Introduction, Executive Summary, and List of Main Proposals

chapter 1

The Committee on Financial Sector Reforms (henceforth 'the Committee') was tasked with proposing the next generation of reforms for the Indian financial sector. The immediate question, of course, is whether we need a new generation of reforms at all. There are two ways of answering this.

First, so much is yet to be done. On the retail side, financial services are still not reaching the majority of Indians. The single most frequently used source of loans for the median Indian household is still the moneylender. On the wholesale side, the financial sector is not able to meet the scale or sophistication of the needs of large corporate India, as well as of public infrastructure, and does not penetrate deeply enough to meet the needs of small and medium-sized enterprises in much of the country. Large parts of our financial system are still hampered by political intervention and bureaucratic constraints, limiting their potential contribution. And with external forces such as commodity prices and external demand volatility buffeting us, it is not clear we have the macroeconomic frameworks, the risk management structures, or the microeconomic flexibility to cope.

Second, there is so much to be gained from doing it. The financial sector has built capabilities such that, with appropriate policy changes, it can grow tremendously, both domestically and internationally. It can generate millions of well-paying jobs, and more important, have an enormous multiplier effect on inclusion and economic growth. Given the right environment, financial sector reforms can add between a percentage point and two to the economic growth rate. Financial sector reform is both a moral and an economic imperative!

There are thus at least three reasons for financial sector reform: to include more Indians in the growth process; to foster growth itself; to improve financial stability, flexibility, and resilience and thus protect the economy against the kind of turbulence that has affected emerging markets in the past, and is affecting industrial countries today.

Why do we need a new report? After all there have been numerous well-written reports over the past few years, many of whose recommendations remain unimplemented. One reason why this report is different is that other reports have been tasked with looking at specific segments of the financial sector (the corporate bond market, infrastructure financing, the inclusion agenda, the cooperative sector, etc.). By the very nature of their terms of reference, though, the analysis and proposed reforms have had to be partial. This Committee has had both the benefit of studying those earlier reports and the luxury of painting on a broader canvas, that is, the entire financial sector. The Committee has attempted to see links that others have not because of their narrower mandate. Hopefully, its proposals then take these linkages into account and attempt to create mutually reinforcing influences in the financial sector. Indeed, while the report is divided into separate self-contained chapters, the underlying theme behind all our proposals is the need to enhance inclusion, growth, and stability by allowing players more freedom, even while strengthening the financial and regulatory infrastructure.

An example may be useful. Reports on why India does not have a sizeable corporate bond market point out that many natural investors, such as banks and insurance companies, have restrictions placed on them, forcing them to invest large amounts in government securities. Foreigners are strictly limited in how much government debt they can buy. A straightforward recommendation seems to be to remove these restrictions. But why do regulators impose them in the first place?

In part, it is because regulators know the government deficit needs funding, in part they are overly conservative because their reward structure penalizes any failures on their watch far more than it penalizes lost growth, and in part corporate bonds are indeed risky given weak creditor protection. So a solution needs to address issues ranging from how the government deficit will be financed, to regulator incentive structures, to fixing the credit infrastructure. Similarly, if we wonder why foreign participation is so restricted, we have to address issues ranging from how open the capital account should be to whether the monetary framework should target the exchange rate at all. The point is that both analysis and recommendations have to ensure consistency across a number of policy areas, which this report attempts to achieve.

An equally important reason for a new report is that we need a new paradigm in the financial sector. Such a paradigm should recognize that efficiency, innovation, and value for money are as important for the poor as it is for our new Indian multinationals, and these will come from deregulation, new entry, and competition. The role of the government is not to take on the tasks that should legitimately be delegated to the private sector, but to create an enabling environment by building sound financial infrastructure. In other words, the kind of liberalization, as well as the more effective regulation, that has had such beneficial results in sectors like telecom, should now be extended to the financial sector, where the rewards could be so much more substantial. In this dynamic environment, we will need skilled regulators who encourage growth and innovation even while working harder to contain risks. The shift in paradigm, if implemented, could usher in a revolution in the financial sector almost as dramatic as the revolution that hit the real economy in the early 1990s, whose fruits we are now reaping.

There has been an enormous amount of attention paid to issues like capital account convertibility, bank privatization, and priority sector norms. While important, there are many other areas where reforms are less controversial, but perhaps as important. An example of the kind of reforms we would support is the trading of warehouse receipts. With the promulgation expected soon of the Warehousing (Development and Regulation) Act, 2008, warehouse receipts will become a negotiable instrument. They will become a new, reliable form of collateral in the agricultural sector, where till now there was no other security except land, which has its own infirmities. Warehouse receipts can be in physical or electronic form and must be issued by registered warehouses, which will be accredited by the Warehousing Development and Regulatory Authority.

The advent of the warehouse receipt system will result in a lower cost of financing and an increase in liquidity for agriculture, and is a break from the focus of the last few decades on targeted lending as a way to energize agricultural credit. In addition, the Act encourages scientific warehousing of goods, improved supply chains, enhances rewards for grading and quality and encourages better price risk management. This is an example of how forward looking regulation can help build the credit infrastructure (in this case, for agriculture) and enhance the availability of finance.

In anticipation of the legislation being passed (the Bill was introduced in 2005), and assisted by some well-targeted government schemes to build rural godowns, a large number of technologically advanced warehouses are already in various stages of construction. In addition, the traditionally unreliable warehouse keepers are being upstaged by newer actors such as collateral management agencies, assayers for checking the quality/grades of commodities stored, and authorized warehouse agents, who under the new Act will become legally liable for any shortfall in quantity and any variation in quality, from what is stated in the warehouse receipt issued by them. Assuming that at any time, about 15–20 per cent of the annual agricultural produce is stored in warehouses, the Act has the potential to inject over US$ 30 billion of agricultural credit.

This is the kind of reform the country can easily achieve. Instead of focusing primarily on a few large, and usually politically controversial steps, we also need to take a hundred small steps in the same direction that will collectively take us very far. As another example, credit to small and medium enterprises could be boosted enormously if the trade receivable claims they have on large firms could be converted to electronic format, accepted by the large firms, and sold as commercial paper. Mexico has a central agency facilitating this process, there is no reason why we could not create an environment where some institution like the National Securities Depository Ltd could do this. All this is not to say that we should not tackle the controversial large issues, and the report does offer comprehensive proposals on them, but it is to say progress can be made even otherwise.

This is, however, a difficult time to propose financial sector reforms in India. The near meltdown of the US financial sector seems to be proof to some that markets and competition do not work. This is clearly the wrong lesson to take from the debacle. The right lesson is that markets and institutions do succumb occasionally to excesses, which is why regulators have to be vigilant, constantly finding the right balance between attenuating risk-taking and inhibiting growth. In the United States, they clearly failed this time. But this is not to say they cannot find the right balance elsewhere. At the same time, well-functioning competitive markets can reduce vulnerabilities—the US equity, government debt, and corporate debt markets, despite being close to the epicenter of the crisis, have remained far more resilient than markets in far away countries.

It is important to recognize that vulnerabilities may be building up in India. Underdeveloped markets and strict regulations on participation are no guarantee that risks are contained, in fact they may create additional sources of risk, a forewarning of which may come from recent reports of substantial losses incurred by corporations on currency bets. For instance, a significant quantity of lending is undertaken by non-bank financial companies (NBFCs), some of which are growing at extremely rapid rates, free of burdens that hamper other sectors and relatively free of regulatory oversight. These entities have a very light regulatory burden because they do not take deposits. Yet their funding could, in some cases, be short-term money from mutual funds or from deposit taking institutions like banks, even though their assets are long term. This structure is risky because of the mismatch between the duration of assets and the duration of funding. The banking system, which is part of this structure through its loans, is thus not insulated from risk because of its direct loan exposure to NBFCs.

