Indian Economy: Some Contemporary Perspectives
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Lecture 23
Indian Economy-Financial Sector 5

So, hi everyone, so let us start so we are going to talk about the Indian economy some contemporary perspectives. And in this particular course, we are talking the financial sector and we were in the financial, if its financial sector legislative reform commission. And we had a given some background about that particular commission report. And it also mentions about how we can understand better about the newly suggest, Indian financial code IFC code.

Because it is important to understand and then going ahead in this particular lecture we will be also going through some recent development in the India's financial sector. Basically, the India banking crises what lead to and what were the reasons. So now we will not be exploring much towards the textbooks and the reports. But we will be more relying on the economic survey. So now it is more like contemporary context. We will be talking more about the recent developments, recent changes.

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So, in this process I have designed this particular lecture in the form of going through the FLSRC recommendations how these particular recommendations have helped in terms of improving the financial structure of the country. So, under this I have referred Patnaik and Shah, it was also in the last lecture reforming India's financial system. And then we also mentioned about the economic reforms that were talking about. So economic reform we also mentioned about the financial sector reform. So, under this we had Economic survey 2016-17 and 2017-18 we have referred.

So, in this I have referred Patnaik and Shah reforming India's financial system. So, I have referred the Carnegie endowment in international peace. This particular report mentions about the commission recommendations in Indian financial code. And then the most relevant is the economic survey 2016-17, 2017-18. And I would also refer to for some portions basically on the bankruptcy law economic survey 2018-19. And mostly these are from the volume 1 and volume 2 both.

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So wherever applicable I will be highlighting those things. So as if now these two are the major references that we will be talking about. So, the objective is the same to understand the India's banking system and for the financial sector reforms. And the recent developments and financial sector whatever we have implemented some regulations. So, there is the underlying idea.

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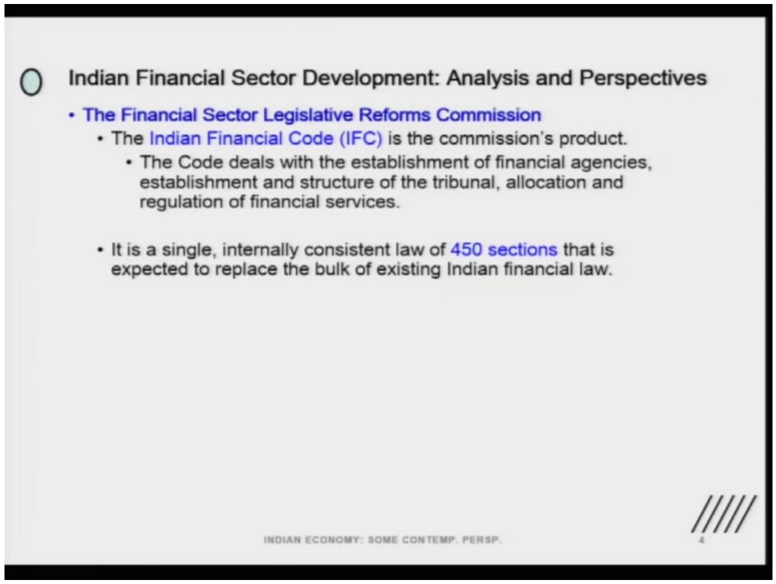

So, the as I have given the background that Indian financial code for the first time Srikrishna committee report which was set up in 2011 and submitted the report in 2013 it is the first after independence the I would say gigantic reforms process that the committee has recommended at every level. So even we have the micro-prudential norms to devise the or to revise the existing financial laws.

So, keeping that in mind, we will going through, so we have already, we are already going through something call consumer protection. So, what happens under consumer protection? So, for the first time the IFC code has recommended that there will be some kind of regulatory body set up at the district level. So that the consumers living in the semi urban and even the rural areas they will have some kind of redressal process to have a and to solve the financial concerns.

