Treasury and it is accountable to the Treasury and Parliament. However, it does not receive funding from the government and depends on fees imposed on the firms it regulates.

PRA and FCA regulate the insurance sector in the UK. While PRA focuses on the resilience of the sector, the FCA tries to ensure that customers are treated fairly. PRA requires insurers to be resilient against failure and maintain continuity of financial services. To these ends, PRA sets rules and standards for firms to follow (Bank of England, 2014). [25] Given the cross-border nature of the insurance business, it works closely with the European Insurance and Occupational Pensions Authority (EIOPA).

The Pension Regulator has oversight of pension schemes in the UK. It works with trustees, employers, pension specialists and business advisers. The organisation has been established under the Pensions Act of 2004 after disbanding the Occupational Pensions Regulatory Authority (OPRA) (Pensions Act, 2004). The primary aim of this agency is to regulate work-based pension schemes and to support employers in complying with their automatic enrolment duties in relation to those schemes. It is an independent statutory body and, in exercising regulatory functions, it is not subjected to any external authority other than courts (Department of Work and Pension, 2015).[26] The chairman of the pension regulatory board is appointed by the Secretary of State for Work and Pensions. The pension regulator works with numerous other government bodies such as PRA, FCA, Department of Work and Pension, Pension Protection Fund, Pensions Ombudsman, the Pensions Advisory Service, and the European Insurance and Occupational Pensions Authority (EIOPA) (Pension Regulator, 2015).[27]

Commodity market regulations are included in the Financial Services and Markets Act 2000 (FSMA) and in the past FSA was the regulatory authority. Under the 2012 Financial Service Act, FCA is responsible for regulation of the commodity derivatives. However, it is not responsible for regulating underlying physical markets. It supervises firms and market operators, and works closely with other countries' counterparts and physical market authorities such as the Office of Gas and Electricity Markets (Ofgem) (FCA Annual Report 2013-14).

1.3 Germany

Germany has historically followed a bank-based financial system with significant public sector holdings. However, regulatory changes since 1995 have been pushing it towards the Anglo-Saxon model (Detzer et al, 2013). [28]

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[24] FCA, "Annual Report 2013-14", Financial Conduct Authority
[25] "The Prudential Regulation Authority's approach to insurance supervision", Bank of England, 2014
[26] "Framework Document", Page 2, the Pensions Regulator, Department for Work and Pensions, March 2015.
[27] The Pensions Regulator, "Corporate Plan 2015-2018", Page 7.
[28] "The German Financial System", Detzer et al, 2013, Page 22

Prior to 2002, Germany followed an institutional approach to regulating its financial sector. The Federal Banking Supervisory Office (BaKred) regulated banking, the Federal Securities Supervisory Office (BaWe) regulated securities, the Federal Insurance Supervisory Office (BAV) regulated insurance and state regulators supervised stock exchanges.

However, with the introduction of the Euro, Germany introduced radical regulatory changes. In 2002, it moved away from an institutional approach to integrated supervision of the financial sector[29] (Martin Schüler, May 2004). The Bundesbank and the German Federal Financial Supervisory Authority (BaFin) became the regulatory supervisors. The Federal Banking Supervisory Office, the Federal Supervisory Office for insurance enterprises and the Federal Supervisory Office for securities trading were merged to create a new regulatory agency called German Federal Financial Supervisor.

The Deutsche Bundesbank is the central bank of Germany. With Germany becoming part of the Euro area, the role of the Bundesbank was reduced as the responsibility for monetary policy moved to the European Central Bank (ECB). The Bundesbank is autonomous and it is independent of instructions from the Federal Government. Under the 2002 Act, Bundesbank is responsible for most of the operational tasks in banking supervision. In collaboration with BaFin, the Bundesbank oversees the solvency, liquidity and risk management systems in about 2,300 credit institutions in Germany (Bundesbank).[30]

BaFin is an independent federal agency and is subject to legal and technical oversight of the Federal Finance Ministry.[31] It is funded by the fees and contributions of the institutions it supervises. The primary objective is to ensure the integrity and soundness of the German financial system. Fourteen separate departments of BaFin deal with credit institutions, insurance and asset management firms and financial services institutions, and investigate and prosecute market abuse. Currently, BaFin regulates around 1,780 banks and 676 financial services institutions in Germany (BaFin).[32]

All public and private insurance companies in Germany, which fall under the Insurance Supervision Act, are monitored by either BaFin or by the supervisory authorities of the federal states. Since the 2002 Act, the responsibility for supervising pension funds has come under BaFin’s insurance supervision department. Currently, 573 insurance undertakings and 31 pension funds are regulated by BaFin. However, social insurance institutions such as statutory health insurance funds, the statutory pension insurance fund, statutory accident insurance institutions and unemployment insurance do not fall under the Insurance Supervision Act and are regulated by other government agencies. The statutory pension and health insurance funds are subject to the legal supervision by the German Federal Insurance Authority (GFIA), which is accountable to the Federal Ministry of Labour and Social Affairs (BaFin Insurance undertakings and pension funds).

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29 “Integrated Financial Supervision in Germany”, Martin Schüler, ZEW Mannheim, May 2004

30 https://www.bundesbank.de/Redaktion/EN/Standardartikel/Bundesbank/Tasks_and_organisation/tasks.html

31 Handbook on International Corporate Governance: Country Analyses, Chris A. Mallin, Pg 43.

32 http://www.bafin.de/EN/Supervision/BanksFinancialServicesProviders/banksfinancialservicesproviders_node.html

BaFin monitors the listed companies' compliance with various regulations under the Securities Trading Act. However, it does not supervise individual stock exchanges. These are supervised by the stock exchange supervisory authorities of the federal states (BaFin Stock exchanges & markets).

BaFin also oversees domestic asset management companies and investment funds managed by those companies under the investment code. Currently, it supervises more than 6,000 investment funds and about 260 domestic management companies (BaFin Supervision Asset management companies and investment funds).

Europe's financial sector was severely affected by the global financial crisis. To enhance financial stability and ensure regulatory consistency across the EU, the European System of Financial Supervision (ESFS) was established. Two institutions have been established under the ESFS: the European Supervisory Authorities (ESAs) and the European Systemic Risk Board. ESAs & ESRB work with national partners (ECB).[33]

1.4 Japan

Japan's boom during the 1980s turned to bust in the early 1990s. Stock and land prices, which increased steadily in 1980s, fell sharply in the early 1990s (Hirakata et al. 2014).[34] As asset prices collapsed, the Japanese economy entered into systemic crisis in1997 (Kanaya 2001).[35] Subsequent deleveraging by financial institutions and corporations affected the economic health of the country adversely. GDP contracted by 2.0 per cent and 0.2 per cent in 1998 and 1999 respectively.

The responsibility for supervising and inspecting financial firms and planning for financial system was with Ministry of Finance, until the mid-1990s (Ueda 2009).[36] The Bank of Japan conducted onsite examinations of major financial institutions. The close relationships between finance ministry officials and financial firms were widely criticised (Kamikawa 2012).[37]

To ensure the integrity of capital markets and to protect investors, Japan's financial administration has undergone major changes over the past few years. Japan initiated financial sector reforms, namely the "Japanese Big Bang," in 1996 to transform an over-regulated, bank-oriented system to a transparent, market-based system (Aronson, July 2011).[38]

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33 Refer Annex 1 for ESAs and ESRB's responsibilities

34 Japan's Financial Crises and Lost Decades*, Hirakata et al., Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, working paper no: 220, December 2014.

35 "The Japanese Banking Crisis of 1990s: Sources and Lessons", Akihiro Kanaya and David Woo, Essays in International Economics, No. 222, Princeton University Press, June 2001.

36 Kazuo Ueda (2009, December), "The Structure of Japan's Financial Regulation and Supervision and the Role Played by the Bank of Japan", CIRJE-F-703

37 "The Interaction between Financial Regulation and Financial Crisis in Japan : Change in Financial administration and Two Financial Crises from 1980 to 2010", Kamikawa, Osaka University Knowledge Archive

38 "Reassessing Japan's 'big bang': Did financial reform really fail?", Bruce E Aronson, Creighton University, East Asia Forum, July 9, 2011.

The objective of the reforms was to build "free, fair and global," financial markets (FSA). Despite vehement opposition from the ministry of finance officials, the Diet passed the Financial Supervisory Agency Establishment Law in June 1997 (Amyx, 2004). Under this law, a new integrated supervisor, the Financial Supervisory Agency (FSA) was established in 1998, to supervise and inspect financial institutions and provide surveillance of securities transactions. In 2000, Financial Services Agency (FSA) was established with responsibility for the oversight of financial markets (Yamori et al. 2013).[39] Banking, insurance and securities oversight had been placed under a single regulatory authority.

The FSA's annual report 2014 states its three major responsibilities are to: (i) maintain stability in financial markets; (ii) protect the interest of users of financial products; and (iii) facilitate the smooth functioning of financial services (FSA Annual Report 2014).

The FSA is part of the Cabinet Office and is headed by a commissioner appointed by Prime minister (IMF 2003).[40] The Minister for Financial Services, the Senior Vice-Minister, and the Parliamentary Secretary, who are appointed by the Prime Minister, oversee the FSA's operations (FSA organisation chart 2015).

FSA has delegated some of the important enforcement functions to other organisations. Two important subsidiary agencies of FSA are the Securities Exchange and Surveillance Committee (SESC) and the Certified Public Accountants and Auditing Oversight Board (CPAAOB). The Securities and Exchange Surveillance Commission (SESC) was established in 1992 to ensure fair transactions in securities and financial futures markets and to maintain the confidence of investors in these segments (SESC 2015).[41] The SESC is governed by a chairman and two commissioners, who are appointed by the Prime Minister with the consent of parliament (FSA organisation 2015).[42] SESC has the mandate and authority for market surveillance, inspection of financial business firms, inspection of disclosure statements investigation of misconduct, and criminal investigation (SESC 2015). If SESC spots violations, it recommends administrative action to the prime minister and the commissioner of the FSA (FSA-SESC).[43] SESC can also seek court injunctions against entities that violate regulatory requirements, such as selling funds without proper registration and giving false information to consumers to solicit funds (SESC Annual Report 2014/15).

The CPAAOB, which was established in 2004, is an independent authority within the FSA (FSA-CPAAOB).[44] CPAAOB overseas the work of the Japanese Institute of Certified Public Accountants (JICPA) and conducts its own inspections of auditors (IMF, August 2012).[45]

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39 "Japanese Banking Regulations and SME Finance under the Global Financial Crisis", Yamori et al., Japanese Journal of Monetary and Financial Economics Vol. 1, No. 1, pp. 59-90, 2013.

40 "Japan: Financial Sector Stability Assessment and Supplementary Information", International Monetary Fund, September 2003.

41 http://www.fsa.go.jp/sesc/english/aboutsesc/all.pdf

42 http://www.fsa.go.jp/sesc/english/aboutsesc/02.pdf

43 http://www.fsa.go.jp/sesc/english/aboutsesc/actions.htm

44 http://www.fsa.go.jp/cpaaob/english/overview.html

45 "Japan: Financial Sector Stability Assessment Update", International Monetary Fund, August 2012.

The Bank of Japan (BOJ) is not a regulator. However, its objectives include maintaining an orderly financial system (Tamaki 2008).[46] BOJ conducts on-site examinations and off-site monitoring of banking institutions and acts as the lender of last resort to maintain financial stability. Bank of Japan reviews the risk management, capital adequacy and profitability of financial firms that have current accounts at the Bank of Japan such as securities companies and banks (Bank of Japan).[47]

The Japan Pension Service (JPS) was established in 2010, after the abolition of the Social Insurance Agency (NPS Annual Report 2012). JPS functions under the Ministry of Health and Labour and Welfare (MHLW), with responsibility for the operation and services delegated to it, while the ministry is responsible for pension finance and administration (JPS and its Operation, October 2014).

1.5 Financial Stability Board

After the crisis, many developed countries recognised the following as major reasons for the collapse of the financial sector. One was excessive compensation for executives of large institutions who took unconscionable risks in order to gain short-term benefits, e.g. to get large bonuses. Over-the-counter derivatives, which were a significant causal part of the financial crisis, have come more closely under the regulatory lens. The process of creating central clearing platforms for these derivatives is in progress. There were country specific causes too, e.g., credit rating agencies accorded higher than warranted ratings to complex mortgage backed securities.

A common feature across large developed countries after the 2008 crisis is that the jurisdiction and powers of regulators have been reviewed and strengthened. Fresh legislation has been passed in the US and the UK. The separation of investment banking from commercial banking activity has been reviewed. The new laws have made regulators more accountable and, in the US, an oversight council, namely the Financial Stability Oversight Council (FSOC), has been set up. The endeavour will now be to also watch out for regulatory gaps and overlaps.

Concurrently, to improve monitoring of national, cross-border and complexity related risks the Financial Stability Board (FSB), which succeeded Financial Stability Forum (FSF), was established after the crisis in 2009. The Financial Stability Board’s mandate includes promotion of international financial stability by assessing and addressing systemic risks. The mechanisms include financial sector reforms in member countries and better co-ordination across national regulators. The FSB can only recommend measures to strengthen the financial system in member countries. However, there is no mechanism to enforce these measures among member countries. The member countries are expected be mindful of the analysis and suggestions made by FSB while pursuing financial sector reforms.

46 “Bank Regulation in Japan”, Nobusuke Tamaki, Page 1.
47 Outline of Financial System Stability, Bank of Japan, https://www.boj.or.jp/en/finsys/outline/index.htm/

In a letter to G20 countries, the FSB chairman has claimed that the Board has pursued several reforms and measures to strengthen the international financial system (FSB chair's letter to G20 finance ministers, October 5, 2015). The annual consolidated report on the implementation of financial reforms and their effects was presented in the G20 Antalya summit in the November 2015.

1.5.1 Basel III

Basel norms were set up by the Basel Committee for Banking Supervision (BCBS) to strengthen the banking sector. BCBS sets capital and liquidity ratios for banks. Basel II norms, which were in practice before the financial crisis, were replaced by the Basel III norms under which capital adequacy ratios have been increased and new norms were introduced keeping in mind the 2008 financial crisis.

Basel III risk-based capital rules are already in place in 24 FSB jurisdictions well before 2019 deadline and the rules on liquidity ratios are also in force in a majority of the jurisdictions (FSB, November 2015).[48] Twenty-seven member jurisdictions have risk-based capital rules in place and all but two members have published final liquidity coverage ratio (LCR) regulations. Members are now turning to the implementation of leverage ratios, putting in place a systemically important banks (SIBs) framework and the net stable funding ratio (NSFR) (BIS).[49]

The Regulatory Consistency Assessment Programme (RCAP), which was started by the Basel Committee in 2012, assessed the adoption of Basel III standards by 22 countries and the adoption of LCR standards by five members.

1.5.2 Ending too big to fail

The Financial Stability Board (FSB) has issued guidelines to contain systemic risks and mitigate the risk of failure of systemically important financial institutions (SIFIs). The supervision of these institutions is expected to be more stringent as compared to other financial institutions. The Standing Committee on Standards Implementation (SCSI) has recommended that the SIFIs should adopt clear risk management strategies that are more transparent and effective and the implementation of which can be assessed more objectively. These institutions are subject to higher loss absorbency rules and the resolution mechanisms need to be in place in line with the "Key Attributes" (Key Attributes, FSB)[50] issued by FSB for effective resolution mechanism.

[48] FSB (2015, November 9), "Implementation and effects of the G20 financial regulatory reforms", Financial Stability Board

[49] "Ninth progress report on adoption of the Basel regulatory framework", Bank for International Settlements, October 2015

[50] "Key Attributes of Effective Resolution Regimes for Financial Institutions", FSB

FSB has noted that legal uncertainties in different jurisdictions are an obstacle to implementing resolution mechanisms (FSB, November 2015).[51] FSB in its report to the Brisbane G20 summit said that most jurisdictions have not yet adopted resolution mechanisms and less than half of them have such arrangements in place for domestically important institutions. There is still a significant amount of work to be done to put effective resolution regimes into practice.

