REGULATORY FRAMEWORK OVERHAUL

The Financial Sector Legislative Reforms Commission (FSLRC) has released a report advocating a complete overhaul of the existing regulatory framework, including replacement of a substantial body of existing laws with the Indian Financial Code drafted by it

India's regulatory framework has been uncharitably, if accurately, described as an accumulation of responses to crises, replete with instances of turf squabbles and blind spots, rather than a comprehensive system of diverse parts with a unified purpose.

The Union Ministry of Finance constituted the Financial Sector Legislative Reforms Commission (FSLRC) in March 2011, with a mandate to review and suggest changes to existing laws and regulatory institutions in the financial sector to bring them up to speed with globally prevalent standards. Two years later, a report was released which advocated a comprehensive overhaul of the existing regulatory framework, including the replacement of a substantial body of existing laws with the Indian Financial Code (Code) drafted by the FSLRC.

The seven pillars

The FSLRC has suggested the creation of the Unified Financial Agency (UFA), a new body which would be entrusted with micro-prudential regulation and consumer protection for all financial sectors other than banking and payment

systems. This body would subsume the existing regulators for capital markets (the Securities and Exchange Board of India), forward markets (the Forward Markets Commission), insurance (the Insurance Regulatory and Development Authority) and pension (the Pension Fund Regulatory and Development Authority).

The Reserve Bank of India (RBI) would continue in the new setup as the regulator for banking and payment systems and frame monetary policy, although its role would now exclude supervision of non-banking financial companies (NBFCs) not accepting public deposits. The RBI would also be responsible for capital outflows from the country (capital inflows being regulated by the Finance Ministry), a change from the present model where the RBI makes rules for capital account transactions in consultation with the government and vice-versa for current account transactions.

The FSLRC also envisages the creation of the Public Debt Management Agency (PDMA), an independent body which will take over the task of handling governmental market borrowings from the RBI, and will additionally manage the cash and contingent liabilities of the government.

The Financial Stability and Development Council, which currently comprises various sectoral regulators and officials of the Ministry of Finance, will be granted the status of a statutory body and will be responsible for managing systemic risks and co-ordinating between different regulatory agencies.

The FSLRC has suggested the creation of a Resolution Corporation in place of the Deposit Insurance and Credit Guarantee Corporation to assist in the speedy resolution and closure of all systematically important financial institutions or those having strong linkages to consumers (such as banks, insurance companies or pension funds).

Operating as a consumer grievance redressal mechanism across the financial sector would be the newly instituted Financial Redressal Agency (FRA). Appeals from the FRA and decisions in respect of certain functions of the UFA, the RBI and the Resolution Corporation, will be heard by the Financial Sector Appellate Tribunal (FSAT), within which the Securities Appellate Tribunal will be subsumed. Additionally, the FSAT will be empowered to review regulations on grounds like procedural defects, the regulator exceeding its mandate, or the regulations being in violation of the Code.

Change for change's sake

The FSLRC's recommendations have attracted their fair share of criticism - the report itself features four notes of dissent. A recurring theme has been questioning the need for radical structural alterations in the absence of clinching evidence of the superiority of the super-regulatory model. The experience of the United Kingdom in this regard is pertinent, with the Financial Services Authority (FSA) - the sole financial regulatory watchdog - recently being replaced by a 'twin peaks model.' This revamped system will see consumer protection, and prudential regulation and supervision of financial entities being handled by separate regulatory bodies, under the overall supervision of the country's central bank.

Tellingly, this overhaul was prompted due to repeated failures of the FSA in the performance of its duties, with household names like Lloyds, Northern Rock, and the Royal Bank of Scotland all requiring to be bailed out during its tenure. In stark contrast, given that the Indian economic system seems to have been shielded from the worst excesses of the global financial crisis, domestic regulators may feel hard done by.

Ignoring the elephant in the room

The division of labour between the UFA and the RBI has been allocated on the premise that consumer protection can be done by a unified regulator imposing common standards, while the banking system would be better served by an agency having a full view of impending systemic risks. However, this chain of logic appears

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to have been inconsistently applied in the proposed exclusion of non-banking finance companies (NBFCs) and housing finance companies (HFCs) from the purview of the RBI, despite

them being systemic risks.

