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DISCUSSION DOCUMENT
April 16th, 2013

Comments on The Financial Sector Legislative Reforms Commission's Recommendations

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EXECUTIVE SUMMARY

Appointed by the Government of India in 2011, the Financial Sector Legislative Reforms Commission (FSLRC) submitted its report in March.

Had this Commission completed its work before 2008, it might have stood a better chance of being taken seriously for its assumptions were valid in a world dominated by finance, before the crisis seriously undermined them. The pro-cyclical nature of financial markets and credit creation necessitates tight regulation of the sector.

The Commission's failure to understand that has led it to recommend trimming the powers of Indian financial sector regulators, especially the Reserve Bank of India. That is as dangerous as it is flawed. Furthermore, the Commission has reversed the trend towards greater regulatory autonomy and competence by vesting the government with more powers over the sector. Given the government's record of wanton disregard for fiscal probity, financial repression and its lack of talent, these recommendations are regressive and bode ill for India.

Therefore, the government that takes office in 2014 after the general elections must appoint another Commission to propose a more reasonable set of proposals for legislative reforms and the strengthening of regulations and regulators in the financial sector.

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RATIONALE

The Government of India announced the appointment of the Financial Sector Legislative Reforms Commission (FSLRC) in March 2011 "with a view to re-writing and cleaning up the financial sector laws to bring them in tune with current requirements."

The Commission was set up with ten members. Two members passed away in the twenty four months the Commission took to submit its report to the Government of India. One did not participate in the Commission's work. Out of the remaining seven, four members submitted dissenting notes on various aspects of the Commission's mandate.

The Commission's work, for the most part, is based on the principle that regulations exist to address market failures. This premise is fundamentally questionable since financial markets are not well functioning markets as conventionally understood in economics. Unlike in the markets for normal goods and services, rising prices do not deter demand. Rising financial asset prices stoke demand. Similarly, falling prices do not lead to a rise in demand. It encourages more selling. Thus, financial markets are not self-regulating or self-stabilising. They are inherently unstable.

Hence, regulation of the financial sector must go hand-in-hand with the growth and evolution of the sector. There is a danger that the belief that regulation exists to address market failures leads to a hands-off attitude or light-touch regulation. Empirically, both the approaches failed spectacularly globally resulting in the global financial crisis of 2008.

COMMENTS

The Commission has taken the view that "status-quo framework of a low-level fragmented financial sector supporting the current modest economic size of our nation is incapable and insufficient to perform this aspirational role, which our economic institutions should play for our future. Further, such a framework encourages the growth of twilight zones like shadow banking and other shadow financial entities leading to major issues of consumer protection and systemic risk."

There are at least two objections to this statement. One is that such a defensive attitude towards the existing legal and regulatory framework in India for the financial sector is unnecessary. Despite occasional failures, India's financial regulators have, for the most part, done the job of protecting systemic integrity and stability rather well. Second, shadow banking and twilight zones emerged faster and on a massive scale in jurisdictions globally deemed to be financially more sophisticated than India.

This underlying assumption of a 'low-level fragmented financial sector' in India has persuaded the Committee to embrace 'global best practices' without ascertaining that they are indeed the best practice either for the globe or for India.

Two examples of the global best practice that the Commission has embraced are the separation of the sovereign debt management functions, currently being performed by the Reserve Bank of India, into a separate debt management office and the formation of a committee for the Reserve Bank of India to conduct monetary policy.

It is true that sovereign debt management is handled by an independent agency in most countries. However, in the case of India, **as long as the fiscal deficit remains high, as long as the bulk of the banking system remains state-owned and as long as these banks are forced to subscribe to government debt in the name of complying with statutory liquidity ratio requirements, sovereign debt management must remain with the Reserve Bank of India.** When all of the above circumstances change, then debt management can be taken out of the remit of the Reserve Bank of India.

The second example is that of the appointment of a monetary policy committee. It is true that in most countries monetary policy is set by a committee in the central bank. However, its efficacy over a single person setting the policy has not been formally documented or verified. In reality, in most countries, the Chairman's view prevails.

The Commission has recommended that the monetary policy committee comprise of three direct government nominees and two others appointed in consultation with the governor of the Reserve Bank of India. **Thus, the government representation in the Committee is too large. It undermines the independence of the central bank.** The risk of political considerations determining monetary policy decisions is thus substantially enhanced. It is a threat to macro-economic stability in the country.