The typical regulatory response is to tighten bank exposure norms. But if the NBFCs are to maintain lending and sustain economic growth, they have to find funding somewhere. NBFCs would be far more stable if they funded themselves with long-term debt from the corporate debt market. Moreover, the market and passive investors would absorb any risk associated with the NBFCs' lending, instead of that risk being passed on to financial institutions like banks. A corporate bond market could thus serve as a useful buffer between financial institutions, and be an important source of stability in the current environment. But as indicated earlier, this will require a number of ancillary reforms, some of which taken by themselves may seem to increase the potential for instability (such as opening the corporate bond market further to foreign investors). This is yet another reason why a holistic picture is necessary.

Put differently, the Asian financial crisis is etched in the minds of Indian commentators. Yet the primary lesson of the Asian financial crisis is not that foreign capital or financial markets are destabilizing, but that poor governance, poor risk management, asset liability mismatches, inadequate disclosure, excessive related party transactions, and murky bankruptcy laws, make an economic system prone to crisis. Financial sector reform can reduce these vulnerabilities substantially. As much as the Committee's report focuses on the need to deregulate certain areas of the financial sector, we also focus on creating necessary institutions, and closing important gaps in regulation. Clearly, there is little urgency for reforms because India is not in a crisis. This is where political leadership is of essence. Reforming in a crisis is similar to driving with a gun to your head—you pay more attention, but there is much greater risk of accidents. Better to do it in normal times!

This Committee believes that it is critically important to introduce new ideas (or reintroduce old ones) into the debate. India mulls over many issues far longer than some would like, but eventually takes the right step. With apologies to Keynes, practical pieces of legislation, that seem to be exempt of any intellectual influence, are usually drawn from some long-forgotten report. Despite the current political climate, this is indeed the reason we have no doubt that this report will not be a wasted effort.

In what follows, we list the Committee's major proposals, as well as a brief rationale for them. As far as possible, in this report the Committee has tried to focus on a few key areas, and even there, on broad principles and directions, without entering too much into details of implementation—the Committee's broad mandate necessitates such an approach. We do propose some intermediate, or bridging, steps wherever possible. We do not go into nuances in this chapter. We end the chapter with a discussion of possible sequencing.

The chapters that follow offer a much more detailed and nuanced analysis, as well as more specific, and ancillary, proposals. Anyone who wants to take issue with specific proposals should read the background chapter for that proposal before coming to a definite conclusion.

THE MACROECONOMIC FRAMEWORK

Chapter 2 is on the macroeconomic framework. The Committee believes that while monetary management has been very creditable thus far, the framework will need to adjust more to a world of rapid capital flows. While inflows have been the problem in recent years, outflows could well be a problem in the future. The Committee believes that given how open India has become, it will be impossible to control capital flows in either direction for anything more than the very short term, and even that will create substantial uncertainty and volatility in markets.

Moreover, given capital flows, the real exchange rate, which is the key factor determining India's competitiveness, is influenced by factors such as productivity growth and demand supply imbalances that are not changed by central bank intervention against the dollar. So given that the real appreciation has to take place, the country has the Hobson's choice of taking it as inflation or as a nominal exchange rate appreciation.

The central bank can keep the market guessing about which option it will choose, sometimes intervening in currency markets to keep the exchange rate fixed and accepting more inflation, and at other times letting the exchange rate appreciate while focusing on controlling inflation. This freedom of action however confuses markets, even while the real exchange rate goes where fundamentals say it must. This is not a theoretical assessment, it is consistent with the experience of a number of countries including ours. But the confusion does have adverse effects. To the extent that the public is not sure about the central bank's commitment to controlling inflation, it will expect higher inflation, and charge a high interest rate premium for inflation risk, both of which will increase long-term interest rates, hurting growth.

We therefore believe the Reserve Bank of India (RBI) can best serve the cause of growth by focusing on controlling inflation, and intervening in currency markets only to limit excessive volatility. This focus can also best serve the cause of inclusion because the poorer sections are least hedged against inflation. There are other benefits in choosing this option. By reducing the accumulation of foreign reserves beyond what is necessary for precautionary purposes, the burden on the budget will be limited. And an exchange rate that reflects fundamentals tends not to move sharply, and serves the cause of stability. Lastly exporters weaned away from expecting an undervalued exchange rate will focus on increasing productivity, thereby contributing to growth.

Proposal 1: The RBI should formally have a single objective, to stay close to a low inflation number, or within a range, in the medium term, and move steadily to a single instrument, the short-term interest rate (repo and reverse repo) to achieve it.

The RBI should be as willing to cut rates when inflation is expected to fall below the objective, so that the policy revives growth, as it is to raise rates when inflation is expected to exceed the objective because growth exceeds the economy's potential. It is in this way that the RBI can best support the objectives of growth and stability.

The Committee is well aware of the problems posed by substantial capital inflows. The real exchange rate is likely to appreciate when foreign capital flows in, and this can hurt the country's competitiveness. But what is the alternative? Is shutting off inflows, that is, imposing capital controls, likely to work in helping India retain competitiveness? We think not, simply because capital controls are ineffective beyond the short run. In an economy as open to trade as India is today, capital will always find a way to come in on the back of trade, for example as under-invoicing and over-invoicing, or as trade credit. Moreover, even though India looks attractive right now, it may not in the future. We should not stamp on foreign capital now for we may need to retain its confidence in the future. Similarly, sterilized currency intervention by the central bank can re-export inflows, but it is rarely effective beyond the short term, and creates a number of other costs for the economy.

While the Committee recognizes there are no easy solutions here, and a wide divergence of beliefs amongst respectable economists, the Committee believes we should use the current period when foreign investors are rediscovering India to strengthen India's markets so that foreign investors feel comfortable entering, and use them to help improve the experience for domestic investors too. For instance, given India's infrastructure needs, it has too few long-term domestic investors. Similarly, India relies too much on force-feeding government debt to its financial institutions. By allowing foreign investors in greater numbers into the corporate rupee-denominated bond market, we can build liquidity in that market through investors who are willing to take risks domestic investors are not. In turn, that liquidity will attract domestic investors and create a virtuous cycle. By allowing foreign investors into the government bond market, we fund our government debt more easily, freeing the balance sheets of domestic financial institutions to finance other entities and expand access.

Proposal 2: Steadily open up investment in the rupee corporate and government bond markets to foreign investors after a clear monetary policy framework is in place.

Of course, there is a worry about whether we will encourage more foreign inflows by opening debt markets further, exacerbating our real exchange rate appreciation. It may well be that some of those who now can only get India exposure through equity might switch to debt. But given our concern about appreciation, we should liberalize the bond markets opportunistically, expanding foreign investor limits more when other forms of capital inflows are at low ebb. Of course, it would not be prudent to wait till foreign investors shun India to liberalize, for there would be no interest precisely when the country needs them. Instead, we should accept the possible costs of appreciation as a legitimate down payment on the more robust markets and financing we will enjoy in the future.

We should also relieve pressure from inflows by becoming more liberal on outflows, especially in forms that can be controlled if foreign currency becomes scarce. For instance, we should encourage greater outward investment by provident funds and insurance companies when inflows are high. Such diversification will make these funds more stable (give them less exposure to high volatility Indian markets). The relevant constituencies need to be persuaded that by restricting their investment options to domestic government securities, they are greatly limiting future returns and possibly increasing risk. At the very least, a first step would be to diversify across foreign government securities, so that we offset foreign inflows into our government debt markets with outflows into foreign government debt markets, without these flows being driven by the RBI.

