Report of the High Powered Expert Committee on

Making Mumbai an International Financial Centre

Report of the High Powered Expert Committee on

Making Mumbai an International Financial Centre

Ministry of Finance
Government of India
New Delhi
2007

Report of the High Powered Expert Committee on
Making Mumbai an International Financial Centre
Ministry of Finance, Government of India, New Delhi

Published by Sage India, B-1/I-1, Mohan Cooperative Industrial Area, Mathura Road, New Delhi 110044, India.

Printed in India by

Typeset using PDFTeX and GNU/Linux operating system by River Valley Technologies, Trivandrum, India, http://www.river-valley.com. The main text font used is Minion and Frutiger for floats and headings.

The TeX packages used for typesetting this book have been released under General Public Licence for free usage, modification and redistribution and are available at http://sarovar.org/projects/goi-book.

The High Powered Expert Committee (HPEC) on

Making Mumbai an International Financial Centre

The Hon. P. Chidambaram
Minister of Finance, Ministry of Finance
Government of India, North Block
New Delhi 110001

10th February 2007

Dear Honourable Minister:

We submit herewith the HPEC's Report on *Making Mumbai an International Financial Centre*. Our choice of the term 'International' instead of 'Regional' has been explained in our report.

Yours sincerely,

M. Balachandran

C. B. Bhave

K. V. Kamath

K. P. Krishnan (Convenor)

Ravi Narain

P. J. Nayak

N. Mohan Raj

O. P. Bhatt

Bharat Doshi

Nimesh Kampani

Subodh Kumar

Ms. Usha Narayanan

Aditya Puri

T. T. Srinivasaraghavan

Acknowledgements

HPEC would like to place on record its grateful thanks to Ajay Shah, Kshama Fernandes, Saugata Bhattacharya, Ritu Anand, and S. Ravindranath who constituted the Research Team that supported the Committee.

The HPEC also wishes to express its appreciation to Mr. M. Balachandran who put the facilities of the Bank of India at the disposal of the Committee. The HPEC and the Government of India would like to acknowledge their appreciation to the Bank of India for meeting the administrative expenditure for the production of this report.

Contents

Executive Summary

1. International Financial Services (IFS) and Centres (IFCs) in Perspective

Historically, finance has always been 'international' in character; capital has rarely been immobile. Money has moved freely across borders for all of civilisation with gold and silver (in various weights and measures) being global currencies for millennia. But, the freedom of capital was dramatically curtailed during the 'Bretton Woods' regime, created in 1945, when capital controls were imposed on war-ravaged, capital-starved economies. With post-war recovery, that regime broke down in 1971. World finance has since been reverting to its natural state with the removal of capital controls and the gradual re-integration of national capital and banking markets; but this time on a *global* scale.

OECD countries opened their capital accounts between 1974 and 1990. A number of emerging markets did so in the 1990s – often at the IMF's urging. In 1996, the IMF contemplated making an open capital account a condition of membership. But the idea was shelved when the Asian financial crisis erupted in 1997. That was precisely when India first contemplated re-opening its capital account. A series of similar mini-crises occurred elsewhere in 1998 engulfing Russia and Latin America. By 2002 all these crises were contained. Capital account opening resumed but with reduced momentum as the IMF and others began to reconsider its benefits and costs. The question of capital account convertibility now weighs heavily on China and India, where financial systems with structural weaknesses, legacy constraints and varying degrees of State domination now confront the irresistible forces of globalisation.

Even with an open capital account, some financial services (e.g. deposit banking) remain local and non-tradable. But most financial services are now tradable across borders: i.e. they are ***international financial services*** (IFS). A cross-border market for IFS has existed over millennia. But it has been transformed in the 19th and 20th centuries and grown quite differently and more dramatically since 1980. It has also become extremely competitive, with buyers and sellers around the world now having a choice of procuring IFS from competing ***international financial centres*** (IFCs).

A concrete example of procuring IFS from an IFC would be the raising of debt. If Mumbai became an IFC, a South African railway project could issue a bond there in the primary market. It would wish to do so because of Mumbai's sophisticated securities markets, along with a number of asset managers in Mumbai running global portfolios. If the INR bond market was developed, the South African bond issue could be INR denominated. Global investors would buy these bonds and trade them on the secondary market in Mumbai. Each of these three steps – primary market bond issuance by the South African entity, primary bond purchases by global and Indian investors, and secondary bond market trading by global players – would generate revenues from the export of financial services from Mumbai. Creating an IFC in India requires that Mumbai must be viewed as competitive in the eyes of the South African railway and in the eyes of global bond investors, when compared with alternatives like Singapore or London.

The global IFS market in the 21st century is one in which competition is driven by rapid innovation in financial products, services, instruments, structures, and arrangements to accommodate and manage myriad requirements, risks, and a ceaseless quest for cost reduction. Competitive advantage in IFS provision depends on seven key factors:

1. An extensive national, regional, global network of corporate and government (supranational, sovereign, sub-sovereign

and local) client connections possessed by financial firms participating in an international financial centre (IFC).

2. High level human capital specialised in finance, particularly quantitative finance, supported by a numerate labour force providing lower level paraprofessional accounting, book-keeping, compliance and other skills.
3. World-class telecommunications infrastructure with connectivity around the clock, and around the world.
4. State-of-the-art IT systems, capability to help develop, maintain and manage the highly sophisticated and expensive IT infrastructure of global financial firms, trading platforms and regulators; systems that are evolving continuously to help firms retain their competitive edge.
5. A well-developed, sophisticated, ***open*** financial system characterised by: (i) a complete array of proficient, liquid markets in all segments, i.e. equities, bonds, commodities, currencies and derivatives; (ii) extensive participation by financial firms from around the world, (iii) full integration of market segments, i.e. an absence of artificially compartmentalised, isolated financial markets that are barred from having operational linkages with one another; and (iv) absence of protectionist barriers and discriminatory policies favouring domestic over foreign financial firms in providing financial services.
6. A system of financial regime governance (i.e. embracing legislation, policies, rules, regulations, regulatory agencies etc.) that is amenable to operating on global 'best-practice' lines and standards; and finally
7. A 'hinterland advantage' in terms of either a national or regional economy (preferably both) whose growth is generating rapid growth in demand for IFS.

Advances in information and communications technologies (ICT) have eased interactions over a distance and reduced their cost dramatically. However, activities involving complex judgment and intellectualisation continue to be clustered at a few physical locations, where key individuals meet face-to-face. This is characteristic of R&D in computer technology – clustered in Silicon Valley and the Cambridge Corridor – despite extensive use of email, voice telephony and video conferencing. India has achieved a minor miracle with the explosion of export revenues from IT services; yet, these revenues are a fraction of Silicon Valley's. Similarly, routine production of financial services takes place everywhere. But, the most important and high value decision-making functions are concentrated in a handful of IFCs that have effectively (and consequently) become *global cities*[1]

At present, London, New York and Singapore are the only ***global*** *financial centres* (GFCs). Many emerging IFCs around the world are aspiring to play a global role in the years to come: e.g. Shanghai and Dubai. Other IFCs in Europe and Asia, like Paris, Frankfurt or Tokyo, connect their financial systems to the world. But they have lost market share and importance in competing for *global* IFS for reasons explained in the report. The world market for IFS is represented mainly by the EU, US and Asia which together account for over 80% of global GDP. Correspondingly the global IFS market is concentrated in the three GFCs located in each of these regions.

2. Implications for India and Mumbai

Given that an IFC in Mumbai must be rooted in (and serve) India's financial system, rather than be an artificial offshore appendix, the call for creating an IFC in Mumbai at this time is implicitly a metaphor for (and synonymous with) deregulating, liberalizing and globalising, all parts of the Indian financial system at a much faster rate than is presently the case. Raising the issue of an IFC in Mumbai now suggests that the pressing need for a new, more intensive phase of deregulation and liberalization of the financial system has been anticipated by India's policy-makers and regulators

[1]To understand what such a city is see Sassen (2001).

and that the IFC is a device to accelerate movement in that direction. An IFC will not be created quickly in Mumbai, nor will it succeed, if action on further deregulation and liberalisation is not taken in real time.

In sustaining its trajectory as an emerging, globally significant, continental economy, the HPEC believes that India has no choice but to: (a) become a producer and exporter of IFS; and (b) capture an increasing share of the rapidly growing global IFS market. To achieve these two goals, its financial centre in Mumbai **must** compete to become a successful IFC. Incremental growth in the global IFS market is now being driven by the growing demands of China, India and ASEAN. With its strengths in human capital, a globally powerful IT services industry, and its own hinterland, India has many natural advantages for competing successfully in this market. In evolving as an IFC, Mumbai will probably grow in two distinct phases:

1. In the *first* phase (2007–2012) Mumbai must connect India's financial system with the world's financial markets through IFS. That is what IFCs like Frankfurt, Paris, Sydney, Tokyo and a host of smaller IFCs do now in respect of their national economies.
2. In its *second* phase (2012–2020) Mumbai must develop the capacity to compete with the three established GFCs for *global* IFS business that goes beyond meeting India's needs. After 2020, HPEC would hope that Mumbai would hold its own in competing with the other GFCs and acquire increasing global market share.