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In case of any kind of dispute happen between the financial form and the consumer. Then it talks about the micro-prudential regulation. It also talks about the resolution, systemic risk regulation, capital controls, monetary policy, public debt management, development and redistribution, contract trading and market abuse. For the sake of simplification these particular reports because this source huge to read and it is very difficult to comprehend each and every portions of the report.

So, for the sake of simple understanding this report has been divided into nine sub sections. And I should be thankful to Doctor Patnaik and Shah for mentioning these reports in a such a nice manner. So, the report that I have mentioned it is this, the reference the reforming India's financial system. So, it is available online freely and some of you if you are interested you can refer that.

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Let us talk about the micro-prudential regulation. So, for the first time IFC code has considered. The role of the micro-prudential so normally in most of the countries what we see is that we have the micro-prudential norms. So, under micro-prudential norm what typically happens is that you look from the perspectives of the economy as a whole. So, suppose we have the banking system and we have the financial market and we expect that there will be some shock penetrating to either the banking sector or the financial sector.

And it may happen that there will be collapse of one or more than one institution. So, you safeguard certain norms or you implement certain norms to make sure that such thing does not happen. And as a result, you’re in at the time of any unwanted events your economy is saved. And even your sector which are crucial for the economic growth or development are also safeguarded. So, this is called the micro-prudential norms.

So, under that there will early varnished signals then there will be data repository to analyze what are the patterns and developments in terms of certain sectoral developments. For example, how financial sector expanding towards the masses which are unbanked so that becomes quite risky because they are the harden money of a small investor will also be mobilized by the financial sector.

And if financial sector is not robust and enough to avoid those external shocks then it may happen that in the event of financial crises or the global crises that we saw during 2007-8. It may lead to have a spillover effect on rest of the sectors. And as a result, the economic growth process may turn back and it may backfire in terms of going for persistent low inflation and low growth for longer period of time. So, there is a whole lot of literature talking about these things.

But at the same time there is a need to think about the micro-prudential in the sense that there will be some kind of norms devise by the central regulation, central regulatory body. So that if the form is going to bankrupt and if it is deporting losses. Then there will be some safeguard or checks imposed on that firms. So that it does not go into the CIRP process that is called corporate insolvency resolution process.

And it remains solvent and then the regulators may go for either merger or it can sell to some other well doing reforms. It can also recommend some kind of restructuring mechanism through which this particular reform can be survived. So, in case of government institution it typically happens that government institutions are more or less more safeguarded so people have a blind faith on that and that is why they do not find it difficult to mobilized savings for or to go for any kind of borrowing and lending.

Because if you are individual and if you are investing in government institution then you always think that you are going to lend money to the government and government will not default. So, it is like a race free asset. But in case of private firms this not the case because there is a common apprehension that after some years if the form will not do well then, this particular form may fail and it may lead to a heavy loss.

So, people do not recommend I would say private firm's investment as compare to the government firms so that is why there is a need to bring some kind of micro-prudential regulations. So that these firms may also be safeguarded and at the same time these firms will also have the access to a singular set of market which the government institutions are, so basically the role of micro-prudential regulation is that what about apprehension that we have about the private firms.

And now since we are looking for a market-oriented economy. So, it is obvious that there will be penetration of private firms and if there are no safeguards designed for these firms. Then in case of any adverse event this firms may become one unable to fail your bankruptcy as a result they will be panic among the investors, those who have invested money. So, for the first time at this level a particular commission has thought about that we should have an institution while prudential norms through which we can monitor these institutions.

And in case of any unwanted event these institutions can also be safeguarded for instance it typically happens that if a bank is going through a failure then under some guaranty scheme there is an insurance of at least one lac rupees that is paid to the depositor in the same way if we have a mutual fund. And mutual fund is going for having or going for reporting of higher net asset value in a wage.

And if this is not the case and if there is a some mutually reporting happening and if there is some kind of adverse effect on this mutual fund. Then this mail it to create some kind of negative impact on the investment of the borrower, investment of the savers. And as a result, if the government and if there is are no rules to take care of such norms then it may happen that after some point of time people may not like to invest in a mutual funds which are mostly privately on or they may again go to post office savings.

