

Y V Reddy: Legal Aspects of International Financial Standards - National Law Perspective

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The references for the speech can be found on the Reserve Bank of India's website.

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Professor Giovanoli and friends,

I am thankful to the Bank for International Settlements for giving me opportunity to make this presentation on the national law perspective, though a large number of presentations in the Seminar relate to international law. The presentation is based on Indian approach and Indian experience and focus is on processes and current status of various legislative changes that evolve in the consideration of international standards and codes. Some generalisations are attempted on the link between domestic law and international law. The first section captures general observations in regard to international financial standards and codes with particular reference to Indian approach. The second section attempts some generalisations on the domestic legal framework in this regard. The third section describes the processes of consideration in India while the fourth narrates the changes in legal and policy framework that are addressed in the processes. The daunting agenda for legal reform arising out of the process is covered in the fifth section. The penultimate section deals with the current legislative processes and responsibilities for implementation. The final section attempts some generalisations on national law perspective and international law.

Indian Approach to International Financial Standards and Codes

The development of international standards and codes in the current context has five important features, viz., it is part of the reform of the international financial architecture; it represents a consolidated view of several interrelated standards and codes; it is a collaborative effort involving different groups of countries, markets and international financial institutions and standard setting agencies and bodies; it has elements of both external and internal assessments of degree of compliance; and, finally there is an assumption of linkage between the implementation of standards and codes and financial stability.

There are several reasons for the widespread interest in international financial standards and codes. Among them, the most notable are the increasing cross-border flows; improvements in technology making such capital flows faster thereby enhancing both efficiency and hard behaviour; large private corporate entities operating significant resources, particularly, highly leveraged institutions impacting on both efficiency and stability, and the large institutional funds such as pension funds and mutual funds replacing to some extent the severely supervised banks' dominance in the financial intermediation in a relatively closed economy. In such a situation, public policy has every reason to minimise systemic risks by encouraging, to the extent desirable, transparency of operations and uniformity in definitions to minimise risks of misunderstandings among the participants.

The extent of relevance of international financial standards and codes, the task of implementation and the legal as well as other processes by which these standards are implemented would necessarily depend on the country concerned. For example, in India, the major challenge in designing and implementing the standards has been to chart a course of financial sector related reform in the domestic arena, which ties up closely with the overall economic reform. At the same time, the need for gradual harmonising with international standards has to be kept in view. Further, in taking a global view and charting domestic reforms, there is need for built-in flexibility. The implementation of international standards involves a virtual paradigm shift say, from a strong centralised planning system (where the objectives are pre-determined and Fabian socialism dominated along with suspicion of markets) to a system where contracts, prices and well defined inter-institutional relationships work.

The legal framework built on the socialist principles is being reformed and standards and codes become a part of such changes.

While there is a strong case for considering international best practices, to the extent they exist and are perceivable, there are several reasons to be circumspect about the role of standards and codes as primary instruments of enhancing international financial stability. The recent efforts have focussed on measures mainly designed to discipline debtor countries. While it is conceded that all the reforms that are being prescribed have their merits, there is an overriding presumption in the prescriptions that the causes of the crisis rests primarily with policy and institutional weaknesses in the debtor countries and hence place the onus of responsibility of reform on the debtors. The obligations contained in the standards and codes seem to reflect the view that the main flaws in the system for international capital movements are to be found in recipient countries which should thus bear the burden of adjustment needed to prevent or contain financial crisis. The UNCTAD Report (2001) states: "the reform process rather than focussing on international action to address systemic instability and risks has placed emphasis on what should be done by national institutions and mechanisms. Even in this regard, it has failed to adopt an even-handed approach between debtors and creditors. Thus, it seems as if standards and codes are being pressed upon developing countries to improve transparency and disclosure without corresponding obligations for disclosure by financial institutions and hedge funds".