India's financial services industry will not become export-orientated, nor derive significant IFS export-revenues, if Mumbai fails to become an IFC. That will compromise not just export earnings from IFS, but the quality, efficiency and range of domestic financial services offered in India as well. For Mumbai to become an IFC, India's policy-makers and financial operators need to understand fully the nature of and opportunities in: the global IFS market; the activities undertaken in GFCs; and the gap in capabilities that now exists between Mumbai and established GFCs.

3. The difference between BPO and IFS

The production of financial services worldwide is now fragmented into a series of interrelated sub-processes undertaken separately. Business process outsourcing (BPO) of individual processes occurs at a considerable distance from the point of customer contact where their eventual resynthesis occurs. India is now a highly successful BPO venue for the global financial services industry. In the last five years, it has gone beyond simple BPO towards complex *knowledge process outsourcing* or KPO. This is a positive development for India to realise its ambitions of creating an IFC in Mumbai. Finance-related BPO/KPO builds up skills in India and increases the 'mind-share' of India amongst global finance professionals.

However, there is a substantial difference between BPO/KPO and providing IFS via an IFC. Financial processes that get outsourced under BPO involve low-value, low-skill tasks. They are codified in a manual that indicates how tasks are to be performed, controls quality/integrity, and measures whether they are being done correctly. Once the protocols are in place, the task is performed repetitively. But some outsourced activities in finance, involving research and analysis, are moving up the KPO value chain. For example, company financial analysis, credit research, and stock market research functions are now also being outsourced.

Still, the real value in financial services provision remains concentrated in a small number of jobs performed by qualified, super-numerate, imaginative people with the specialised expertise, experience, domain knowledge and skill-sets to be innovative in designing financial instruments and structures. Such people have extensive cross-border networks of clients and colleagues. Their work involves fine judgment in making decisions covering a vast array of circumstances. It cannot be scripted in a manual codifying its mechanics. Such judgments rely on intensive interaction, inter-personal information flows, and complex negotiations among a number of highly qualified professionals including financial experts, specialised corporate lawyers, accountants, tax experts, etc. Such interaction takes place at an IFC.

From an Indian perspective, further progress with expanding the BPO/KPO chain in financial services (horizontally and vertically) is inevitable and positive. But that should not be confused with what is required to provide the full array of IFS via an IFC. Intuitively, moving up from BPO/KPO to a fully fledged IFC is analogous to moving up from low-end programming to replicating Silicon Valley. Incremental progress in the Indian IT industry will not bring Silicon Valley to India; that requires a quantum leap. Similarly, doing more BPO/KPO for the global financial services industry will not, as a matter of course, result in India automatically graduating to providing IFS through natural evolution. BPO/KPO will be done by specialised sub-contractors with different skill sets and competencies. IFS can only be provided by qualified and internationally known ***financial*** firms; which is what Indian financial firms must quickly strive to become. India's growth in BPO/KPO is about doing more through IT services firms (like Infosys, Satyam, Wipro or TCS). India's growth in IFS is about exporting IFS through established and new financial intermediaries.

4. What are International Financial Centres (IFCs) and Services (IFS)?

Financial centres that cater to customers outside their own jurisdiction are referred to as *international* (IFCs) or *regional* (RFCs) or *offshore* (OFCs). These three different adjectives are often (but wrongly) used synonymously in the literature. Yet these three types of IFCs are difficult to define in a clear-cut, mutually exclusive fashion; although they are quite distinct. All these centres are '*international*' in the sense that they deal with the flow of finance and financial products/services across borders. But that description does not differentiate them sufficiently in terms of their scope.

We categorise IFCs in this report in four ways; i.e. as:

Global (GFCs) These are centres that genuinely serve clients from all over the world in the provision of the widest possible array of IFS;

Regional (RFCs) They serve their regional rather than their national economies (see below) – examples of such RFCs would be Dubai or Hong Kong[2];

Non-global and non-regional, ordinary international IFCs These are centres like Paris, Frankfurt, Tokyo and Sydney that provide a wide range of IFS but cater mainly to the needs of their national economies rather than their regions or the world – one might be tempted to call them *national* IFCs although that term is an awkward one because its two defining adjectives are contradictory; and

Offshore (OFCs) These are centres that are primarily tax havens for wealth management and global tax management rather than providing the fully array of IFS.

The IFS products and services that IFCs provide include the following eleven activities. GFCs provide all of them. Other IFCs provide some combination of them.

a. **Fund Raising:** for individuals, corporations and governments (sovereign and sub-sovereign). This includes debt and quasi-debt across maturity/currency

[2]Singapore and London are also regional in the sense that they serve Asean and the EU while New York serves North and Latin America. But because these three centres serve the global economy, well beyond meeting the IFS needs of their respective regions, we classify them as *global* rather than regional. In that sense, the HPEC sees limited potential for Mumbai to be a *regional* financial centre for South Asia given current geopolitical realities. South Asia is more likely to be served by Singapore and Dubai for the time being. We see Mumbai being an IFC that serves India in the first stage and leapfrogs to serving the global economy in its next stage of evolution. Ironically, Mumbai as an IFC is likely to serve its region *after* it serves the world, rather than before. For that reason, although the HPEC was asked to look into Mumbai becoming a *regional* financial centre we dispensed with that characterisation early on in the knowledge that it would be misleading. Throughout this report therefore we refer to Mumbai becoming an *international* rather than a *regional* FC.

spectra; equity and quasi-equity for private, public and public-private corporations; as well as risk-management appendices attached to primary fund-raising transactions to ensure that the risk exposure of the primary borrower or fund-raising entity (to currency, interest rate, credit, market, operational and political risks) does not exceed tolerable limits.

b. **Asset Management and Global Portfolio Diversification:** undertaken by a variety of national, regional and global asset managers including, *inter alia* pension funds, insurance companies, investment and mutual funds of various types characterised by nature of instrument (i.e. debt, equity or convertibles), geography, or sector of activity.

c. **Personal Wealth Management (PWM):** for high-net worth individuals (HNWIs). This activity is estimated to involve the management of personal assets of $8–10 trillion worldwide. Overseas Indians are estimated to hold *financial* wealth (i.e. apart from real estate, gold, art, etc.) of over $500 billion and total wealth of over $1 trillion. PWM takes place in established IFCs, but is more skewed towards specialised PWM-IFCs in the Channel Islands, Switzerland, Luxembourg, Monaco and Lichtenstein for the EU and Africa; Caribbean offshore centres for the US and Latin America; Bahrain and Dubai for the Middle East; Singapore, Hong Kong and some Pacific Island offshore centres for East/North Asia.

d. **Global Transfer Pricing:** This is an activity that GoI, like most governments, looks askance at, but needs to realise and accept the reality of, in a global economy dominated by transnational corporations. This will become increasingly important to Indian firms as they evolve into multinationals.

e. **Global Tax Management and Cross-border Tax Liability Optimisation:** which provides a business opportunity for financial intermediaries as well as accountants and law firms until national tax regimes begin to converge toward a global low tax norm. This activity will become increasingly important to Indian firms as they evolve into MNCs.

f. **Global/Regional Corporate Treasury Management Operations:** involves fund raising, liquidity investment and management, asset-liability and duration matching, and risk-management through insurance and traded derivative products for currency, interest-rate, credit and political risk exposure.

g. **Global/Regional Risk Management Operations and Insurance/Re-insurance:** which involves highly developed exchange traded and tailored derivatives (futures, options, swaps, swaptions, caps and collars) as well as world class derivatives exchanges that trade a variety of global contracts.

h. **Global/Regional Exchange Trading of Financial Securities, Commodities and Derivatives Contracts in Financial Instruments/Indices and in Commodities:** There is an increasing tendency toward multiple listings of financial securities (equities and debt), and of derivative and commodity contracts, on different exchanges with emerging investor demand for 24 x 7 x 365 trading of all listed securities across all exchanges. Demand is highest for the securities of index-corporations in each major capital market. It will gradually cascade downwards to cover global trading of all listed securities in all markets – developed and emerging. Mumbai is better placed than most IFCs to meet this demand, because of its human capital and IT capability, as well as its world-class exchanges and improving exchange regulation.

i. **Financial Engineering and Architecture for Large Complex Projects:** This primarily involves energy and infrastructure projects requiring funds from a variety of global sources (public and private) with attached risk-management. Again, Indian financial institutions and former FIs have well-honed skills in this particular arena.

j. **Global/Regional Mergers and Acquisitions Activity:** This will become increasingly important in India and for which a considerable amount of back-office

BPO/KPO and due diligence research work is already being outsourced to India.

k. **Financing for Global/Regional Public-Private Partnerships:** This relatively new activity has emerged on scene with considerable force since the development of the London Underground PPP. It has particular and immediate relevance for the financing and rapid development of Indian infrastructure without recourse to the treasury.