The Government of India must also recognize that fiscal discipline is an essential adjunct to the process of financial reforms. A high level of public deficit financing soaks up capital and has serious consequences for macroeconomic development and for the financial system. With a more flexible exchange rate and a more open capital account, fiscal policy also has an important role to play as a short-term demand management tool. Moreover, disciplined fiscal policy—lower levels of government deficits and a declining ratio of public debt to GDP—is necessary to free up monetary policy to focus on its key objective of price stability. Indeed, the effectiveness, independence and credibility of monetary policy can be severely compromised by high budget deficits. The principal elements of the framework laid out in this chapter—strengthening fiscal, financial and monetary institutions—would thus reinforce each other.

Finally, one cannot overemphasize the need for real sector reforms. Finance ultimately provides the lubrication that allows the engine of the economy to run smoothly. But it is not the engine itself—that needs real sector reforms such as building out infrastructure, reforming the labour laws, improving the social safety net, etc. The effects of the proposals made by this Committee will be magnified if they can piggy-back on real sector reforms.

BROADENING ACCESS TO FINANCE

In Chapter 3, the Committee turns to the most important issue of financial inclusion. The Committee proposes a paradigm shift in the way we see inclusion. Instead of seeing the issue primarily as expanding credit, which puts the cart before the horse, we urge a refocus to seeing it as expanding access to financial services, such as payments services, savings products, insurance products, and inflation-protected pensions. If, for example, the enormous transfers to the poor through various government programmes can be channelled into savings accounts that the poor open, not only will leakage be reduced, but the poor will be able to build savings histories with their bank which can then open the door to credit. Moreover, the financial experience dealing with the account and the bank will help households build a greater business capacity, a critical need in making better use of credit. This is why the Committee advocates a national goal of ensuring in three years that 90 per cent of households, if they so desire, have access to a deposit account and to the payments system, and that government transfers under various schemes be implemented through this system. While the proposed nationwide electronic financial inclusion system (NEFIS) could utilize much of the existing infrastructure, some elements, especially the last mile, will have to be built out, and should be encouraged on an expedited basis.

Ultimately, though, it is opportunities in the real sector, created by broader growth, which will give the poor the ability to use credit effectively. Instead of forcing credit to household that could thereby become heavily indebted, the focus should be on making them creditworthy so that when opportunities arise, they have access.

In addition, this Committee would suggest moving away from a sole focus on rural areas, where undoubtedly many of our poor live, to also include the urban areas where more of them are migrating. But perhaps the most important shift in paradigm is to alter the emphasis somewhat from the large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focused strategy for inclusion. The poor need efficiency, innovation, and value for money, which can come from motivated financiers who have a low cost structure and thus see the poor as profitable, but who also have the capacity of making decisions quickly and with minimum paperwork. The Committee proposes two organizational structures to foster such delivery:

Proposal 3: Allow more entry to private well-governed deposit-taking small finance banks offsetting their higher risk from being geographically focused by requiring higher capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms (loans as a share of capital that can be made to one party). Make significant efforts to create the supervisory capacity to deliver the greater monitoring these banks will need initially, and put in place a tough prompt corrective action regime that ensures these banks do not become public charges.

The small finance bank proposed above emulates the Local Area Bank initiative by the RBI that was prematurely terminated, though the details of the Committee's proposal differs somewhat. The intent is to bring local knowledge to bear on the products that are needed locally, and to have the locus of decision making close to the banker who is in touch with the client, so that decisions can be taken immediately. It would also offer an entry point into the banking system, which some entities can use to eventually grow into large banks.

A large number of commentators believe, based on historical evidence, that small banks will be unviable in India. They question the honesty of small promoters, as well as the profitability of these banks given high fixed costs. This Committee recognizes that small banks have not distinguished themselves in India in the past, often because of poor governance structures, excessive government and political support as well as interference, and an unwillingness/inability of the regulator to undertake prompt corrective action. These are not the banks the Committee wants, and the Committee would call for substantial care in who is licensed, as well as greater regulatory oversight.

There is, however, no necessary link between size and honesty, as the recent experience with large banks suggests. Indeed, the larger number of potential applicants for small banks suggests the regulator can be far more selective in applying 'fit and proper' criteria. Moreover, technological solutions can bring down the costs of small banks substantially, even while increasing their transparency. Finally, the failure of even a few small banks will not have systemic consequences, unlike the failure of a single large bank. In sum, the Committee believes there has been sufficient change in the environment to warrant experimentation with licensing small banks.

The second organizational structure the Committee proposes makes it easier for large financial institutions to 'bridge the last mile'. Large institutions have the ability to offer commodity products like savings accounts at low cost, provided the cost of delivery and customer acquisition is reduced. They should be able to use existing networks like cell-phone kiosks or kirana shops as business correspondents to deliver products. The RBI's proposals on business correspondents, with some relaxations, are an important step in this direction.

Proposal 4: Liberalize the banking correspondent regulation so that a wide range of local agents can serve to extend financial services. Use technology both to reduce costs and to limit fraud and misrepresentation.

Cooperative banks, both urban and rural, are the face of banking that most Indians encounter. Unfortunately, primarily because of excessive political interference, poor governance and a willingness of governments to recapitalize and refinance even poor performers, this sector has underperformed seriously. This Committee supports the thrust of the Vaidhyanathan Committee recommendations on governance reforms and recommends they not be diluted in implementation. Indeed, it would suggest rethinking the entire cooperative bank structure, and moving more to the model practiced elsewhere in the world, where members have their funds at stake and exercise control, debtors do not have disproportionate power, and government refinance gives way to refinancing by the market. The Committee would suggest implementation of a strong prompt corrective action regime so that unviable cooperatives are closed, and would recommend that well-run cooperatives with a good track record explore conversion to a small bank license, with members becoming shareholders.

The Committee believes that priority sector mandates have a role in promoting inclusion, but they should be revised down to focus solely on the sectors that truly need access (including the urban poor). The process by which the mandates are implemented should be reformed to emphasize efficiency and ease of compliance, and once the new process is in place, the mandate should be strictly enforced. The focus should be on actually increasing access to services for the poor regardless of the channel or institution that does this—large banks may or may not be the best way to reach the poor, and while the mandate may initially force them to pay for expanding access, others may be able to offer the service more efficiently.

The Committee proposes the following scheme to allow a more efficient implementation of the priority sector lending mandate (with similar schemes extending to possible financial service mandates also—see later). Any registered lender (including microfinance institutions, cooperative banks, banking correspondents, etc.) who has made loans to eligible categories would get 'Priority Sector Lending Certificates' (PSLC) for the amount of these loans. A market would then be opened up for these certificates, where deficient banks can buy certificates to compensate for their shortfall in lending. Importantly, the loans would still be on the books of the original lender, and the deficient bank would only be buying a right to undershoot its priority sector-lending requirement by the amount of the certificate. If the loans default, for example, no loss would be borne by the certificate buyer. The merit of this scheme is that it would allow the most efficient lender to provide access to the poor, while finding a way for banks to fulfil their norms at lower cost. Essentially the PSLC will be a market-driven interest subsidy to those who make priority sector loans.

Proposal 5: Offer priority sector loan certificates (PSLC) to all entities that lend to eligible categories in the priority sector. Allow banks that undershoot their priority sector obligations to buy the PSLC and submit it towards fulfilment of their target.