The link between implementation of standards and codes and financial stability by itself is neither theoretically established nor backed by sufficient empirical evidence though on the basis of first principles and judgement, the linkage between the two elements is apparent. Despite the apparent emphasis on their voluntary adoption, there is a danger that incentives and sanctions linked to standard setting will become features of IMF surveillance and conditionality. In such a scenario, publication of information on the compliance status, particularly the information presented in the ROSC reports, is fraught with the danger of classifying the countries into performers and non-performers. Even when the international agencies associated with the work on standards and codes may not intend so, once the information is disseminated, it is possible that credit rating agencies may assign country ratings on the basis of the levels of achievement of standards.

Briefly stated, the recent international initiatives in regard to standards and codes provide at best a partial solution to the problems of existing international financial architecture. Furthermore, in the context of a crisis, they provide solutions at domestic level for issues that may often originate outside the country. Finally, they do not assure international financial stability although they may contribute to it. Yet, there are several reasons why public policy and national authorities need to focus on the international standards and codes and these reasons centre around both efficiency and stability of financial sector in the country. In this context, a desirable approach to the consideration of international standards and codes can be explored in national interest.

Although the standards have evolved in the context of international stability, they have enormous efficiency-enhancing value by themselves. Standards by themselves may be presumed to be, *prima facie*, desirable, and it is, therefore, in the national interest to develop institutional mechanisms for consideration of international standards. Thus, the implementation of standards needs to be given a domestic focus with the objectives of market development and enhancing market efficiency. Often, there are significant differences among the standards adopted, as in the case of accounting, and in any case, mere existence of a set of codes does not guarantee either transparency or integrity of the institutions concerned and transactions - a matter amply illustrated by the recent events involving Enron and Arthur Anderson. Many standards keep evolving and it is important to keep a close track of development in these areas. It also needs to be recognised that the process is evolutionary and say two years down the line, present standards themselves can change, in degree and detail though not in kind.

Role of Domestic Legal Framework

It may be possible to classify the standards in a conceptual framework under three broad elements, viz., technical, policy and socio-cultural. Standards like SDDS, accounting and auditing, and supervision may be classified as purely technical and, therefore, easily amenable to implementation. Standards on monetary and financial policies, fiscal transparency and securities regulation have certain policy implications and would form an integral part of the economic reform process in many developing countries. The changes in these areas depend on timing, sequencing and complementarity in related areas and availability of institutional, technological and legal infrastructure. Nevertheless, while it is desirable to adopt these standards as soon as possible, it actually boils down to an issue of

managing policy reforms in a non-disruptive fashion. Finally, standards in the areas of corporate governance, insurance and to a certain extent, insolvency and bankruptcy practices take a socio-cultural dimension and pose challenges of design, adoption and implementation.

It would thus follow that the scope and need for reviewing legal framework will vary depending on whether it is technical, policy-oriented or socio-cultural. In technical issues, legal framework should not be prohibiting appropriate standards, while policy should enable, and procedures ensure their adaptation. The policy-oriented standards have significant link with conduct of policy and legal framework may either enable or even assure policies that are consistent with international standard. Those with predominant socio-cultural dimension would need significant legal backing, policy and procedural elements. In other words, legal framework is of significance in varying degrees among different standards and codes.

It is also possible to attempt a construct of the link between transparency and macroeconomic policy. Good macroeconomic policy and good standards is perhaps an ideal situation for a country. Good macroeconomic policy and poor transparency though not ideal is perhaps not risky by itself. Bad macroeconomic policy and good transparency has large elements of risk and warrants change in policy before launching into transparency. The most risky combination perhaps is bad macroeconomic policy and bad standards. In a more dynamic sense, it can be argued that transparency provides incentives to adopt good macroeconomic policies.

In this background, it is necessary to make it clear that a legal framework can address the issue of transparency, and for that matter codes, in a variety of ways. First, it may be possible to ensure adoption of such standards and codes within the existing legal framework. The issue would be whether such compliance be made mandatory by law or the disclosure of the extent and nature of compliance be mandated by law. Second, legal framework may have to be put in place to enable compliance as and when considered appropriate. Third, legal framework could mandate compliance but from a date to be specified. In fact, role of delegated legislation in the legal framework needs to be explored in the context of standards and codes that keep evolving and need adoption. Fourth, legal framework could provide for institutional arrangements that would assure a continuous basis for compliance. Finally, legal framework may enable or mandate independent regulatory bodies that happen to be relevant for the purpose to ensure compliance.