5. Growth and globalisation drive India's demand for IFS

Since 1991, India has grown rapidly and its economy has globalised. As India grows, it globalises faster. That happens through the increased share of trade and foreign investment in economic activity. Evidence of that lies in two-way cross-border flows. Such flows, on the current and capital accounts combined, rose from $105 billion in 1992 (<32% of GDP) to $658 billion in 2005 (>90% of GDP). The forces that resulted in this six-fold increase are intensifying and will further accelerate growth of cross-border flows. The next decade is likely to see cross-border flows growing as fast.

Current and capital account flows invariably necessitate purchases of IFS. For example, current account transactions involve payment services, credit enhancement, currency risk management, etc. Capital account flows involve purchase of investment banking, legal, accounting, risk management, research and other similar services. When FDI/FPI enters or exits India, fees are paid to various IFS providers (e.g. commercial and investment banks, securities brokerages, exchanges, insurance companies, asset managers, etc.). As India engages more with the world, the *stock* of assets held in India by foreigners rises. Similarly, the *stock* of foreign assets held by Indian households and firms also rises. Purchases of risk management services grow in proportion to these *stocks* which are far larger than the capital flows of any one year.

It is estimated that Indian households have accumulated considerable wealth outside the country; well beyond the present limits set by RBI. The ability of Indian households to move resources across the border has increased with India's increasing openness. The proliferation of Indian MNCs operating around the world – and transfer pricing with their subsidiaries abroad – has led to IFS demand for fund-raising, corporate treasury management and global tax management. With rapidly increasing annual flows, the stock of assets outside the country controlled by Indian households and firms is rising rapidly. These assets require IFS for wealth, asset and global tax management. All these phenomena imply inevitable increases in IFS purchases associated with the growing size of cross-border flows. Calculations in this report suggest that on average, the IFS revenue stream works out to 2% of the gross flows across the boundary.

This translates to about $13 billion of IFS purchases by Indian clients in 2005.

Looking ahead, India's engagement with the world will intensify in three ways: (a) reduction in barriers such as customs duties and capital controls; (b) improvements in infrastructure; and (c) greater participation by MNCs (Indian and foreign) in the Indian economy. These developments will induce deeper globalisation of the Indian economy in the coming decade, inducing an upsurge of IFS purchases.

Our estimates suggest that IFS purchases by Indian households and firms will rise to $48 billion by 2015 on the basis of conservative assumptions in a 'base-case' scenario. Under more propitious circumstances (e.g. if GDP growth is sustained at 9%) that figure could be over US$70 billion. By 2025 that amount could exceed US$120 billion in nominal terms.

These estimates warrant a different way of thinking about IFS exports and about an IFC in Mumbai. Traditional conceptualising by Indian exporters about market opportunities typically assumes tapping into a quasi-infinite world market.[3] Financial ser-

[3] This was the approach taken by the Indian software industry which now has domestic sales of a mere $500 million while its exports are a 30-fold multiple of roughly $15 billion a year. The search for growth on the part of firms like TCS, Infosys or Wipro has been primarily about finding international customers. The

vices are like software services in that they are labour, skill, IT/communications intensive. But, in terms of market opportunity, there is a fundamental difference between finance and software. It lies in India's hinterland advantage. Rapid growth, even more rapid integration with the rest of the world, and the high consequent growth rate of two-way cross-border financial flows now being seen, all serve to make India a large and growing customer for IFS. Unlike IT service exports, India provides a platform for nurturing IFS capabilities that can 'go global' instantly.

Against that growing demand for IFS, a failure to respond on the supply-side, (i.e. by creating a successful IFC in Mumbai) will simply oblige Indian customers to do increasing IFS business abroad. That will fuel the growth of Singapore, Dubai, London and other IFCs while depriving Mumbai of capturing opportunities for high value-added IFS exports. For example, the Tata Steel-Corus deal generated IFS revenues in Singapore and London. Some elements of such transactions do not appear in Indian BOP accounts. Financial firms and policy makers in the three GFCs and DIFC are highly attuned to the opportunities for selling IFS into India. They have embarked on strategies that exploit the current infirmities of the Indian financial system. The most capable Indian financial firms are likely to move to these centres in order to acquire the flexibility to provide their extant client base with the IFS they need, rather than risk losing their clients to global financial firms.

Rapidly growing demand for IFS in India provides an opportunity for its financial services industry that its software industry never had. Indian software exports were generated by ingenious Indian human capital exploiting foreign markets and requiring nothing from the State other than telecom reforms. Indian IT genius conquered world markets between 1996 and 2006 in a way that was not imagined in even the most optimistic forecasts of 1996. In the case of IFS, an identical opportunity exists for Indian financial genius to achieve similar export success in world markets; but with one key difference. India's own growth and globalisation, and consequent domestic demand for IFS, generates natural opportunities for IFS producers in India (local and foreign) to acquire IFS skills and exploit economies of scale. Indian software exports required an enabling framework from the State in the form of telecom reforms. Indian IFS exports will require a similar enabling framework from the State. Deeper and wider reforms and improvements are needed in: (a) India's financial system and the way it is governed and regulated; as well as (b) Mumbai's urban infrastructure and political/administrative governance on a scale not yet envisaged.

domestic market does not loom large to the CEOs of these firms, and played no role in their graduating into export-oriented MNCs.

6. India's competitive advantages in creating an IFC

Hinterland Advantage: As argued above the growth of the Indian economy and more rapid growth of cross-border financial flows have created substantial local demand for IFS. This 'driver' supports the development of skills, and generates economies of scale on the part of financial firms operating in Mumbai. China has the same hinterland advantage. New York has the North American economy as its hinterland. London has the even larger EU economy, as well as its own national economy, to serve. Singapore has a limited national economy. But it is the financial epicentre of an ASEAN regional economy that is almost as large as China and larger than India. Dubai does not have that kind of national or regional economy. But it is located in a region that is generating enormous financial surpluses for investment abroad.

Human Capital: India has four strengths by way of human capital endowments that give it a competitive edge over Shanghai, Singapore and Dubai:

- The extensive use of English, which is the *lingua franca* of international finance

- Generations of experience with entrepreneurship, speculation, trading in securities and derivatives, risk taking, and accounting. Indeed the ability to provide IFS seems to be genetically coded into Indian finance professionals
- Strong skills in information technology and quantitative thinking
- Individuals of Indian origin play a prominent role in the top 20 global financial firms. They are well-positioned to intermediate between the business strategies of these vital firms and the genuine strengths and weaknesses of India as an IFC.

Location: Mumbai is well located in being able to interact with all of Asia and Europe through the trading day. Apart from the Americas, transactions with most of world GDP can occur in daylight. Given the remarkable and growing role of London in providing global IFS today, India has the advantage of having a 4–5 hour overlap with London time. There is no IFC operating within an hour's variation of the Indian Standard Time zone. India has an edge over Shanghai, but not over Dubai, in this respect.

Democracy and Rule-of-Law: Properly functioning financial markets require a constitutional basis and machinery for system governance that is stable, reliable, resilient and flexible; i.e. one that reduces future political risks and uncertainty. Globally credible financial systems need to be rooted in legislative, judicial, and regulatory frameworks that adhere to rule-of-law and respect/protect property rights; in principle and in practice. IFS can be provided credibly only from environments that permit open and honest expression of independent views by portfolio managers, analysts, commentators, researchers, etc. even when such views contradict those of governments and powerful personalities with a vested interest. India has proven strengths in upholding liberal values, protecting property rights and maintaining political stability. It fares well compared with China, Singapore or Dubai but does not match London or New York.

Mindshare: High GDP growth, the BPO/KPO phenomenon, and the success of Indians in global finance all over the world, ensure that India has significant 'mindshare' at policy-making levels in global financial firms. India has an edge over Singapore and Dubai, and perhaps even over China, in this respect.

Strong securities markets and advanced trading platforms: India has the foundations for providing global IFS by virtue of its dynamic, technologically capable securities trading platforms in the NSE and BSE. These are the 3rd and 5th biggest exchanges in the world measured by number of transactions. India has an edge over China and Dubai, but not over Singapore, in this respect.

