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Financial Sector in India: Regulations and Reforms

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FINANCIAL SECTOR IN INDIA : REGULATIONS AND REFORMS

INTRODUCTION

India's financial sector is diversified and expanding rapidly. It comprises commercial banks, insurance companies, non-banking financial companies, cooperatives, pensions funds, mutual funds and other smaller financial entities¹.

Ours is a bank dominated financial sector and commercial banks account for over 60 per cent of the total assets of the financial system followed by the Insurance. Other bank intermediaries include regional rural banks and cooperative banks that target under serviced rural and urban populations. Many non banking finance companies (NBFC) operate in specialized segments (leasing, factoring, micro finance, infrastructure finance), though some can accept deposits. Pension provision covers 12 percent of the working population and consists of civil service arrangements, a compulsory scheme for formal private sector employees, and private scheme offered through insurance companies.²

CURRENT REGULATORS OF THE FINANCIAL SYSTEM

The regulation and supervision of the financial system in India is carried out by different regulatory authorities. The Reserve Bank of India (RBI) regulates and supervises the major part of the financial system. The supervisory role of the RBI covers commercial banks, urban cooperative banks (UCBs), some financial institutions and non-banking finance companies (NBFCs). Some of the financial institutions, in turn, regulate or supervise other institutions in the financial sector, for instance, Regional Rural Banks and the Co-operative banks are supervised by National Bank for Agriculture and Rural Development (NABARD); and housing finance companies by National Housing Bank(NHB). Department of Company Affairs (DCA), Government of

¹ India.RBI, Perspective on Banking in India, speech by Shri Deepak Mohanty, dated 18.5.2013

² IMF. India: Financial System Stability Assessment update, January 2013

India regulates deposit taking activities of corporate, other than NBFCS. registered under companies Act, but not those which are under separate statutes. The Registrar of Cooperatives of different states in the case of single state cooperatives and the Central Government in the case of multi-state cooperatives are joint regulators, with the RBI for UCBs, and with NABARD for rural cooperatives. Whereas RBI and NABARD are concerned with the banking functions of the cooperatives, management control rests with the State/ Central Government. This 'dual control' impacts the supervision and regulation of the cooperative banks. The capital market, mutual funds, and other capital market intermediaries are regulated by Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector; and the Pension Funds Regulatory and Development Authority (PFRDA) regulates the pension funds³.

SALIENT FEATURES OF THE PRESENT REGULATIONS

At present, financial regulation in India is oriented towards product regulation, i.e. each product is separately regulated. For example, fixed deposits and other banking products are regulated by the Reserve Bank of India (RBI), small savings products by the Government of India (GoI), mutual funds and equity markets by the Securities and Exchange Board of India (SEBI), insurance by the Insurance Regulatory Development Authority of India (IRDA) and the New Pension Scheme (NPS) by the Pension Fund Regulatory and Development Authority (PFRDA). All these regulators have a key mandate to protect the interests of customers - these may be investors, policy holders or pension fund subscribers, depending on the product⁴.

India has a legacy financial regulatory architecture. The present work allocation between RBI, SEBI, IRDA, PFRDA, and Forward Market Commission (FMC) – was not

³ India. RBI, Working Paper on Benchmarking Indian Regulatory Practices to the G20 Financial Reforms Agenda, by Anupam Prakash and Rajiv Ranjan, 27.3.2012, p. 26

⁴ Consumer Protection in the Indian Financial Code by Shubho Roy and Others, Chartered Secretary: The Journal for Corporate Professional, May 2013, p. 521

designed; it has evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time⁵.

Each regulator have their own rules on registration, code of conduct, commissions and fees to monitor the product providers and distributors. RBI, SEBI and IRDA have grievance redress procedures through sector financial Ombudsmen services⁶.