And they may start going through the conventional product so as a result there will be not much scope for diversification in the financial sector. And one of the important parts of the financial sector expansion or the reform process is that it should expand, it should give the greater number of choices to the investors. So that they can invest in a large number of product so portfolio diversification risks the diversification asset this should be easily adopted.

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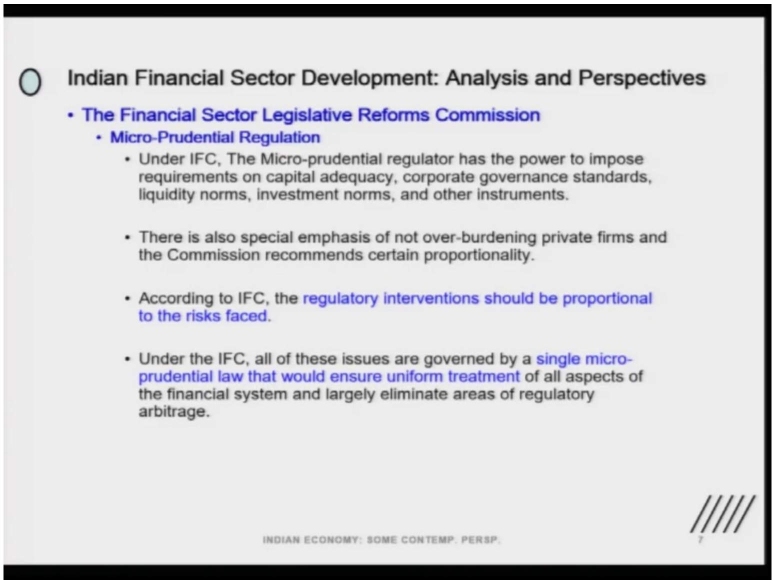

So, under IFC Indian financial code for the first time the commission has recommended that depending upon the nature of the business how risky it is authorities will be empowered to regulate those and to devise or to undertake majors to make sure that the firms operating in that particular sector do not have the cases of bankruptcy. So, for instance if there are NBFCs then capital education norms may be higher.

I can give you an example that in case of under basel 2 we have the capital education ratio of 9 percent if the regulator thinks that this particular sector requires more safeguard then they can put a higher check. And they can say that now the capital education norm for that particular sector maybe 11 percent 12 percent or so that is required corporate governance standard because this has been the case that when early 2000 and in the late 1990s when we had the boom in the NBFC sector where there was large mobilization of savings coming from NBFCs at that time there were cases were corporate governance norms.

So regulatory body should have a particular check on that particular sector where it feels that there is a need to have a different set of board composition, the mixture of particular sector concentration plus the individual from related sector or another sector. Investment norms can also be devised in the same way that there should be a limit of investment that if a particular sector is not able to absorb a higher liquidity then they can devised that there should not be investment of more than 50000 in a year or something or so there can be balances other instruments means if it is a commodity market and if you feel that this particular commodity market is very sensitive to the inflation.

Then government can devise certain norms that particular set of commodities may not be traded. In the same way if you are looking for the reforming chain market then reforming chain market may also be but the micro-prudential norms are devised to safeguard the interest of consumers so or consumers or investors.

So, if the financial institutions are being monitored on a very based on their size, based on their market share, based on their sensitivity to the micro economic fundamentals then of course it will lead to and will bring more stability into the system. So, for the first time IFC had gone for that.

There is also a special emphasis of not over burning private firms and commission recommends certain proportionality in the sense that there should be some breathing space given to these sectors, for example I gave you the example of mutual fund. If the mutual funds are not giving proper space to grow and if there are more checks and safeguards, then ultimately this will lead to the deterioration in the market of the mutual funds. And they may not be able to survive for so long.

So, some kind of proportionality must be adopted so that we can either risk profile of these institutions may be measured on certain parameters and those measurements may become yardstick to avoid certain risk and measures. According to IFC the regulatory intervention should be proportion to the risk a phase that I mentioned about under the IFC all of these institutions are governed by a single micro-prudential law that we would ensure uniform treatment of all aspect of financial sector.