One big factor impeding the flow of credit from formal institutions to the poor is that interest rate ceilings (either imposed by the centre or the state) make priority sector lending unprofitable, and ensure that the banker attempts to recover his money through hidden charges in the loans that are made, or that he does not lend so the poor are driven to the moneylender. The Committee believes a better way to proceed is to liberalize interest rates while increasing safeguards that prevent exploitation.

Proposal 6: Liberalize the interest rate that institutions can charge, ensuring credit reaches the poor, but require (*i*) full transparency on the actual effective annualized interest cost of a loan to the borrower, (*ii*) periodic public disclosure of maximum and average interest rates charged by the lender to the priority sector, (*iii*) only loans that stay within a margin of local estimated costs of lending to the poor be eligible for PSLCs.

Liberalizing interest rates would allow the formal sector to lend to the poor and keep them from the moneylender, though liberalization would require the political will to accept the widespread evidence that low interest rate ceilings simply do not help the poor. Formal institutions will have reputational reasons to not charge exorbitant rates, even after liberalization. The Committee believes that through a combination of transparency, incentives, and eventually competition, liberalized interest rates to the poor can be kept within reasonable limits, and liberalization would enhance, and improve the sources of, credit to the poor.

The Committee believes that we also have to improve methods of risk mitigation for the poor. Finally, technology may be the way of reducing costs so that services can be provided cheaply, and the Committee examines potential actions the government can take to facilitate roll-out.

LEVELLING THE PLAYING FIELD

There are a number of ways the playing field is not level in India. Some institutional forms, such as banks, are favoured in certain ways relative to others, while disfavoured in other ways. The public sector is constrained in some ways but enjoys some privileges in other ways. The domestic private sector enjoys some privileges relative to foreign players, but not everywhere. In an efficient financial system, the playing field is level so that different institutions compete to provide a function, no institution dominates others because of the privileges it enjoys, competition results in resources being allocated efficiently, and society gets the maximum out of its productive resources. This is also equitable for only thus will the interests of the consuming masses be emphasized, instead of the more usual trend of privileged producers being protected.

The Committee makes a number of recommendations on ways to level the playing field, with a focus on the banking sector. In particular, it believes it is time to unwind the grand bargain underlying the treatment of banks in India whereby banks get access to low-cost deposits in return for fulfilling certain social obligations such as lending to the priority sector, as well as meeting prudential norms such as statutory liquidity ratios (that also have a quasi-fiscal objective of funding the government). The reason, quite simply, is that the bargain will become increasingly unbalanced as competition erodes bank privileges. This is why the Committee suggests that the government pay more directly for the social obligations it wants banks to undertake (for example, by reducing priority sector obligations and, over time, paying directly for PSLCs), while it steadily allows more competition in banking activities.

Perhaps the greatest source of uneven privileges in the banking system stems from ownership. The public sector banks, accounting for 70 per cent of the system, enjoy benefits but also suffer constraints, with the latter increasingly dominating. There is little evidence that the ownership of banks makes any difference to whether they undertake social obligations, once these are mandated or paid for. So on net, what matters is how an ownership structure will affect the efficiency with which financial services are delivered. And it is here that government ownership is likely to have serious adverse effects going forward. Much of the public sector is falling behind in its ability to attract skilled people, especially at senior levels, in its ability to take advantage of new technologies, in its ability to motivate employees at lower levels, and in its ability to innovate. Since all these capabilities are needed in the emerging areas of opportunity, public sector banks risk falling seriously behind, and because risk management is one of the needed new areas, also risk becoming destabilizing.

The majority of this Committee does not see a compelling reason for continuing government ownership. There are other activities where government attention and resources are more important. However, the Committee does recognize that public opinion in the country is divided on the issue of privatization. A parallel approach is to undertake reforms that would remove constraints on the public sector banks, even while retaining government ownership. Intermediate steps such as reducing the government's ownership below 50 per cent while retaining its control (as suggested by the Narasimham Committee) are also possible.

Unfortunately, ideology has overtaken reasoned debate in this issue. The pragmatic approach, which should appeal to practical people of all hues, is to experiment, as China does so successfully, and to use the resulting experience to guide policy. One aspect of the pragmatic approach would be to sell a few small underperforming public sector banks, possibly through a strategic sale (with some protections in place for employees), so as to gain experience with the selling process, and to see whether the outcomes are good enough to pursue the process more widely.

Proposal 7: Sell small underperforming public sector banks, possibly to another bank or to a strategic investor, to gain experience with the process and gauge outcomes.

For the largest PSBs, the options are more limited. The selling of large PSBs to large private sector banks would raise issues of concentration. The selling of banks to industrial houses has been problematic across the world from the perspective of financial stability because of the propensity of the houses to milk banks for 'self-loans'. Without a substantial improvement in the ability of the Indian system to curb related-party transactions, and to close down failing banks, this could be a recipe for financial disaster. While large international banks could swallow our largest banks, it is unlikely that this would be politically acceptable, at least in the foreseeable future. That leaves a sale through a public offering. But such a sale would require confidence in the corporate governance of these enterprises so that a high price can be realized.

This Committee therefore believes that the second aspect of the pragmatic approach, especially for large and better performing public sector banks, should be to focus on reforming the governance structure, while perhaps also acquiring strategic partners, with the eventual disposition determined based on experience with privatization, the public mood, and the political environment.

Proposal 8: Create stronger boards for large public sector banks, with more power to outside shareholders (including possibly a private sector strategic investor), devolving the power to appoint and compensate top executives to the board.

Proposal 9: After starting the process of strengthening boards, delink the banks from additional government oversight, including by the Central Vigilance Commission and Parliament, with the justification that with government-controlled boards governing the banks, a second layer of oversight is not needed. Further ways to justify reduced government oversight is to create bank holding companies where the government only has a direct stake in the holding company. Another is to bring the direct government stake below 50 per cent, perhaps through divestment to other public sector entities or provident funds, so that the government (broadly defined) has control, but the government (narrowly defined) cannot be considered the owner.

Turning from the public sector to the banking sector as a whole, the Committee believes that fewer constraints should be imposed on banks, and more growth, competition, and entry should be encouraged. One method to foster bank growth is to allow bank mergers.

To the extent that takeovers of Indian banks (or domestically incorporated subsidiaries of foreign banks) do not raise issues of excessive concentration or stability, they should be permitted. It may be sensible to start by being more liberal towards the takeover of small banks with a view to allowing bidders, targets, regulators, and market participants gain experience in how to manage takeovers. Domestically incorporated foreign banks should be treated on par with private and public sector Indian banks in this regard from April 2009, as announced by the RBI in its roadmap.

Proposal 10: Be more liberal in allowing takeovers and mergers, including by domestically incorporated subsidiaries of foreign banks.

The commitment to allow foreign banks subsidiaries to participate in takeovers will substantially increase the pressure on domestic banks. This can be salutary, but domestic banks need to prepare themselves to meet the challenge. A second way to foster growth and competition, but also to strengthen banks, is to de-license the process of branching immediately. The RBI can retain the right to impose restrictions on the growth of certain banks for prudential reasons, but this should be the exception rather than the norm.

Proposal 11: Free banks to set up branches and ATMs anywhere.

Domestic banks have not had the freedom to set up branches anywhere thus far, and will not have anticipated such liberalization (which was not an element of the RBI roadmap). Given that foreign banks have deeper pockets, experience, and skills relative to domestic banks in rolling out a branching strategy in the newly liberalized environment, the Committee believes it necessary to allow a period of say two years from the announcement of the policy till the liberal licensing policy applies to domestically incorporated subsidiaries of foreign banks. Till such time, the existing policy of branch licensing will apply to domestically incorporated subsidiaries of foreign banks. They will, however, be able to acquire branches through takeovers of existing Indian banks.