Crisis management groups (CMGs) have to be established and key host jurisdictions of global systemically important financial institutions (G-SIFIs) have been identified to handle management and resolution in the event of a cross-border crisis. These CMGs have to report periodically to the FSB on the recovery, resolution planning and resolvability of G-SIFIs (Key Attributes, FSB).[52]

According to the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS), assessment methodologies for 30 banks and 9 insurers have been identified as the Globally-Systemically Important Banks (G-SIBs) and Globally-Systemically Important Insurers (G-SIIs) respectively (FSB, November 2015).[53] Based on several indicators such as size, global activity, and interconnectedness, lack of substitutability or financial institution infrastructure, and the complexity of the G-SIBs, FSB segregated G-SIBs into different buckets; each G-SIB is expected to maintain additional capital reserves in addition to minimum 8 per cent requirement according to the bucket it belongs (Table 1).

Table 1: List of Globally-Systemically Important Banks (G-SIBs)

Bucket	G-SIBs in alphabetical order within each bucket
5 (3.5%)	Empty
4 (2.5%)	HSBC, JP Morgan Chase
3 (2.0%)	Barclays, BNP Paribas, Citigroup, Deutsche Bank
2 (1.5%)	Bank of America, Credit Suisse, Goldman Sachs, Mitsubishi UFJ FG, Morgan Stanley
1 (1.0%)	Agricultural Bank of China, Bank of China, Bank of New York Mellon, China Construction Bank, Groupe BPCE, Group Crédit Agricole, Industrial and Commercial bank of China Limited, ING Bank, Mizuho FG, Nordea, Royal Bank of Scotland ,Santander, Société Générale, Standard Chartered, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group, Wells Fargo

Source: FSB, 2015

Limiting cross-border risks: FSB jurisdictions have implemented structural banking reforms which support financial stability and improve resilience in the system in line with the global reform agenda. A major reform in banking to contain risks is to separate banking from investment activities. The FSB, in collaboration with IMF and OECD, will provide an assessment of the progress of structural reforms in banking within 2016 to G20 leaders.

51 FSB (2015, November 9), "Implementation and effects of the G20 financial regulatory reforms", Financial Stability Board

52 "Key Attributes of Effective Resolution Regimes for Financial Institutions", FSB

53 FSB (2015, November 9), "Implementation and effects of the G20 financial regulatory reforms", Financial Stability Board

1.5.3 *Shadow banking regulation*

Shadow banking[54] activity including in developed countries such as United States contributed to the financial crisis in 2008. In 2014, shadow banking volumes had increased by USD2 trillion to reach USD80 trillion (Shadow Banking Report, FSB, November 2015).[55] In order to strengthen the financial sector and make it less susceptible to risks stemming from under/unregulated shadow banking, the FSB has recommended a system wide monitoring framework and the identification and strengthening of supervision of these institutions. In an effort to create a monitoring framework, FSB has started an annual assessment of global trends and risks in the shadow banking sector which has prompted national authorities to supervise shadow banking in their respective jurisdictions. Currently, such monitoring covers 25 jurisdictions, representing 80 per cent of global GDP and 90 of global financial assets.

To strengthen supervision and the regulatory framework, FSB has asked BCBS to suggest measures to mitigate the risks in interactions between banking and non-bank financial institutions. The Basel Committee on Banking Supervision recommended the following policy measures: (i) risk-sensitive capital requirements for bank investment in equity funds and (ii) supervisory framework for measuring and controlling large exposures. BCBS members will implement capital requirement measures starting January 1, 2017. Under the second policy measure banks are now subjected to a hard limit on large exposures to a single counterparty of 25 per cent of their Tier 1 capital (15 per cent for G-SIBs) compared to 25 per cent of total capital, which is the norm in most jurisdictions currently. This will be implemented by January 1, 2019. BCBS intends to continue to look for ways to improve prudential regulation of shadow institutions and it expects to publish a framework by the end of 2015.

To reduce the risk of a freeze in money markets, the FSB has recommended a conversion of the MMF's with stable Net Asset Value (NAV) to floating Net Asset Value wherever possible. In the US, despite severe opposition from the financial industry, SEC adopted amendments to rules that govern MMF's. Similarly, in the EU, a 3 per cent capital buffer has been proposed for constant NAV and other measures (FSB, November 2014)[56].

In emerging economies, the size of shadow banking has grown in the last several years particularly in China. The share of emerging markets in global shadow banking assets is estimated to have grown from 6 per cent in 2010 to 12 per cent in 2014, driven mostly by China. According to the IMF, shadow banking assets in China amount to 35 per cent of 2014 GDP.[57] According to FSB's shadow banking report, China is yet to develop and implement financial reforms in this area and in most other jurisdictions too, progress has been slow,

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54 FSB has defined shadow banking as "credit intermediation involving entities and activities (partly or fully) outside the regular banking system"

55 FSB (2015, November 12), "Transforming Shadow Banking into Resilient Market-based Finance", Financial Stability Board

56 FSB (2014, November 14), "Transforming Shadow Banking into Resilient Market-based Financing", Financial Stability Board

57 "Shadow banking in China: A primer", Douglas Elliott, Brookings Institution, March 2015

However, Brazil and India have implemented reforms in this area (Shadow Banking Report, FSB, November 2015).[58]

1.5.4 OTC derivatives market regulation

The regulation of OTC derivatives has improved in the last few years and some OTC derivatives such as plain vanilla swaps are now being traded on exchanges in developed countries. Implementation of reforms in this area is still underway. Most of the reforms are targeted at trade reporting and capital rules for non-centrally cleared derivatives. In five jurisdictions, central clearing parties (CCPs) were established at least for one or more product types and seven other jurisdictions are considering whether certain derivatives should be centrally cleared (OTC Derivatives Report, FSB, July 2015).[59] Some progress in OTC derivatives market regulation has been achieved.

A few developed country jurisdictions have set up trade Repositories to accept transaction reports. By end-2016, most jurisdictions are expected to have reporting requirements in force covering more than 90 per cent of OTC derivatives transactions (OTC Derivatives Report, FSB, July 2015).

1.6 Accounting

After the 2008 financial crisis, G20 leaders and the FSB requested International Financial Reporting Standards (IFRS) and Financial Accounting Standards Board (FASB) to review existing accounting standards as these were criticised for being complicated with many exceptions. Further, the concept of fair value was misleading for investors. Changes in standards such as simplifying classification and measurement of financial instruments, etc., were developed gradually in three phases (IMF METAC).[60]

Taking a step back to reflect, it appears that after the 2008 crisis there have been many regulatory improvements in the banking and non-banking sectors. However, in relative terms, the importance of regulating and reforming accounting standards and audit firms has been somewhat neglected.

In the United States, the Dodd Frank Act was adopted as a single overarching law to reform the financial industry. However, it did little to address financial reporting and audit issues that were among the factors that enabled many financial sector firms hide their true liquidity and solvency conditions. These were again highlighted in recent scams such as the Toshiba accounting fiasco in Japan in 2015 and Tesco scandal in UK in 2014.

In an annual study conducted by the UK based Centre for Compliance and Trust (CCP) Research foundation in 2014, it was reported that following the crisis, 16 large banks have been fined USD 300 billion for various forms of misconduct (Table 2). The striking fact is

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[58] FSB (2015, November 12), "Transforming Shadow Banking into Resilient Market-based Finance", Financial Stability Board, Page 7

[59] FSB (2015, July 24), "OTC Derivatives Market Reforms", Financial Stability Board

[60] See this for technical details http://www.imfmetac.org/Upload/Link_651_48.pdf

that investors did not receive any advance warning about bank wrong-doing from auditors (Financial Times, June 2015).[61]

Table 2: Fines imposed on banks for misconduct

	Total: 2010-14 (£bn)	Total: 2009-13 (£bn)
Bank of America	64.05	66.4
JPMorgan Chase	32.91	35.78
Lloyds Banking Group	15.62	12.72
Citigroup	14.75	7.57
Barclays	12.19	7.89
RBS	10.9	8.47
Deutsche Bank	9.37	5.62
HSBC	8.9	7.21
BNP Paribas	7.76	3.54
Santander	6.94	3.57
Goldman Sachs	6.13	3.65
Credit Suisse	5.85	3.58
UBS	5.41	4.18
National Australia Bank	2.82	2.34
Standard Chartered	1	NA
Société Générale	0.94	0.7
Totals	205.54	173.22

Source: Financial Times, 2015

A study published by the US based journal, "The Accounting Review", in May 2015 has analysed the financial statements of over 650 companies. Of these companies, only about 20 per cent provided information to investors about material weaknesses. The study also indicated that there is little incentive for firms to come clean. In another paper by professors from Duke and Emory universities, it was reported that a survey of 400 Chief Financial Officers indicated that about 20 per cent of companies intentionally misrepresent their earnings and the magnitude of such misrepresentation could on average be 10 per cent of reported earnings (Rice et al. 2012).[62]

In the California Management Review,[63] Harvard Business School Professor Karthik Ramanna wrote "rules on accounting and auditing are examples of "thin political markets" in which people who have the most to gain set the rules and this is partly due to the esoteric (and boring) nature of these disciplines". He illustrated this by referring to the current rules for mergers and acquisitions accounting where only a handful of auditing and investment banking firms set the rules (Fortune, June 2015).[64]

The data collected by Morgan Stanley Capital International (MSCI) for the Financial Time's 2015 review of the fund management industry showed that many firms in the US have had

[61] FT (2015, June 8), "Banks' post-crisis legal costs hit $300bn", Financial Times

[62] Sarah Rice, David P. Weber and Biyu Wu, "Does SOX 404 Have Teeth? Consequences of the Failure to Report Existing Internal Control Weaknesses", 2012

[63] Karthik Ramanna, "Thin Political Markets - The Soft Underbelly of Capitalism", California Management Review, Vol. 57 No. 2, Winter 2015; (pp. 5-19)

[64] Eleanor Bloxham (2015, June 18), "Should companies eliminate audits?", Fortune magazine

the same auditors for more than 50 years. For example, the consumer products giant Procter & Gamble has used Deloitte as its auditor for 125 years and General Electric has used KPMG for 106 years. Many believe that such long-term relationships between firms and their audit companies limit independent oversight. In Europe, all listed companies are required to change their auditors at least every 20 years. The US Public Company Accounting Oversight Board (PCAOB) tried to introduce similar rules in US but, due to lobbying by the US business community, this was blocked by the US House of Representatives (Financial Times, June 2015).[65]

Measures taken by Regulators: The Securities and Exchange Commission (SEC) intends to consult investors on how best to strengthen the audit function. SEC is also considering changes that would require dissemination of more information such as compulsory disclosure of auditor tenure, which would be helpful for investors and the markets (Financial Times, June 2015).

1.7 Auditing

In India, concurrent audit systems are in place for commercial banks and auditors are appointed by the RBI for each public sector bank (RBI). The insurance regulator IRDA and pension funds regulator PFRDA do not maintain lists of approved auditors (IMF 2013).[66]

SEBI: A SEBI report (May 29, 2015) titled "Enhanced Supervision of Stock Brokers" recommends a larger inspection role for stock exchanges. It is also asking brokers to improve their audit mechanisms. Besides, SEBI wants the firms concerned to separate the handling of client accounts and their own accounts (proprietary trading). SEBI plans to make auditor rotation mandatory for stock brokers and it has directed stock exchanges to maintain a list of internal auditors for all stock brokers. These recommendations are expected to come into effect through the budget following the approval of the report.

Section II: Overview of Indian Financial Sector

The liberalisation of the Indian financial sector in early 1990s, with hindsight it appears without adequate supervisory safeguards, led to mega scams such as the episodes involving Harshad Mehta (1992), plantation and other get rich schemes in the mid-1990s, Ketan Parekh (2001) and UTI (2001). The resilience of India's financial sector during the global financial crisis of 2008 is often cited as proof of an efficient regulatory architecture. However, the Indian financial sector was insulated due to restrictions on access to foreign exchange for Indian citizens and several other factors. For instance, there are restrictions on cross border flows such as volume limits on purchase of government debt securities by foreign entities. Besides, the RBI had built up foreign exchange reserves and the management of the Indian rupee's real effective exchange rate was sound. Further, the raising of risk capital requirements in the domestic housing sector meant that Indian financial institutions did not try to copy the excesses in the US relating to complex mortgage-backed securities.

[65] FT (2015, June 14), "SEC seeks views on 'shocking' auditor relationships", Financial Times
[66] IMF (2013), "India: Financial System Stability Assessment", International Monetary Fund, Page 78

Recent examples of wrong-doing such as the National Spot Exchange Limited (NSEL) fraud (2013), chit fund, co-operative bank frauds and cheating of Sahara India "Pariwar" investors highlight the continuing inadequacies in the regulatory architecture of India's financial sector. Further, the non-performing assets (NPAs) of the banking sector, particularly public sector banks, have risen sharply over the last decade. Although, the overall balance sheet deterioration of Indian banking is partly due to the continued weakness in the global economy including the Chinese slowdown, the role of the regulatory structure in not anticipating and limiting imprudent lending cannot be overlooked.

Segments of India's financial sector are still relatively underdeveloped. Specifically, the coverage of pensions and insurance services is relatively poor. Although the availability of products and market efficiencies are quite high in Indian capital markets, only a small fraction of household savings invested in the financial market is allocated to the equity market. As average national incomes and financial literacy go up, a larger proportion of Indian savings should be intermediated by the financial sector. The challenge for regulatory authorities and government is to maintain sound regulation along with widening and deepening the coverage of the financial sector.

2.1 Banking

As the pensions and insurance sub-sectors and the corporate and municipal bond markets are relatively shallow, India has relied on banks to provide the bulk of longer term funding. There were several private banks in India at the time of independence. Post the nationalisation of the Imperial Bank (State Bank of India) in 1955,[67] the government started to make its presence felt in the sector. The government consolidated its ownership of banks with the nationalization of 14 large private commercial banks in 1969. However, as part of economic reforms in the early 1990s, government started opening up the banking sector. Based on the Narasimhan Committee report, the Banking Regulation Act was amended in 1994, which deregulated the banking industry.[68]

The financial sector in India is still dominated by public sector entities. For instance, public sector banks account for about 73 per cent of total credit and more than 80 per cent share of the number of branches (Table 3).[69] Even though the market share of private sector Indian banks in total credit has steadily increased over the years, it remains below 20 per cent. In terms of assets, the Regional Rural Banks (RRBs) have a very low share of assets. However, given their geographic reach, they play an important role in providing financial services to low and middle-income households.[70] Foreign banks have 335 branch offices in India, mostly in urban areas and their share in total credit is less than 5 per cent.

[67] Gandhi (2015), "Indian PSU Banking Industry: Road Ahead", Speech delivered by Shri R. Gandhi, Jan 12, 2015

[68] Roland (2006), "Banking Sector Liberalization in India", Indian Institute of Capital Markets 9th Capital Markets Conference Paper

[69] Including Regional Rural Banks (RRBs)

[70] Subbarao (2013), "Banking Structure in India Looking Ahead by Looking Back" Speaking notes of Dr. Duvvuri Subbarao, Governor, Reserve Bank of India, August 13, 2013

Table 3: Market share of Bank Groups

Bank Group	Number of Offices	Deposits (%)	Credit (%)
State Bank of India & its associates	22893 (18.9)	21.5	22.1
Nationalised Banks	60825 (50.3)	52.4	51.1
Foreign Banks	315 (0.3)	4.3	4.8
Regional Rural Banks	18539 (15.3)	2.9	2.5
Private Sector Banks	18393 (15.2)	18.8	19.4
All Scheduled Commercial Banks	120965 (100)	100	100

Source: RBI (2015)

The Reserve Bank of India (RBI) regulates and supervises a significant part of the financial sector including the banking sector. RBI was established in 1935 under the Reserve Bank of India Act, 1934. Since nationalisation in 1949, RBI has been owned by the government of India.[71] The Preamble of the Reserve Bank describes the basic functions of RBI as follows: "...to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage".[72]

The Indian financial sector is still relatively under-developed. Table 4 shows that the ratio of domestic credit[73] to the private sector was 51 per cent of GDP in 2014, significantly lower than the global average of 125 per cent.