Taking these formidable advantages into account, the initial conditions supporting India's entry into the global market for IFS are promising; especially when compared with the early days of software exports from India. In the latter case, there was no hinterland advantage, location did not matter, democracy did not matter, and there was no beach-head. The six comparative and competitive advantages that India has, suggest that there is a genuine opportunity for India to create a viable IFC able to compete with the best in providing IFS to the Indian and global markets in a short span of time. But, it confronts some daunting challenges. Our report highlights these in detail. They include: (a) financial regime governance in India; (b) missing markets and institutions and (c) urban facilities and governance in Mumbai.

7. Financial regime governance: policy and regulation

A sound basic framework for developing/applying law and regulation are intrinsic to IFS. The quality and credibility of IFS provided from India is inextricably linked to the soundness and global acceptability of the regulatory/legal system that governs finance in India. Global competition in IFS is, to an extent, a function of global competition (in terms of reputation, capability, efficiency and effectiveness) among regulatory regimes and the institutions that apply those regimes. The market share of an IFC is determined as much by the quality and reputation of its regulatory/legal regime as by the abilities of its financial firms. A cross-country assessment suggests that India is weak on many aspects of the legal and regulatory framework governing its financial system which the report discusses in detail. The report also identifies two key strategic institutional (or structural) weaknesses in Indian finance that impede IFS production:

- **'Missing' Debt, Currency, and Derivatives Markets:** The most critical financial market components missing in India are: a properly functioning bond market, a currency market and a derivatives market for currencies and interest rates. These three interlinked markets are termed collectively as the ***bond-currency-derivatives (*BCD*) nexus*** in this report. Six specific deficiencies in this respect include the absence of: (a) a liquid and efficient sovereign bond market with an arbitrage-free INR yield curve, (b) a wide range of essential derivatives on INR interest rates, (c) a liquid spot market for INR-denominated corporate bonds, (d) credit derivatives on credit spreads or credit events, (e) a liquid currency market and (f) a full range of currency derivatives.

  Under a functional BCD nexus, all six elements are based on vibrant speculative price discovery, and are tightly knitted by arbitrage. They interact to result in market efficiency. There is no successful IFC that lacks such a BCD nexus. Its conspicuous absence in India handicaps the country's ability to provide IFS. Another shortcoming is the inadequacy of India's spot and derivatives markets – in terms of the variety of contracts traded and their traded volumes – in all areas other than equities. A normative rule-of-thumb would suggest that the traded volume of an exchange-traded futures contract in India should be at least one-tenth the turnover of a corresponding product in the US. By this yardstick, the turnover of Nifty futures is about that size. But that is not the case for almost all of the top 20 underlying contracts in the US.

- **An inadequate universe of institutional investors:** The second deficiency in India is a universe of institutional investors that have the size, visibility and capability of those in established IFCs. The progress made so far with liberalisation has been based largely on speculative price discovery by non-institutional investors in equity markets. Other segments are dominated by state-owned entities which are bound by restrictive rules. Banks and insurance companies are restrained, if not banned, from undertaking risk-hedging activities and other kinds of sophisticated business due to regulatory restrictions. Consequently their assets are growing too slowly.

  Indian financial firms tend to operate in one key business segment at a time. Their portfolios are narrowly confined and concentrated; so is their risk exposure. That has stunted their growth, imagination and ability to handle risk. Indian financial firms now need to evolve into full fledged *large, complex financial institutions* (LCFIs in Basel parlance). They need to operate in all financial market segments of finance to come up with credible IFS offerings and 'packages' for the export market.

  India lacks domestic commercial and investment banks capable of taking on global counterparts without higher levels of capitalisation, global market access, BCD operational expertise, and high-level human capital. India also lacks large securities brokerages capable of competing with global counterparts. India's brokerage industry reflects the infirmities of its retail sector as a whole. It is characterised by too many small, undercapitalised, limited-capability firms (brokers and sub-brokers) that are mostly still single proprietorships in corporate form. Structural reforms are required urgently to create Indian financial firms that are equivalent in size and capabilities to global counterparts. Looking ahead, if India is to create an IFC, there is no escape from inviting the participation of domestic and foreign institutional investors of adequate size, who would deploy the economies of scale, global market-reach and efficiency-enhancing behaviour that is evident at other IFCs.

Why does India have these weaknesses? Close scrutiny of the regulatory regime examines the origins of these infirmities through a matrix that identifies and analyses restraints on the activities of different financial firms in providing various IFS. Such a matrix has been prepared as a 'wallchart' for this report. It outlines activities that take place at IFCs and the kinds of financial firms that typically undertake them. A careful analysis of this wallchart reveals that, at present, most of the IFS activities that take place at IFCs are banned or severely proscribed in India. The red ink across the wallchart – signifying activities banned in India – portrays the *license-permit-control raj* that still operates in Indian finance. It retards development and sophistication of the financial sector and inhibits IFS exports. A pragmatic view of these constraints highlights three urgent, cross-cutting priorities for reform:

- **Competition Policy**: India's experience with liberalisation in the real economy, suggests that the most powerful tool for having efficient and well-functioning firms is ***competition***. Application of sound competition policy in all market segments of India's financial sector is now a matter of urgency.
- **Compartmentalisation of the Financial System**: Global competitiveness requires exploiting fully the economies of scale and scope. India's hinterland advantage represents an opportunity to exploit such economies. However Indian finance has been artificially fragmented by financial sector policy and regulation. There is no IFC that has so compartmentalised an approach to the structuring, management and regulation of its financial markets. Reversing counterproductive segmentation of financial markets in India, and removing barriers to entry, would result in greater: economies of scale/scope, competition, and global market-reach.
- **Inhibiting Financial Innovation**: Whether an IFC should be created for India to catch up with the world, or to exploit comparative advantage in a global IFS market, a considerably faster pace of financial innovation in India is essential. But, financial regime governance in India can only cope with change slowly. The regulatory approach to any change in the structure or functioning of the financial system is conservative, cautious and inconducive to innovation. As a result India falls behind international practice by the day in every market segment. The default signal emitted by Indian regulators when faced with any new idea seems to be set at 'amber' if not 'red'. Innovative instruments, contracts and new ways of doing business are acted upon in days in the three GFCs. Such a pace of rapid progress is not found in India. Basic contracts like interest rate futures and options have failed to materialise in this climate.

Deregulation and liberalisation through the 1990s have largely unshackled India's manufacturing sector, and much of its real economy. Competition, innovation and scale economies in these sectors are no longer blocked by the State. Yet, somewhat dissonantly, a much higher degree of control continues to operate in key parts of the financial sector; despite the many regulatory reforms of the 1990s. This financial governance regime now needs to be overhauled to create a more modern governance regime. It does *not* need traditional fine-tuning with the extant regime remaining largely intact.

Regulatory reform has had a positive impact on the functioning of India's *capital markets* and the *insurance* sector. In the capital markets, India has achieved global standards in some aspects. Other financial markets lag behind in not yet having been reformed as widely or deeply. Despite the presence of a large number of different types of banks, and despite incremental measures aimed at 'opening-up', the banking market in India has yet to improve substantially in competition, innovation and efficiency. The improvements achieved at the margins have not yet permeated the banking system as a whole. They are unlikely to, without a major reformative push and diminished public presence.

For that reason, a dramatic change in the governance regime for all financial markets in India is now imperative. Without it India will not be able to create an innovation-orientated financial system that can evolve and compete at a pace commensurate with changes in the Indian economy and global finance. Such a system would have the following activities undertaken on a par with global norms: (a) continual innovation and improvement in the design of financial products and customer services as well as in their delivery; (b) the rapid reintegration of segregated financial markets into more liquid and more integrated markets; and (c) the rapid growth and market-induced consolidation of Indian financial firms in a manner that enables them to achieve economies of scale.

For this to be achieved, Indian financial system regulation needs to be brought up to world standards. Regulatory attitudes, policies, practices as well as institutional arrangements need to undergo a sea-change. They need to become more attuned to, and supportive of, the dynamism, growth and global competitiveness of the Indian financial services industry. **Policy and regulation must adjust and adapt to the needs of Indian and global financial markets. Financial markets should not be artificially fragmented, segmented, compartmentalised.**

This report does not advocate using the hinterland argument as a reason for protectionism. Nor is the HPEC making an argument for 'self-sufficiency'. Instead the HPEC believes that India and Indian financial firms should be globally competitive in providing IFS through an IFC in Mumbai. The goal of public policy is to foster high economic growth and enhance welfare in India; it is not to cater to the interests of Indian firms or their shareholders. But, in saying this, the HPEC is mindful of the reality that developments during the last decade have resulted in a debilitating anomaly for Indian financial firms versus their foreign competitors. In manufacturing, the removal of barriers to imports was accompanied by a simultaneous unshackling of Indian firms. Indian firms were exposed to greater competition from imports and the entry of foreign MNCs in domestic market space. But they were, simultaneously, given a transitional period and considerable freedom in terms of formulating business strategies and innovating.