One objective of branch licensing is to force banks into under-banked areas in exchange for permission to enter lucrative urban areas. This is again an obligation that will have to be revisited as competition increases in urban areas, but it can be explicitly achieved today by instituting a service norm—for every x savings accounts that are opened in high income neighbourhoods, y low-frill accounts have to be opened in low income neighbourhoods. The service provision obligation could become traded (much as the priority sector norms earlier), with small banks or cooperatives acquiring certificates for the excess number of accounts they provide and selling them to deficient banks. The government may provide added incentives by buying certificates, and should take over this obligation from banks over time.

Turning finally to the need for structures that allow a variety of financial functions under one roof, the Committee endorses much of the RBI proposal for holding companies.

Proposal 12: Allow holding company structures, with a parent holding company owning regulated subsidiaries. The holding company should be supervised by the Financial Sector Oversight Agency (see later), with each regulated subsidiary supervised by the appropriate regulator. The holding company should be well diversified if it owns a bank.

Universal banking should thus be possible in India through holding company structures. Some legislative and tax change is required to make these structures viable, and these are outlined in the report.

CREATING MORE EFFICIENT AND LIQUID MARKETS

Financial markets and institutions need to evolve considerably in order to keep up with the requirements of Indian firms and Indian investors in coming years. The corporate bond market is moribund and will have to be revived and a number of missing markets will have to be created, including exchange traded interest rate and foreign exchange derivatives contracts. But even in markets that exist, apart from the equity market for large capitalization stock, the ability to trade consistently at low cost (that is, liquidity) and the tendency of market prices to reflect fundamentals (that is, market efficiency) are typically low for most markets. This needs to change for markets to play a bigger role in inclusion, growth and stability.

In the equity markets, the environment needs to be made more conducive to private equity, venture capital, and hedge funds. Mutual funds and pension funds (when they emerge) should play a more active role in governance. In other markets, participation needs to increase substantially to enhance liquidity, and foreign players could play a key role, as could domestic financial institutions such as insurance companies and provident funds. Access to markets for the poor need to be increased, as does access to international financial services for Indian firms and investors. The production of international financial services by Indian financial firms needs to be enhanced.

Turning to specific suggestions, the Committee believes that there are substantial efficiencies to be had by consolidating the regulation of trading under one roof—this will allow scope economies to be realized, improve liquidity, and increase competition. Moreover, all markets are interconnected, so fragmenting regulation weakens our ability to regulate.

Therefore,

Proposal 13: Bring all regulation of trading under the Securities and Exchange Board of India (SEBI).

In areas where multiple regulators share concerns about a market (for example, RBI has a legitimate interest in the government bond market), regulators will have to cooperate even after the supervision of trading moves to SEBI. The rest of the Committee's main market-related proposals are self-explanatory.

Proposal 14: Encourage the introduction of markets that are currently missing such as exchange traded interest rate and exchange rate derivatives.

Proposal 15: Stop creating investor uncertainty by banning markets. If market manipulation is the worry, take direct action against those suspected of manipulation.

Proposal 16: Create the concept of one consolidated membership of an exchange for qualified investors (instead of the current need to obtain memberships for each product traded). Consolidated membership should confer the right to trade all the exchange's products on a unified trading screen with consolidated margining.

Proposal 17: Encourage the setting up of 'professional' markets and exchanges with a higher order size, that are restricted to sophisticated investors (based on net worth and financial knowledge), where more sophisticated products can be traded.

Proposal 18: Create a more innovation-friendly environment, speeding up the process by which products are approved by focusing primarily on concerns of systemic risk, fraud, contract enforcement, transparency and inappropriate sales practices. The threshold for allowing products on professional exchanges (see Proposal 16) or Over the Counter markets should be lower, so that experimentation can take place.

Proposal 19: Allow greater participation of foreign investors in domestic markets as in Proposal 2. Increase participation of domestic investors by reducing the extent to which regulators restrict an institutional investor's choice of investments. Move gradually instead to a 'prudent man' principle where the institutional investor is allowed to exercise judgement based on what a prudent man might deem to be appropriate investments. Emphasize providing access to suitable equity-linked products to the broader population as part of the inclusion agenda.

CREATING A GROWTH-FRIENDLY REGULATORY ENVIRONMENT

Sixteen years of reforms have created a fairly sound regulatory framework. Though the task is by no means complete, the groundwork that has been laid will allow us to move rapidly towards the regulatory architecture that is appropriate for a country of India's size and aspirations. While building on past successes, it is also important to remember there are deficiencies in the current regulatory system.

A number of problems exemplify the substantial road that still has to be travelled in achieving an adequate financial regulatory and supervisory structure in India. First, the pace of innovation is very slow. Products that are proposed to be introduced in India (though well established elsewhere in the world) take several years to get regulatory approval.

Second, excessive regulatory micro-management leads to a counter-productive interaction between the regulator and the regulated. The regulated respond to the needs and opportunities in the marketplace while attempting to comply only with the letter of the law. The regulator then attempts to stamp out violations of the spirit through new rules and the regulated find new ways to get around them.

Third, some areas of the financial sector have multiple regulators, while others that could pose systemic risks have none. Both situations, of unclear responsibility, and of no responsibility, are dangerous.

Fourth, regulators tend to focus on their narrow area to the exclusion of other sectors, leading to balkanization even between areas of the financial sector that naturally belong together. Financial institutions are not able to realize economies of scope in these areas, leading to inefficiency and slower growth. Moreover, by ignoring the links between areas, regulators miss sources of systemic risk. Macro-prudential risk assessments will become increasingly important as the economy modernizes and becomes integrated with the world economy.

Finally, regulatory incentive structures lead to excessive caution, which can be augmented by the paucity of skills among the regulator's operational staff relative those of the regulated. Such caution could actually exacerbate risks.

Of course, any discussion of regulation has to take cognizance of the recent turmoil in financial markets in industrial countries. While it is too early to draw strong lessons, a number of issues seem apparent:

1. It is not sufficient for regulators to only look at the part of the system under their immediate purview. Because markets are integrated, any unregulated participant can infect markets and thus contaminate regulated sectors also. For instance, there is some evidence that unregulated mortgage brokers originated worse loans than regulated ones, contaminating the securitization process. While the immediate conclusion is not to regulate everyone to the same degree, it does suggest regulators have to be alert to entities that could have systemic consequences, including on markets.
2. Capital regulation is no substitute for ensuring the incentives of financial institution management are adequate—that the spirit of the regulation is being obeyed rather than just the rule. For example, the off-balance sheet entities of the major banks, including the structured investment vehicles (SIVs), met the rules of being off-balance sheet (and hence did not require a charge on capital), but in practice turned out to be effectively on-balance sheet. Indeed, there is increasing debate about whether the Basel II capital norms are adequate, both in good times in preventing excessive risk taking, and in bad times when strict capital norms can hold back bank lending and result in a downward spiral.
3. In a market-based system, banks are not the only source of illiquidity risk. Any entity that has mismatched assets and liabilities (mismatched in terms of duration or liquidity) is subject to the risk of becoming illiquid. To the extent that entity is of systemic importance—either too big, too interlinked, or too many investors to fail—it will have a call on public funds. To the extent that regulators are likely to provide either liquidity or solvency support (and the line between these is very thin), they owe it to the public to monitor these entities and ensure the charge on the taxpayer is limited. Moreover, systems will have to be evolved to assess and maintain the overall liquidity position of the financial system, over and above its capital adequacy.
4. Deep markets with varied participants can absorb overall risk better. While indeed