While transparency and financial stability appear fundamentally complementary, there could be a trade-off at some point. Therefore, codes should be treated as milestones and the exact manner and timing of dissemination of information including the structure of reporting should depend not only on constitutional, legal and institutional mechanisms but also the likely impact of dissemination on the financial sector soundness and stability in a given context.

Many codes emphasise legislative provisions in a concrete manner and legislation provides the shield or back up for such actions. The emphasis should be to promote a general effort to improve legislative provisions and it is necessary to recognise that the process of legislation is time consuming and complex. While it is essential to recognise the importance of legislation, given its complexity, it is essential to appreciate that sound practices also could be as satisfactory. For example, in India, several regulatory prescriptions in respect of banks' investment in Commercial Paper brought about changes in the money market though legal framework did not provide for mandating such prescriptions on all the participants. Broadly speaking, the legal framework is one element of set of actions that should be considered in regard to public policy on the issues of adoption of transparency and codes. The others relate to actual conduct of policy and detailed procedures. In fact, apart from critical roles for different regulations, there is a significant role for self-regulatory bodies in matters relating to documentation, common procedures and promoting market discipline in favour of best practices. In brief, the need for, scope of, and limits to the legal framework should be explicitly and continuously appreciated.

The emphasis on the implementation of standards and codes and accountability thereof is still heavily concentrated in the official sector. An optimal balance between regulation and competitive efficiency in the financial system and markets can be achieved only with equal emphasis on responsibility and accountability of the private sector. The focus of IMF is also with regard to codes mostly in respect of regulators and not so much with private sector. International accounting standards and standards set by securities market associations are, no doubt, expected to cover issues relating to private sector market participants. Every effort should be made to recognise and correct the asymmetry in considering legal framework.

Processes

Inspired by own reflection on the subject and the likely gains from implementation of international financial standards, the Reserve Bank, in consultation with the Government, constituted a high level Standing Committee on International Financial Standards and Codes in December 1999. The terms of reference of the Committee entrusted it with the task of monitoring developments in global standards and codes and assessing aspects of their applicability to the Indian financial system. The Committee was, *inter alia*, required to reach out its Reports to a wide range of audience including relevant public and financial sector organisations and institutions to sensitise public opinion and create awareness in different subject areas. The approach of the Committee, therefore, was unique as it recognised public consensus and concord as essential precursors to facilitate a voluntary adoption rather than merely mechanical compliance.

The Standing Committee formed Advisory Groups in ten different subject areas in the financial system by drawing intellectual resources in the form of groupings of eminent non-official experts. The Advisory Groups were entrusted with the task of studying, in detail, (a) the present status of applicability, relevance and compliance of standards and codes, (b) reviewing the feasibility of compliance and the time-frame over which it could be achieved, given the prevailing legal and institutional practices, comparing levels of adherence in India, vis-à-vis in industrial countries and emerging economies, and (c) to chalk out a course of action for achieving the best practices.

The ten different core subjects areas identified by the Standing Committee corresponds to the official list of codes suggested by the Financial Stability Forum (FSF) for implementation. These were : Transparency in Monetary and Financial Policies, Data Dissemination, Payments and Settlement Systems, Banking Supervision, Securities Market Regulation, Accounting and Auditing, Fiscal Transparency, Insurance Regulation, Bankruptcy Laws and Corporate Governance. At this juncture, the Committee, however, did not consider the set of codes on market integrity as fortified in the 40 recommendations of the Financial Action Task Force (FATF), though a technical report commissioned on the subject has been finalised presently.