Table 4: Domestic credit to private sector (% of GDP)

	1960	1980	2014
Brazil	20.2	42.5	69.1
China	-	53.0	141.8
Germany	-	73.9	80.0
India	7.7	20.2	51.1
Japan	56.3	129.4	188.1
Malaysia	7.0	49.0	124.7
United Kingdom	17.6	26.2	141.2
United States	70.9	94.2	195.6
World	50.5	72.0	125.2

Source: World Development Indicators

A large percentage of the population still depends on informal sources for their financing requirements.[74] In the past decade, the government has been successful in providing access to formal banking through basic accounts. Initiatives such as "no-frill" accounts, transfer of MNREGA wages directly to the workers' accounts and the Pradhan Mantri Jan-Dhan Yojana

71 RBI website, Organisation and Functions of RBI
72 RBI website, Organisation and Functions of RBI
73 Domestic credit to private sector refers to funding provided to the private sector by financial corporations, including monetary authorities and deposit money banks and other financial corporations (World Bank)
74 The break-up of institutional and non-institutional rural credit shows that non-institutional agencies accounted for 44 per cent of outstanding debt in 2012-13 (Hoda & Terway, 2015, ICRIER Working Paper 302, page 6)

have extended the reach of banking to a significant proportion of the population.[75] However, as of now, financial activity in these accounts is negligible. The Government of India, while launching the Pradhan Mantri Jan-Dhan Yojana, acknowledged that efforts to provide access to financial services have not produced the desired outcome as yet. A large number of bank accounts remain dormant, resulting in costs for banks and no commensurate benefits to the account holders.[76,77]

Rising non-performing assets and lack of regulatory/supervisory attention

The banking sector in India is passing through a difficult phase. The stress in balance sheets of financial institutions has increased significantly in the last four years. The situation is particularly worrisome for public sector banks (PSBs). At the end of 2010-11, the Gross Non-Performing Assets (GNPAs) in both PSBs and private sector banks was at a satisfactory level of 1.8 per cent and 2.3 per cent respectively.[78] However, a sharp deterioration can be seen since then. The GNPAs of PSBs has increased to 6.2 per cent and private banks reported NPAs of 2.2 per cent in September 2015 (Table 5). A similar worrisome trend can be noticed in restructured assets.

Table 5: Non- per forming assets (as a percentage of gross advances)

	Mar-13	Mar-14	Mar-15	Sep-15
Public Sector Banks				
Gross NPAs (%)	3.8	4.7	5.4	6.2
Net NPAs (%)	2	2.7	3.2	3.6
Restructured Assets (%)	7.2	7.2	8.1	7.9
Gross NPAs + Restructured Assets (%)	11	11.9	13.5	14
Gross+ Restructured + Written off (%)	13.4	14.1	16.1	17
Private Sector Banks[79]				
Gross NPAs (%)	1.9	1.9	2.2	2.2
Net NPAs (%)	0.5	0.7	0.9	0.9
Restructured Assets (%)	1.9	2.3	2.4	2.4
Gross NPAs+ Restructured Assets (%)	3.8	4.2	4.6	4.6
Gross NPAs+ Restructured+ Written off (%)	5.4	6.4	6.7	6.7

Source: Table taken from the presentation of S. S. Mundra (Deputy Governor, RBI)[80]

Rising NPAs in the banking sector can be attributed to an extent to the slowdown in the global economy and reduction in domestic investment coupled with stoppages in large infrastructure projects, which has reduced the ability of borrowers to service outstanding

75 In recent years, 398 million basic savings bank deposit accounts (BSBDAs) have been added. It includes the 147 million accounts opened under the Pradhan Mantri Jan Dhan Yojana (PMJDY) (RBI Annual Report 2014-15, page 72)

76 MoF (2015),"A National Mission on Financial Inclusion", Ministry of Finance, August 24, 2014

77 As of 09.03.2016 the number of accounts under PMJDY has increased to 21.22 crores, 28.02 per cent are of zero-balance-accounts (PMJDY website)

78 RBI (2014) "Report of The Committee to Review Governance of Boards of Banks in India"

79 Does not include foreign banks

80 Presentation of S. S. Mundra, "Asset Resolution & Managing NPAs – What, Why and How?" , 1st CII Banking Summit February 11, 2016 Mumbai

loans.[81] This was partly due to Supreme Court judgments banning iron ore and coal mining and slower than projected acquisition of land. Besides, some private sector borrowers probably exaggerated capital costs and had little equity capital in the large infrastructure projects, relying mostly on bank loans. Five sectors namely mining, iron and steel, textiles, infrastructure and aviation constitute about 24.8 per cent of the total credit of scheduled commercial banks (SCBs). However, their share in stressed loans is 51.1 per cent.[82] Prima facie, it appears that there was an element of lack of supervisory attention on the part of regulators and the government as the majority owner of public sector banks.

One of the recurring themes of RBI's annual reports between 2008 and 2011 is the somewhat self-congratulatory stance about the resilience of India's financial system during and after the global financial crisis due to its "sound regulatory and supervisory framework".[83] The 2010-11 RBI annual report states that the "the Indian banking system remained largely sound and resilient to shocks as indicated by various stress tests".[84] In the 2011-12 and 2012-13 reports, the RBI acknowledges rising risk in the banking system.

The RBI's annual report for 2011-12 states that the "banking sector remained robust with high capital adequacy, even though rising NPA levels emerged as a concern. The NPAs, however, are pro-cyclical in nature and a rise in the same may be a reflection of overall slowdown in the economy".[85] According to RBI's 2012-13 annual report, "the asset quality of banks has deteriorated significantly thereafter due to the slowdown in the economy and the emergence of sector-specific issues amid structural bottlenecks in the economy".[86] It appears that there was inadequate acknowledgment of the poor assessment made by the PSBs of the cost of projects and their timely completion. After the sharp rise in the NPAs of public sector banks (PSBs), RBI recognised that there were shortcomings in credit monitoring. In its annual report for 2013-14, RBI states that "asymmetry in information is a fundamental challenge that impacts the quality of banks' credit risk assessment and supervisors' ability to track emerging credit risks in the system". It is not explained why this affects PSBs more than private banks. To overcome this challenge, RBI introduced "Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalizing Distressed Assets in the Economy" in January 2014. The framework outlines a corrective action plan to incentivise "(i) early identification of problem accounts, (ii) timely restructuring of accounts that are considered to be viable and (iii) lenders taking prompt steps for recovery or sale of unviable accounts" (RBI 2014).[87]

The P. J. Nayak Committee, constituted in Jan 2014, identified shortcomings in the governance of Indian banks. The committee suggested that dual regulation of public sector banks by the Ministry of Finance and RBI results in governance difficulties. It also argued

81 Standing Committee on Finance (2015-16), "Non-Performing Assets of Financial Institutions"
82 RBI (2015), "Financial Stability Report", page 14, June 2015
83 RBI Annual Report 2009-10, page 103
84 RBI Annual Report 2010-11, page 96
85 RBI Annual Report 2011-12, page 100
86 RBI Annual Report 2012-13, page 11
87 RBI (2014), "Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy" (RBI, January 30, 2014, page 1)

that "bank boards are disempowered, and the selection process for directors is increasingly compromised".[88] The Nayak committee report recommended that the composition of public sector bank boards needs to be improved to provide greater strategic focus. According to the report, "with RBI having moved away from detailed to risk-based supervision, the annual financial inspections investigate asset quality reporting of banks less rigorously. It appears desirable, therefore, that RBI conducts random and detailed checks on asset quality in these banks".

Finance Minister Pranab Mukherjee said in his budget speech 2009-2010 that, "our government's approach to the banking and financial sector has been to ensure robust oversight and regulation while expanding financial access and deepening markets. The merit of this balanced approach has been borne out in the recent experience, as the turbulence in the world financial markets has left the Indian banking and financial sector relatively unaffected. Never before has Indira Gandhi's bold decision to nationalise our banking system exactly 40 years ago – on 14th of July, 1969 – appeared as wise and visionary as it has over the past few months. Her approach continues to be our inspiration even as we introduce competition and new technology in this sector".[89]

Budget speeches between 2010-2011 and 2013-2014 do not mention the growing stresses in the banking sector. These speeches declare that capital would be provided to public sector banks to meet Basel III risk capital requirements.[90,91,92] However, the 2014-2015 interim budget speech highlighted the banking sector stress due to rising non-performing assets[93]. It is evident that government underestimated and glossed over the extent of governance and regulatory shortcomings in the banking sector.

Institutional steps to expedite recovery of NPAs have not been adequate. Debt Recovery Tribunals (DRTs) were established to help financial institutions to recover debt faster[94]. However, larger borrowers have managed to prolong the proceedings of DRTs on various grounds. For instance, borrowers have claimed in courts that if DRTs allowed auctioning of their assets, irreparable damage would occur to the companies and shareholders.[95] In addition,

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88 In the Union budget 2016-2017, Finance Minister Arun Jaitley announced the establishment of a Banks Board Bureau. This body will recommend the appointment of bank directors.

89 Budget 2009-2010 speech of Pranab Mukherjee, Minister of Finance, July 6, 2009

90 The 2010-11 budget proposed capital infusion of Rupees 16,500 crores in public sector banks to ensure that they are able to maintain minimum 8 per cent Tier-I capital by March 31, 2011 (Speech of Pranab Mukherjee, Minister of Finance, February 26, 2010)

91 Budget 2011-12 proposed Rupees 6,000 crores for the year 2011-12 to ensure that the public sector banks maintain minimum Tier I CRAR at 8 per cent (Speech of Pranab Mukherjee, Minister of Finance, February 28, 2011)

92 In the budget speech of 2013-14 finance minister P. Chidambaram said "before the end of March, 2013, we shall provide Rupees 12,517 crores to infuse additional capital into 13 public sector banks. In 2013-14, I propose to provide a further amount of Rupees 14,000 crores for capital infusion" (Budget 2013-2014 Speech of P. Chidambaram, Minister of Finance, February 28, 2013)

93 In the budget speech of 2014-15 finance minister P. Chidambaram said "bankers have assured me that as the economy turns they will be able to contain the NPAs, recover more loans, and build healthier balance sheets".

94 Bankdrt website, Debts Recovery Tribunal

95 Bankdrt website , "Laws of The Debts Recovery Tribunal"

competing claims of employees and clash of jurisdiction between official liquidators appointed by high courts and the recovery officers of the debts recovery tribunals has further slowed the resolution process.[96] The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) was enacted to reduce court interventions in debt recovery. The SARFAESI Act provides three methods of recovery: (i) securitisation; (ii) asset reconstruction; and (iii) enforcement of security without the intervention of courts.[97] In practice, SARFAESI has failed to improve debt recovery.

The failure of the DRTs can be gauged from the recovery of just 14 per cent of the amounts involved in 2014-15 (Table 6). Similarly, delay and backlog is evident in the number of new cases filed during the year 2013-14, which was about one and a half times the cases disposed of in the same year.[98]

Table 6: NPAs of scheduled commercial banks recovered through various channels

Year	No.	Recovery Channel	Lok Adalats	DRTs	SARFAESI Act	Total
2012 -13	1	No. of cases referred	840691	13408	190537	1044636
	2	Amount involved (Rs. Billion)	66	310	681	1057
	3	Amount recovered (Rs. Billion)	4	44	185	233
	4	**3 as per cent of 2**	**6.1**	**14.1**	**27.1**	**21.9**
2013 -14	1	No. of cases referred	1636957	28258	194,707	1859922
	2	Amount involved (Rs. Billion)	232	553	953	1738
	3	Amount recovered (Rs. Billion)	14	53	253	320
	4	**3 as per cent of 2**	**6.2**	**9.5**	**26.6**	**18.4**
2014 -15	1	No. of cases referred	9131199	171113	1241086	10543398
	2	Amount involved (Rs.. Billion)	887	3789	4705	9381
	3	Amount recovered (Rs.. Billion)	43	531	1152	1726
	4	**3 as per cent of 2**	**4.8**	**14**	**24.5**	**18.4**

Source: RBI

Notes: Refers to amount recovered during the year, which could be with respect to cases referred during that year and earlier years.

The RBI has introduced various measures to help banks address non-recovery problems.[99] On balance, in the absence of an effective bankruptcy law, lenders will continue to find it difficult to recover outstanding debt from defaulting firms.

96 Bankdrt website , "Laws of The Debts Recovery Tribunal"

97 United Bank of India website, Sarfaesi Act

98 Rajan (2014), "Saving Credit" Talk by Dr. Raghuram G. Rajan, Governor, Reserve Bank of India, Nov 25, 2014

99 Some of the important measure are flexible structuring of long-term project loans provided to infrastructure and core industries (5-25), labelling borrowing as wilful defaulters, if they have capacity to pay but do not pay, or have not utilised the funds for stated objectives, strategic debt restructuring scheme and restrictions on ever-greening (details in Annex 2)

2.2 Pensions

The Indian pension sector is still at a nascent stage. The aging population in India has relatively little pension protection. For instance, estimates indicate that in the unorganised sector, which accounted for about 88 per cent of the labour force of 47.29 crores according to the 66th Round of NSSO Survey of 2011-12, does not have any formal provision[100] for pensions. Cross-country comparisons show that in India, public spending on pension is about one per cent of GDP while advanced economies such as Germany and Japan spend more than 10 per cent of their GDP on pensions (Table 7). Only 2.6 per cent of India's population benefits from some form of pension, which is significantly lower than the coverage in developed countries (Table 8).

Table 7: Total public pension spending (% of GDP)

	Recent Year	Total Spending(% GDP)
Germany	2009	10.60
Japan	2009	10.10
United States	2010	6.80
Brazil	2010	6.14
UK	2009	5.00
Malaysia	2012	3.75
China	2006	2.5
India	2010	1.00

Table 8: Pension coverage (% of total population)

	Recent Year	Beneficiaries Coverage (all pensioners / tot. pop.)
Germany	2010	28.7
Japan	2003	24.1
UK	2010	22.4
United States	2008	14.9
China	2011	12.4
Brazil	2010	11.4
India	2010	2.6
Malaysia	2011	2.5

Source: World Bank pension data

Pension schemes can be broadly divided into two broad categories – defined benefit and defined contribution. Under defined benefit schemes, the benefits are specified as fixed amounts or correlated with years of service and salary.[101] However, defined contribution depends on the contributions of employees and employers. The pension benefit depends on accumulated contributions and earnings from the investments of these contributions.

As the definition suggests the defined benefit pension scheme could create fiscal stress for the public exchequer. In 2004, based on the recommendations of the Old Age Social & Income

[100] Press Information Bureau Government of India, New Delhi May 8, 2015
[101] (Bhattacharya (2004),“ Defined Benefit Pension Scheme – Can it survive?”

Security (OASIS) report, the central government replaced the defined benefit pension system with defined contribution pension for new government employees[102] (PFRDA, 2016). A contributory scheme called the National Pension System (NPS) started functioning from 2004.

An interim regulator, the Pension Fund Regulatory and Development Authority (PFRDA), was constituted through an administrative order in 2004 to manage the NPS.[103] Subsequently, the Pension Fund Regulatory & Development Authority Act was passed on September 19, 2013[104]. The Preamble of PFRDA explains its role: "to promote old age income security by establishing, developing and regulating pension funds, to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental thereto." PFRDA is administered by a chairperson, three whole-time members and three part-time members, all of whom are appointed by the central government.[105] The PFRDA Act, 2013, allowed up to 26 per cent foreign investment in the pension sector.[106] In 2015, this limit was increased to 49 per cent (DIPP, April 2015).