the risk that has infected world markets started in the US sub-prime sector, in part because of excessive financial exuberance, despite its proximity and exposure the United States financial system has weathered the losses thus far surprisingly well. Indeed, US equity markets have held up better than the Indian stock markets! Part of the reason has to be its openness and variety. US banks could recapitalize quickly by tapping into sovereign wealth funds elsewhere. Even while banks are hamstrung by overloaded balance sheets, hedge funds and private equity players are entering the markets for illiquid assets.
5. Consumer protection is important. Not every household is fully cognizant of the transactions they enter into. While the line between excessive paternalism and appropriate individual responsibility is always hard to draw, in a developing country like ours, it may well veer to a little more paternalism in interactions between financial firms and less-sophisticated households. It is important to improve consumer literacy, the transparency of products that are sold, and in some cases, limit sales of certain products in certain jurisdictions, especially if they have prudential consequences.
6. There is no perfect regulatory system. The problems with Northern Rock in the United Kingdom are being attributed to the fact that the United Kingdom had moved to a single supervisor, the Financial Services Authority (FSA), with the monetary authority having no supervisory powers. At the same time, the Bear Stearns debacle in the United States is being attributed to the absence of a single supervisor. What is essential is effective cooperation between all the concerned authorities, which transcends the specifics of organizational architecture.

In sum then, the Committee believes that there is no room for complacency. The imperatives of the need to grow the economy and improve inclusion will necessarily create more risk. The regulators cannot stand in the way, they have to monitor and manage the greater risk, and the public has to be more tolerant of regulators in that more losses are part and parcel of the greater risk. At the same time, we have to become more clever about managing the risks, focusing efforts better at warding off the really big ones, and making participants cooperate more in the process rather than making them adversaries. Furthermore, financial sector development can help the risk management process, both by reducing risks, and by shifting them to where they can be borne better, a theme through much of this report. The Committee's proposals therefore seek to create:

1. A better risk management process for regulators and the regulated, addressing both the environment in which they operate, as well as the way they tackle risks, while allowing the innovation needed to spur growth.
2. A more streamlined regulatory architecture that reduces regulatory costs, overlaps, silos, and gaps.
3. Better coordination between regulators so that systemic risks are recognized early and tackled in a coordinated way.
4. A coordinated process to protect consumer interests as well as raise literacy levels.
5. Better frameworks for reducing the level of financial risk—for example, through prompt corrective action.

Changes to legislation

The primary source of the micro-management starts with the legislation governing regulation. For instance, the requirement that banks obtain regulatory approval for a range of routine business matters, including opening branches, remuneration to board members and even payment of fees to investment bankers managing equity capital offerings, is enshrined in the Banking Regulation Act. The Committee supports the recommendation of the High Powered Expert Committee on Making Mumbai an International Financial Centre that legislation governing financial sector regulation has to be fundamentally rewritten, focusing on broad principles rather than specific rules.

Proposal 20: Rewrite financial sector regulation, with only clear objectives and regulatory principles outlined.

However, such legislation would have to be drafted carefully, as Indian courts are not likely to look upon excessive delegation favourably (the Supreme Court of India has held that the 'essential legislative function' cannot be delegated and a statutory delegate cannot be given an unguided or un-canalized power). What should be left to the regulator is the ancillary function of providing the details.

Changes to the process of evaluation and compensation

It should also be recognized that excessive micro-management or rule-based regulation is not merely reflective of the statute books of the nation, but is also reflective of the approach adopted by the regulator. A regulator that adopts a 'rule-based' approach will seek to prosecute every minor breach of a rule, irrespective of its import in the larger scheme of things. It may well be that the regulator's fear that an acquittal may result in a possible vigilance commission inquiry leads to this emphasis. By contrast, when adopting a 'principle-based' approach, a regulator may ignore a minor violation of positive law, so long as the spirit of the laws is retained.

This is why the Committee believes that regulators should be given a clearer sense of their mandate and the specific outcomes they will be evaluated on, with any evaluation focused on whether those outcomes were achieved, and if not, whether the actions the regulator took had a high expectation of achieving the outcomes at the time they were taken. In other words, regulators at the highest level should not run the risk of having to face roving enquiries that second guess specific decisions with the benefit of hindsight. Regular interaction with parliament, where they explain how they are adhering to their mandate, should give them safe harbour against such enquiries.

Proposal 21: Parliament, through the Finance Ministry, and based on expert opinion as well as the principles enshrined in legislation, should set a specific remit for each regulator every five years. Every year, each regulator should report to a standing committee (possibly the Standing Committee on Finance), explaining in its annual report the progress it has made on meeting the remit. The interactions should be made public.

In addition, to ensure there are more direct checks on the regulator in a system that is less rule-bound, the Committee recommends Proposal 22.

Proposal 22: Regulatory actions should be subject to appeal to the Financial Sector Appellate Tribunal, which will be set up along the lines of, and subsume, the Securities Appellate Tribunal.

To enhance the quality of regulatory staff, the Committee suggests that regulators continue their ongoing attempts to give recruits higher remuneration as well as responsibilities, but also that every effort should be made to allow mobility to and from the private sector. Each individual organization will, however, have to take reasonable precautions against conflicts of interest arising out of prior or subsequent employment.

Changes to the regulatory architecture

The Committee felt it premature to move fully towards a *single* regulator at the moment, given other pressing regulatory changes that are needed. However, regulatory structures can be streamlined to avoid regulatory inconsistencies, gaps, overlap, and arbitrage. Steps in this direction should include a reduction in the number of regulators, defining their jurisdiction wherever possible in terms of functions rather than the forms of the players, and ensuring a level playing field by making all players performing a function report to the same regulator regardless of their size or ownership. In addition, the Committee felt it is prudent to start the process of unifying regulation and supervision at certain levels, and recommends a strengthening and consolidation of regulatory structures to deal with large complex, systemically important, financial conglomerates on the one hand, and with the consumer on the other.

One aspect of regulatory architecture has already been presented—to bring all regulation of trading under SEBI. The Committee also suggests a proposal (23).

Proposal 23: Supervision of all deposit taking institutions must come under the RBI. Situations where responsibility is shared, such as with the State Registrar of Cooperative Societies, should gradually cease. The RBI will have to increase supervisory capacity to take on this task. The Committee recognizes this involves constitutional issues but nevertheless recommends a thorough overhaul of the system of shared responsibility.

Drawing a lesson from the current crisis in industrial countries, the Committee recommends that joint responsibility for monetary policy and banking supervision continue to be with the RBI, and that the RBI play an important role in the joint supervision of conglomerates and systemically important NBFCs (see the proposal for the Financial Sector Oversight Agency below).

In India, annual accounts are filed with the Registrar of Companies under the Department of Company Affairs in the Government of India. However there is no system of reviewing accounting reports even on a selective or sample basis. The Committee believes that such a process of review is absolutely essential so that the public can have more confidence in company reports. This process can be outsourced initially. Furthermore, it should be monitored carefully so that it does not become a source of harassment but indeed adds genuinely to public confidence in accounts.

Proposal 24: The Ministry of Corporate Affairs (MCA) should review accounts of unlisted companies, while SEBI should review accounts of listed companies.

As financial conglomerates or holding companies begin to dominate the system, a consolidated system of supervision becomes more important. Moreover, spillovers between various aspects of the financial system necessitate constant communication between regulators at the highest levels. Regulators also need to have an overall view of the financial sector to initiate prompt and coordinated corrective action, and to remove inconsistencies in approach. Even though our Committee recommends separate prudential regulators, it strongly recommends strengthening the ties between them and improving coordination.

