

# The question of innovation in Indian finance

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# Current global discussions on finance and innovation

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- Some believe that with the complex structures of home loan securitisation, financial innovation ran ahead of the capabilities of regulators
- Hence - it is claimed - a better world economy requires control on innovation.
- Prevent financial firms from doing new things and the world will be a better place.

# The Indian discussion on finance and innovation

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- One emerging claim is that India is the pioneer and the leading exponent of **sound financial regulation**.
- However, good regulation should not be confused with preventing financial innovation which is what India has done.

# Part I

## The licence-raj regime in Indian finance

## The license-permit raj in Indian finance

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- Credit derivatives are banned.
- Lending government bonds is banned.
- Repos on corporate bonds are not permitted.
- Covered interest parity arbitrage is mostly blocked for banks and impossible for everyone else.
- Two companies are not permitted to do an OTC derivatives transaction against each other. One counterparty has to be a bank.

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This permission was not given!!

Gifting candy from an ATM is banned.

## Much like Indian controls against trade and industry

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- Until the early 1990s, India operated a similar license-permit raj on trade and industry.
- Firms required permission from the government for all kinds of activity.
- Permissions were generally not given.
- Since then, India has broken with that system in the case of trade and industry.
- This has not yet been done with finance.

# 'Innovation' in Indian finance

- Between 1994-1998, several institutions got developed for equity markets:
  - Electronic order matching.
  - Zero credit risk owing to a clearing corporation.
  - Full dematerialisation of equity shares, and now bonds as well.
- Equity markets bloomed.
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- Equity markets bloomed.
- However, the currency and the bond markets have not seen similar growth or institutional/product development.
- For example, there is nothing more ordinary than currency futures. It has been around internationally since 1972.
- This “product innovation” is banned in India.

## A mess involving “innovative” products in India

- Many banks sold exotic OTC FX derivatives to firms.
- Some firms started bearing losses on these positions.
- Some firms refused to pay the losses, some firms have sued the banks.
- The legal cases have yet to wind through the courts. However, the preliminary sense: the banks will lose.
- A big mess, particularly on the watch of the central bank which is the banking supervisor.
- Innovative OTC FX derivatives as a business has died owing to this legal risk.

# The context

- In 2006, an 'RBI Amendment Act' established the enforceability of OTC derivatives.
- But a system of capital controls remains, enforced through a law called FEMA.
- Even though exotic OTC FX derivatives are clearly enforceable owing to the RBI Amendment Act of 2006, they are repugnant of the capital controls.
- This resulted in a big legal conundrum.
- Was financial innovation at fault?

# The context

- In 2006, an 'RBI Amendment Act' established the enforceability of OTC derivatives.
- But a system of capital controls remains, enforced through a law called FEMA.
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- This resulted in a big legal conundrum.
- Was financial innovation at fault?  
No, it was poor legal and regulatory drafting work, along with the capital controls.

# Policy directions to develop the financial sector

- 1 A committee focused on international finance chaired by Percy Mistry (2007).
  - 2 A committee focused on domestic finance chaired by Raghuram Rajan (2008).
- Main recommendations of both committees: tear down the license-permit raj.
  - Opposed by RBI and other opponents of change.

## In summary

- India operates a byzantine system of controls on finance
- Recently, the RBI has staunchly claimed that financial innovation must be held back.
- Breaking down this system of controls is not particularly 'innovative'. It's just delicensing, decontrolling.
- There is absolutely no difficulty with decontrol in India.

## In summary

- India operates a byzantine system of controls on finance
- Recently, the RBI has staunchly claimed that financial innovation must be held back.
- Breaking down this system of controls is not particularly 'innovative'. It's just delicensing, decontrolling.
- There is absolutely no difficulty with decontrol in India.
- Once the sector has been freed from the license-permit regime, we can start a sensible debate on true "financial innovation" in India.

Thank you.