All Advisory Groups of experts had the option of interacting amongst themselves on matters of overlapping or common concerns to evolve a consensus approach. The Advisory Groups also had the option to include officials from regulatory and Government organisations as special invitees to discuss and understand the prevailing position in the relevant standards and codes, for bringing improvements in the existing practices. They also had the benefit of deliberations with market participants, members from professional bodies as well academics. The arrangement afforded the Advisory Groups an independent or impartial status and prompted a critical evaluation of the relevance and compliance with each of the aforesaid standards and codes. The work of the Advisory Groups in some cases happened to continue alongside similar subjects addressed by groups constituted by the Government or other regulatory bodies. In any case, the work of the Advisory Groups was considered unprejudiced and non-intrusive to any such official or non-official initiatives taken by others. The Advisory Groups were requested to take cognisance of these parallel efforts and to provide inputs, wherever necessary. All ten Advisory Groups have already submitted their reports to the Standing Committee. The Standing Committee has made efforts to disseminate these Reports as widely as possible including their expeditious posting to the Reserve Bank website. The Committee has also requested the Advisory Groups to organise seminars for creating awareness and concretising views on recommendations. The Committee would also take up regular annual review of the status and progress regarding compliance with, and implementation of standards and codes and submit it to the Ministry of Finance.

Changes in Legal and Policy Framework

The implementation of the recommendations of Advisory Groups in relevant sectors would require a co-ordinated approach based on elements of consensus, incentives, technical support, resources and encouragement to concerned institutions and regulatory bodies. Broadly speaking, the recommendations of Advisory Groups can be categorised into three levels, viz., requiring (a) constitutional, (b) legislative and (c) procedural and policy changes. Quite a number of recommendations require new legislative enactments or amendments to existing laws, while several others could be implemented by making appropriate changes in the existing policy and procedures under the powers vested to relevant bodies under the law. A few recommendations could also require changes in the Constitution of India. Some of the issues pertaining to the financial system are also being addressed by the National Commission to Review the Constitution. Of these changes, amendments to the legal framework of the country assume utmost importance as they institutionalise

changes as formal laws with parliamentary endorsement and, therefore, provide clear-cut mechanisms for enforcement.

There are several overlaps in the recommendations of Advisory Groups with concomitant relevance for legislative changes keeping in view such overlaps. Some of the notable overlaps are between (a) Monetary and Financial Policies and Fiscal transparency; (b) Corporate Governance and Banking Supervision; (c) Payment and Settlement System and Securities Market Regulation; (d) Accounting and Auditing and Banking Supervision. The issues of regulatory overlap were highlighted by several Advisory Groups which has a bearing on the policy and procedures though not on legal framework as such.

Daunting Agenda for Legal Reform

The Reports of Advisory Groups have identified several areas requiring legislative actions to ensure enhancement in standards and codes relating to financial sector. The agenda arising out of the reports is daunting as will be clear from the description below.

First, the improvements suggested by the Advisory Group on Payment and Settlement System would necessitate amendments to Reserve Bank of India Act and Banking Regulation Act. While a new enactment viz. The Payment Systems Regulation Act may also be needed, the implementation of the rest of the recommendations would require notification of Regulations under all the above enactments as well as in the Information Technology Act and the Indian Contract Act.

Second, on matters covered by the Advisory Group on Banking Supervision, amendments and appropriate notifications under Reserve Bank of India Act and Banking Regulation Act would suffice.

Third, in respect of Securities Market Regulation, amendments are needed in respect of Securities Exchange Board of India Act; Unit Trust of India Act, and The Companies Act. It may also be desirable to consider a new enactment to deal with financial frauds. Several policy and procedural changes would, no doubt, be needed by the Securities Regulator. The self-regulatory bodies are also required to enunciate Code of Conduct and best practices in securities transactions.

Fourth, in respect of the Report of Advisory Group on Transparency in Monetary and Financial Policies, a possible amendment to Constitution of India was expressed in the context of an ongoing review by a National Commission. More important, several amendments to Reserve Bank of India Act and Banking Regulation Act supplemented by policy and procedural changes on the part of RBI and Government of India would be essential.