Indian old age pension schemes can be grouped as follows:

- **Civil services scheme:** All central and state employees, who joined prior to 2004, are covered under this scheme. Pensions are linked to final salary. Public expenditure on this scheme was 0.7 per cent of GDP or 6.6 per cent of tax revenue in 2013-14.[107]

- **Employees Pension Scheme (1995)**: Employees Pension Scheme (EPS) is administered by the Employees' Provident Fund Organisation (EPFO), which covers formal sector entities with more than 20 employees. Employees drawing a salary of less than Rupees 15000 are eligible for EPS (EPFO 2014).

- **Occupational pension schemes:** Public and private enterprises also offer pensions. The companies concerned either manage such pension schemes themselves or in co-ordination with companies such as Life Insurance Corporation of India Ltd. Public sector entities too have moved away from defined benefit pensions and replaced these with defined contribution schemes. The nature of pension schemes provided by private enterprises differs from one firm to another[108] (PFRDA Annual Report 2013-14). Mutual funds and insurance companies also offer pension schemes.

- **National Pension System (NPS)**: The NPS replaced the civil service pension scheme for government employees joining after 2004. All employees of the central government,

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102 The Armed Forces are an exception; they continue to receive defined benefits.
103 PFRDA Annual Report 2013-14
104 Ministry of Law and Justice (2013), "The Pension Fund Regulatory and Development Authority Act, 2013", The Gazette of India
105 Ministry of Law and Justice (2013), "The Pension Fund Regulatory and Development Authority Act, 2013", The Gazette of India
106 Ministry of Law and Justice (2013), "The Pension Fund Regulatory and Development Authority Act, 2013", The Gazette of India
107 PFRDA Annual Report 2013-14
108 PFRDA Annual Report 2013-14

central autonomous bodies and 26 state governments are now mandatorily covered under NPS.[109] Initially the NPS was only for government employees. However, from 2009, it was extended to all citizens on a voluntary basis.[110] Government employees contribute 10 per cent of salary (basic + allowances) and an equivalent amount is contributed by the government.[111]

- NPS launched Swavalamban Yojana to provide pension to workers in the unorganised sector who are not covered under any other scheme.[112] Atal Pension Yojana was also launched in 2015 for individuals in the unorganized sector. In February 2015, the subscriber base of NPS was 8,361,793 with Rupees 77,702 crores of assets under its management (Table 9).

Table 9: National Pension System

Number of Beneficiaries Registered under New Pension System (NPS) in India (As of 14.02.2015)		
Employer/Sector	**No. of Subscribers**	**Total Assets under Management (Rupees Crores)**
Central Government	1,488,414	35,855
State Government	2,547,697	34,511
Corporate	349,598	5,318
Unorganised / All Citizens	84,803	574
NPS-Lite	3,891,281	1,445
Total	**8,361,793**	**77,702**

Source: Indiastat

- **Indira Gandhi National Old Age Pension Scheme (IGNOAPS) and other pension schemes offered by states:** IGNOAPS is a non-contributory scheme for senior citizens (age 60 years and above) belonging to below poverty line households.[113] State governments also provide old age non-contributory pensions. The coverage of such schemes is very wide. Under IGNOAPS, 23 million individuals were provided pensions in 2014-15 (Table 10). However, the low pension amounts under these schemes do not amount to adequate protection.[114]

109 PFRDA Annual Report 2013-14
110 RFRDA website
111 Ministry of Finance (2008), "Implementation of the Defined Contribution Pension Scheme (DCPS)" , Office Memorandum, September2, 2008
112 National Portal of India
113 Ministry of Rural Development, 2011
114 Indira Gandhi National Old Age Pension Scheme (IGNOAPS) for those 60-79 years old is only Rupees 200 per month and for people above 80 years the pension amount is only Rupees 500 per month (Department of Rural Development, 2015)

Table 10: Beneficiaries under non-contributory pension schemes (in millions)

	Beneficiaries under Indira Gandhi National Old Age Pension Scheme (IGNOPAS)	Beneficiaries under Indira Gandhi National Disability Pension Scheme (IGNDPS)	Beneficiaries under Indira Gandhi National Widow Pension Scheme (IGNWPS)
2009-10	16.3	0.7	3.2
2010-11	17.1	0.7	3.4
2011-12	20.5	0.8	3.6
2012-13	22.7	1.1	5.0
2013-14	22.2	1.6	6.2
2014-15	23.0	1.1	6.3

Source: Indiastat

2.3 Insurance

A well developed insurance sector not only provides a safety net but also generates long term funding for infrastructure and other projects with long gestation periods (IRDA, 2007). The insurance markets in India are still at an under-developed stage, with a majority of Indians without insurance coverage.

Government of India nationalised life insurance in 1956 and general insurance in 1972. Subsequently, based on the Malhotra Committee (1994) recommendations, this sector was opened to private players in 2000. In the same year, foreign companies were also allowed ownership of up to 26 per cent in private companies, which was increased to 49 per cent in 2015.

Initially, the insurance sector was regulated by a Ministry of Finance appointed "Controller of Insurance". This Controller functioned within the ambit of the Insurance Act, 1938, Life Insurance Corporation Act, 1956 and the General Insurance Business Act, 1972.[115] The Malhotra Committee (1994) had also recommended setting up of an independent regulator for the insurance sector. Based on this committee's recommendations, the Insurance Regulatory and Development Authority (IRDA) was established in 1999, to regulate and develop the insurance industry.[116] IRDA consists of a chairman and nine other members (five permanent and four part-time members). All members are appointed by the central government. IRDA's primary responsibility is to protect policy holders and to regulate, promote and ensure orderly growth of the insurance business in India.[117]

Despite the entry of private players, life insurance is still dominated by the public sector Life Insurance Corporation of India (LIC), with a market share of 75.4 per cent (Table 11). In the non-life insurance sector, the share of the public sector in premium income is 54.7 per cent while private sector collects the remaining 45.3 per cent.

[115] MoF (2002), "Insurance (Amendment) Act, 2002"
[116] "History of insurance in India"
[117] "Duties, powers and functions of IRDAI"

Table 11: Market share based on the premium income (%)

	Life Insurers	**Non-Life Insurers**
Public	75.4	54.7
Private	24.6	45.3

Source: IRDA Annual Report (2013-14)

Table 12 shows that in 2014, insurance penetration measured as the ratio of premium to gross domestic product (GDP) was 3.3 per cent against a global average of 6.2.[118] The penetration of life insurance is 2.6 per cent, while non-life insurance accounts for 0.7 per cent. The situation is similar if we turn to insurance density, which is defined as per capita premium. Table 13 indicates that per capita premium in India is $58 against a global average of $662. There are multiple factors which are responsible for the low level of insurance penetration in India. The most important among them are economic development and access and understanding of financial instruments.

In 2011-12, around 21.9 per cent of the population was living below the poverty line.[119] Due to the high marginal propensity to consume their savings are naturally low. Financial illiteracy and lack of access to financial institutions means that they prefer investing their savings, if any, in non-financial products.

Table 12: Insurance penetration: premium percentage of GDP

	Life Insurance	Non- Life Insurance	Total Business
India	2.6	0.7	3.3
Brazil	2.1	1.9	3.9
China	1.7	1.5	3.2
Malaysia	3.1	1.7	4.8
Japan	8.4	2.4	10.8
Germany	3.1	3.4	6.5
UK	8	2.6	10.6
United States	3	4.3	7.3
World	3.4	2.7	6.2

Source: Swiss Re (2015)

[118] Swiss Re 2015
[119] Indiastat database. Poverty estimate based on Tendulkar Methodology

Table 13: Insurance density: premium per capita ($)

	Life Insurance	Non-Life Insurance	Total Business
India	44	11	55
Brazil	222	200	422
China	127	109	235
Malaysia	338	186	524
Japan	2926	852	3778
Germany	1437	1617	3054
UK	3638	1185	4823
United States	1657	2360	4017
World	368	294	662

Source: Swiss Re (2015)

Recently launched schemes such as the Pradhan Mantri Suraksha Bima Yojana (PMSBY) and Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY) are intended to significantly increase insurance coverage. Insurance cover at relatively low premiums is the major attraction of these schemes. However, success will depend on the effectiveness of the steps taken by the government and IRDA to increase awareness. The ease of subscribing to these schemes and speed with which claims are processed will also play an important role in widening effective coverage.

Investment and solvency issues in the insurance sector

Insurance companies are required to invest at least 25 per cent of their funds in central government securities and not less than 50 per cent has to be invested in central/state government or other government approved securities (IRDA 2015). General insurance companies are required to invest at least invest 20 per cent of their funds in central government securities and not less than 40 per cent has to be invested in central/state government and other state approved securities (IRDA 2015).

The investments of insurance companies show that they are compliant with these guidelines. However, concerns are being expressed about investments made by LIC (Table 15). LIC has played a significant role in investing in equity markets during downturns and has supported the government's disinvestment process. Similarly, it has lent crucial support to stressed public sector banks by raising its equity stakes in them (Table 14). This quasi-fiscal function of the LIC is inconsistent with its primary purpose which is to widen and develop insurance markets.

Table 14: LIC investments120 in public sector banks

	11-Dec	12-Dec	13-Dec	Dec-14	15-Jun	Mar-16
Corporation Bank	23.75	25.49	22.54	22.54	22.54	21.22
Bank Of India	8.93	13.47	11.82	12.53	14.93	-
Canara Bank	4.97	4.97	5.35	6.4	14.49	13.75
Bank Of Maharashtra	6.68	8.94	6.17	13.4	13.85	12.72
Central Bank Of India	7.44	9.99	5.44	10.04	12.97	14.5
Dena Bank	6.17	8.5	4.03	13.12	12.7	14.5
Punjab National Bank	8.54	14.02	12.94	11.15	12.7	13.85
Indian Overseas Bank	8.89	10.32	6.45	12.62	12.62	14.5
Allahabad Bank	8.65	10.61	11.44	11.48	12.5	14.5
Bank Of Baroda	8.04	11.99	11.44	9.96	12.19	11.89
United Bank Of India	-	4.77	3.1	14.19	12.12	-
State Bank Of India	12.76	10.66	13.72	12.26	11.51	11.49
UCO Bank	8.44	11.55	10.2	8.69	13.86	14.36
Union Bank Of India	7.81	12.34	10.28	9.47	11.03	10.24
Punjab & Sind Bank	-	4.94	4.21	10.49	10.49	10.49
Syndicate Bank	10.27	13.98	10.31	8.34	8.6	9.16*
I D B I Bank Ltd.	12.01	11.75	8.59	8.59	8.59	14.37
Oriental Bank Of Commerce	8.87	8.87	8.22	8.22	8.36	14.06
Andhra Bank	9.07	8.56	7.58	6.99	7.46	11.58
Vijaya Bank	6.82	10.15	10.73	6.58	7.19	14.5
Jammu & Kashmir Bank Ltd.	-	-	-	1.96	3.17	3.17
Indian Bank	2.27	2.42	2.42	2.61	3.14	3.14
State Bank Of Bikaner & Jaipur	1.91	1.94	2.22	2.02	2.02	2.02
State Bank Of Mysore	1.51	1.51	1.47	1.47	1.47	-

Source: Collected from BSE shareholding pattern data

*December 2015

In February 2013, the Ministry of Finance raised the investment cap in a single company from 10 per cent to 12-15 per cent of outstanding equity shares for large[121] insurance companies.[122] This allowed LIC to increase its equity holdings in several public sector banks. LIC is a "systemically" important financial institution and literally too big to fail. Therefore, excessive investments by LIC in equity instruments could lead to significant asset-liability mismatches since its liabilities are mostly of the nature of fixed income instruments. RBI has expressed its concern about LICs rising investments in bank stocks.[123] IRDA too has voiced

[120] Investment by LIC and its various schemes

[121] Companies with investment assets of Rupees 2,50,000 crores were permitted to invest up to 15 per cent of outstanding equity shares (face value) in the investee company. For insurance companies with investment assets of Rupees 50,000 crores or more, the Rs.2,50,000 crore investment limit was raised to 12 per cent. The investment limit remained 10 per cent for companies with investment asset of less than Rupees 50,000 crores ((IRDA (Investment) (Fifth Amendment) Regulations, 2013)

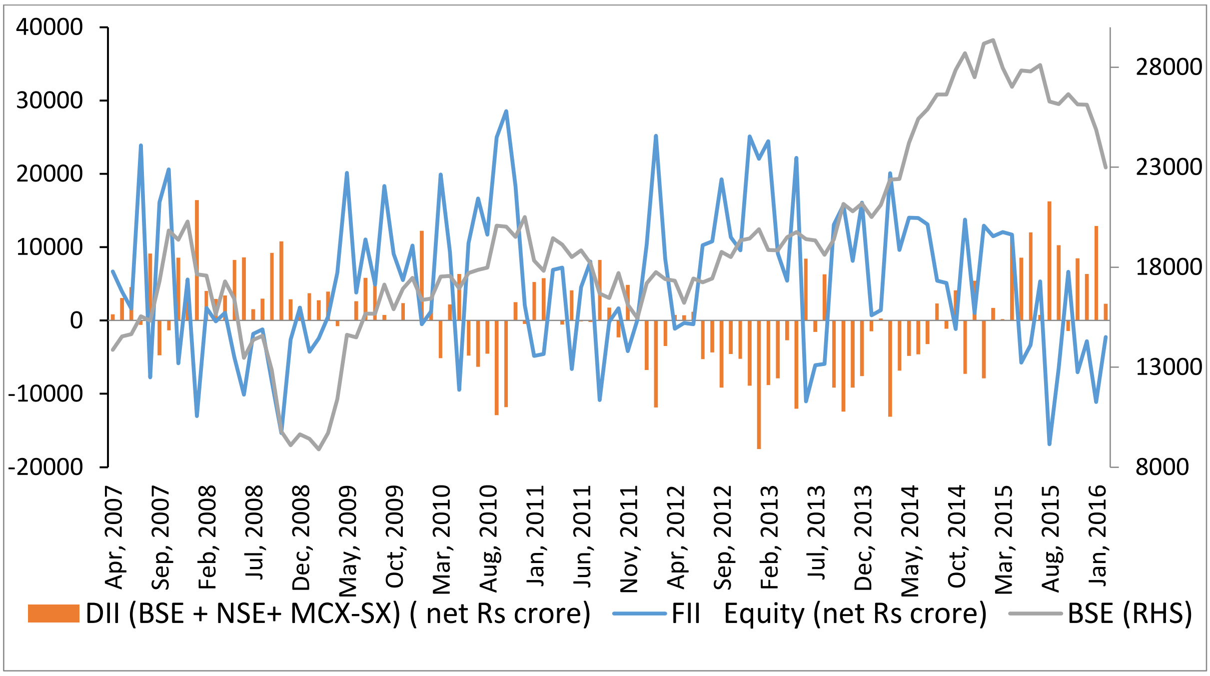
[122] IRDA (Investment) (Fifth Amendment) Regulations, 2013

[123] "Suppose the banking sector is not doing well and is in trouble, the equity holding of LIC will see value erosion. This affects the capability of the insurer to serve policyholders. The other interconnected issue is that if LIC wants a fire-sale of the shares, then it creates a contagion in the markets. In any case, if too much

its disquiet. However, LIC has its own Act of parliament and it appears to be functioning at times under the direct supervision of the Ministry of Finance.