Problems with multiple regulators in India: with multiple regulators in India, there are varying regulatory requirements which often leads to regulatory arbitrage. An example of this is the similarity between mutual funds and ULIPs, the first which is regulated by the SEBI and the second which were regulated by the IRDA. SEBI imposes very different levels of disclosure and ongoing transparency on the outcomes of mutual funds compared to the standards of disclosure required by the IRDA. In an example on differing standards of regulation on distributors, employees of banks who come under regulation by the RBI can distribute financial products such as mutual funds and insurance products, without adhering to the rules and regulation of SEBI and IRDA⁷.

The present arrangement has gaps for which no regulator is in charge – such as the diverse kinds of ponzi schemes that periodically surface in India, which are not regulated by any of the existing agencies⁸. Organizations such as chit-funds appear to be completely out of the purview of any financial sector regulator⁹.

The existing framework also contains overlaps between laws and agencies leading to incidences in which conflicts between regulators has consumed the energy of economic policy makers and held back market development¹⁰. Securities and Exchange Board of India's (SEBI) extended litigation against the Sahara group, and the

⁵ India. Ministry of Finance, Financial Sector Legislative Reform Commission, chaired by Justice B.N. Srikrishna, Vol. I, p. xxiv

⁶ *op.cit.*, Consumer Protection in the Indian Financial Code, p. 521

⁷ *Ibid*

⁸ *op.cit.*, Financial Sector Legislative Reform Commission, Vol.1 p.132

⁹ *op.cit.*, Consumer Protection in the Indian Financial Code

¹⁰ *op.cit.*, Financial Sector Legislative Reform Commission, Vol 1 p.132

recent investigations on alleged money laundering by some banks using insurance products are good examples of both regulatory gaps as well as opportunities for arbitrage¹¹.

Reflecting these difficulties, the present Indian financial regulatory architecture has, over the years, been universally criticized¹².

REGULATORY SYSTEMS PREVALENT IN OTHER COUNTRIES

Based on the lessons from the recent global financial crisis, several changes have been introduced in the regulatory framework across countries. The most radical changes are being contemplated in the **United Kingdom**. The United Kingdom formerly had a unified regulator, the Financial Services Authority, formed in 1997. The Financial Services Authority has been disbanded and replaced by the Financial Services Act. This Act gives the Bank of England responsibility for financial stability, bringing together macro and micro prudential regulation, creates a new regulatory structure consisting of the Bank of England's Financial Policy Committee, the Prudential Regulation Authority and the Financial Conduct Authority. The Financial Conduct Authority is responsible for regulating and policing the banking system. The Prudential Regulation Authority carries out the prudential regulation of financial firms, including banks, investment banks, building societies and insurance companies.

The **United States** has a Financial Stability Oversight Council that looks at monitoring risks to the US financial system and being a consultative council to facilitate communication among financial regulators¹³.

In **Australia**, prudential regulation and conduct regulations had been divided and mandated to two distinct regulatory bodies, the Australian Prudential Regulation Authority (APRA) that governs the financial institutions and the Australian Securities & Investments Commission (ASIC) that governs corporate conduct. This model which was

¹¹ The Livemint, dated 01.04.2013

¹² *op.cit.*, Financial Sector Legislative Reform Commission, Vol.1 p.132

¹³ *op.cit.*, FSLRC: Transformational and Pioneering by S. Ramesh, Chartered Secretary

adopted in the mid 1990s, withstood the crisis relatively better. Similarly in **Canada**, Prudential Regulation and Conduct Regulation has been placed in separate agencies¹⁴.

FINANCIAL LEGISLATIVE STRUCTURE IN INDIA

The present landscape of financial law is less than satisfactory in certain respects. Today, India has over 60 Acts and multiple rules / regulations that govern the financial sector¹⁵. Many laws from the 1950s and the 1960s have an emphasis on banning certain financial activity, rather than on establishing regulatory structure for it¹⁶. The genesis of many of the Acts, rules, regulations that govern the financial sector in India can be traced back more than half a century in some cases. The RBI Act and the Insurance Act were enacted in 1934 and 1938 respectively and the Securities Contracts Regulation Act, which governs securities transactions, was legislated in 1956 when the financial landscape was very different from that seen today. For example, Let's take the banking regulations, they were established before ATMs, credit cards, internet banking, investment advisory services, private banking, selling mutual funds and debt products, direct selling agents, vehicle loans, derivatives and a whole lot of other new products and services existed. These Acts have been amended time and again to keep pace with a changing reality but its legal foundations remained more or less static .The result is a frame work which is at times complex, ambiguous, inconsistent, and occasionally open to regulatory arbitrage¹⁷.