Fifth, the Report of Advisory Group on Corporate Governance covers a wide spectrum of institutions and practices warranting actions in three broad areas. Amendments in Companies Act accompanied by stipulations in regard to listing agreements of Stock Exchanges by securities regulators would address the set of issues governing private shareholders in corporates in general. Amendments in Banking Regulation Act and other statutorily established but Government-owned financial intermediaries, especially public sector banks would be needed to bring entities in financial sector under the overall best practices for corporate governance, especially in financial sector. In regard to several other government owned enterprises also, there may be need for amendments in Memorandum and Articles of Association, and in some cases the special laws that may govern their establishment and functioning. In any case, substantial changes would also be needed in the management practices and relationship between Government and the entities concerned where both Government and private shareholders co-exist.

Sixth, the Advisory Group on Fiscal Transparency took account of the ongoing efforts to enact a Fiscal Responsibility and Budget Management Bill, and expressed that such an enactment would fulfil most of the requirements of transparency, when supplemented by appropriate rules and regulations, under the proposed legislation. There is also a reference to proposed amendments to Reserve Bank of India Act and Banking Regulations Act, which would, *inter alia*, address the issue of quasi-fiscal deficits.

Seventh, in regard to insurance, the Advisory Group found the legal framework to be upto international standards though a couple of amendments are suggested. However, several of the recommendations relate to the issuance of regulations by the Insurance Regulatory Authority.

Eighth, on issues relating to auditing, amendments are needed in respect of Companies Act, Income-tax Act and Chartered Accountants Act.

Ninth, the compliance with the Report on Data Dissemination needs no legislative change.

Finally, in regard to Bankruptcy Law, a new legislation on a comprehensive bankruptcy code is advocated. In addition, repeal of Sick Industries Companies Act, substitution of the institution of official liquidator with professional trustees, creation of dedicated bench of High Court etc. have been recommended. A special chapter on cross-border insolvency in line with the UNCITRAL model law has also been suggested. Similarly, in respect of market integrity, a new legislation relating to terrorism is under consideration while legislation to prevent money laundering is at an advanced stage of consideration. Procedural actions by Reserve Bank of India in regard to strengthening of Know-Your-Customer are also contemplated. Amendments to Banking Regulation Act are also expected to enhance the powers available to Reserve Bank in this regard.

Current Legislative Process and Responsibilities

It must be recognised that the legislative process is complex, particularly in a democratic polity. Many of the proposals are at different stages of processing. Thus, while Fiscal Responsibility and Budget Management Bill and Prevention of Money Laundering Bill have been returned to Government with opinion of Parliamentary Standing Committee, the Prevention of Terrorism Ordinance is likely to be re-promulgated in a modified form. Proposals for amendment of Reserve Bank of India Act; Banking Regulations Act are already at final stages of consideration in Government. Matters relating to amendments to Indian Contract Act are still in the drafting stage. Some of the amendments to Companies Act are being processed in the Government, though some of them are not strictly in consonance with the recommendations of the Advisory Groups on Bankruptcy and Corporate Governance. Independent of this process, the Government had also created a Committee on law relating to insolvency and winding up of Companies, and based on the Committee's recommendations, the Government has introduced amendments to the Companies Act. On others, particularly in regard to Income Tax Act, action has not been initiated. On several aspects such as separation of debt management from monetary policy, policy decisions have been taken but the legislative process is yet to be commenced. There are several recommendations relating to transparency of monetary policy and publicly owned entities where consensus is yet to emerge.

It is interesting to note that the Reports on the Observance of Standards and Codes (ROSC) BY IMF, World Bank etc. draw heavily from the work of the Advisory Groups. These include fiscal transparency, monetary and financial policy transparency, banking supervision, securities market regulation, payments system and corporate governance.

On the whole, much of the responsibility of implementing the standards and codes falls on authorities charged with the responsibility of regulating various areas of the financial system such as the Department of Company Affairs (DCA) of the Ministry of Finance, Reserve Bank, Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA). A large number of recommendations could be implemented by self regulatory organisations specific to market segments such as the Indian Banks' Association (IBA), Fixed Income Money Market and Derivatives Association of India (FIMMDA), Association of Merchant Bankers (AMBI), Association of Mutual Funds of India (AMFI), Foreign Exchange Dealers' Association of India (FEDAI), Primary Dealers' Association of India (PDAI), and stock exchanges among others.