Which means that there is a recommendation there should be a micro-prudential law dealing with all types of firms participating in the financial space of the country. So, for the first time the appreciation is that for the first-time committee has gone and thought about such kind of framework.

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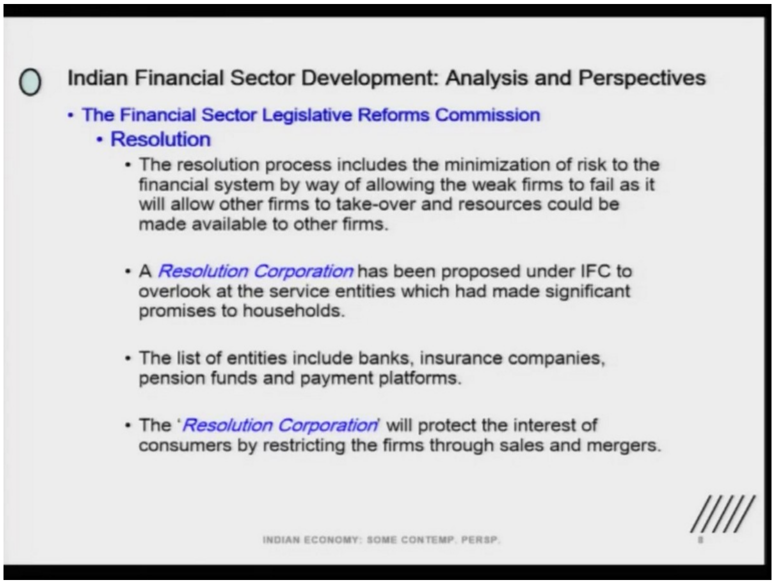

Then, after this the next issue is the resolution. Suppose there is a bank and there is a consumer and both have some kind of dispute then some kind of understanding must be there. So, in this case the resolution process is basically considers that if there are cases of failures in the firm. And if the regulator thinks that this particular failure may not have that much impact and it will lead to transfer of resources. So, for example if they seek firm or the weak firm is going to go for bankrupt.

Then in certain cases may be allowed because this will free up the capital and the resources for the other firms and they may utilize to in augment their efficiency. And this will bring ultimately the efficiency into the overall system. So, keeping that in mind this resolution process has been devised. So, it has been recommended under IFC that there will be a resolution corporation under IFC to overlook at the service entities which have made significant promises to household.

Which means that if we have a one particular institutions, for example insurance, suppose for example a firm operating in insurance industry. This particular firm sales product to the house hold and households have been given promise that they will be given certain incentive after some years. And again, there will be further compounding of those incentives.

And so whatever product has been sold to the households if the firm is not complying with those promises, then it may lead to further deterioration of the market and there will be low sentiment in the investment of the, investment in the insurance industry and that may have adverse impact on the growth and development of the insurance industry as a whole. So, keeping that in mind IFC recommends that there should be a particular body to look into these things where the firms are over promising things to the customers and they are not able to deliver. So, there must be some kind of regulatory check on such type of incidences. So, the list of entities in this include banks, insurance companies, then we pension funds and even payment platforms.

So for the first time Indian financial code had gone to an extent that whatever changes suppose if somebody has a cashback from Amazon or Flipkart and if it not being monitored and if the firm is not being able to deliver then there will be some kind of regulatory check on those violations, so that in future it should not happen and as a result the smaller investors which are the first time immerse and utilizing such type of services for the first time their interest are safeguarded and this will ultimately benefit the financial each and every segment of the financial sector.

So, this is not the only case in case of India. It has been devising in each and every country so they have a check and balance it at each level. So that even a smaller investor feels that the it cannot be the case that firm can cheat them. So that is the way they go for sorting out some kind of differences between consumer and firm and come up with some resolution. So, this resolution corporation will protect the interest of consumers basically the investors or buyers or any kind of by restricting the firms through sales and mergers.

