Financial regulations in India: what do we learn?

Susan Thomas
IGIDR Finance Research Group

October 8, 2012

Indian financial regulations and reform : Stage 1

- Regulators: RBI, FMC, CCI.
- The early 1990s
- Equity market reforms:
  - Establishment of SEBI.
  - Establishment of NSE, NSDL up to 2001 and the start of derivatives trading
  - A new concept of ownership and governance of exchanges : “three way separation”.
    BSE shifted to a new model of ownership and governance.
  - NSE and BSE are in the top 5 exchanges of the world by number of trades.
- Next: IRDA, PFRDA

Two case studies

- Where regulation worked: The Indian Mutual Fund Industry
- Where regulation killed an industry: The Indian Micro Finance Industry

Key concepts

- All activities of the government in finance are rooted in:
    1. Consumer protection.
    2. Micro-prudential regulation.
    3. Systemic risk.
    4. Resolution.
- Interventions must be motivated by this economic purpose.

Example 1: the Mutual Fund industry reforms

- Trigger: 1998 crisis, C. R. Bhansal
- Regulatory action: improve disclosure
- Empower customers of the MF products.
- Outcome: A very stable and robust MF industry.

Example 2: the Micro-finance institutions reforms

- Trigger: reports of multiple suicides amongst borrowers, September 2010.
- Regulatory responses: mostly targetted micro-prudential regulation or systemic risk.
  Malegam report, DFS draft bill on MFI Regulation & Development Bill.
- The crisis arose as a problem of *consumer protection*. Solving this requires tools of consumer protection: laws, disclosures, redressal mechanisms.
- Outcome: A large fraction of MFIs have shut down; the only left standing are the large ones that were accused during the crisis.
- Our work here (see http://www.igidr.ac.in/FSRR/papers.html)

Example 3: SEBI AIF regulation

- Private equity fund or hedge fund or venture capital fund
- No problem with consumer protection.
- No problem with micro-prudential regulation.
- A potential problem with systemic risk.
  Put in place resolution and micro-prudential regulation
  when AUM exceeds 1% of GDP.

Law is the DNA

- Why do Indian financial regulators behave as they do?
- The checks and balances are written in the law.
- How to make progress?
- A bold step: Rewrite the law.

FSLRC

- Financial Sector Legislative Reforms Commission
- Chaired by Justice Srikrishna
- Has released an approach paper: http://goo.gl/Vd7HX

Key insights

- Sound foundations of independance and accountability for regulators.
- Sectoral regulators are a bad idea:
  - Tends to adopt the worldview of the indsutry
  - Tends to see this as turf
  - Meddling / central planning / similar notions
- Much better to have one regulatory agency that has clear economic purpose.

Insights for global regulation?

- Regulations and rules have power when they are backed by law.
- No discussions about global market regulations focus centrally on this.
  Dealing with laws are left to participants as part of implementation details.
- This approach misses the accountability of regulation; throws their independance into question.
- Needs to be solved to truly empower global regulation.

Thank you.
http://www.igidr.ac.in/FSRR