REFORMS IN THE FINANCIAL SECTOR

Financial sector reform affects everyone in the country and beyond given the growing interface of our economy with the rest of the world. We live in a globalizing world with strong and growing inter-connections between our financial systems. What

¹⁴ *op.cit.*, India. Ministry of Finance, Financial Sector Legislative Reform Commission, Vol. 1 p.8

¹⁵ *op.cit.*, FSLRC: Transformational and Pioneering by S. Ramesh, Chartered Secretary, p.524

¹⁶ *op.cit.*, Financial Sector Legislative Reform Commission : an approach paper, p. 7

¹⁷ *op.cit.*, FSLRC: Transformational and Pioneering, p. 524

happens anywhere in the world will have an impact everywhere, as indeed demonstrated by the experience of the last five years. As foreign banks come into our country, and our banks expand their global footprint, we cannot afford to be offline on global standards and international best practices. As the former Managing Director of the IMF has said “just because this crisis originated in advanced economies, emerging economies cannot assume that they have insulated themselves from all future crises. Such hubris can be dangerously costly”¹⁸.

Along with financial globalization, complexities of financial regulation have also increased. This became more complex after the crisis and following the adoption of greater scrutiny of the concerns arising from terrorism-related financial activities. The new obligations under the Financial Action Task Force (FATF) and Combating the Financing of Terrorism (CFT) regimes have necessitated co-ordination between domestic financial regulators amongst all the jurisdictions and between the global coordinating institutions. Greater co-ordination has also become imperative in the context of concerns on financial stability. All these factors necessitate the need to redraft our legislation and harmonize them with international standards¹⁹.

An efficient financial system has been regarded as a necessary pre condition for higher growth. Propelled by this ruling paradigm, several developing countries undertook programmes for reforming their financial system.

FINANCIAL SECTOR REFORMS IN INDIA

The role of the financial system in India, until the early 1990s, was primarily restricted to the function of channeling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost.

¹⁸ India. RBI, Speech on the Global Financial Crisis and the Indian Financial Sector by D. Subbarao, dated 5.6.2013

¹⁹ *op.cit.*, Financial Sector Legislative Reform Commission, Vol. 1 p.8

After the nationalization of large banks in 1969 and 1980, public ownership dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management system and the prudential standards were weak. All these resulted in poor asset quality and low profitability.

Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms. In the insurance sector, there was little competition. The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz., the Unit Trust of India. Non-banking Financial Companies (NBFCs) grew rapidly, but there was no regulation of their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions on movement of funds/participants between the market segments. Apart from inhibiting the development of the markets, this also affected their efficiency.

Against this backdrop, wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s. Financial sector reforms in India were grounded in the belief that competitive efficiency in the real sectors of the economy will not be realized to its full potential unless the financial sector was reformed as well. Thus, the principal objective of financial sector reforms was to improve the allocative efficiency of resources and accelerate the growth process of the real sector by removing structural deficiencies affecting the performance of financial institutions and financial markets²⁰.

The main thrust of reforms in the financial sector was on the creation of efficient and stable financial institutions and markets. Reforms in respect of the banking as well as non-banking financial institutions focused on creating a deregulated environment and enabling free play of market forces while at the same time strengthening the prudential

²⁰ India. RBI, Working Paper on Financial Structure and Economic Development in India; An Empirical Evolution by S. Sahoo, February 2013

norms and the supervisory system. In the banking sector, the focus was on imparting operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability, imparting strength to the system and ensuring accountability and financial soundness. The restrictions on activities undertaken by the existing institutions were gradually relaxed and barriers to entry in the banking sector were removed.