So, in case it happens that there is a particular firm, and this particular firm after some point of time it has been sold to some other firm. And whatever the contracts or the clauses that were there in the consumer’s service document now it has to be changed, it has to be revised ultimately the loser is the consumer so that should not be the case. Even in terms of sales if you are selling certain product and if this product is coming under some kind of controversy.

So, a regulatory body may put those products for review and may ask the, may ask for suggestions so that this product service may be improved. So those situations, those conditions are also being minutely dealt and explained here in case of resolution.

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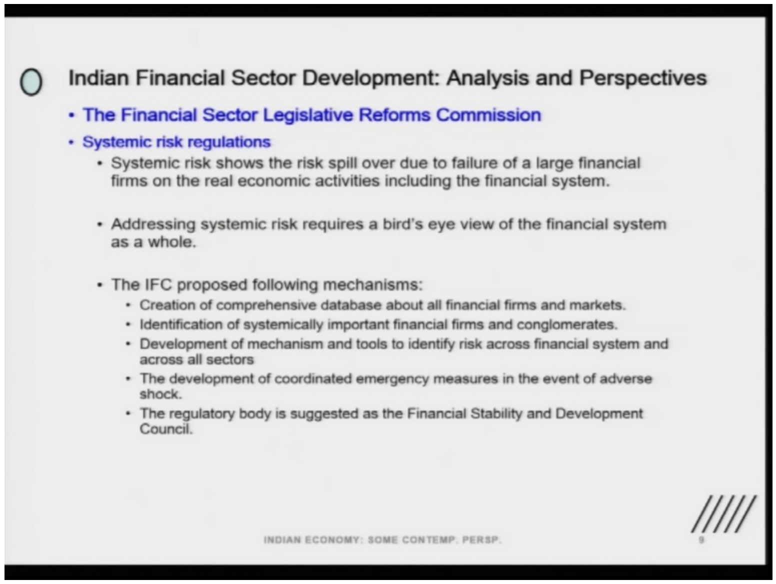

Then, what comes the systemic risk regulation, systemic risk regulation is very important but it is important for those economies where the banks are completely lift to the market government or the central bank does not have the or even the government and the central bank do not have that much control on that. But in case of India in most of the cases what we find that we have the regulated banking system.

And this regulated banking system it is being assumed that if the banks are going to face any problem then government will come to rescue them. And as a result, what happens is that there will be lot of inefficiencies coming into the system in the form of higher NPAs. And also, higher defaults and there will be some kind of mismanagement financial mismanagement that may lead to further inefficiencies into the banking system.

And then after some period of time whenever there will be spillover on sectors real economic activities in this creates some kind of shock that we have seen in case of 2007-8 global financial crises that happened in US. But systemic risk in case of regulated banking system cannot be ignored because this is one particular framework that has now become a binding norm for most of the central banks even the government to adopt such a structure of checking banks regularly for their financial health.

And also checking these banks from the perspective that how long they have this operation quotient to survive in case there is some kind of adverse shock coming from US or the external sectors then how the banking and other financial segments of the system are safeguarded. So systemic risk basically talks about the failure for the risk is spillover due to failure of one large institution or highly systemically important institution.

Systematically institution that those institutions which are, which have the larger coverage in terms of activities. And these institutions are also one of the prime lenders to business and real activities. And if these institutions fail then this will have the collapse or I would say collapsing effect on the other segments of the economy including the real economic activities. So, addressing systemic risk requires a bird's eye view which means that a central bank or the authority issued have a particular check on this that how they can revise a bird.

I would say mechanism through which they can regulate such type of systemic shocks spread of such type of systemic shocks. So Indian financial code is having some kind of mechanism designed. So how they have designed they have mention that there will be creation of comprehensive database about all financial firms and market which means that there will be a body that will be taking care.