Proposal 25: A Financial Sector Oversight Agency (FSOA) should be set up by statute. The FSOA's focus will be both macro-prudential as well as supervisory; the FSOA will develop periodic assessments of macroeconomic risks, risk concentrations, as well as risk exposures in the economy; it will monitor the functioning of large, systemically important, financial conglomerates; anticipating potential risks, it will initiate balanced supervisory action by the concerned regulators to address those risks; it will address and defuse inter-regulatory conflicts.

The FSOA should be comprised of chiefs of the regulatory bodies (with a chair, typically the senior-most regulator, appointed from amongst them by the government), and should also include the Finance Secretary as a permanent invitee. The FSOA should have a permanent secretariat comprised of staff including those on deputation from the various regulators. There should be a prescribed minimum frequency of meetings of the FSOA. All issues of regulatory coordination, and supervision of systemically important financial conglomerates and financial institutions will be taken up by the FSOA.

The discussions of the FSOA with the management of systemically important institutions will be 'principles-based', and this will initiate the process of gradually implementing more 'principles-based' regulation throughout the system. It will be important that the FSOA add value by substituting for some existing processes instead of adding another layer, while bringing collective regulatory views to bear. It is not our intent that the FSOA be a 'super-regulator' displacing existing regulators. Instead it provides needed coordination and fills gaps that current structures have proved inadequate for.

In addition, there is merit in setting up a Working Group on Financial Sector Reforms with the Finance Minister as the Chairman. The main focus of this working group would be to monitor progress on financial sector reforms (such as the proposals of the Patil, Parekh, Mistry, and this Committee), and to initiate needed action. The working group's membership would include the regulators, as well as ministries on as-needed basis. The working group would be supported by a secretariat inside the Finance Ministry.

Proposal 26: The Committee recommends setting up a Working Group on Financial Sector Reforms with the Finance Minister as the Chairman. The main focus of this working group would be to shepherd financial sector reforms.

The Committee also notes the consumer faces an integrated portfolio of services. It is increasingly important for the consumer to have a 'one stop' source of redress for complaints, a financial ombudsman. Also, an integrated ombudsman is needed to enhance financial literacy and financial counseling, issues that span regulators. The ombudsman can also monitor the selling of different products, the degree of transparency about their pricing, and their suitability for targeted customers. Finally, given that household debt loads are increasing, the ombudsman can provide a neutral forum (and possibly act as an arbitrator) for out-of-court negotiated settlement of debt.

Proposal 27: Set up an Office of the Financial Ombudsman (OFO), incorporating all such offices in existing regulators, to serve as an interface between the household and industry.

Finally, the Committee noted that a large number of undercapitalized deposit taking entities continued to survive in the system. Regulatory forbearance should be the exception, especially when there is more rapid entry into the system.

Proposal 28: The Committee recommends strengthening the capacity of the Deposit Insurance and Credit Guarantee Corporation (DICGC) to both monitor risk and resolve a failing bank, instilling a more explicit system of prompt corrective action (see Proposal 3), and making deposit insurance premia more risk-based.

The combination of the proposed changes to legislation, regulatory incentive structures, and regulatory architecture, should help create a far more enabling regulatory framework, which will provide for greater stability, higher growth and innovation, and more inclusion.

CREATING A ROBUST INFRASTRUCTURE FOR CREDIT

In order for credit to flow freely, lenders should have sufficient knowledge about borrowers, be able to take the borrower's assets as collateral, be able to enforce penalties in case the borrower defaults (such as shutting the borrower's access to credit, at least for a while, or seizing the borrower's pledged assets), and be able to renegotiate their claims in an orderly fashion in case the borrower is simply not able to pay. A strong credit infrastructure allows widespread credit information sharing, low-cost pledging and enforcement of collateral interests, and an efficient bankruptcy system, which renegotiates un-payable financial claims while preserving the assets in their best use.

Even though a strong credit infrastructure seems to enhance creditor rights only, research shows it also significantly enhances the capacity of individuals to borrow, since creditors are now confident they will be repaid. Conversely, weakening the infrastructure, which seems politically appealing, while seemingly letting borrowers off the hook, also hurts their future access to credit. Despite progress on a number of fronts, India still has weak credit infrastructure, a major factor in limiting financial inclusion. Some of the Committee's key proposals are stated below.

Proposal 29: Expedite the process of creating a unique national ID number with biometric identification.

Any system of tracking individual information requires a unique identifier, and our credit information system is hampered by the lack of one. Furthermore, in a country where so many of our people are excluded from the formal financial system, credit information alone may not help inclusion much because so many have never had credit. More sources of information, such as payments of rent or of utilities/cell-phone bills, need to be tapped to build individual records of payment, which can then open doors to credit and expand access.

Proposal 30: The Committee recommends movement from a system where information is shared primarily amongst institutional credit providers on the basis of reciprocity to a system of subscription, where information is collected from more sources and a subscriber gets access to data subject to verification of 'need to know and authorization to use' of the subscriber by the credit bureau. This will also require rethinking the incentives of providers to share information, and a judicious mix of payments as well as mandatory requirements for information sharing will have to be developed.

Turning to collateral, it can be pledged if the potential borrower has clear title to assets. Land is probably the single most valuable physical asset in the country today. Unfortunately, the murky state of property rights to land make it less effective as collateral than it could be. The current state of land rights has many other adverse effects, including preventing agricultural land from migrating to its best use, slowing land acquisition for industrial and infrastructure projects, clogging courts with disputed cases, and elevating the level of political conflict. While making land rights clear and transparent is expensive, it is probably one of the most pressing needs of the country today.

Proposal 31: Ongoing efforts to improve land registration and titling—including full cadastral mapping of land, reconciling various registries, forcing compulsory registration of all land transactions, computerizing land records, and providing easy remote access to land records—should be expedited, with the Centre playing a role in facilitating pilots and sharing experience of best practices. The Committee also suggests the possibility of special law courts to clear the backlog of land disputes be examined.

Widespread prohibition of land leasing is not consistent with efficient resource allocation. It raises the cost to rural-urban migration as villagers are unable to lease their land, and often have to leave a family member (typically the wife) behind to work the land. Lifting these restrictions can help the landless (or more efficient large land owners) get land from those who migrate, and allow those who currently lease land informally to formalize their transactions and thus obtain institutional credit and other benefits. To the extent that liberalization of land leasing enhances owners' security and may allow adoption of long-term contracts, it is also likely to increase investment incentives for all parties.

Proposal 32: Restrictions on tenancy should be re-examined so that tenancy can be formalized in contracts, which can then serve as the basis for borrowing.

Given clear title to an asset, let us now turn to the process of registering a creditor's interest in the asset. In order for creditors to establish they have a secured claim to an asset, and in order that prospective lenders or purchasers be made aware of prior claims, a well organized system to register and publicize security interests is essential. The current system of registration in India is fragmented and neither fully computerized nor easily accessible. The Committee offers some suggestions in the report on how this can be remedied.

Once registered, secured debt claims are valuable only if they are enforced. Two important recent initiatives towards this purpose are the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SRFAESI), and asset reconstruction companies (ARCs).

The SRFAESI Act helps secured creditors by promoting the setting up of asset reconstruction companies to take over the Non-Performing Assets (NPAs) accumulated with the banks and public financial institutions. Furthermore, it provides special powers to lenders and asset reconstruction companies to enable them to take over the assets of borrowers without first resorting to courts. There is no reason though that only a special group should enjoy the powers of SRFAESI.

Proposal 33: The powers of SRFAESI that are currently conferred only on banks, public financial institutions, and housing finance companies should be extended to all institutional lenders.