National Law Perspective and International Law on Standards and Codes

The contribution of Professor Mario Giovanoli is pioneering and unique to the legal aspects of international financial standard setting. As mentioned by him, the standards currently monitored by Financial Stability Forum, by and large, belong to the category of rules which it has become customary to designate as "soft law". In this context, the three criteria suggested for positioning the standards in the gradation between "soft law" and "hard law" are very valid. These relate to degrees of obligation, precision and delegation.

On a very judgmental basis, most of the current processes relating to international financial standards (described in this paper in the Indian context) appear to be at the soft law end of the spectrum. The recent suggestion floated by Ms Ann Krueger, First Deputy Managing Director of IMF, on new approach to Sovereign Debt restructuring, however, appears to be closest to the 'hard law' end of the spectrum. After describing the four key features of the proposed formal sovereign debt restructuring mechanism, the question of legal basis for such a mechanism is raised and answered in the following words. "If we are to restrict the ability of creditors to enforce their claims in national courts, then the mechanism must have the force of law in those countries where enforcement might be sought. It

would not be enough to pass laws in a few leading countries. In practice, the mechanism must have the force of law universally. Otherwise, creditors will deliberately seek out the jurisdictions in which they have the best chance of enforcing their claims". While it is not appropriate to comment on this proposal which is still evolving, it is proposed to make some very general statements on the issue of national law in the overall setting of international law, based on the current approach and experience of India in regard to standards considered by Financial Stability Forum.

The approaches and processes in India clearly bring out the challenges being faced even in regard to the domestic legislative processes in India at this stage of national development and global integration. Further, there is clearly a significant 'soft law' element within the national legal framework for financial architecture, and much of the legal framework, if not the whole of it, is enabling rather than binding, thus circumscribing the scope for moving towards hard law in the foreseeable future. Moreover, the regulatory bodies have significant role in the implementation of many standards, thus imparting some discretion or considerable flexibility in regard to application of general principles. In particular, the inevitable role of self-regulatory bodies in regard to many of the standards makes it difficult to impact large elements of hardness to their soft law nature.

However, there are several ways in which greater harmonisation could be encouraged. For example, model legislations like the one by Commonwealth Secretariat on money laundering will help both expeditious processing and relative clarity of concepts as well as definitions. This approach is of particular significance due to the predominant cross-border nature of money laundering operations.

Similarly, there can be a special chapter in bankruptcy law only in so far as cross-border insolvency issues are involved. Such an approach could be considered, keeping in view the UNCITRAL model law. For example, the Report of the Advisory Group on Bankruptcy Laws enunciates the scope of the special Chapter on cross-border insolvency. The Chapter applies where assistance is sought in India by a foreign court or a foreign representative in connection with foreign proceedings; or assistance is sought in a foreign State in connection with proceedings under the laws of India relating to insolvency; or foreign proceedings and proceedings under the laws of India relating to insolvency in respect of the same debtor are taking place concurrently; or creditors or other interested persons in a foreign State have an interest in requesting the commencement of, or participating in, proceedings under the laws of India relating to insolvency.

Finally, the recent experience of Enron and Arthur Andersen gives a new dimension to the institutional dynamics in financial structures and transactions revolving around 'conflicts of interests' among the participants and political or diplomatic forces operating at transnational level on matters which should strictly be commercial.

Conclusion

To conclude, the complexities relating to the global financial system in the context of strong national interests continuing to dominate public policy viewed in the light of Indian experience warrant, more than a legal basis, emphasis on three aspects, namely (i) the standards may be set domestically with a recognition that they have some international dimension also; (ii) the processes of setting, prioritising, incentivising, monitoring and reorienting should be consultative and participative in both domestic and international dimensions; and (iii) effective implementation is a complex and varied process with domestic legal framework being one enabling factor at this juncture.