The Indian financial reforms: A status report

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Measuring outcomes

- There are many good measures of outcomes.
  
  *Example:* To measure the outcomes associated with the bankruptcy process, we would look at the recovery rate.
  
  *Example:* To measure the outcomes associated with financial markets reform, we would measure various notions of liquidity (depth, resilience).
The outcome is not shaped by policy alone

- In the US, securities are big, so fairly shabby financial markets give good liquidity.
- In Sri Lanka, it’s very hard to make an index futures market liquid.
- Further, macroeconomic conditions matter.
- E.g. in a crisis, bankruptcy process would do fire sales and the recovery rate would go down.

Hence: We should measure the inputs by policy makers. The outcomes do not uniquely identify the inputs.
What should we look for in financial reforms?

Three components:

1. Legal foundations
2. Markets
3. Financial firms
Legal foundations

1. Governance of financial agencies
2. Legislative, executive, judicial processes
3. Consumer protection
4. Micro-prudential regulation
5. Development
6. Capital controls
7. Resolution
8. Financial redress
9. Monetary policy
10. Public debt management
11. Financial regulatory agency
12. Council of regulators for systemic risk regulation
13. Systemic risk data centre
14. Appellate Tribunal
15. SOEs as ordinary companies
16. Ministry of Finance restructuring
Markets

1. Equities
2. Bond-Currency-Derivatives Nexus
3. Commodities
Financial firms

1. Banks
2. Payments
3. Insurance
4. Mutual funds
5. Pensions.
The Indian story on legal foundations

- Fairly shabby beginning
- FSLRC: Volume 1 with concepts and arguments, and version 1.0 of Indian Financial Code
State of progress

1. RBI CPI inflation targeting
2. Monetary policy committee
3. Financial Sector Regulatory Appointment Search Committee (FSRASC).
4. Merged FMC into SEBI
5. Moved capital controls regulation-making power for non-debt flows to MOF from RBI.
7. MOF setup five ‘Task Forces’ for setting up RC (M. Damodaran), FDMC (Subir Gokarn), FRA (D. Swarup), PDMA (D. Swarup), FSAT (Justice Sodhi).
8. RC draft law on MOF website.
9. Some movement on FDMC.
10. 4 October 2016: Revival of the PDMA project.
Markets

Equities

1. Decent foundations; one key piece missing – securities lending.
2. Mistakes: margins, time of day, taxation of non-residents.
3. Decent liquidity
4. Losing ground to the overseas market.
5. Badly need better processes at SEBI and RBI.

Bond-Currency-Derivatives Nexus

1. Mostly faulty.
2. INR is a big market, that’s giving liquidity.
3. Bond market is mostly broken.

Commodity futures

1. Commodity futures merged into the main financial market system, *de jure* but not *de facto*.
Financial firms

**Banks**  Entry barriers, inefficiencies, SOE domination.

**Payments**  Captured by banks.

**Insurance**  Problems of consumer protection, concerns about micro prudential regulation.

**Mutual funds**  Working reasonably well; need to strengthen SEBI processes.

**Pensions**  Early foundations of NPS laid, now need to see this through in its original vision.
Scorecard for Legal foundations

<table>
<thead>
<tr>
<th>Topic</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance of financial agencies</td>
<td>33</td>
</tr>
<tr>
<td>Legislative, executive, judicial processes</td>
<td>33</td>
</tr>
<tr>
<td>Consumer protection</td>
<td>33</td>
</tr>
<tr>
<td>Micro-prudential regulation</td>
<td>33</td>
</tr>
<tr>
<td>Development</td>
<td>33</td>
</tr>
<tr>
<td>Capital controls</td>
<td>40</td>
</tr>
<tr>
<td>Resolution</td>
<td>40</td>
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<tr>
<td>Financial redress</td>
<td>40</td>
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<tr>
<td>Monetary policy</td>
<td>55</td>
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<tr>
<td>Public debt management</td>
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<td>Financial regulatory agency</td>
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<tr>
<td>Council of regulators for systemic risk regulation</td>
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</tr>
<tr>
<td>Systemic risk data centre</td>
<td>40</td>
</tr>
<tr>
<td>Appellate Tribunal</td>
<td>50</td>
</tr>
<tr>
<td>SOEs as ordinary companies</td>
<td>15</td>
</tr>
<tr>
<td>Ministry of Finance restructuring</td>
<td>15</td>
</tr>
<tr>
<td><strong>Overall</strong></td>
<td><strong>38.3</strong></td>
</tr>
</tbody>
</table>
### Markets