The evolution of Indian finance, in contrast, has resulted in growing dissonance between external competition and a repressive license-permit raj. India's long and tortuous evolution towards *de facto* convertibility (which in some respects is not dissimilar to tariff reductions in the real economy) has *not* been accompanied by Indian financial firms being given the same opportunity and room for manoeuvre to develop their competitive capabilities. They are at a disadvantage in coping with competition (for their clients' IFS business) from global IFS providers operating in India and from abroad for two reasons:

- *First*, key financial markets (i.e. the BCD nexus and risk management) have been prevented from developing in India because of regulatory restraints. That has resulted in Indian financial firms not having the opportunity or the time/space to develop domain knowledge and skill-sets in crucial areas e.g. global fund-raising or developing sophisticated risk management products/services tailored to client needs.
- *Second*, the same regulatory restraints have deprived Indian financial firms of the freedom they need to develop and the necessary flexibility in formulating global business strategies. They have not had the scope for innovating for IFS and thus developing the skills required to compete with global IFS providers.

The HPEC is clear that, in providing IFS from India, there is no case whatsoever for protectionism. The interests of Indian customers, and that of economic efficiency, are best served by enabling them to choose from the best IFS providers in the world. But, the asymmetry in policy that has placed Indian financial firms at a disadvantage, underlines the case for phasing reforms aimed at creating IFS capabilities in a manner that enables Indian financial firms to be similarly unshackled in competing to provide IFS.

8. Reorienting the financial system towards IFS provision: A temporal roadmap for reform

The strategy proposed in this report for creating an IFC comprises in essence a ten-point agenda:

1. ***Macroeconomic (i.e. Fiscal and Monetary) Management.***

   As a new competitor in global financial markets, the credibility of India's macro-economic policies, and the quality of its macroeconomic and financial system management, will be judged more stringently than in the case of established IFCs. This asymmetric reality highlights the importance of redoubling efforts in reforming policies, legal and institutional arrangements to achieve and sustain a high growth rate (8–10%) for the economy in general and the financial sector in particular.

   Creating a vibrant, competitive IFC in Mumbai will require, as an integral backdrop, success in meeting the legal commitments entered into by the Government of India, and the governments of individual states, to reduce the consolidated fiscal deficit on the timeline announced. In addition, it will require (a) reducing the total public debt/GDP ratio to more acceptable levels; and (b) pursuing sound fiscal and monetary policies thereafter.

   HPEC therefore recommends that further action should be taken to reduce more rapidly the consolidated debt of centre and states, including on-and-off-balance-sheet liabilities (such as pensions) and endorses a lower level (than the present 80%) for the total consolidated public debt-to-GDP ratio. A public debt ceiling should be bolstered by flexible triggers for actions to be taken by the Ministry of Finance (e.g. accelerated sales of public assets whose proceeds are used to liquidate outstanding public debt if that is deemed appropriate) when the adopted debt ratio ceiling is breached. While the HPEC did not wish to recommend a particular debt ceiling ratio without looking more deeply into the matter, global experience suggests that ratios in the range of 50–65% are widely applied as prudent. Such a debt ratio should be added to existing FRBM measures for deficit and debt reduction.

   For an Indian IFC to be credible, in keeping with 'best-practice' worldwide, India's central bank should be independent and separate from government. It must be independent and separate from government; i.e. in the same way that the Federal Reserve in the USA, the ECB in Europe, the various national central banks of Europe and Japan, and the Bank of England, are independent of and separate from their governments. The central bank must employ global best-practices in the conduct of monetary policy, in order to suffuse international investors and issuers with growing confidence in the INR as an acceptable global currency for IFS transactions. The level of confidence engendered should permit the INR to become one of the world's major reserve currencies by 2020 or 2025 at the latest.

   The gold standard for a stabilising monetary policy is a transparent, independent, inflation-targeting central bank. With such an arrangement the Indian State would be: (a) underlining its commitment to delivering low and predictable inflation; and (b) inducing greater confidence in the INR in the eyes of domestic and global investors. The HPEC recommends that the Ministry of Finance consider: (a) reforming monetary institutions in the light of recent developments in monetary economics; and (b) doing so in a way that bolsters the case for a credible IFC in Mumbai.

HPEC also recommends a fresh look at applying key principles in guiding reform of the tax system on the revenue side, to ensure that India remains globally competitive, and avoids price distorting subsidies on the expenditure side. This has particular implications for ensuring that inflation-targeting is not distorted or rendered ineffective because subsidies (e.g. for key energy prices) emit the wrong inflation signals.

2. ***Strategy for Public Debt Financing***.

Traditionally, India has eschewed bond issuance outside the country, fearing the currency risk that arises with issuing forex bonds while having INR revenues. This risk of 'original sin' does not arise if INR denominated bonds are sold to meet foreign demand for such debt. **The HPEC therefore advocates opening up fully to foreign investment in INR denominated sovereign bonds issued by GoI . It further recommends that no limits should apply to purchases by foreign clients of INR denominated corporate bonds or bonds issued by sub-sovereign entities (states and metropolitan administrations). In addition, the HPEC believes that the function of a public debt management office should be placed in the Ministry of Finance rather than in a regulatory institution to avoid any perceptions of conflicts-of-interest**.

This would achieve two goals. *First*, it would open up a new financing channel for GoI (and state and municipal governments as well) thus enabling it to abandon repressive policies that pre-empt domestic savings with an array of undesirable and unintended consequences (e.g. crowding out and undue pressure on the INR interest rate). *Second*, the *internationalisation* of INR bonds (issued by the sovereign, sub-sovereigns and corporates) would accelerate the emergence of an Indian IFC on the world stage.

There is considerable unmet global demand for INR bonds on the part of long-term institutional investors such as foreign pension funds. A rapidly emerging INR *bond market* would trigger currency trading in India and foster the use of INR currency and interest rate derivatives. That would facilitate the evolution of the INR as a global currency, used as a *numeraire* by bond investors and issuers from India and around the world. Internationalisation of the INR (a prerequisite for a successful IFC in Mumbai) would expand transaction volumes in India's bond, currency and derivatives markets, as well as its equity and commodity markets, coterminously. It would expand the range of financing options open to, and seignorage revenues derived by, the Government of India and its central bank.

3. ***Creation of the* BCD *Market Nexus***.

The most important missing piece in Indian finance is the BCD nexus explained earlier: i.e. the set of interlinked bond-currency-derivatives markets for spot and derivative instruments on interest rates, currencies and credit risk. In order to ignite these markets, **HPEC recommends the immediate creation of a currency spot market, with a minimum transaction size of Rs. 10 million, accessible to all financial firms. In addition, an INR-settled exchange-traded currency derivatives market should be created, with trading in futures, options and swaps on currencies, accessible to all**.

These two initiatives, along with developing more rapidly the spot market for bonds, need to be merged into the existing securities exchange ecosystem so as to trade alongside the spot and derivatives markets for equity. The policy problems that have held back interest rate futures need to be rapidly resolved. The responsibility for regulation of these markets – spot or derivatives; exchange or OTC; government bonds, corporate bonds, and currencies – needs to be moved to SEBI without further ado and unified with the regulation of all organised financial trading. The goal should be to create and launch a significant BCD nexus, in conformity with world standards, within 12 months.

4. ***Financial Market Integration and Convergence vs. Market Segmentation***

Indian finance suffers from a fragmented approach whereby the overall financial industry has been cut up into pieces reflecting legislation that is outdated by 50 years or more. IFS exports will not take place as long as the competencies of Indian financial firms are artificially stunted. India now needs its own LCFIs present in all lines of business, and able to achieve economies of scope and scale. **A series of measures are needed to achieve market integration and convergence, and thus enable economies of scale, economies of scope, greater competition and enhanced IFS export capability,** i.e.:

4.1 Redraft the legal foundations for organised financial trading, so as to unify all organised financial trading under SEBI regulation. This would include currencies, equities, sovereign and corporate bonds, and commodity derivatives. It would immediately diminish some of the fragmentation which has taken place amongst financial firms.

4.2 Remove barriers to a holding company structure through which virtual financial firms can be created, with an array of subsidiaries that fit Indian regulatory constraints but with corporate headquarters and top management able to operate a unified financial firm. The holding company would be regulated only by the Companies Act. It would typically be listed and able to leverage itself; while its subsidiaries might be unlisted. All barriers to M&A in finance need to be identified and removed, so as to achieve a market-induced consolidation process which would permit Indian LCFIs to emerge.

4.3 Create *wholesale asset management businesses* with freedom for outsourcing by existing financial firms such as banks or insurance companies. This would separate the legal and contractual structures through which assets are sourced and securities are created – across multiple front-ends across the country – from the 'factories' in which assets are managed. It would also achieve economies of scale in asset management.

4.4 Shift away from regulation by *entity* to regulation by *domain*. As an example, IRDA would regulate only the insurance *business*, not all the activities of insurance companies.