LIC's trading patterns in Indian equity markets are puzzling. LIC as the largest domestic institutional investor in the country has invested in 307 companies[124]. Although LIC's monthly investment data is not available, estimates show that LIC accounts for about 40 percent (Rs.3.93 lakh crore) of the total market value of domestic institutional investor (DII) investment in listed companies.[125] Trading data since 2011 shows that DIIs, led by LIC, may be playing a stabilizing role in the equity market. An Indian equity market rally started in January 2012 and lasted till January 2015. In this period of 37 months, the BSE Sensex went up by 88 per cent and in this period, DIIs sold shares worth about Rs.1.7 lakh crore[126] (Figure 2). When the BSE Sensex declined by 22 per cent between February 2015 and February 2016, DIIs bought stocks worth Rs.90,000 crore. It is not clear that the largest insurance company in India, namely LIC, should be used for equity "market stabilization" when its core responsibility is to widen and deepen insurance markets.

Figure 2: DII investment in the equity market



Source: BSE and NSDL

of bank shares are held by one entity, the habit and capability of banks in tapping the market gets impacted. This has an implication for financial stability" (RBI Deputy Governor S S Mundra, May 21, 2015)

124 ET (2015), "DII stake value in NSE companies hits 6-yr high at Rs 10.21 lakh cores", Economic Times, May 19, 2015

125 Vardhan (2015), "Major Shareholders of Indian Stock Market", valueresearchonline.com July 27, 2015

126 BSE website

Table 15: Investments of Insurers (Instrument-Wise), March 2014

(Rupees Crore)

Life Insurers		
Traditional Products	Amount	Percentage
Central Govt. Securities	6,04,651	37.19
State govt. and other	3,33,951	20.54
Housing & Infrastructure	1,55,026	9.54
Approved Investments	5,03,059	30.94
Other Investments	29,118	1.79
A. Total (1+2+3+4+5)	**16,25,804**	**100**
ULIP Funds		
Approved Investments	3,22,456	97.22
Other Investments	9205	2.78
B. Total (6+7)	**3,31,661**	**100**
Grand Total (A+B)	**19,57,466**	

Source: IRDA

Non-Life Insurers		
	Total	% to Fund
Central Govt. Securities	35,877	25.66
State govt. and other	14,326	10.25
Housing and Loans	12,742	9.11
Infrastructure Investments	24,544	17.56
Approved Investments	49,264	35.24
Other Investments	3,056	2.19
Total	**1,39,809**	**100**

Source: IRDA

According to IRDA guidelines, all insurance companies are required to be mindful of their solvency ratios. "Insurers shall maintain an excess of the value of assets over the amount of liabilities of not less than an amount prescribed by the IRDA, which is referred to as a Required Solvency Margin"[127] (IRDA Annual Report, 2013-14). This solvency ratio is defined as the ratio of the amount of available solvency margin to the amount of required solvency margin (IRDA 2000). Currently the insurers are required to maintain a solvency ratio of 1.5. At the end of financial year 2014, all the 24 life insurers and 26 non-life insurers (including the health insurers) had complied with the stipulated solvency ratio of 1.5 (IRDA Annual Report, 2013-14). LIC reported a solvency ratio of 1.54, which is the lowest among life insurers.

[127] IRDA Annual Report, 2013-14

2.4 Capital markets

The reform measures undertaken since the early 1990s have transformed the Indian capital markets. Significant improvements have been implemented in the spot and derivatives markets to minimise credit, liquidity, solvency and operational risks. Some of the important measures are the introduction of a clearing and settlement system, formation of a centralised counterparty for transactions, establishment of a modern depository system for stocks, and a move from a carry-forward (badla) system to the introduction of exchange traded derivatives (futures/options contracts).[128]

Securities and exchange regulations were initially framed under the Securities Contracts (Regulation) Act of 1956. The Securities and Exchange Board (SEBI) was constituted as an interim administrative body to function under the overall administrative control of the Ministry of Finance.[129] SEBI was given statutory status by an Act of Parliament in 1992. It is responsible for the monitoring and inspection of firms and stock exchanges dealing with equity, debt and commodities and related derivatives. SEBI is a quasi-judicial body and is empowered to frame regulations. SEBI orders can be challenged in the Securities Appellate Tribunal (SAT), which is a statutory body established under the provisions of Section 15K of the SEBI Act, 1992.[130]

SEBI board members are appointed by the Government of India. The board consists of a chairman, two members from among officials of the Ministry of Finance, one from the RBI and five other members. Under the SEBI Act, the duty of the board is to "protect the interests of investors in securities and to promote the development of, and to regulate the securities market by such measures as it thinks fit" (SEBI Act 1992).

Stock market capitalisation is often used as a measure of the level of financial sector development. Table 16 shows that India's stock market capitalisation as a percentage of GDP has increased significantly from 17 per cent in 1991 to 69 per cent in 2012.[131] Table 16 shows that 5191 companies were listed in India in 2012, which is the highest in the world and its share in the total number of companies listed globally is impressive at eleven per cent. However, many of these shares are not traded and others are thinly traded. The US has the second largest number of listed companies with a global share of around 9 per cent. As can be expected given the relative size of the Indian economy, India has only a two per cent share in global market capitalisation of listed companies, while the share of the US is 35 per cent.

[128] Raghavan et al, (2014), "A Study of Corporate Bond Market in India: Theoretical and Policy Implications**"**, DRG Studies Series, study no. 40

[129] Bhat (2008), "Security Analysis & Portfolio Management", Excel Books

[130] Securities Appellate Tribunal website

[131] At the end of the 2015, the market capitalisation as percentage of GDP of BSE listed companies was 71 per cent (Estimated from SEBI bulletin January 2016 and IMF database)

Table 16: Equity market

	Listed domestic companies, total		Market capitalisation of listed companies ($ trillion)		Market capitalisation of listed companies (% of GDP)		Stocks traded, total value (% of GDP)	
	1991	2012	1991	2012	1991	2012	1991	2012
Brazil	570	353	0.043	1.2	11	51	3.3	34.6
China	14	2494	0.002	3.7	0.5	44	0.2	68.9
Germany	428	665	0.393	1.5	21	42	20.4	34.7
India	2556	5191	0.048	1.3	17	69	8.4	34.0
Japan	2107	3470	3.130	3.7	88	62	28.2	60.5
Malaysia	321	921	0.059	0.5	119	156	21.7	40.8
UK	1623	2179	0.988	3.0	86	115	27.6	95.2
US	6742	4102	4.090	18.7	66	115	35.4	132.2
World	26093	47520	11.347	53.2	50	74	22.6	68.9

Source: World Development Indicators

Developed bond markets can facilitate fund raising at competitive interest rates as compared to syndicated bank finance.[132] Moreover, as equity markets can be volatile, bond markets may enable firms to better match their asset and liability portfolios to reduce duration mismatch risk.[133]

One of the major reasons for the relative underdevelopment of the Indian corporate debt market is the lack of a bankruptcy code and the interminable delays in Indian courts. The Indian corporate sector depends mostly on equity markets or securitized loans to fund their investments. Table 17 shows that outstanding corporate bonds in India amount to only three per cent of GDP, compared to 36 per cent in US, 9 per cent in China and 16 per cent in Japan. Non-securitised loans stood at 54 per cent and 60 per cent of GDP in India and the US respectively in 2012. The relatively small corporate bond market in India is dominated by government-owned companies and quasi-government entities.[134]

Table 17: Financial depth in 2012 (per cent of GDP)

	Equity	Financial bonds	Corporate bonds	Securitised loan	Non-securitised loans
United States	116	99	36	66	60
Japan	61	25	16	2	131
Western Europe	59	113	14	12	108
China	47	18	9	-	132
India	60	5	3	-	54

Source: McKinsey Global Institute

132 SEBI Annual Report 2013-14
133 Acharya (2011), "Corporate Bond Market in India: Issues and Challenges", Reserve Bank of India Occasional Papers Vol. 32, No. 3, Winter 2011
134 SEBI Annual Report 2013-14

In an emerging economy such as India, mutual funds could play an important role to encourage savings and investments in capital market securities. Mutual funds are important for financial inclusion purposes too as these provide an investment platform for lower net-worth investors. Mutual funds also provide market analysis, which is generally not readily available to lay investors and enable them to make better informed decisions.[135]

Since 1993 when the SEBI Mutual Fund Regulations were put in place, private sector mutual funds have grown sharply, particularly after the repeal of the Unit Trust of India Act 2003.[136] The private sector share in gross resource mobilisation was 82.4 per cent in 2013-14.[137].

Despite the growth of the industry in the last decade, it is significantly below its potential. An international comparison shows that India's mutual fund industry is comparatively small (Table 18). In 2013-14, SEBI framed long term policies for mutual funds in India, which inter-alia include promotion of financial inclusion, transparency of tax treatment and obligations of various stakeholders.[138]

Table 18: Mutual fund assets as proportion of GDP (%)

	2004	2005	2012	2013
Brazil	32	34	50	50
China	-	-	5	5
India	5	5	6	6
Malaysia	18	18	31	34
USA	61	64	82	91
UK	23	29	47	-
Japan	9	10	12	16
Germany	41	45	50	53

Source: Global Financial Development Database (World Bank)

Scams in capital markets and reforms

Along with the development of capital markets in India, its regulatory structure has also evolved. The introduction of new financial products and trading practices necessitated establishment of new institutions and regulations to improve transparency and fairness. Several corrective measures have also been taken in response to repeated instances of market malpractices.

The securities and stock market scam of 1992 exposed the flaws in the regulatory architecture of that era. Banks traded short maturity debt securities with each other to maintain the required balances at the end of each working day. However, instead of the traded securities actually moving from one bank to another, banks used bank receipts (BRs). Harshad Mehta

135 RBI (2011)"Mutual Funds and Market Development in India", Address by Dr. Subir Gokarn, Jul 07, 2011
136 Bhagwati (2008), "Towards Globalization of India's Financial Sector"
137 SEBI Annual Report 2013-14
138 SEBI Annual Report 2013-14

was the broker for several banks. He issued fake BRs (i.e. BRs without underlying securities) and used the proceeds to create an artificial boom in stock prices. He profited from a booming stock market, which helped him to return the money he borrowed from banks in lieu of fake BRs. However, Harshad Mehta lost heavily due to a sharp correction in the stock market in 1992 and could not meet his obligations to banks, which were left with fake BRs. The Joint Parliamentary Committee, which was set up to look into this scam, found that the amount involved was around Rs.4400 crore.[139]

One of the corrective measures taken following the Harshad Mehta episode was the establishment of security depositories. To overcome the problems such as bad delivery and delayed transfers of securities, the SEBI (Depositories & Participants) Regulations, 1996, was adopted which paved the way for dematerialisation of securities.[140] The National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL) were established to hold securities in electronic form.[141]

In the early 2000s, the Indian stock market was hit by another instance of wrong-doing. A sharp decline in stock market levels post the 2001 budget and excessive volatility in some scrips resulted in SEBI looking more closely into the activities of several brokers. Enquiries initiated by the SEBI at the Ministry of Finance's insistence unearthed several irregularities involving brokers and promoters[142]. The vulnerabilities of banks lending against equity as collateral were also exposed. It was found during enquiries that promoters and brokers often acted in collusion through the use of circular trading in shares of less known companies to create an impression that the scrip was heavily traded, thus enticing unsuspecting retail investors to purchase stocks of the companies concerned.[143]

During investigations, Ketan Parekh emerged as the key player involved in several aspects of this and other frauds. He used multiple entities aimed at hiding the nexus between sources of funds from corporate houses, banks, financial institutions and foreign institutional investors.[144] The artificial inflation in the stock prices of a set of companies, which came to be known as K-10 stocks, created a mistaken belief about the future positive performance of specific scrips resulting in higher than warranted investments in these stocks. Transactions were carried out through a large number of entities so that the concentration of transactions in a particular stock could not be easily noticed, making it difficult to link the sources of funds to investors.[145] The Madhavpura Mercantile Co-operative Bank (MMCB) was a major

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139 BS (2011), "I-T, SBI get Rs.2,195 cores from Harshad Mehta's assets", Business Standard, March 17, 2011

140 NSDL Website, "About NSDL"

141 SEBI Website, "Understanding Depository System"

142 JPC (2002) "Joint Committee on Stock Market Scam and Matters Relating Thereto" Volume-1

143 MoF (2003) "Action Taken Report on the Report of the Joint Parliamentary Committee on Stock Market Scam and Matters Relating Thereto" Ministry of Finance, page 8, May 9, 2003

144 MoF (2003) "Action Taken Report on the Report of the Joint Parliamentary Committee on Stock Market Scam and Matters Relating Thereto" Ministry of Finance, page 8, May 9, 2003

145 JPC (2002) "Joint Committee on Stock Market Scam and Matters Relating Thereto" Volume-1

causality of this type of wrong-doing in 2001-2002. Disregarding RBI's guidelines, MMCB lent Rs.1200 crores to share brokers, including Ketan Parekh and his associates.[146]

The payment crisis which surfaced in the Calcutta Stock Exchange during the Ketan Parekh episode highlighted the shortcomings of the badla system (JPC 2002). Under the badla system, stocks could be traded on margin and settlement could be deferred from one period to another.[147] Counterparty risk under the badla system was high given that the settlements could be deferred indefinitely.[148] Government banned this financial instrument in 1993, after the wide criticism that it caused unwarranted high volatility in stock prices.[149] Due to the lobbying of brokers, government brought back badla trading in early 1996.[150] The Joint Committee on the Stock Market Scam (2002) noted: "the payments crisis on CSE arose because the SEBI in consultation with the Ministry of Finance had permitted the resumption of badla without arranging for curbing or regulating rampant off-market internal badla".[151] SEBI banned badla trade in 2001.[152] Since then, exchange traded derivative products such as futures and options have been introduced for hedging and trading purposes.[153]

The flouting of laws and regulations in Indian capital markets exposed regulatory gaps or jurisdictional issues. The plantation schemes of the 1990s are examples of such scams. In such schemes, investors are duped by companies with the promise of unrealistically high returns. SEBI, RBI and law enforcement agencies were unable to prevent such dubious schemes because of ambiguities/gaps/overlaps in jurisdiction and regulatory arbitrage.

The Collective Investment Schemes Regulations were adopted in 1999 to give authority to SEBI to regulate schemes wherein companies pool funds from investors.[154] However, recent chit fund scams have again exposed regulatory and jurisdictional gaps. The Ministry of Finance is now considering "comprehensive central legislation" to deal with "illicit deposit taking schemes".[155] One of the objectives of the FSLRC in proposing a super regulator is to plug regulatory gaps and ambiguities.

SECTION III: FSLRC recommendations and next steps

The following Table 19 provides a listing of the current functions of financial sector regulators RBI, SEBI, IRDA and PFRDA and the proposed structures and corresponding functions suggested by the FSLRC.

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146 RBI (2012), "Reserve Bank Cancels the Licence of The Madhavpura Mercantile Co-operative Bank Ltd., Ahmadabad (Gujarat)" Reserve Bank of India Press Release, Jun 07, 2012

147 SEBI glossary "Badla"

148 Shah & Susan (2001), "Policy issues in the Indian securities market", IGIDR

149 Bhattacharya et al. (2003), "Stability of the Day of the Week Effect in Return and in Volatility at the Indian Capital Market : A GARCH Approach with Proper Mean Specification" Applied Financial Economics, Vol. 13, No.8

150 Thomas (2001), "Ban on badla, take 2" Economic Times on 29 June 2001

151 Page 117 of the JPC report

152 Sarkar (2006), "Indian Derivatives Markets"

153 Nagarajan (2004), "Recent Trends In Capital Market" address of Shri T. M. Nagarajan, Whole Time Member at the meeting of ICSI, ICAI and ICWAI at Madurai on April 12, 2004

154 SEBI (1999), Securities And Exchange Board Of India (Collective Investment Schemes) Regulations, 1999

155 Budget 2016-2017 Speech of Arun Jaitley Minister of Finance February 29, 2016

Table 19: FSLRC recommendations

Functions	Current accountabilities	Proposed accountabilities
Monetary policy; regulation and supervision of banks; regulation and supervision of payments system.	RBI	RBI
Regulation and supervision of all non-bank and payments related markets.	SEBI, FMC, IRDA and PFRDA	Unified Financial Agency (UFA)
Hear appeals against RBI, the UFA and FRA.	Securities Appellate Tribunal (SAT)	FSAT
Resolution work across the entire financial system.	Deposit Insurance and Credit Guarantee Corporation (DICGC)	Resolution Corporation
Statutory agency for systemic risk and development.	Financial Stability Development Council (FSDC)	FSDC
An independent debt management agency.	New Entities	Debt Management Agency
Consumer complaints.		Financial Redressal Agency (FRA)

Source: FSLRC Report, PRS

The substantive recommendations in Part I of the FSLRC report are discussed under the subject headings indicated below.