And there will be a whole lot of gathering of information and this database will be utilized for certain signaling mechanism through which it can be propagated where the banking sector is heading. And how they are heading and what is there financial situations. Identification of systemically important financial firms and conglomerates. If we go to RBI website or even some segments of the RBI website, then you will find that they have the ranking of all major banks which are called based on their size.

So, they rank based on their size for example state bank of India. Then right now it is HDFC bank, then we have the ICIC bank, state bank of India, then Axis bank so these are the four major banks that we have in India. And it has been ranked by RBI based on their size and the coverage that they have and if these banks face any problem then this will have tremendous impact on the other segments of the financial sector real economy activities.

As a shock trigger will be so impactful that it will be really difficult to subside those shocks or even to monitor those shocks on a regular basis even in India we have a D-SIB equals to D-SIB D hyphen SBI is systemically important banks. So, these banks are given ranking based on their size. Similarly, we have the SI NBFCs systemically important non-banking financial corporations.

And these corporations play a very important role in terms of knowing at least that which all NBFCs are critical for the safeguard they would development then we have the development of mechanism in tools to identify risk across financial system and across all sector which means that once we have the database once we have the ranking then we can easily see the integration, the kind of development the transmission of information.

Some kind of analysis that gives us idea about how we can see the interdependence or some kind of contagion analysis that we can process the development of coordinated emergency measures in the event of adverse shock. Which means that some kind of measures must be taken to make sure that if a banking sector is going face a problem. Then the financial sector may be safeguarded by just getting into some other activities.

That has a low dependence so some kind of diversification maybe possible. To monitor all this the regulatory body which has been suggested is called financial stability and development council FSDC I will be giving you the background of this in a later section and this is one important aspect that we have.

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So, the FSDC the body this IFC Indian financial code suggests in this way that finance minister will be the member RBI governor will be also the member of head of non-banking financial agency for example we have the insolvency bankruptcy board of India. So, the head insolvency bankruptcy board of India may become the member of this head of resolution corporation which the IFC suggest and the head of debt management office that is going to come after this.

So, the Indian financial code suggests that there should be the formation of financial stability and development council and this will have these members.

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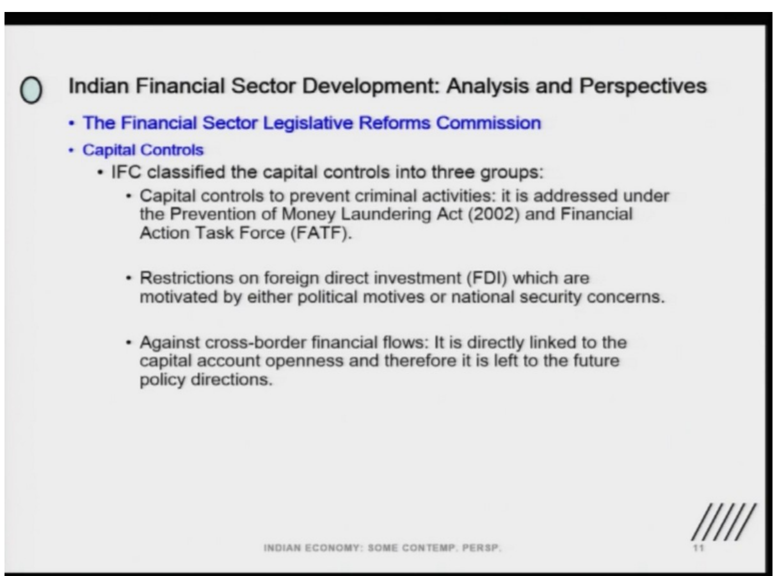

Then we have the capital control as we are expanding our economy is now having a on almost like expanded structure where we had the well diversified financial system. But at the same time, we have to look from the perspective of capital inflow outflow which means the cross-boarder inflows outflows. And how we can think about so in this set up I will be continuing from here in terms of capital control.

So, so far, we have covered the FSLRC committee recommendation the Indian financial code and we have referred to some extent the major portions of the so we are going through the sub components the major recommendations under that now we are discussing. So, in the next session I will be talking about the capital control in detail. So, thank you, thank you so much.