In the case of non-banking financial intermediaries, reforms focused on removing sector-specific deficiencies. Thus, while reforms in respect of DFIs focused on imparting market orientation to their operations by withdrawing assured sources of funds, in the case of NBFCs, the reform measures brought their asset side also under the regulation of the Reserve Bank. In the case of the insurance sector and mutual funds, reforms attempted to create a competitive environment by allowing private sector participation.

Reforms in financial markets focused on removal of structural bottlenecks, introduction of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions improvement in trading, clearing and settlement practices, more transparency, *etc.* Reforms encompassed regulatory and legal changes, building of institutional infrastructure, refinement of market microstructure and technological up gradation. In the various financial market segments, reforms aimed at creating liquidity and depth and an efficient price discovery process.

Reforms in the commercial banking sector had two distinct phases. The first phase of reforms, introduced subsequent to the release of the Report of the Committee on Financial System, 1992 (Chairman: Shri M. Narasimham), focused mainly on enabling and strengthening measures. The second phase of reforms, introduced subsequent to the recommendations of the Committee on Banking Sector Reforms, 1998 (Chairman: Shri M. Narasimham) placed greater emphasis on structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with international best practices²¹.

²¹ *Ibid*

During the last four decades, particularly after the first phase of nationalization of banks in 1969, there have been distinct improvements in the banking activities which strengthened the financial intermediation process. The total number of offices of public sector banks which was merely at 8262 in June 1969 increased to 62,607 as of June 2011. Similarly, there have been many fold increases in aggregate deposits and credit indicating existence of a vibrant bank-based financial system.

Some interesting facts could be drawn from the following table:

Table 1: Financial Development - Select Indicators					
Item	1960s	1970s	1980s	1990s	2000s
Private Credit/Total Credit (%)	43.0	58.4	59.0	56.6	64.5
Private Credit/GDP (%)	9.5	18.8	28.7	28.6	43.0
Total credit/GDP (%)	22.2	32.0	48.8	50.6	66.2
M3/GDP (%)	21.2	28.4	40.8	49.9	73.5
M3 Velocity (times)	5.0	3.9	2.7	2.2	1.5
M1 Velocity (times)	7.0	6.7	7.1	6.4	5.4
Market Capitalization/GDP (%)	-	-	8.8	35.8	58.7
Per Capita Real GDP Growth (%)	1.6	0.5	3.2	3.7	5.4
Real GDP Growth (%)	4.0	2.9	5.6	5.8	7.2
Note: Domestic credit to the commercial sector is taken as proxy for private credit. Source: RBI, Working Paper on Financial Structure and Economic Development in India; An Empirical Evolution by S. Sahoo, February 2013					

First, an important indicator of bank-based financial deepening, *i.e* Private sector credit has expanded rapidly in the past five decades thereby supporting the growth momentum. **Second**, financial innovations have influenced velocity circulation of money by both reducing the transaction costs and enhancing the liquidity of financial assets. A relatively increasing value of velocity could be seen as a representative indicator of an efficient financial sector. In case of India, the velocity circulation of broad money has fallen since 1970s partly reflecting the fact that, in the midst of crisis, money injected to the system could not get distributed efficiently from the banking system to non-banks. Sharper fall in the velocity of narrow money reflected reluctance among banks as well as the public to part with liquidity. **Third**, the market-based indicator of financial

deepening, *i.e.*, market capitalization-to-GDP ratio has increased very sharply in the past two decades implying for a vibrant capital market in India. Various reform measures undertaken since the early 1990s by the Securities and Exchange Board of India (SEBI) and the Government of India have brought about a significant structural transformation in the Indian capital market. Although the Indian equity market has become modern and transparent, its role in capital formation continues to be limited. Unlike in some advanced economies, the primary equity and debt markets in India have not yet fully developed. The size of the public issue segment has remained small as corporate have tended to prefer the international capital market and the private placement market. The private corporate debt market is active mainly in the form of private placements.