3.1 Proposed changes in financial sector legislation

Indian Financial Code to replace a number of laws

As stated in the FSLRC report, there are far too many separate yet overlapping pieces of legislation (more than 60 Acts) that govern the functioning of the financial sector. It is logical that Acts which created Financial Institutions (FIs), Developments Financial Institutions (DFIs), and govern nationalised banks or majority government owned institutions need to be amended or even repealed. Specifically, it is time to amend/repeal, for example, the SBI and LIC Acts and those pieces of legislation which govern the functioning of institutions such as the National Housing Bank (NHB) and National Bank for Agriculture and Rural Development (NABARD). It is not just the largest scheduled commercial bank SBI or the largest insurance company LIC which have separate individual Acts. Several other significantly large financial institutions such as the Employees' Provident Fund Organization (EPFO) are governed by their Acts. This is not necessarily because of their continued relevance in promoting public interest. Unfortunately, these institutions at times become the instruments that government uses to take so called counter-cyclical or public-interest related lending or investments, resulting inevitably in market distortions.

The FSLRC's proposal that specific laws for banking, capital markets, insurance and pensions should be replaced by overarching legislation to cover the financial sector as a whole is reasonable. For instance, investor protection which is an objective common to all segments of the financial sector may be enhanced if regulatory overlap, ambiguity or gaps are plugged through such legislation. However, it does not follow that merging SEBI, IRDA and PFRDA as suggested in the FSLRC report is immediately necessary. The UK experience of merging all financial sector regulatory authority into one body called the Financial Services Authority (FSA) was not successful in addressing banking and other infirmities in the UK (including rigging of LIBOR rates) with an acceptable measure of anticipation.

If the FSLRC's proposed Indian Financial Code (IFC) is to be adopted, sweeping legislative changes would need to be approved by Parliament and then put into effect with the support of the four financial sector regulators (RBI, SEBI, IRDA and PFRDA). Political consensus across all major political parties would be needed for this to happen. This is not likely and hence, in practical terms, it would be preferable not to take on the multiple political-economy interests all at once.

An interim approach, till such time as other major FSLRC proposals such as the Financial Stability and Development Council (FSDC) become effective over time, could be to continue to regulate the financial sector with the oversight of the four existing regulators. Given the current lack of political consensus on how to dilute or give up government ownership, publicly owned financial institutions could remain so but as companies under the Companies Act. Similarly, institutions such as EPFO and Employees State Insurance Corporation could continue as companies but not as statutory bodies. Clearly, the implementation of the FSLRC's proposed sweeping changes would require considerable political will and agreement across a wide range of informed sections and the general public. However, the multiple Provident Fund Acts (page 19 of report) for separate categories of workers are lower hanging fruit and should be repealed.

The laws governing the functioning of RBI, banking and insurance, go to back to the 1930s and need to be overhauled. This is a logical approach since there are multiple anachronisms and inefficiencies stemming for laws and regulations which have not kept pace with a basic requirement to maintain arms-length distance between the regulated and regulators. For instance, the State Bank of India Act provides for an RBI nominee on its Board. There are other statutes which compel regulators to participate in the management of financial institutions they are meant to regulate.

3.2 Pluses-minuses of the proposed Indian Financial Code (IFC)

The IFC is comprehensive and would improve regulation by plugging legislative gaps and doing away with antiquated legislation. However, the IFC even if government-parliament decide that each sub-sector of the financial sector does not need separate legislation may not prevent major financial sector wrong-doing. As Carmen Reinhart and Kenneth Rogoff have catalogued in their book "This Time it is Different", the financial sector attracts highly motivated professionals some of whom will continue to game the system or commit outright fraud in the hope that they will not be detected. Alternatively, the trade-off between possible financial penalties and/or imprisonment is worth the extremely high potential gains. All that revised legislation can aim for is to make this trade-off sharply skewed against potential wrong-doers.

Each of the four financial sector regulators would have their own views, including about rules and regulations under existing legislation and about the proposed IFC. Similarly, infrastructure institutions, i.e. depositories and those responsible for settlement and clearing would also need to provide their reactions to the suggestions made in the report. Stock exchanges would need to be consulted as also the Institute of Chartered Accountants of India. If the Ministry of Finance decides to finally go ahead, it would then submit a draft IFC to its standing parliamentary committee.

The government would need to be cautious about repealing the many Acts relating to the financial sector all at once to ensure that this does not result in legal ambiguities or gaps. In the first place, legal departments of existing regulators would need to put their examination of the proposed IFC in the public domain.

FSLRC's objective to draft a law "which will stand the test of time" is not realistic. As financial instruments and technology change in unanticipated directions, the law and associated legal structures would need to change. Financial innovation invariably outstrips regulations by taking advantage of regulatory gaps or ambiguities. Of course, the law could be drafted flexibly enough to allow new instruments/practices to be regulated without amending the law. In other words, the IFC, if and when it is approved by parliament, should allow for new products and services with prior information to or with Financial Stability Development Council (FSDC) approval. The regulators concerned should responsible for the changes effected.

Simplicity in financial sector legislation is an important objective but it is not clear that simplicity is better than non-ambiguity. If simplicity is on the lines of making the law less amenable to multiple interpretations that would be a move forward. However, an omnibus IFC is not necessarily a solution. One of the principal reasons why regulators find it difficult to enforce existing laws is the extremely dilatory nature of court proceedings in India. Indian judicial processes take long and among the several requirements was a bankruptcy law, which has now been passed by parliament. This law has to be fully in effect if the IFC or a modified version is to be proposed for approval to parliament.

Financial innovation invariably tries to get around existing legislation to take advantage of any grey areas. Therefore, the IFC or its variant should leave elbow room for regulators, in consultation with the central government, to revise secondary legislation, i.e., rules and regulations. Further, the IFC and subordinate legislation should allow new products to be introduced without necessarily requiring amendments to the law.

It is proposed by the FSLRC that individual regulators could have powers for emergency regulations. How would an emergency be defined? What about the impact on existing transactions which could involve losses/profits for market participants? How would transactions be unwound if emergency regulations make that necessary?

3.2.1 Principles versus Rules

One of the stated objectives in the FSLRC report is to evolve a "common set of principles" for "financial sector regulatory institutions". Although such an objective sounds desirable it is not clear exactly what this means in implementation terms. In a practical sense both overall principles and specific rules are required. It would be more tangible to focus on specific sets of common objectives across the financial sector regulators e.g. consumer protection or how to ensure that the financial intermediaries hold enough risk capital. For purposes of illustration, pre-agreed rules are needed (in addition to principles), to mark portfolios to market at specific frequencies and to specify what would be done if there is little liquidity and no reliable market indicators.

3.2.2 Systemic risk

Two overall objectives of sound financial sector regulation are to provide adequate consumer protection and protect against systemic risk. Consumer protection would depend on the speed with which fraud is detected and the speed at which the judicial processes work to provide compensation. Systemic risk could also arise from a lack of consolidated regulation. However, as illustrated by the UK's experience with the setting up of the FSA, which incorporated all regulation including that of banks in one body, this did not prevent egregious wrong-doing.

In practice, the difficult issues to anticipate are invariably in the details. For instance, exactly how much unfettered risk capital is available and under what circumstances could it be deployed? One obvious area of weakness for co-operative banks is that they are inadequately capitalised for the risks they take and insufficiently monitored. Marking-to-market is an important component of managing systemic risk. However, significant parts of our debt markets, as distinct from equity, are not adequately liquid to provide market prices. Further, the government rupee yield curve is not fully arbitrage free since short selling in government securities is not allowed. Additionally, at different points on the sovereign rupee yield curve, liquidity is not adequate to arrive at robust market driven prices. In such situations, there could also be information asymmetries. Hence, penalties should be high if market participants push low liquidity products at artificially inflated prices or without adequate disclosure about the risks involved. As in the case of "lemon" laws, marketing of products such as chit funds, which promise unrealistically high returns on capital, need to be accompanied by commensurate penalties. It is prompt implementation and unambiguous interpretation of laws and regulations which lie at the core of prudent regulation.

3.2.3 Accounting oversight

The FSLRC report does not focus adequately on the importance of impartial and sound accounting. Although the RBI lists the accounting firms that are eligible to vet accounts of banks, the key question is - which body regulates all accounting firms and how thoroughly? It follows that a separate regulator is needed for accounting other than just the Institute of Chartered Accountants of India. To stretch this point beyond its elastic limit, if the ICAI is adequate as the watchdog for accounting, the Association of Mutual Funds of India (AMFI) could be the regulator for mutual funds and SEBI could withdraw from this segment of capital markets. This is not practical as we know from the Satyam and other accounting fraud episodes in India and elsewhere.

3.2.4 Regulatory gaps & shortcomings

Market manipulators look for regulatory gaps and overlaps to try and get away undetected or collude with regulators. In the Indian financial sector, the usual issues of market malpractices are accompanied by frauds committed on dispersed and less than well-informed investors. For instance, scams involving plantation companies, chit funds and other get rich quick schemes.

Another type of wrong doing, again to take advantage of unsuspecting less than well informed investors, is through various types of Ponzi schemes. As was evident from the Bernie Madoff episode, even a developed country such as the US did not take action in time against an egregious Ponzi scheme, which accumulated US$52 billion. It is less than credible that this large volume of funds could be collected without regulators having an inkling of what was going on. It follows that it is important that officials in regulatory institutions function in an environment that is more transparent to both market participants and the media.

As for scheduled commercial banks, non-banking financial companies (NBFCs) or other lending institutions/mechanisms there could be collusion between debtors and creditors. A serious complication in the regulation of Indian co-operative banks is that this responsibility is shared between the state governments/registrars of the co-operative societies concerned and RBI. Such dual control has not worked satisfactorily and in episode after episode, cooperative banks were rendered insolvent or left with high proportions of stressed assets due to the partisan actions/inactions of their management. The use of Article 252 to get state governments to give up their jurisdiction over co-operative bank is likely to be opposed. However, the central government/RBI could make public, at regular intervals, evidence of co-operative banks being managed less than professionally and the numerous instances of outright cheating.

A very different kind of fraud in India was an episode of fake stamp paper being sold widely in at least 12 states (the Telgi scam – Telgi was convicted in 2010). The scandal involved Rupees 30,000 crores and the scale and length of time that this fraud persisted could not have been possible without the complicity of some among regulators/political executive.

Other international examples of wrong doing in the last decade are the manipulation of LIBOR interest rate benchmarks, non-transparent foreign exchange transactions and repeated examples of tax evasion. Further, foreign banks with branches in India have been associated with money laundering and surreptitious transfer of funds to foreign locations.

Although no amount of vigilance or follow up action will eliminate fraud, larger financial penalties could be part of deterrence. To this end, the law should provide for disgorging of “profits” for all four sub-sectors to say five times the estimated profits from the transactions involved.

3.2.5 Financial inclusion and market development

According to the Socio Economic and Caste Census of 2011, which was released in July 2015, in about 75 per cent of Indian households, the highest income earner receives Rupees 5000 per month. It is small wonder that fly-by-night operators can mislead retail investors with minimal financial literacy to invest their meagre savings into what are touted as assured high return schemes.

Past experience has repeatedly shown that plantation, chit fund and other get rich quick schemes attract unsuspecting retail investors. Of course, some of these schemes could also be ways to mainstream unaccounted funds as is alleged about the Sahara schemes, which has led to the imprisonment of Subroto Roy, its principal promoter. There should be an element of buyer beware and appropriate “lemon” laws, since there are huge information asymmetries between providers of financial products and consumers.

An important aspect of the work of regulators has to be to develop their respective sub-sectors and to educate/inform investors and market-makers. However, financial inclusion and the development of Indian financial markets is correlated to economic growth. In this context, regulators should not be overburdened. In India, even basic financial literacy is limited to a small proportion of the population. Financial numeracy and inclusion are related to education levels including basic quantitative skills. The imparting of basic education has to be responsibility of the central and state governments and not financial sector regulators.

3.2.6 Financial Stability Development Council (FSDC)

In regulatory and financial sector circles, doubts have been expressed about the need for an FSDC. The concern is that an FSDC headed by the finance minister would be akin to a super regulator. It has been suggested that the autonomy of financial sector regulators and particularly that of the RBI would be compromised. The reality is that, if the Indian political executive were so inclined, it could, even without the FSDC, use its statutory powers to summarily dismiss the head of a regulatory body and appoint someone else whose views are more aligned to that of the government.

The US has set up such a statutory body called the Financial Stability Oversight Council (FSOC) under the Dodd-Frank legislation of July 2010. The FSOC is headed by the US Treasury Secretary and the members include Chairpersons of the Federal Reserve, SEC and other regulators. In the US, the Federal Reserve is perceived to have sufficient autonomy even after the passage of the Dodd-Frank law.

It is logical that inter-regulatory co-ordination and anticipatory crisis management should be part of the proposed FSDC's mandate and responsibility. Financial sub-sector regulators could and do have sharp differences of opinion on issues which fall between or across two such regulators. Left entirely to themselves, financial sector regulators may not co-ordinate their efforts adequately and in time. This was starkly evident in the case of unit linked insurance schemes (ULIPs), which have both insurance and equity characteristics. IRDA and SEBI did not agree on jurisdiction. It should be for FSDC to resolve such turf disputes.

Decisions on tax-payer funded support for any systemically important financial institution after evaluation of whether it is facing liquidity or solvency problems should be taken by the elected political executive. It follows that this should be done by the FSDC since it is headed by the finance minister. The FSDC has an important co-ordination role too across the four financial sector regulators and needs to be statute-based to have the required authority. And, FSDC meetings could have a defined periodicity of once a quarter rather than be required to meet only when confronted with a crisis.

It should also be the responsibility of the FSDC to review systemic risk once a quarter, based on inputs from the four regulators. Even globally significant financial firms find it difficult to accurately estimate their exposure to systemic and episodic risks and their risk capital has been found to be inadequate at times. FSDC could review risk and adequacy of capital for systemically important Indian financial institutions.

The development of financial instruments and coverage through cross-subsidies across the financial sector should be an objective which needs to be actively pursued and monitored by the FSDC. The process of making regulations and rules under the proposed Indian Financial Code should be left to the regulators. As and when necessary, they could consult with each other and in the case of disagreement they could approach the FSDC. Fresh regulations should be brought to the attention of Parliament at the earliest available opportunity.

Real sector firms working with NBFCs, which depend mostly on their finance functions for revenues, need financial sector regulatory oversight in co-ordination with the Ministry of Corporate Affairs. Further, given the range of issues on which the Ministry of Corporate Affairs overlaps with SEBI (e.g. accounting and registration norms) and with the other financial sector regulators, the finance minister should invariably be the cabinet minister for corporate affairs with a minister of state (MoS) to run that department. It follows that this MoS should be a member of the FSDC. Instead of MoUs between regulators and the Competition Commission of India (CCI), the FSDC should also have close interaction with the CCI and the chairman of the commission should be a permanent invitee to FSDC meetings.

The FSLRC report suggests that FSDC should conduct its own research. This would not be practical in India as staff with specialist training are not available in the Ministry of Finance. And, they would replicate work which should be best done efficiently at the level of the regulators. Indian regulators should not sense that they are absolved of the responsibility to conduct their independent research which keeps them abreast of latest innovations in financial markets as also improvements in regulatory practices around the globe.