5. ***Principles-based Regulation***

Over the decades India has built up a license-permit *raj* in finance. It over-emphasises compliance at the expense of competence, competition and innovation in financial services. A similar *raj* dominated the real economy since independence. But it was dismantled during the 1990s to the immense benefit of the Indian economy and particularly Indian global competitiveness. To achieve the same objectives, that *raj* in finance now needs to be dismantled if India is to develop IFS provision and export capabilities and if an IFC is to emerge in Mumbai.

At present financial regulation in India is fragmented and rules-based. It is over-prescriptive and restrictive of managerial discretion. In every market segment, regulators attempt to codify every detail of a business in which the shape of the future can neither be anticipated nor predicted. Anything not explicitly permitted is banned. Any proposed change in the way of doing business requires clearance from the regulator. Supervisors apply checklists in verifying that every rule is met while not quite understanding all the dimensions of the business possibilities of the regulated entity and how it might evolve. This approach is inflexible and unamenable to swift adaptation of a kind that the world of global finance demands. This is counterproductive for the purposes of fostering IFS provision capabilities and inappropriate for an IFC.

HPEC therefore recommends that rules-based regulation in India be replaced by principles-based regulation. That will require redrafting India's securities and banking laws as well as re-skilling of all regulatory staff. **HPEC also recommends that a new unified Financial Services Modernisation Act (FSMA) be drafted to bring together, under a single omnibus legislative umbrella, all aspects of financial services: i.e. securities trading, banking, derivatives, insurance and commodity-finance.** Such omnibus legislation should reflect the holistic nature of the financial services industry while creating the foundations for regulation to be modernised and, possibly, unified in the fullness of time. This new law should draw on the models of the UK's FSMA and the US' CFMA, and be aligned with the shift away from rules-based regulation that is now being witnessed around the world. The new omnibus law should embed an appeals procedure – under an International Financial Services Apellate Tribunal (IFSAT) – that allows for: (a) appeal against any action of any financial regulator in India; (b) broadening the scope of appeal; and (c) judges having specialised domain knowledge in finance.

6. ***Capital Account Convertibility***

The convertibility question is critically linked to the possibility of a currency crisis, which India has successfully avoided over 1991–2007. This discussion needs to be illuminated by three key points. First, the present Indian policy configuration is not a 'consistent' one, given a pegged exchange rate and attempts at having an autonomous monetary policy while having significant capital account openness. This has, in the past, led to potentially destabilising one-way bets for foreign capital. Second, it is clear that if IFS export is the goal, this is incompatible with capital controls. Third, the growing integration of India into the world on the current account and the capital account is giving de facto convertibility in any case. Myriad other countries have perfected the combination of autonomous monetary policy and convertibility. India needs to emulate the dozens of successes, and avoid the mistakes made by the few failures.

Having considered the recommendations of the Tarapore-2 Committee Report very carefully, the HPEC nevertheless recommends that full capital convertibility should be achieved within a time-bound period of the next 18-24 months and by no later that the end of calendar 2008.

This recommendation needs to be dovetailed with an 18-24 month timetable for acting on HPEC's other recommendations. That would kill two birds with one stone. It would accommodate the accepted international consensus that a country moving to convertibility must have liquid and efficient financial markets and strong institutions. Also, India's opportunity to export IFS will really open up *after* convertibility. So, between now and then, a window of opportunity exists to tackle issues of public debt management, and missing markets/institutions, with forceful remedial measures.

7. ***Taxation of* IFS *and Financial Transactions***

HPEC recommends a rational and fair tax system for IFS which is competitive by international standards. The HPEC is against creating a tax haven in an Indian IFC.

A key HPEC recommendation endorses the Kelkar Committee Report's proposals for including financial services under the Goods and Services Tax (GST) regime with the simultaneous removal of all central and state transaction taxes including the Securities Transaction Tax (STT), stamp duties, etc. These recommendations should be implemented as swiftly as possible.

8. ***Inducing greater competition and innovation in the Indian financial system***

HPEC has made a series of specific recommendations in Chapter 15. All of them aim at inducing greater competition and innovation in the Indian financial system and in the provision/export of IFS. Apart from what has already been said about reversing the excessive segmentation and compartmentalisation of financial markets, these measures include, *inter alia*:

- **Removing existing barriers to entry of private domestic corporate players in some segments of the financial services industry;**
- **Removing barriers to the entry of foreign financial firms in the provision of IFS on the grounds that unilateral liberalisation is in India's own interests;**
- **Restricting demands for reciprocal market access only to domestic financial services;**
- **Reducing the extent of public ownership progressively in Indian financial institutions;**
- **Removing existing barriers to friendly or hostile mergers, acquisitions and takeovers in the financial services industry within/across market segments; and**
- **Encouraging the emergence of Indian LCFIs through market-driven initiatives.**

9. ***Improving the performance of the legal system for finance/*IFS**

   HPEC believes that significant improvements need to be made in the Indian legal system in resolving disputes, adjudicating settlements and enforcing financial contracts in real time. If that does not happen the prospects for Mumbai emerging as an IFC, or aspiring to become a GFC, will be irreparably damaged.

10. ***Opening up space for* IFS *support services infrastructure***

    Related to improvements in the legal system as they apply to finance and IFS, the **HPEC recommends opening up domestic space to permit the entry of well-known international law firms that operate in other IFCs and GFCs as well as international accounting firms and tax advisory firms as well as specialist management consulting firms focusing on the IFS industry.** This recommendation is made so that India can catch up quickly with the rest of the world in becoming a competitive provider of IFS through an IFC in Mumbai. It will not do so if it is left to existing domestic law, accounting and tax advisory firms to develop domain knowledge and skill-sets organically – in coping with the demands for IFS related legal, accounting, tax and business advisory services –without being confronted with the pressures of competition and innovation in their market.

Swift implementation of this ten-point programme, would orientate Indian financial firms towards achieving IFS export competitiveness. It has ramifications for macro-economic policy that have already been spelt out. It is consistent with the pursuit of sound practices in fiscal, monetary and exchange rate management. These recommendations constitute a dovetailed agenda that would be wise for India to follow in any event regardless of the arguments for or against an IFC.

9. Urban infrastructure and governance in Mumbai

The lure of the burgeoning Indian market has already attracted a large number of foreign financial firms to Mumbai. They have, in turn, located an increasing number of high-level expatriate staff in the city, creating intense competition and driving up prices quite dramatically for limited accommodation and lifestyle facilities that are not yet world class. A Mumbai-IFC that provides IFS only to the Indian market will not face the same pressures from foreign firms and expatriates to remedy the privations that they presently have to suffer: i.e. inadequate infrastructure, massive congestion, rampant pollution, along with poor standards of urban governance and law enforcement. In HPEC's view the present state of play can be tolerated reluctantly even as Mumbai grows as an IFC in its first phase, connecting India to the rest of the world. But that can only last for the next five years or so.

In its second phase of growth, if Mumbai is to be a successful GFC that exports to global markets competitively, it will have no choice but to match London, New York and Singapore in terms of attracting the requisite high-level human talent to the city. If it fails to do so it will not succeed as a GFC. To match these global cities in the span of the next 5-10 years for their world class quality of infrastructure and their global standards of governance, Mumbai needs to make a start **now**.

The individuals that Mumbai must attract (and who matter most) to be globally competitive in providing IFS– whether Indian or not and whether working for Indian or foreign firms – are affluent, mobile, and multi-culturally inclined in terms of their habits, tastes and preferences. They demand world class facilities to live, work and play, as well as world standards of infrastructure and urban governance. They have ample choice in terms of where they (and their families) choose to be located, and how their time is allocated. Whether they choose to locate in Mumbai will be influenced by the attractions of Mumbai as a *global* city in which they can live, work and play in a manner similar to what they can do in other GFCs. This reality may involve the creation of facilities to support lifestyles that could result in increasing social tension in the city; that risk will need to be managed sensitively and adroitly.

For Mumbai to become an IFC that can operate on a par with the three established GFCs, it will eventually need to attract a large population of individuals who are an integral part of the globally mobile (*globile*) finance workforce that already exists. Perhaps 25–30% of them will be of Indian origin. The remainder will be expatriates from around the world representing every country that has significant trade and investment links with India (and Asia). Most of them will be working for foreign financial firms that will include, *inter alia*: commercial and investment banks, asset management companies, insurance companies, securities and commodities brokerages, bills discounting houses, private equity firms, venture capitalists, hedge funds, as well as the financial media and financial reporting agencies (such as Bloomberg, Reuters, major global financial publications) and exchanges – even external and global regulatory agency representatives – from over a hundred different countries. To attract such internationally mobile high-level human capital to an IFC in Mumbai, special efforts will be required on four fronts: i.e.