However, the domestic credit provided by the Indian banks still remains at an abysmally low as compared with major emerging market and developing economies (EDEs) and advanced economies (Table 2). Furthermore, the level of credit disbursement is also far below the world average levels. Therefore, there is scope for the Indian banks to expand their business to important productive sectors of the economy²².

Table 2: Domestic Credit Provided by Banking Sector								
(% of GDP)								
Country/ Region	1980	1990	2000	2005	2008	2009	2010	2011
Brazil	43.0	87.6	71.9	74.5	96.9	95.8	95.2	98.3
China	53.3	89.4	119.7	134.3	120.8	145.1	146.3	145.5
Euro area	93.6	97.0	119.4	127.3	142.8	152.6	156.0	153.6
India	37.0	50.0	51.4	58.4	67.7	70.4	73.0	75.1
Japan	185.7	255.3	304.7	317.6	302.4	329.8	329.0	340.9
Russia	-	-	24.9	22.1	23.9	33.7	38.4	39.6
South Africa	76.4	97.8	152.5	178.5	173.8	184.2	182.4	167.0
South Korea	43.4	51.9	74.7	88.3	109.4	109.4	103.1	102.3
UK	36.2	118.2	130.2	161.9	213.5	229.2	222.6	213.8
US	120.2	151.0	198.4	225.4	222.0	234.9	232.9	233.3
World	93.5	130.6	158.9	162.1	154.7	169.1	167.4	165.3
Source: RBI, Working Paper on Financial Structure and Economic Development in India; An Empirical Evolution by S. Sahoo, February 2013								

²² *Ibid*

India weathered the disruptions in the global financial system mainly due to a robust regulatory and supervisory framework, limited openness and global exposure of banking system with timely policy actions especially to manage liquidity. It was, however, acknowledged that financial sector reforms has to keep progressing with continued improvements in regulation, supervision and stability areas in order to avoid build up of new vulnerabilities. The global financial crisis provided a renewed impetus to the second generation financial sector reforms in India whose major components could be identified as: (i) adherence to international standards, especially implementing G20 commitments; (ii) developmental measures; and (iii) stability measures²³.

Against the backdrop of a felt need that the legal and institutional structure of the Financial sector in India need to be reviewed and recast in tune with the contemporary requirements of the sector, The Financial Sector Legislative Reforms Commission (FSLRC), headed by Justice B.N. Srikrishna, was set up by Ministry of Finance in March 2011 to review, simplify and rewrite the legal and institutional structures of the financial sector.

THE FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION (FSLRC)

The FSLRC presented its Report to the Finance Minister in March, 2013. . The Commission looked at two important aspects of the Financial Sector- the numerous laws governing the financial sector and the multiple regulatory setups across the sector. Among the most important of the recommended changes by FSLRC are: (1) The decision to merge the roles of the Securities and Exchange Board of India, the Forward Markets Commission, Insurance Regulatory and Development Authority, and Pension Fund Regulatory and Development Authority into a single regulator called the “Unified Financial Agency” (UFA), on the grounds that all financial activity other than banking and the payments system, which would continue to be regulated by the Reserve Bank of India (RBI), should be brought under a single authority. (ii) The continuation of the Financial Stability Development Council (FSDC) with the mandate to monitor and

²³ *op.cit.*, Benchmarking Indian Regulatory Practices to the G20 Financial Reforms Agenda, pp. 26-27

address systemic risk, which is to be led by the finance ministry. (iii) The creation of a Resolution Corporation that would identify institutions that are threatened by insolvency and resolve the problem at an early stage. (iv) The creation of a Public Debt Management Agency that would take the responsibility of public debt Management away from the RBI²⁴.

The Commission believes that this proposed financial regulatory architecture is a modest step away from present practice, embeds important improvements, and will serve India well in coming years²⁵.

Challenges and Outlook of the Financial Regulatory Structure

India has been a late starter in the process of reforming financial markets. Nevertheless, beginning the 1990s, a package of reforms comprising measures to liberalize, regulate, and develop the country's financial sector by adopting best international practices has been initiated. The results of these reforms have been encouraging and the country now has one of the most vibrant and transparent capital markets in terms of market efficiency, transparency, and price discovery process. However, there are still certain challenges in the development of the Indian financial sector which need to be addressed to make it an important avenue for productive channelization of savings by domestic investors and a preferred investment destination for international investors.