3.2.7 Domain knowledge in government and regulatory bodies

The FSLRC report does not adequately address the lack of domain knowledge in government and regulatory bodies. Of course, this is a shortcoming which extends beyond the financial sector. The prescribed selection processes should be statute based and more transparent. Compensation levels for regulatory staff cannot match those of the private sector. In the US, the Federal Reserve or the SEC pay much less than private banks or financial sector firms. However, the experience gained in regulatory bodies is deemed to be valuable and some move on to better paid positions in the private sector.

Heads of RBI, SEBI, IRDA and PFRDA, are often retired government officers at times with little substantive background in finance or economics. The legislation (whether the IFC or any other version) which is finally accepted should include detailed procedures for recruitment of heads and board members of regulators. The government should be responsible for setting up selection committees. A majority of the members of such committees should be non-government, drawn from the private sector and retired officers from government (to be less vulnerable to political-economy pressures). Government should go by the recommendations of such selection committees. If no one from among the persons short-listed is acceptable to the government, it should ask the selection committee to come back with alternative names but not impose its own choice. To reduce the possibility of regulators taking partisan decisions, the heads of regulatory bodies should not be eligible for any government appointment for at least five years after their tenure is over. Except for board level positions, recruitment for regulators should only to be done at the entry level through competitive entrance examinations. Ideally, nobody should be deputed from government to any regulator. If anyone is chosen from government based on competence, that person should resign from government to maintain the required distance between government and regulators.

Government officials in the Ministry of Finance should have at least a bachelor's degree in economics and some experience in the financial sector at the state or central government level. For example, consider the Basel II capital adequacy norms for banks and EU solvency II framework for insurance companies. How would FSDC co-ordinate with regulators to implement the related norms in the absence of basic domain knowledge within government? The three key elements necessary for appointment to any senior public office are integrity, domain knowledge and drive – regulatory bodies cannot be an exception.

3.2.8 RBI - Monetary Policy

As the FSLRC report suggests, the RBI's exclusive role in the framing of monetary policy should be explicitly acknowledged and its primacy in this area should continue. The governor need not have a veto except if the vote is tied. The government's decision to provide a statutory basis for making of monetary policy, by amending the RBI Act 1934 through

Finance bill 2016[156], is a welcome development. This significant improvement can be directly attributed to FSLRC's recommendations to this effect.

The FSDC with the finance minister at its head would be expected to have the final accountability for financial sector stability. However, since banks including NBFCs constitute a large and systemically important part of the financial sector, RBI has to be explicitly first among equals with respect to the other regulators when it comes to issues related to the overall stability of the financial sector.

3.2.9 Merger of SEBI, IRDA & PFRDA

It was a long and difficult process for the Forwards Markets Commission to be absorbed by SEBI. Such mergers are easier conceived than executed. A convincing case is not made, based on past experiences of countries with multiple and single regulators, in the FSLRC report that a Unified Financial Agency (UFA) would necessarily be better at "implementing consumer protection law". It is possible that in practice the merger itself rather than effective regulation would become a final objective. Further, the experience of UK's Financial Service Authority (FSA), which combined all financial sector regulation including banking was not successful as was amply evident in the UK at the time of the financial sector meltdown of 2008.

The LIC's range of operations extends across the jurisdiction of these three regulators plus the RBI. However, given its size and because it is governed by the LIC Act, there is a wariness on the part of financial sector regulators to take issue with LIC about the wide ranging nature of its activities, some of which violate risk and even regulatory norms. A UFA would be just as powerless as IRDA because it is government which has to decide to stop using LIC to prop up state owned enterprises and stock markets. For instance, as detailed in Section II, LIC owns substantial equity stakes in PSBs and private sector firms. Given the nature of LIC's liabilities, which are essentially fixed-income, such investments have possibly resulted in asset-liability mismatches which should be a cause for concern.

3.2.10 Public Debt Management Agency (PDMA)

The preparatory work to set up the front and middle offices has not been done despite the time that has elapsed since this idea was first broached about 15 years ago in the then finance minister's budget speech. In substance, RBI would not be constrained in managing liquidity through open market operations or through other mechanisms. However, RBI would no longer have the ability to manage the auction calendar if there is an independent PDMA. The handing over of management of internal and external government debt to a professional and autonomous body is overdue. It would free the RBI to manage monetary policy without being distracted by the responsibility of issuing and managing government debt denominated in rupees.

[156] 2016-17 Budget speech of Arun Jaitley, February 29, 2016.

On balance, however, an independent/autonomous PDMA although it would be useful is not critically important at this stage of evolution of the government debt market. There are multiple inefficiencies in Indian interest rate markets with government determined interest rates for example for small scale and employee provident fund savings. Additionally, to promote debt markets the new Insolvency and Bankruptcy Act should be first made effective by accelerating the processes of the Debt Recovery Tribunals and the SARFAESI Act. The Ministry of Finance and RBI could co-ordinate and work towards putting the External Debt Management Unit of MoF and a future PDMA together. Thereafter, over time, PDMA could be entrusted with the responsibility for developing state government and municipal bond markets by lending professional support on a fee based basis.

3.2.11 Financial Redressal Agency (FRA)

As of now the financial sector regulators also function as redressal agencies for their specific sub-sectors. The FSLRC suggests setting up of an omnibus FRA. Effectively, this would set up yet another body to question and follow up with existing regulators on consumer and investor grievances. This could dilute the accountability of regulators to parliament both directly and via government. It is also likely that setting up a separate FRA would lead to overlaps and unproductive differences of opinion between the proposed FRA and the regulators. It would be more efficient to strengthen the FRA function within the regulators.

Again, an advisory council on consumer protection, as suggested by the FSLRC, may dilute regulatory powers and again more importantly accountability.

3.2.12 Resolution Corporation (RC)

The Indian Deposit Insurance and Credit Guarantee Corporation legislation dates back to 1961. Subsequently, this Act was amended in 2006. The FSLRC’s recommendation that a new body called the Resolution Corporation should replace DIGCC is timely. It is necessary to take stock on how best to protect depositors while simultaneously increasing competition across deposit taking institutions.

It is the FSDC which should interact with the Competition Commission of India and not the RC. Anti-trust and financial sector laws co-exist in other countries and courts can rule rapidly if there is any confusion about jurisdiction. However, no law or administrative construct can get around legal delays, which could be deliberate or because of back-log.

The RC could be funded through a small charge, perhaps a fraction of a basis point, which would need to be defined very precisely. However, FSDC approval should be required for disbursement above a threshold amount out of this fund.

3.2.13 (Excessive) Oversight of Regulators

The contents of Tables 4.4 and 4.5 on page 32 of Part I of the FSLRC report suggest excessive oversight of statute based regulators. The crucial first step in ensuring responsible regulation is to appoint persons with impeccable records both in terms of their professional careers and integrity rather than constantly peer over their shoulders once they are in office.

As explained in the section above on the setting up of a Financial Redressal Agency, this does not appear necessary. It should be left to regulators to carry out this function since addressing grievances too needs specialised skills. On page 44 of the report, it is mentioned that the proposed redressal agency would have front-ends in every district in India to accept complaints. If access to regulators is an issue, perhaps post offices or even State Bank of India branches could be collection points for grievances. We need to piggy back on existing networks including block development officers.

3.2.14 Fair disclosure requirements

On page 48 of Part 1 of the FSLRC report under "Additional protections for retail consumers" it is stated that the IFC requires that "any person who advises a retail consumer in relation to the purchase of a financial product or service must obtain relevant information about the needs and circumstances of the consumer before making a recommendation to the consumer". In practice it would difficult to prove whether "all" relevant information was provided or not. It should be left to regulators to decide whether material information was deliberately suppressed rather than have an explicit statutory provision of this nature. As far as new financial products and the ability of the regulator to suggest modifications (page 50) are concerned, it should be for the provider of the product to certify and explain what the product aims to provide and that no fraud is intended. It is for regulators to accept or reject the certification before the product is launched. Of course, regulators can stop an existing product from being continued and that is possible under existing laws and regulations.

3.2.15 Sound regulation

Implementation of prudent regulation depends on the steady vigilance of personnel with integrity and well qualified professional background. It would be impossible for any legislation, howsoever well drafted, to anticipate every type of wrong-doing. Additionally, there could be inconsistencies across the interests of managers, owners, customers/clients and others. The short and long-term interests of these several categories of people could and do diverge considerably. It is also difficult to assess who is a genuine consumer/customer or is a competitor and brings in a complaint.

Customers and clients who are less well informed about the financial sector need to be protected. Clearly, excessive compensation and consequent lack of controls within financial sector firms is an issue which plagues developed economies as well. There are no easy legislative solutions. Often, there are time period inconsistencies, i.e., the financial health of a firm may become apparent over time while select personnel receive unusually large bonuses annually which insulate them and their progeny from ever having to look for employment.

The FSLRC report suggests that if the proposed IFC is passed by Parliament, government should hire a transition team to effect the approved regulatory changes. If the Ministry of

Finance does not have qualified personnel it should look to hiring from other parts of government or from the regulators. Accountability would be diluted if such a major transition is handled by those who would necessarily have short-term accountability.

3.2.16 Financial Data Management Centre (FDMC)

An FMDC that can be easily accessed would be useful. The key to how extensively such a data-base would be used is whether the database is comprehensive and up-dated regularly. To that end, the efficient and unstinted support of financial sector regulators would be a pre-requisite. A sub-set of this database could be made available to market participants and analysts.

As proposed in the FSLRC report (page 35), such a database should include legal cases and outcomes thereof. And, it is logical that FDMC should be located in the MoF. The finance minister confirmed in the budget speech on February 29, 2016, that such a data management centre would be set up.

3.2.17 Financial Securities Appellate Tribunal (FSAT) - Unified Tribunal

It should be ensured that the FSAT rulings would be challenged only at the level of the Supreme Court. Additionally, serving, not retired, judges should be appointed to the FSAT. Within the FSAT, domain knowledge of the four sub-sectors should be ensured and it could be broadly divided between banking and the other three sub-sectors in terms of personnel.

At the analyst and working level, FSAT would need personnel with detailed knowledge and experience in dealing with issues relating to financial sector legislation. Such persons are highly sought after and it would be near impossible for FSAT to offer remuneration which is competitive with that offered by the private sector. Hence, FSAT personnel policies should anticipate relatively quick turnover of key analysts.

It would be an inefficient duplication of efforts for FSAT to review financial sector regulations (as suggested in page 32 of the FSLRC report). It would be more efficient to leave this to the regulators and the FSDC.

3.3 Dissent notes

3.3.1 J. R. Varma

According to J.R. Varma, the FSLRC requirement that professionals such as accountants, lawyers, actuaries and even academics need to register themselves with regulatory authorities to provide any "financial service" could lead to regulatory overreach. This concern about regulatory overreach is justified.

3.3.2 K.J. Udeshi

One of the objections in this dissenting note is to the recommendation in the FSLRC report that Government should be responsible for framing regulations on all capital inflows and RBI on capital outflows. On FDI equity inflows and outflows, government could continue to make policy and there is no need for a specific reference to consultation with RBI. Such consultation would happen anyway given the paucity of officials in the Ministry of Finance with the required technical background. As for all other capital account transactions, as suggested by K. J. Udeshi, it would be appropriate for RBI to take the lead in consultation with government.

Additionally, as suggested by K.J. Udeshi, the responsibility for managing the rupee exchange rate should continue to rest with RBI. However, we (the authors) suggest that it should be mandatory for RBI to provide quarterly confidential reports to government on what are the considerations which have guided its exchange rate policies and accumulation of FX reserves. This is a matter on which there are consultations between the RBI and government but the periodicity of written exchanges need to be transparent and formalised. Additionally, RBI should need to explain its exchange rate policies and make it part of its regular interaction with the media as it does for its interest rate decisions.

3.3.3 P.J. Nayak

The concern in the dissenting note about the FSDC and the ministry of finance becoming a super-regulator is reasonable. However, there have been instances of differences between SEBI and RBI (on regulation of brokers trading in government debt securities) and between SEBI and IRDA (on unit linked insurance plans or ULIPS). This is a difficult and sensitive issue but resolution of such differences between regulators should not be undertaken by one or the other regulator – it has to be government. In the US, the 2010 Dodd-Franklin legislation provides for exactly such a body, which is headed by the US Treasury Secretary and the members include the chairperson of the Federal Reserve.

According to P.J. Nayak, the FSLRC suggestion that "rule making powers on capital account transactions for all inward foreign exchange flows" rest with government has "alarming implications". As suggested by P.J. Nayak, it would be better to retain the current allocation of responsibilities i.e. formulation of policies for FDI equity foreign exchange (FX) flows remains with government and RBI continues to be accountable for all other FX inflows and outflows.

As for the FSLRC suggestion that principles based regulation is better than rules this dissenting note's point is that "rules based legislation brings greater certainty". According to P.J. Nayak a principles based approach would lead to ambiguities in interpreting the law and hence considerable delays particularly since the Indian judicial system is overburdened and has a huge backlog of cases. This logic is sound since the obvious danger is potential legal challenges on whether specific contracts are in line with the principles or not. Plus, the long delays in our legal system cannot be ignored. A rules based approach, within overall principles, would be better. Although there is a trade-off with innovation, an approach which is overly dependent on principles would be counter-productive.

3.3.4 Y.H. Malegam

As suggested in this dissent note, for now, except for FDI flows, all other foreign exchange flows should be regulated by RBI. However, contrary to the suggestion made by Y. H. Malegam, rules governing FDI outflows too should be framed by government. It could be confusing if rules for FDI inflows were to continue to be made by government and FDI outflows by RBI. RBI monitors all foreign exchange flows since such flows affect money supply and have an impact on exchange rate management and monetary policy. Presumably, RBI briefs government if it has any concerns about FDI flows.

As indicated by Y. H. Malegam, given the size of the deposit base of NBFCs (about 13 per cent of scheduled commercial banks) and close linkages between their working and that of banks, it is imperative to let the regulation of NBFCs remain with the RBI. Further, housing finance corporations are significant in terms of their linkages with the banking sector and also need to be regulated by RBI.

Section IV. CONCLUSIONS

Lessons from past international financial sector crises

After the 2008 financial sector Armageddon, developed market economies passed fresh legislation and raised capital requirements to make another such crisis less likely. Contrary to what was said by apologists after the event, there were several advance warnings that all was not well in the risk-return trade-offs across share-holders, managers of financial firms including banks, investors and depositors. For instance, emails exchanged between analysts within the major credit rating agencies Moody’s and Standard & Poor explicitly stated that the complex mortgage backed securities (MBSs) should not be rated triple A.[157] MBSs were repackaged such that the underlying credit risk was less obvious and for a few years the rise in real estate prices fuelled consumer spending. Less nimble financial institutions were left holding the risk on their books and firms such as Lehman which provided credit default swap (CDS) cover did not have adequate risk capital.

Looking way back, the two World Wars devastated Europe and US-based firms were able to establish themselves as dominant international financial houses. And, as capital was scarce at that time, financial firms had a stranglehold over the corporate sector. Till the 1970s and even the early 1980s, bankers in Western countries continued to have exclusive relationships with corporate clients. Investment banks underwrote debt and equity issues on terms that were profitable for them. US companies grew, consistent with the economic ascendancy of the US, and set up triple A-rated financial subsidiaries. Later, from the mid-1980s onwards, as underwriting margins decreased, firms such as Salomon Brothers moved away from traditional investment banking to focus on proprietary trading of stocks, bonds and later options.

[157] “Wall Street and the Financial Crisis: The Role Of Credit Rating Agencies”, Pages 2-13, United States Senate Permanent Subcommittee on Investigations, 2010, April 23

In "Liar's Poker", Michael Lewis has documented that as deregulation continued in the 1980s, savings and loans managers were allowed to sell mortgages as bonds. Michael Milken emerged as the junk bond king and went to jail in 1989 for "racketeering and securities fraud". In 1990, Drexel Burnham Lambert was driven to bankruptcy for its involvement in junk bonds.