ARCs have additional powers such as step-in rights and the ability to change management, and the right to sell or lease the business. Given these additional powers, it is important that a number of ARCs flourish so that no single ARC has excessive power. There is really no sensible case to keep foreign direct investment out of ARCs. The kind of risk capital as well as the kind of expertise foreign investors bring is useful in the economy, and can help provide a valuable buffer. From an economic perspective, capital that comes into the country when the banking sector is distressed and a flood of assets are sold to ARCs, is particularly valuable, and foreign investors, not domestic financial institutions, are most likely to be flush with capital at those times.

Proposal 34: Encourage the entry of more well-capitalized ARCs, including ones with foreign backing.

Finally, while secured creditors have been empowered, unsecured creditors still have little protection. If India is to have a flourishing corporate debt market, corporate public debt, which is largely unsecured, needs to have value when a company becomes distressed. This means a well functioning bankruptcy code, that neither protects the debtor at the expense of everyone else including employees, as our current system does, nor one that allows secured creditors to drive a well-functioning firm into the ground by seizing assets. A good bankruptcy code is especially needed for large complex infrastructure projects, which typically have many claimholders.

Proposal 35: The Committee outlines a number of desirable attributes of a bankruptcy code in the Indian context, many of which are aligned with the recommendations of the Irani Committee. It suggests an expedited move to legislate the needed amendments to company law.

In the final chapter, the Committee offers views on three important topics, the financing of infrastructure, the financing of old age pensions, and the generation of information in the economy.

PRIORITIES AND SEQUENCING

Low hanging fruit

Many of the proposals of this Committee are not controversial, do not conflict with any political party's views, and require little legislative effort. They should be implemented on an expedited basis. These proposals include almost all the proposals on financial inclusion, on improving markets, and on improving the credit infrastructure.

In particular, it ought to be a national priority to roll out a unique national ID number tied to biometric identification, to offer access to a linked 'no-frills' savings account for every household that wants one, and to channel all government transfer payments to poor households through such accounts. The credit information sharing system should be reformed to allow more information, such as rental and utility payments, to be used in assessing credit histories. Credit information should also be made available to a wider group of users, with appropriate safeguards.

With financial services reaching a wider fraction of the population, the Office of the Financial Ombudsman (OFO) should be set up so as to expand customer literacy, prevent exploitation, arbitrate grievances, and facilitate debt settlements. Technological innovations to reduce transactions costs (such as mobile payments) and new institutional and contractual structures (such as warehouse receipts and trade credit acceptances) should be encouraged.

Many of the market reforms we have suggested in Chapter 5 are also not technically difficult or politically controversial. They typically require steady liberalization and institution building, and will likely occur if the regulatory authorities exercise leadership, and are given support.

Technically simple but difficulties exist

A variety of reforms are technically quite simple (they do not require new thinking, new institutions, or substantial new legislation) but either do not command widespread consensus among technocrats, or are opposed by regulators or interest groups.

Among the reforms that do not command widespread consensus include those on monetary policy and on liberalizing the few remaining capital controls opportunistically. This report has encouraged more debate on these issues, and it is our hope that technocrats will realize the merit of our proposals. Unfortunately, this is an area where experimentation is not possible, and policy will have to be reformed in the face of substantial uncertainty. All the policy choices involve some benefits and some costs. A pragmatic assessment needs to be made about the path that is best suited for India's trajectory as a fast growing and rapidly internationalizing economy. Ultimately, though, it is our belief that if we do not undertake the needed reforms willingly, circumstances will force our hand.

Some reforms, such as allowing more small banks, are controversial amongst technocrats, burnt by the past experience with small cooperative banks. But unlike with macroeconomic policy, experiments can, and have, been conducted (see, for example, the licensing of Local Area Banks). We need a more pragmatic approach here amongst policymakers, and need to begin experimenting more widely. Successful experiments should be rolled out quickly on a nationwide scale. Amongst the other policies where experiments or evidence could prove useful are the Priority Sector Loan Certificate scheme, and the proposal to liberalize interest rates.

Improving land titling and registration is a reform, the need for which is not controversial but for which the right approach is a matter of substantial debate. Experiments have been under way in different states, and it is now important to distill lessons, develop a national consensus on a possible approach (or approaches), and find a way to allocate the expenses. Administrative, rather than political, leadership is required here.

Many of the reforms relating to banking—freeing bank branching, allowing public sector bank boards more freedom and improving bank governance—are blocked because of a natural belief (or desire) amongst some in (or for) command and control. The need here is for a reformist government that is willing to limit its powers (and the powers of future governments) in the national interest.

Finally, the costs of dealing with economic fluctuations will be reduced if we have a rapid and transparent process of dealing with the financial distress of households, firms, and financial institutions. While the OFO could help create a structure for households, much of the elements of a viable corporate bankruptcy code are in place and should be enacted rapidly, and the systems in place for dealing with the distress of large financial institutions should be stress-tested, and deficiencies remedied. It will be much harder putting codes and systems in place in the midst of financial turmoil, when vested interests will come to the fore, so it is best to undertake these reforms now. At the same time, one should not minimize the strength of the interests already in existence, who favour a distress resolution system based on government preferences and patronage, rather than on an arm's length process.

Technically and politically difficult

The toughest reforms are clearly those that are technically difficult (in that there is no agreement on the details on how it would be carried out) and politically controversial (in that support will have to be built for the substantial amount of legislation involved, and to overcome vested interests). These include substantially reducing government control in the financial sector and regulatory reform (such as rewriting archaic legislation to make it more principles based and streamlining the regulatory architecture). While they are extremely important for the health of the financial sector, they will take time. The Committee would suggest that a first step be to build more acceptance of the technical details through a mix of debate and experimentation (where possible).

Overall, the Committee would urge reducing bottlenecks where possible, in particular on legislation. It would urge a high quality technical effort on drafting new laws and putting them through a process of public scrutiny, as well as utilizing various government and non-governmental organizations in educating legislators on their import. It would urge greater speed of action in Standing Committees, and a prioritization of bills to make best use of scarce parliamentary time.

CONCLUSION

India's financial sector is at a turning point. There are many successes—the rapidity and reliability of settlement at the NSE or the mobile phone banking being implemented around the country indicate that much of our system is at the Internet age and beyond. There is justifiable reason to take pride in this.

Yet much needs to be done. Some parts of our system have not yet reached the electronic age, and unfortunately, this is the part that our poor typically face. There is an opportunity here. In the process of gaining the productivity and innovativeness to serve the masses, the financial sector will get the unique edge and scale to be competitive internationally—indeed, the road to making Mumbai an international financial centre runs through every village and slum in India.

But as we argue in this report, there is no easy path for the government. The old system of attempting to mandate outcomes from the centre does not work any more, even if it might have when our private sector institutions were less well developed and the Indian economy was more closed. The proper role of the government today is to improve the financial sector's infrastructure and its regulation even while removing the plethora of constraints and distortions that have built up over the years. It also requires the government to withdraw from financing and direct control of institutions so that the financial sector can get on with the job. The populism and the direct intervention, that unfortunately seems to be making a comeback, should be relegated firmly to the past.

This report places inclusion, growth, and stability as the three objectives of any reform process, and fortunately, these objectives are not in contradiction. With the right reforms, the financial sector can be an enormous source of job creation both directly, and indirectly through the enterprise and consumption it can support with financing. Without reforms, however, the financial sector could become an increasing source of risk, as the mismatches between the capacity and needs of the real economy and the capabilities of the financial sector widen. Not only would the lost opportunities be large, but, the consequences for the economy could be devastating. The country's leaders have a choice to make, and this Committee hopes they will make the right one.