A reasonably well-developed corporate bond market is very much required in any economy to supplement banking credit and the equity market and to facilitate the long-term funding requirement of corporate sector as well as infrastructure development in the country. Some of the issues that need to be addressed in this regard include drawing up a road map for a structural shift from a bank-dominated financial system to a more diverse financial system where top-rated corporate access finance from capital

²⁴ Redistributing Regulatory Power ; Financial Sector Legislative Reform Commission by C. P. Chadrasekhar, Economic and Political Weekly, dated 18.5.2013

²⁵ *op.cit.*, Financial Sector Legislative Reform Commission, Vol.1 p. xxiv

markets strengthening of the legal frame work for regulation of corporate debt by necessary amendments in rules/regulations, and relaxation of investment guidelines for pension, provident, and insurance funds to enable the participation of long term investors in the corporate bond market. The need for long-term finance for infrastructure projects is another issue that needs to be looked into in the context of the limitation of banks to finance such projects. Infrastructure projects, given their long pay-back period, require long-term financing in order to be sustainable and cost effective.

The enactment of the Banking Laws Amendment Act 2012 is expected to make the regulatory and supervisory powers of the RBI more effective and facilitate banks in raising funds from the capital market required for expansion of banking business. It will also facilitate finalization of guidelines by the RBI for providing licenses for new banks, which is essential for achieving the objective of financial inclusion in the current perspective. This needs to be expedited accordingly.

Pension reforms in India have generated widespread interest internationally. They will not only facilitate the flow of long-term savings for development but also help establish a credible and sustainable social security system in the country. Lower levels of financial literacy, particularly among workers in the unorganized sector, non-availability of even moderate surplus, and lukewarm response so far from most of the state / UT governments to a co-contributory Swavalamban Scheme are the major challenges to universal inclusion of poorer sections of Indian society into the pension network. On the supply side, the lack of awareness about the NPS and of access points for people to open their accounts individually have been major inhibiting factors which should be addressed by the pension regulator immediately. As far as the insurance products are concerned, limited choice and high cost of providing covers and assessing claims are some of the issues that need to be suitably addressed to make insurance funds an effective means of channelizing savings to investments.

The recent global financial crises have raised certain issues relating to governance of financial intermediaries and awareness of investors. As investors' awareness is a pre-condition for their protection, attempts are being made to address

this issue through the financial literacy campaign. A simultaneous and coordinated effort on both fronts is needed to enable investors, especially the small investors, to take informed decisions and ensure orderly conditions in the market. The ongoing efforts need to be scaled up in a coordinated way for spearheading financial literacy and promoting investors' protection²⁶.

The need of the hour is to ensure that our unbanked population gains access to formal sources of finance, their reliance on informal channels and on the shadow banking system subsides, and, in the process, consumer exploitation is curbed. A glaring example is the recent case of a chit fund defrauding poor people of their hard earned savings. The fact that people have to rely on such entities for their saving needs indicates a failure on the part of the formal financial system to reach out to such groups and earn their trust and confidence through a transparent and responsive customer service regime. Hence, the financial sector architecture that we aspire for should be one that is most conducive to meeting the objectives of financial inclusion and financial literacy, besides meeting the goals of customer service²⁷. . Keeping in view India's growing integration with global financial markets, external-sector vulnerabilities have an increasingly large impact on India through the trade and capital account channels. It is therefore important that the development of an efficient and healthy financial market should also be accompanied by an effective regulatory mechanism that keeps track of external vulnerabilities²⁸.

²⁶ India. Ministry of Finance, Economic Survey 2012-2013, pp.128-129

²⁷ India. RBI, speech on Regulation for Financial Consumer Protection, by Shri K.C. Chakrabarty, dated 29.4.2013

²⁸ *op.cit.*, Economic Survey 2012-2013, p.105