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>70</td>
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<tr>
<td>Bond-Currency-Derivatives Nexus</td>
<td>20</td>
</tr>
<tr>
<td>Commodities</td>
<td>40</td>
</tr>
<tr>
<td><strong>Overall</strong></td>
<td><strong>44</strong></td>
</tr>
</tbody>
</table>
Financial firms

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>30</td>
</tr>
<tr>
<td>Payments</td>
<td>40</td>
</tr>
<tr>
<td>Insurance</td>
<td>50</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>70</td>
</tr>
<tr>
<td>Pensions</td>
<td>50</td>
</tr>
<tr>
<td><strong>Overall</strong></td>
<td><strong>48</strong></td>
</tr>
</tbody>
</table>
Overall

<table>
<thead>
<tr>
<th>Legal foundations</th>
<th>38</th>
</tr>
</thead>
<tbody>
<tr>
<td>Markets</td>
<td>44</td>
</tr>
<tr>
<td>Financial firms</td>
<td>48</td>
</tr>
<tr>
<td>Overall</td>
<td>45</td>
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</tbody>
</table>
Part I

Quantification
**Example: Bankruptcy reform**

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Get the ideas straight</td>
<td>BLRC v1</td>
</tr>
<tr>
<td>2.</td>
<td>Get a good draft law</td>
<td>IBC dragon edition (90%), BLRC v2 (80%)</td>
</tr>
<tr>
<td>3.</td>
<td>Enact a law</td>
<td>IBC, 2016 (70%)</td>
</tr>
<tr>
<td>4.</td>
<td>Implement the law</td>
<td>We have an early stage IBBI: 10%</td>
</tr>
<tr>
<td>5.</td>
<td>Measure outcome</td>
<td>Recovery rate?</td>
</tr>
</tbody>
</table>
This suggests a report card

<table>
<thead>
<tr>
<th>Component</th>
<th>Weight</th>
<th>Score</th>
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</thead>
<tbody>
<tr>
<td>Ideas</td>
<td>5</td>
<td>100</td>
</tr>
<tr>
<td>A good model law</td>
<td>5</td>
<td>90</td>
</tr>
<tr>
<td>Enact the law</td>
<td>10</td>
<td>70</td>
</tr>
<tr>
<td>Implement it</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>Overall status</strong></td>
<td><strong>30</strong></td>
<td><strong>58.33</strong></td>
</tr>
</tbody>
</table>

By watching the history of each component, we can make a time series of an index of bankruptcy policy reform.
Designing a financial reforms index

Three components:

1. **Legal foundations**
   For all sub-components: (a) Concepts (b) Model law drafted (c) Law enacted (d) Law implemented.

2. **Markets**
   For all sub-components: (a) Market infrastructure (b) Intermediation (c) Regulatory structure (d) Regulations (e) Enforcement.

3. **Financial firms.**
   For all sub-components: (a) Licensing, entry barriers (b) Regulatory structure (c) Regulations (d) Enforcement.
Part II

Example: Monetary policy
Monetary policy: Concepts


2. 12/9/2008: Raghuram Rajan report: Second proposal for inflation targeting. **20%**

3. 22/3/2013: FSLRC: Full picture of inflation targeting RBI. **100%**
Monetary policy: Draft law

1. 22/3/2013: FSLRC v1: A first complete monetary policy draft law. 90%.

2. 23/7/2015: IFC v1.1. 100%.
Monetary policy: Law enacted

1. 20/2/2015: Monetary policy framework agreement. 20%.
2. 28/2/2016: RBI Act amended with IT and MPC. 100%.
18/10/2016: 1st MPC meeting. 20%.
Index of legal foundations for monetary policy

Legal foundations-Reserve Bank of India
Part III

Extending this to the full legal foundations
Index of legal foundations (only 14 of 16)
Conclusion

- It’s useful to think systematically about the inputs, the financial sector reforms that will set the stage for good outcomes like efficiency, inclusion, stability.
- In each sub-component, this requires a chronology, an economic history.
- We will soon release an R program and associated JSON file format through which such information systems can be created and manipulated.
Thank you.

http://ajayshahblog.blogspot.com