Currently, the RBI supervises NBFCs directly, and HFCs indirectly through the National Housing Bank, a wholly owned subsidiary of the RBI. The activities of these kind of entities are, to a limited extent, similar to those performed by banks and therefore are considered among the constituents of the 'shadow banking system.' One of the lessons of the global financial crisis was that the shadow banking sector, if not monitored, could significantly challenge the stability of the banking sector, and therefore ought to be under the purview of the sectoral regulator - which even under the post-FSLRC regime would be the RBI. This would be in keeping with global trends, such as the Dodd-Frank Act of the United States, where the regulatory ambit of central banks have been broadened to include supervision of entities previously not within their charge.

> Now, the regulators would be encouraged to adopt a more holistic approach in their functioning, which would do away with the tendency of isolation and creation of information silos within a specialist body

Splitting the baby

A significant talking point has been the proposed dispersal of regulatory powers in relation to external liabilities, namely monetary policy (RBI), capital control (Union Government) and balance of payments (shared between the RBI and the Union Government). As these elements are intrinsically intertwined, this division seems artificial in nature and may prove detrimental to effective management if implemented.

Another recommendation of the FSLRC which has been hotly contested is the transfer of public debt management functions from the RBI to the PDMA. The FSLRC has stated that the several hats worn by the RBI leads to an inherent conflict of interest. For example, the declaration of increased interest rates as an anti-inflationary measure - in its capacity as the monetary authority - would prove detrimental to its interests as a debt manger - due to costs of borrowing rising as a consequence of such measure - and may perhaps affect its judgement in such matters.

However, critics have pointed out that even an independent PDMA, envisaged to be an agency of the government and accountable to it, may not quite solve this conflict. The majority of banks in the Indian economy have the government as its majority shareholder, and hypothetically could continue to purchase government securities even in a scenario of increased interest rates, in the above illustration. While from the global perspective it is admittedly a rarity for the central bank to handle both monetary and sovereign debt functions, due to the scale of the government's borrowing in India, arguments have been made that such debt has larger implications on the country's monetary policy and therefore ought to continue to be vested with the RBI.

The silver lining

The FSLRC's recommendations for a financial regulatory structure independent of sectoral limits is a substantial change which could lead to unlocking of economies of scale from the perspective of both financial firms and their regulators. The FSLRC report notes with regret that under the current framework, there is a tendency to divide the economic activities of entities so as to mirror that of regulators - which could be done away with in a unified regulatory regime.

Unification of sectoral regulators under one umbrella would also have several benefits such as creating uniform standards and consistency in consumer protection and welfare. The regulator would then be encouraged to adopt a more holistic approach in its functioning, which would do away with the tendency of isolation and creation of information silos within specialist bodies.

In the past, India has witnessed instances where more than one regulator would lay claim to the same subject matter while in others, there would be no regulator having clear jurisdiction on the same. In a scenario of increasingly sophisticated financial products, these instances would become even more common, giving firms the opportunity to indulge in regulatory arbitrage. By altering the description of their activities and products, they could make it appear that they would not fall within the purview of any regulator, or alternatively be subject to the control of a body of their preference. Such artifices would no longer hold good in a unified regime, which would have the mandate of consumer protection across the financial sector.

The long road ahead

However, a lot depends on the execution of the process of integration of the proposed agencies with the existing system. This will hold even more true for the functioning of the UFA, which proposes to subsume several existing sectoral regulators that have in the past not seen eye to eye on several issues. Another significant challenge will be finding adequate human resources to staff such an agency, a task which even the existing framework has long been grappling with.

The Finance Ministry is currently examining the recommendations of the FSLRC and currently, there is no certainty as to the timeline or even the final form of their implementation. However, the FSLRC has given much food for thought to both the government and regulators, with there being much merit in a system that touts the primacy of consumer welfare.

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