The 1933 Glass-Steagall Act, which set up the Federal Deposit Insurance Corporation and separated commercial from investment banking since the Great Depression in the US, was repealed in 1999. This meant that deposit-taking commercial banks such as Citibank could underwrite and trade instruments such as mortgage backed securities (MBSs) and collateralised debt obligations (CDOs), and set up structured investment vehicles (SIVs). In 2000, the elite investment bank J P Morgan, which was reeling from an erosion of its traditional high margin investment banking business, consolidated with Chase Bank.

The global insurance company AIG was inadequately capitalised to sell high volumes of credit default swaps (CDSs) on CDOs linked to MBSs. At a fundamental level, elementary principles of risk management were abandoned by regulators. For example, in 2004, five US investment banks, Goldman, Lehman, Merrill, Bear-Stearns and Morgan Stanley prevailed upon the Securities and Exchange Commission (SEC) to allow them to increase leverage. In what can only be described as regulatory capture, the SEC relaxed its three-decade-old rule, which restricted debt to net capital ratios to 12:1 and allowed these five banks to increase their leverage ratios to 30 and even 40:1.

CEOs of financial firms often do not take responsibility for their actions and compensate themselves excessively. High levels of credit default swap (CDS) protection were sold and regulators did not treat CDSs as insurance contracts and insist on accurate marking-to-market of exposure positions. Lehman sold CDSs on itself – that is, it sold insurance against its own default. This was intended to be a win-win proposition for Lehman. If it survived, it would collect the CDS premiums; and if it did not and Lehman decided not to set aside adequate capital against its own default, the resulting losses would be borne by creditors.

It is not deregulation which lies at the root of the financial sector's recurring liquidity and solvency problems. Deregulation cannot be blamed since it decreases costs through increased competition. Financial meltdowns are due to an abdication of regulatory responsibility, conflicts of interest including irresponsible behaviour on the part of rating agencies and excessively leveraged bets taken by financial institutions. Today, stock, debt, derivatives and other forms of trading rather than financial intermediation is the overwhelmingly dominant activity in far too many globally significant financial sector firms.

Going forward in India

The FSLRC report recommends that regulation by principles would be superior to regulation by rules. In tangible terms, rather than esoteric arguments for or against principles versus rules, Indian regulators have to resist interference from political-economy quarters. This is difficult to achieve consistently and we (authors) have reluctantly come to the conclusion that

Indian regulators should allow only such innovation in finance that they can supervise effectively and consistently.

Given the Rupees 6 lakh crores or more of stressed assets on the books of Indian public sector banks (PSBs), there are renewed calls for a reduction in the government's stake in PSBs to less than 50 per cent. It is surprising that repeated wrong-doing in private financial sector firms and banks in the US and UK does not convince Indian observers that it is not necessarily public ownership that results in malfeasance or negligence.[158] As for the argument that governments do not have to repeatedly provide the same levels of tax-payer funded support in the US and UK as in India, financial sector crises have set back GDP growth rates in these and other developed countries for almost a decade since 2008.

In India, the FSLRC's report is the first comprehensive effort after the 2008 crisis to introspect and improve institutional structures, recommend fresh legislation and tighten corresponding rules and regulations. Consequently, the reactions of the regulators, government and informed investors were awaited with great interest. Financial sector regulators, particularly the Reserve Bank of India, have reacted very warily to the sweeping recommendations of the FSLRC to repeal almost all existing legislation meant to regulate and administer this sector.

Two important aspects of effective regulation of the Indian financial sector which have not received adequate attention from the FSLRC are accounting and credit ratings. As was evident from the last international financial sector crisis, which stemmed from the excesses in the US, rating agencies Standard & Poor and Moody's were both driven with conflicts of interest when rating complex mortgage backed securities as triple A. As for accounting, PricewaterhouseCoopers (PwC), India was perhaps driven more by its need to maintain its relationship with Satyam than providing an accurate picture of Satyam's finances. PwC India was fined US$6 million by the SEC for not following auditing standards in the Satyam case. More recently, there are question marks about the auditing and valuations of the United Breweries group of companies by PwC, Grant Thornton and Deloitte LLP.

The FSLRC report does not focus on credit rating agencies (CRAs). S&P and Moody's are a duopoly in international financial markets and are the majority share-holders of two major Indian CRAs, CRISIL and ICRA respectively. CRAs perform a quasi-regulatory function. It is time that benchmarks are set for the credit rating function since it provides critically important inputs for issuance of debt and equity and investment activities. Government could consider setting up a public sector CRA as this would increase competition in the ratings space, be less focused on income maximisation, conservative in its creditworthiness assessments and provide better guidelines for investors on how to interpret its credit ratings.

The FSLRC also did not focus on the listing of Indian stock exchanges. SEBI appears to have given its approval and NSE may be close to listing. The major share-holders of NSE such as SBI and IDBI are perhaps looking to cash their holdings. Again, stock exchanges too are

158 Ram Mohan T. T. (2016, February 28), "Stop Blaming India's Public Sector Banks", The Wire magazine

quasi-regulators. The positives of listing in terms of infusion of capital and technology from international financial centres may be more than negated by a profit maximisation motivation. Increasing profits could be inconsistent with the role of stock exchanges to ensure a level playing field across market makers and participants.[159]

Government and FSLRC recommendations

Government has opted to take a piecemeal approach to the FSLRC's report and has accepted some of its proposals. The Ministry of Finance and/or finance minister have announced that the following FSLRC suggestions have been accepted for implementation.

- A monetary policy committee (MPC) for setting the repo rate will be set up with three RBI officials including the governor and three others nominated by government. The Reserve Bank of India Act, 1934, would be amended by the Finance Bill of 2016 to provide the statutory basis for the MPC.
- A Financial Data Management Centre, to track and analyse financial sector numbers, would be set up under the Financial Stability Development Council (FSDC).
- A code on Resolution of Financial Firms will provide a mechanism to address bankruptcies in banks and other financial sector firms.
- The SEBI Act will be amended to allow more benches and members in the Securities Appellate Tribunal.
- Legislative changes will be introduced within 2016-17 to counter plantation or other get rich quick types of schemes, which are marketed to less knowledgeable and gullible investors.

The long and much discussed Insolvency and Bankruptcy Code is integral to the FSLRC's recommendations. This code was approved by parliament on 11 May 2016. The SARFAESI Act is to be amended to enable sponsors of asset reconstruction companies (ARCs) to hold up to 100 per cent in ARCs.

The government's has announced its intention to reform PSBs through the "Indradhanush" programme. The government has also indicated that it would provide Rupees 25,000 crores to support PSBs. This amount is small compared to the estimated volumes of stressed assets and it appears that government does not intend to dilute its equity stakes in PSBs below 50 per cent. The recent setting up of the Banks Board Bureau is a positive first step towards greater transparency in the selection of senior management and Board positions in PSBs. As tax-payers we need to be watchful whether government walks the talk on making future bailouts for majority state owned banks much less likely.

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[159] Bimal Jalan et al. (2010, November), "Review of Ownership and Governance of Market Infrastructure Institutions", Securities and Exchange Board of India Committee Report

Annex 1

Financial Sector Regulatory Agencies

The regulatory bodies **in the US** can broadly be categorised into four groups. These are:

1. Prudential bank regulators;
2. Securities and derivatives regulators:
3. Other regulators of financial activities:
4. Co-ordinating forum.

The following table lists the regulatory agencies:

Federal Financial Regulators and Co-ordinators

Prudential Bank Regulators	**Securities and Derivatives Regulators**	**Other Regulators of Financial Activities**	**Coordinating Forum**
Office of the Comptroller of the Currency (OCC)	Securities and Exchange Commission (SEC)	Federal Housing Finance Agency (FHFA)	Financial Stability Oversight Council (FSOC)
Federal Deposit Insurance Corporation (FDIC)	Commodities Futures Trading Commission (CFTC)	Consumer Financial Protection Bureau (CFPB)	Federal Financial Institutions Examinations Council (FFIEC)
National Credit Union Administration (NCUA)			President's Working Group on Capital Markets(PWG)
Federal Reserve Board (FRB, or the Fed)			

Source: The Congressional Research Service (CRS)[160]

Some of these agencies focus on firms while others focus on activities of firms. The result is that a single firm is subject to supervision by multiple regulators which could and does result in regulatory overlaps and gaps.

[160] Edward V. Murphy, "Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Market", Page 2, Congressional Research Service (CRS) Report, January 2015

Banking Regulators

The primary regulating agencies are the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and Federal Reserve Board (FRB). Credit unions are regulated by National Credit Union Administration (NCUA). Communications from firms to investors about their accounts is regulated by the SEC whereas loans are monitored by the Bureau of Consumer Financial Protection (CFPB).

Office of the Comptroller of the Currency (OCC)

The President nominates the Comptroller of the Currency subject to confirmation by the US Senate. The Comptroller also serves as a director of the Federal Deposit Insurance Corporation (FDIC) and Neighbour Works America.

The OCC is responsible for regulating and supervising all national banks and federal savings associations as well as federal branches and foreign banks. The head of the OCC is also a member of FDIC and has voting rights in the Financial Stability Oversight Council (FSOC). OCC has the authority to check the books of national banks and thrifts and to take action against banks and thrifts that do not follow the rules and regulations (OCC).[161]

Federal Deposit Insurance Corporation (FDIC)

FDIC was initially created to protect small depositors in case of bank failures. The insurance amount was raised temporarily to $250,000 from $100,000 during the 2008 financial crisis period and it was changed to $250,000 permanently under the Dodd Frank Act. Under DFA, It is also responsible for orderly liquidation of large, complex financial institutions (Edward V. Murphy 2015).[162]

The Federal Reserve Board

The members of the Board of Governors are nominated by the President of the United States and confirmed by the US Senate.

Under the Dodd-Frank Act, the Federal Reserve (Fed) is responsible for regulating systemically important financial institutions. These firms will be designated as systemically important by the FSOC (Fed is also a member of FSOC). It also regulates savings and loan companies. Apart from this the Fed is responsible for making monetary policy, controlling money supply and regulating several other financial activities (Federal Reserve).[163]

National Credit Union Administration

NCUA is an independent agency that regulates and monitors credit unions. It also manages the Central Liquidity Facility, which acts as a lender of last resort for credit unions.

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161 http://www.occ.gov/about/what-we-do/mission/index-about.html

162 Edward V. Murphy, "Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Market", Page 21, Congressional Research Service (CRS) Report, January 2015.

163 http://www.federalreserve.gov/faqs/about_12594.htm

Members of FSOC

The voting members are Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, Comptroller of the Currency (OCC), Director of the Bureau of Consumer Financial Protection (CFPB), Chairman of the Securities and Exchange Commission (SEC), Chairperson of the Federal Deposit Insurance Corporation (FDIC), Chairperson of the Commodity Futures Trading Commission (CFTC), Director of the Federal Housing Finance Agency (FHFA), Chairman of the National Credit Union Administration (NCUA) and an independent member with insurance expertise who is appointed by the President and confirmed by the Senate for a six-year term.

The nonvoting members, who serve in an advisory capacity, are Director of the Office of Financial Research, Director of the Federal Insurance Office, one state insurance commissioner designated by the state insurance commissioners, one state banking supervisor designated by the state banking supervisors and one state securities commissioner designated by the state securities commissioners.

Non-Banking Financial (Capital Markets) Regulator Securities and Exchange Commission (SEC):[164] The SEC is responsible for regulating securities markets. It is also responsible for protecting investors and to ensure transparency and efficiency in markets. The role of the SEC as a securities market regulator came into sharp focus after the 2008 crisis. In the new regulatory framework under the Dodd Frank Act, the Federal Reserve is responsible for regulating large systemically important financial institutions.

Commodity Futures Trading Commission: The CFTC was created to regulate the commodity futures and options market in 1974. Its major responsibility is to promote competitive, transparent markets and protecting investors from fraud and manipulative practices by certain firms or individuals (CFTC).[165] After the financial crisis, the unregulated swaps markets came under CFTC regulation as credit default swaps was one of the instruments at the centre of the 2008 financial crisis.

Federal Housing Finance Agency (FHFA): After the 2008 financial crisis, FHFA was created to consolidate and regulate the government sponsored entities (GSEs) such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, which were taking excessive risk. It has powers to establish safety and soundness measures such as risk-based capital requirements, standards for investments that the GSEs may hold in their portfolios, and reviewing the salaries of executives (FHFA).[166]

Federal Financial Institutions Examinations Council (FFIEC):[167] There are several regulators such as the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA),

164 http://www.sec.gov/about.shtml
165 http://www.cftc.gov/About/MissionResponsibilities/index.htm
166 http://fhfaoig.gov/LearnMore/FAQ#FHFA3
167 https://www.ffiec.gov/

the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB) who monitor the banking sector in the US. For co-ordination between these regulators and to have uniform rules and regulations across regulatory bodies, the FFIEC co-ordinating forum was created.

European Supervisory Authorities and European Systemic Risk Board:

The European Supervisory Authorities and European Systemic Risk Board were established in January 2011 replacing the earlier supervisory bodies.[168] The following table lists their major responsibilities.

European Supervisory Authorities (ESAs)	**Major responsibilities**
European Banking Authority (EBA)	Supervise and maintain the stability of the banking sector
European Insurance and Occupational Pensions Authority (EIOPA)	Protect policy holders, pension scheme members and ensuring transparency of markets
European Securities and Markets Authority (ESMA)	Supervise financial markets, credit rating agencies and trade repositories
European Systemic Risk Board (ESRB)	Monitor the financial sector in the EU and mitigate systemic risks in the system.

Source: EBA, EIOPA, ESMA and ESRB

Role of the European Central Bank (ECB) under the Single Supervisory Mechanism (SSM): The 2008 crisis exposed the shortcomings in banking regulations in the Euro area particularly in peripheral economies. To overcome these regulatory gaps, a banking union was proposed as a solution to maintain stability in the banking sector. In a major step towards a banking union, ECB has been assigned the bank supervisory role under the Single Supervisory Mechanism (SSM). ECB directly supervises 123 significant banks, which account for 82 per cent of banking assets in the Euro area (ECB).[169]

168 http://ec.europa.eu/finance/general-policy/committees/index_en.htm
169 https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html

Annex 2

Measures taken by the RBI to address rising NPAs

Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries (5-25): RBI has permitted banks to revise the terms of long-term loans for the infrastructure and core industries sectors. Banks can fix a repayment period of 25 years with refinancing every 5 years (RBI Notification July 15, 2014).

Wilful Default: Defaulters will be labelled as wilful defaulters, if they have the capacity to pay but do not pay or have diverted the funds from stated purposes or disposed of or removed the assets offered for securing loans. Such companies/promoters will not be allowed institutional financing from banks or NBFCs (RBI Circular on Wilful Defaulters**,** July 1, 2015).

Restrictions on Ever-Greening of Loans: With some conditions, Indian companies in the manufacturing and infrastructure sectors were permitted to use commercial borrowings (ECBs) for repayment of rupee loans taken from the domestic banking system. However, given that risk remained within the Indian banking system, RBI has prohibited ECBs from overseas branch/subsidiaries of Indian banks. The RBI also found that in some cases exporters were using export advances received on guarantees issued by Indian banks, for repayment of loans taken from Indian banks. The RBI has advised banks to 'desist from such practices'. Restrictions have also been imposed on guarantees issued by banks in India in favour of overseas JV/WOS of Indian companies. The RBI found that in certain cases, guarantees/stand-by letter of credit/letter of comfort were used to obtain foreign currency loans for repayment of rupee loans (RBI Circular April 22, 2014)

Strategic Debt Restructuring Scheme: Under the Strategic Debt Restructuring Scheme, the RBI has provided for the transfer of ownership of companies to banks by converting loans into equity. After conversion, all lenders under the Joint Lenders' Forum (JLF) must own 51 per cent or more of the equity of the company (RBI Notification June 8, 2015).

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