- ***First***, elementary, glaring deficiencies in **Mumbai's urban infrastructure** will need to be addressed and rectified on a war footing. These deficiencies have, over the last decade or more, been discussed in central, state and municipal government circles, the media, the corporate world, and by the public at large. Progress in addressing these deficits is now being made. The HPEC was assured by the CM of Maharashtra that the pace of progress was about to accelerate. Mumbai's deficiencies include: crumbling housing in dilapidated buildings pervading the city; poor road/rail mass transit as well as the absence of water-borne transport in what is essentially an island-city; absent arterial high-speed roads/urban expressways; poor quality of airports, airlines and air-linked connections domestically and internationally; poor provision of power, water, sewerage, waste disposal, as well as a paucity of high-quality residential, commercial, shopping and recreational space that meets global standards of construction, finish and maintenance.
- ***Second***, Mumbai will need to be seen as a cosmopolitan metropolis that welcomes and embraces migrants from everywhere – from India and abroad. That will mean providing more user-friendly visa/resident permit mechanisms, making all arms of government expatriate-friendly, and exhibiting a gentle, tolerant, open and welcoming culture.
- ***Third***, lifestyle facilities that concern human welfare will need to be brought up to world standards and run on world-class lines in terms of their management and growth. These include: hospitals and the health system (public and private); educational facilities

such as primary/secondary schools, colleges, and universities; recreational facilities such as sports stadiums (for a wide variety of sports and not just cricket), gymnasiums, cinemas, theatres, parks, clubs, hotels, bars, restaurants, racecourses, casinos and other entertainment avenues; as well as cultural institutions such as libraries, art galleries, museums and the like, catering to global tastes.

- ***Fourth***, the quality of municipal and state governance, the provision of personal security and of law enforcement, will need to improve dramatically from third-world to first-world standards to accommodate an IFC. That is likely to prove the greatest challenge of all.

Of course, Mumbai needs to tackle these infrastructure deficits for reasons other than becoming an IFC. The IFC is too small a tail with which to wag the much larger urban development dog. But the case for an IFC would be immeasurably enhanced if it succeeds in doing so. For that reason, HPEC recommends a fresh attack on the legal issues of urban governance, in a cohesive effort, undertaken on a war-footing, between the Centre, Maharashtra and Mumbai. The aim must be to create a city government with the necessary autonomy, accountability and power to provide local public goods in Mumbai in a reasonably unfettered fashion. Mumbai's needs must be met irrespective of rural versus urban considerations. The city's administration must have an earmarked funding stream through tax sharing, in addition to user charges and property taxes that it can levy independently, to finance the creation of a 'global city' in Mumbai.

10. The choice

India has already become a large purchaser of IFS from the rest of the world; much larger than is realised in policy-making or commercial circles, leave alone by the public at large. As its economy grows, its demand for IFS will increase in a non-linear fashion. India can, of course, choose to continue buying IFS from abroad indefinitely. But the amounts it will need to spend for that purpose are staggering. They represent a waste of resources on purchasing services that India could provide more competitively for itself. Moreover, an inability to meet its own needs – and those of its trading and investment partners – for IFS will compromise India's growth.

Oddly enough, India does not need to rely on foreign providers for IFS. Quite the contrary: India has several significant strengths that give it an edge in providing IFS not just to itself but to the rest of the world on a competitive basis. Indeed, there is no city in the world that can become an IFC on the scale of London or New York, within a 20-year horizon, in the way that Mumbai can. This reflects India's unique strengths of: democracy, open-mindedness, cultural comfort with foreigners living and working in Mumbai, use of English, a well placed time zone, high quality labour force, a 200 year tradition of speculation and risk taking, and a hinterland advantage.

But such a future for Mumbai is far from guaranteed. At present, India is absent from the global IFS space, owing to weaknesses in financial sector policy, financial market structure, financial regime governance, legal system infirmities, as well as in the urban infrastructure and governance of Mumbai. The situation is worse than initial conditions were for manufacturing and software exports in 1991. India does not have a *low* market share in the global IFS market: it has a *zero* market share.

Looking ahead, the growth of IFS demand in India is inevitable, given the sheer growth of cross-border flows. The pressure of IFS demand that will flow from cross-border transactions of $1–2 trillion per year will inevitably trigger the emergence of rudimentary IFS capabilities in one way or another. The question that India faces is whether incremental evolution towards a limited range of IFS capabilities is adequate, or whether there is a more promising future for India in exporting IFS.

If decision-makers fail to tackle the policy issues outlined in this report, Indian IFS demand will fuel the growth of Wall Street, Singapore, DIFC and the City of London; often through the aegis of Indian financial firms that will graduate into multinationals and relocate their IFS operations outside the country.

The maturity of Indian finance in 2006, in terms of coping with competition and globalisation, is comparable to where Indian manufacturing stood in 1991. The export of financial services from India in 2006 sounds about as unlikely today as the export of automobile components or software sounded in 1991. The outlook for export of automobile components or software in 1991 was nothing but bleak. Yet India managed to find the energy to unleash revolutionary changes in policy.

Such radical changes now need to be replicated in finance, if export competitiveness in the provision of financial services (domestic and international) is desired and to be achieved. Visionary thinking needs to be applied to issues of financial architecture, the role of the central bank, and regulatory philosophy.

In parallel, Mumbai needs to become a first-world city that can attract the brightest minds of the world by being an attractive place to live, work and play.

If India is able to meet these twin challenges, then IFS exports could outstrip IT service exports by 2025. The benefits to the Indian economy, from taking the IFC path, are much greater than the direct revenues that would accrue from sale of IFS to local and foreign customers. India's experience with manufacturing has demonstrated that outward orientation and export competitiveness are the best tools for producing world class quality for the domestic market. An Indian financial sector that can export IFS will do a better task of financial intermediation for India. That is likely to generate an acceleration of GDP growth as growing investment resources (now exceeding 30% of GDP) are more efficiently allocated.

These benefits need to be weighed carefully by India's leadership against the political capital that needs to be expended in overcoming the technical and *realpolitik* constraints of: (a) changing the financial system in India with a second, more intensive set of reforms; and (b) urban governance in Mumbai.

This report has tried to bring objectivity and professional competence to sketching the trajectory, should India's leadership decide to take the IFC path. It strives to deliver a nuanced appreciation of the likely costs and benefits of the path to an IFC, based on understanding of which policy-makers can make a reasoned choice.

HPEC Report on making Mumbai an International Financial Centre: Timelines for Recommended Actions