The Commission has envisaged the government setting monetary policy goals for the central bank to strive for. Simultaneously and separately, the Commission acknowledges the paucity of talent and skills in the government. **Hence, entrusting the government with the responsibility of setting monetary policy goals is a dangerous idea, especially when no mechanism for oversight, review and revision of those goals is proposed.**

Some of the other recommendations made by the Commission are not in line with global best practices either. One of them has to do with the separation of banking regulation and supervision from the central bank. The Commission envisages that at a future date. It has even precluded the sharing of information gathered from banking supervision with the central bank for the purposes of monetary policy decisions. Both recommendations open a Pandora's Box settled by research elsewhere in the world in favour of the central bank[1].

As long as the central bank is (and can be the only) the lender of last resort, it is necessary and desirable that banking supervision rests with the central bank. The lender of last resort must know to whom it is lending to and their health so that appropriate conditions can be imposed and monitored. Banking supervision contains vital information useful for the conduct of monetary policy and vice-versa. The proposed separation of central bank from banking supervision and the preclusion of information about banks to the monetary policy committee militate against sound public policy.

The Commission has complicated the management of capital flows by proposing that the government be made responsible for regulating and managing inward capital flows whereas the central bank is responsible for capital outflows. Neither conceptual logic nor practical convenience underpins this suggestion. It will be chaotic in practice. Currently, the government formulates policies on foreign direct investment. It is administered by the Reserve Bank of India. In addition, the Reserve Bank of India sets regulations for other capital inflows while the overall policy direction for portfolio flows is still in the hands of the government. Capital outflows are overseen and regulated entirely by the Reserve Bank of India. This arrangement has worked well and there is no need to fix something that is not broken.

While it makes operational sense on the surface to merge all regulators under one fold, one should bear in mind the trade-offs. Regulatory capture is a lot harder with multiple regulators. The only regulatory misfit in India in the financial sector today is the Forward Market Commission (FMC) that placed under the Ministry of Food and Agriculture. The FMC regulates trading in derivatives linked to agricultural commodities. That can be brought under the Securities and Exchange Board of India. With respect to creating an umbrella micro regulator other than for payments and banking, the Commission should have taken into consideration the reality of regulatory capture in the West prior to and after the crisis of 2008 and examined the trade-offs more thoroughly.

In fact, the crisis of 2008 had necessitated a re-examination of some of the deeply entrenched beliefs about what really is a financial innovation, what is its use and relevance for the economy, what are its costs, consequences and side-effects. The FSLRC report does not indicate any awareness of this re-examination. The lack of awareness comes through in the Commission's failure in consulting the Bank of England's officials responsible for financial stability. In the last three years, the Bank of England has produced some cutting-edge research that challenges and displaces core assumptions held with deep conviction and religiosity before the crisis.

The Commission would have benefited from interaction with a wider set of practitioners in the United States, Brazil, South Africa and China that are dealing with financial sector regulation, stability and growth, especially in the light of policy developments in the West. It is an opportunity missed.

CONCLUSION

When government's profligacy and populism have produced unusual combinations of economic outcomes—low growth, high inflation and high current account deficit—it makes little sense to weaken the morale and confidence of the only institution—the Reserve Bank of India—that is battling many looming economic crises simultaneously.

The Indian economy is stymied not so much by excessive regulatory zeal or low-level fragmented financial sector as by the financial repression of the Government of India, its brazen unwillingness to behave fiscally responsibly, its persistence with administered and guaranteed returns on certain types of savings, sector-specific lending targets and its pervasive ownership of the banking system.

The Commission's indifference to acts of omission and commission by the Government and its recommendations to vest the government with more powers have neither advanced the cause of the financial sector nor legislative reforms.

[1] See the following for more details:
a) Testimony on "Examining the Link Between Fed Bank Supervision and Monetary Policy", House Financial Services Committee, Anil K Kashyap (March 17, 2010) http://faculty.chicagobooth.edu/brian.barry/igm/kashyaptestimony.pdf
b) Is Bank Supervision Central to Central Banking? By Joe Peek, Eric S. Rosengren and Geoffrey M. B. Tootell (Mimeo, Federal Reserve Bank of Boston, July 1997) http://www.bos.frb.org/economic/wp/wp1999/wp99_7.htm
c) Is Financial Stability Central to Central Banking? By Joe Peek – University of Kentucky, Eric S. Rosengren – Federal Reserve Bank of Boston and Geoffrey M. B. Tootell – Federal Reserve Bank of Boston (October 2009) http://www.bos.frb.org/economic/conf/conf54/papers/peek-rosengren-tootell.pdf