Recommended Actions	2007 by Quarter (1 2 3 4)	2008 by Quarter (1 2 3 4)	2009 by Quarter (1 2 3 4)	2010 by Quarter (1 2 3 4)	2011> Year
A. Actions on Fiscal Deficit, Tax and Public Debt Financing/Management Fronts:					
1. Achieving and maintaining an average growth rate of 9% to 10%	Increase to 9%	Increase to 9.5%	Increase to 10%	Maintain at 10% or more	
2. Reduce the gross consolidated fiscal deficit (GCFD) from 8+ to 4–5% of GDP.	Reduce to 7%by y.e.	Reduce to 6%by y.e.	below 5%		
3. Reduce total public debt to GDP ratio from 80% of GDP to significantly less.	Reduce to 75%	Reduce to 70%	Reduce to 65%	Reduce to 60%	<50%
4. Implement the FRBM Task Force Report of 2004.	Implement 40%	Implement 70%	Implement 100%	Implementation Completed	
5. Eliminate Securities Transaction Tax (STT) and Stamp Duties (SDS).	Eliminate STT	Eliminate all SDS	All Transactions Taxes, Stamp Duties eliminated		
6. Apply GST to the financial services industry.	Technical Studies	Preparation Phase	Pilot Phase	Implementation	
7. Open up purchase of INR denominated debt instruments issued by GoI to All Buyers	Open up fully	No further restrictions on INR denominated paper for any buyer			
8. Restructure budgets/'balance-sheets' of states and metropolitan municipal corporations	Start Phase-1	Phase-2	Phase-3	Phase-4 Complete	
9. Shift burden of future infrastructure financing from public to private sector through PPPS	Pilot PPP Projects	PPPS in 10 states	PPPS in 15 states	PPPS in All states	
10. Set up independent public debt management office (or as second-best locate it in MoF)	*De facto* shift	Independent PDMO	Public Debt Managed Independently		
B. Actions on Monetary Policies and Monetary Management based on Inflation Targeting					
11. Focus Monetary Authority exclusively on single task of managing key short-term 'base rate'	Technical Studies	Policy Decisions	Implementation of Changeover	Separate Regulator	
12. Full CAC to be achieved in a time-bound manner within the next 18–24 months	Technical Studies	Prepare / Execute	Capital and Current Accounts Fully Open		
C. Actions on Financial Regime Governance and Financial System Regulation					
13. Improve functioning of Legal System insofar as it affects financial services.	Phase 1	Phase 2	Phase 3	Legal System at Global Standard	
13A. *Improve knowledge-skills and training of judges and arbitrators*	Train 30% of staff	Train 65% of staff	Train All Staff	Continue training/updating	
13B. *Reduce Case Backlog of cases involving financial contract disputes*	Reduce by 25%	Reduce by 50%	Reduce by 75%	Eliminate Totally	
14. Create International Financial Services Appellate Tribunal (IFSAT) covering all of finance.	Technical Studies	Insurance/Pensions	Extend to Banking	Extend to all of finance	
15. Permit unrestricted entry of well-known global legal firms operating in other IFCS/GFCS	Prepare Ground	Open up Entry	All Global legal firms permitted to operate		
16. Permit unrestricted entry of well-known global accounting firms operating in IFCS/GFCS	Prepare Ground	Open up Entry	All Global Accounting firms permitted to operate		
17. Dismantle barriers between different financial market segments	Except Banking	Include banking	No further compartmentalisation of finance		
18. GoI to prepare 'exit strategy' for its withdrawal from the ownership of financial firms	Build Consensus	Non-bank PSFFS	Strong PSBS	Weak PSBS	All PSFFS
19. GoI to reduce equity stake gradually in all types of public sector financial firms; esp. PSBS	Prepare Ground	Reduce to <49%	Reduce to <33%	Reduce to 26%	0 by 2015
20. Shift Financial Regulatory Regime from Rules-Based (RBR) to Principles-Based (PBR)	Technical Studies	Apply PBR-SEBI	Apply PBR-IRDA	Apply PBR-BR	All PBR
21. Conduct Periodic Regulatory Impact Assessments of the financial regulatory regime.	Prepare Ground	RIA for Banks	RIA-Cap Markets	RIA–Others	Regular
22. Examine Carefully the Need for changing extant Regulatory Architecture	Technical Studies	Consolidation to 4	Consolidation to 2?	Single Regulator?	Unified?
23. Trading platform for sovereign bonds to be moved to exchanges (NSE and BSE)	Technical Studies	Shift Platform	All bond trading to be done on market exchanges		
24. Draft new Financial Services Modernisation Act embracing 'Principles Based Regulation'	Prelim Drafting	Consultations	Final Draft	Table FSMA Bill	FSMA
24A. FSMA *should incorporate redrafted Banking Regulation Act* (BRA) *giving banks more flexibility*	Prelim Drafting	Consultations	Final Draft	Table FSMA Bill	FSMA
25. Transfer all regulation/supervision of any type of organised financial trading to SEBI.	Technical Studies	Execute Transfer	All financial market trading supervised by SEBI		
26. Distinguish between wholesale and retail markets and use appropriate regulation for each	Technical Studies	Separate Markets	Wholesale and Retail Markets regulated differently		
27. Open up immediately to DMA and algorithmic trading	Rules / Open	No bans on DMA and algorithmic trading to be regulated reasonably			
D. Actions on Filling the Gaps in 'Missing Markets'					
28. Create rapidly the Missing BCD Nexus in Indian Capital Markets:					
A. Bond Market	Technical Studies	Shift Platforms	Widen and deepen sovereign/corporate bond markets		
B. Establish Currency trading exchange with a minimum transaction size of INR 10 million	Prepare / Launch	Currency Market operates on NSE/BSE supervised by SEBI			
C. Derivatives Market: Shift trading in vanilla products (futures, options, swaps) to exchanges	Widen Range of Contracts to cover currencies, interest rates, credit default and trade them				
D. Retain and Expand OTC trading of exotic and tailor-made derivatives.	Widen OTC trading	Continually expand range of products traded on OTC to global levels			
E. MoF to review/remove constraints on any financial firm operating in derivatives	Technical Study	Remove all restrictions/bans other than usual prudential regulations			
F. Create INR cash settled currency derivatives on exchanges open to all (FIIS).	Technical Study	Launch range of multi-currency futures, options, swaps for trading			

HPEC Report on making Mumbai an International Financial Centre: Timelines for Recommended Actions

Recommended Actions	2007 by Quarter				2008 by Quarter				2009 by Quarter				2010 by Quarter				2011>
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	Year
E. Actions to Strengthen Institutions operating in Indian Financial Markets																	
29. GoI to support emergence of Indian LCFIs to emerge, through M&A and takeovers.	Technical Studies			Remove Restrictions			Encourage M&A			Let market drive consolidation and segment integration through financial system							
30. GoI to permit Wholesale Asset Management regulated by SEBI (minimum account Rs.10 crores)	Technical Study			Framing of Rules			Launch WAMS		Encourage rapid expansion of WAM with PBR-based regulation by SEBI								
31. Remove all impediments to outsourcing of asset management by banks, insurance companies, mutual funds, pension funds, FIIs, hedge funds, etc.	Technical Study			Remove Restrictions			Full outsourcing of asset management activities by any financial firm operating in India										
32. GoI to bring forward liberalisation of financial sector in keeping with commitments to WTO Agreement on Trade in Financial Services.	Technical Studies			Accelerated liberalisation Programme in place					Indian financial system fully open to global participation subject to prudential regulation and fitness tests								
33. Interim adjustment period of two years for Indian institutions to adapt to global competition.	Capacity building by Indian firms								Indian financial sector open to foreign competition								
34. Opening of branches by domestic banks to be decontrolled immediately.	All restrictions on branch opening by domestic banks to be removed immediately																
35. Opening of branches by foreign banks to be decontrolled after one year					All restrictions on branch opening by foreign banks to be removed												
36. Remove immediately all restrictions limiting corporate ownership of banks to 10%	Restrictions limiting private corporate ownership of banks to 10% to be removed																
37. Open up Indian capital markets to entry of hedge funds and alternative investment vehicles	Remove all restrictions on entry of hedge funds and AIVs																
38. Set up range of programmes for development of specialised human capital for the financial industry	Set up MSc in Finance and a range of specialised technical training programmes																
F. Actions to Improve Infrastructure in Mumbai																	
39. Transport Infrastructure:																	
A. Intra-city roads and arterial routes [PPPS]	Phased development and expansion of Mumbai's road transport capacity																
B. Coastal Highways and Expressways [PPPS]	Technical Feasibility Studies						Tenders Preparation					Contracts			Construction		
C. Suburban Railways and new Metro System [PPP]	Technical Feasibility Studies						Tenders			Contracts			Construction				
D. Water-borne Transport – Ferries/Hydrofoils/Jetfoils [PPPS]	Feasibility			Tenders			Contracts			Facility Construction and Operations							
E. Increase/upgrade airport and runway capacities	Actions already taken for Santa Cruz and Sahar. New plans for Navi Mumbai airport and runways																
40. PPPs for Power Infrastructure:																	
A. Increase in Power Generation Capacity $(24 \times 7 \times 365)$	Studies			Tenders			Contracts			Power Plant Construction and Operations							
B. Increase in Transmission/Distribution Capacity	Studies			Tenders			Contracts			T&D Line Construction and Operations							
41. Water Supply, Sewerage& Drainage:																	
A. Increase in Storage Capacity and Pipelines [PPP]	Plans and Projects underway to increase and improve water supply quantity/availability																
B. Increase in Filtration and Water Quality [PPP]	Plans and Projects underway to increase and improve water quality																
C. Upgrading/Expansion of Sewerage Capacity	Plans and Projects underway to increase and improve sewerage capacity/treatment																
D. Upgrading of Storm and Flood Drainage	Plans and Projects already underway to increase and improve storm/flood drainage																
42. Increase Waste Disposal Capacity: For solid and liquid waste with environmental protection	Develop PPPS				Contracts			PPP Contracts Underway and Operating									
43. Telecommunications Infrastructure:																	
A. Substantial Expansion of Cellular Network	TRAI to hold cellular operators to service quality commitments to upgrade continuously																
B. Expansion of Landlines and Broadband	MTNL to expand landlines in keeping with demand growth; increase competition																
C. Expansion of International Bandwidth	VSNL, FLAG to increase bandwidth rapidly; introduce greater foreign competition																
44. Accommodation: Residential, Office and Commercial	Drop ULCRA/RCA				Normalise rentals				Dispense with all controls except urban planning								
G. Actions to Improve Urban Governance in Mumbai																	
45. GoM and BMC to appoint or arrange to elect a City Manager accountable for Mumbai	Prepare Groundwork			Appoint/Elect			Place City Administration under full control of City Manager										
46. Bring the existing city governance machinery under the full control of the City Manager	Prepare Groundwork																
47. Establish independent financial base for the city that is under the control of the City Manager	Study Options			Agree Fund Sources				Place City on mainly independent financial footing									
48. Rationalise and streamline to organisation structure and lines of responsibility in city management	Organisation Study				Transition			Implement Rationalisation/Streamlining Programme									