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Comments on the Approach Paper of the Financial Sector Legislative Reforms Commission (FSLRC)

I. Background

1.1 For many years now, the financial regulation and supervision across countries in the world have been addressing the need to restructure the function on the grounds that the extant regulatory structures were established in a decidedly different market environment than exists today. The regulatory structure was predominantly based on specialist agencies. The need for restructuring perhaps is also felt on account of the move to financial conglomerates that combine banking, insurance and securities businesses. Some countries are seeking the fruits of economies of scale in regulation through improved management of regulatory resources, like human resources, and infrastructure support while others are driven by the need for effective supervision of financial conglomerates. Mainly, the restructuring efforts have been in one of the following ways:

- Separate agencies for each main sector;
- Combined securities and insurance regulators;
- Combined banking and securities regulator;
- Combined banking and insurance regulators;
- Unified supervision (in the central bank); and
- Unified supervision (outside the central bank).

1.2 A review of the international experience informs that some countries have created a single agency for supervision while others have opted for multiple agencies and some have created unified agencies. In the Pacific, 'twin peaks' model of unified financial services supervision which places emphasis on the objectives of regulation: systemic stability and consumer protection. Mauritius had been contemplating exclusion of banking sector in its model of unified supervision. Countries contemplating restructuring of financial supervision have mainly kept in mind whether some model of unified supervision should be followed and if so, how that should be done.

1.3 The dissimilarities point to the fact that there is a range of alternatives and that too even within the same basic model. Country-specific factors such as historical evolution, structure of the financial system, political environment and the size of the country and the financial sector have prevented emergence of a universal common pattern. Nevertheless, the general trend is to reduce the number of regulatory agencies in the sector.

1.4 The Indian financial sector scenario presents similarly distinctive features, such as:

- Over 60 Acts and multiple rules and regulations;
- The RBI Act and Insurance Act are of 1934 and 1938 respectively;
- The Securities Contract Regulation Act was enacted in 1956 when derivatives and statutory regulators were unknown; and
- Piecemeal modifications in the financial governance regime have induced complex and cumbersome legislations adversely impacting harmonisation and have further fragmented the regulatory architecture.

1.5 The Financial Sector Legislative Reforms Commission (FSLRC) was set up in the Budget 2011-12. Besides the features described above, the immediate trigger necessitating the constitution of FSLRC to address the issue holistically was the regulatory dispute or turf war between Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) over who should control ULIPs.

1.6 That finance is an integral element of India's growth and development and how it impacts a wide range of economic activities has been aptly described by citation of two examples in the Approach Paper of FSLRC. At one end, India requires over 50 percent of its GDP (Rs55tn) by investment in infrastructure which is not available in local markets and thus has to be borrowed in foreign currency often resulting in mismatches between rupee revenues and foreign currency repayment obligations causing acute difficulties. On the other a small oilseed farmer without irrigation is subject to an array of risks such as monsoon failure and oilseed price fluctuation. A capable financial system can manage such extreme uncertainties.

II. Mandate of FSLRC

2.1 The remit of FSLRC as contained in the Terms of Reference (ToR) is holistic as a complete review, simplification and re-writing of legislations affecting financial markets focussing on broad principles; evolving a common set of principles for governance of the sectors regulation; removing inconsistencies/uncertainties in legislations/rules/regulation; making legislations consistent and dynamic to automatically tune them to the changing landscape and streamlining of regulatory architecture of financial markets is sought.

2.2 The ToR could be construed as a line of action in favour of having one regulator for the financial sector in India, i.e. cognate sectors, such as banking, non-banking financial services, stock markets, etc. clubbed under the rubric of 'financial sector'. The ToR could also be construed to indicate taking the specified steps for each of the extant regulators in the financial sector.

2.3 What the ToR does not specify is to examine regulatory co-ordination and sharing of information amongst different existing regulators. This is relevant in respect of financial conglomerates that undertake a combination of activities and are placed under multiple regulators. (Please also see 4.2 and 4.3 below)

III. Work Process

3.1 Of the four components of the report proposed by FSLRC, the critical one is the fourth, namely, transition issues. The challenge here is twofold – one emanating on account of predictable turf wars and the other passage of Bills drafted. While the first issue is sought to be resolved by the on-going process of consultation with existing financial regulators, it is the second one which needs greater attention. Besides, creation of a Unified Financial Agency would itself require a new legislation and that process is likely to be exploited by special interests.

3.2 The numbers of Bills that are pending for passage as on date give an indication of what might be in store for such large-scale changes in legislations.

IV. Financial Regulatory Architecture

4.1 The financial sector architecture proposed by FSLRC alters the landscape to the extent that it brings down financial regulatory agencies from existing eight to seven by reallocating responsibilities of RBI; by unifying work of SEBI, FMC, IRDA and PFRDA and by strengthening the appellate and redressal mechanism. The model proposed by FSLRC, therefore, does not entirely meet with the current global trend to bring down the number of regulatory agencies. This is possibly on account of 'late movers advantage' keeping in mind that the idea of a single regulator is yet to pick up pace worldwide.

4.2 Earlier, the Deepak Parekh Advisory Group on Securities Market Regulation had recommended that a system for sharing market information automatically for the different regulatory bodies be devised to avoid the need for creation of an entirely new system, now being proposed. Similarly, YV Reddy also preferred an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the jurisdiction of existing regulators. What he favoured was regulatory coordination rather than unification. While these would certainly have been examined by the FSLRC, it would be good if reasons for not considering them are also made a part of the exercise and feedback.

4.3 The proposed creation of a new Financial Redressal Agency (FRA) appears to have been tasked with implementing the regulatory architecture and as a nationwide machinery to act as a one-stop window where consumers can carry complaints against all financial firms. Coupled with the proposed creation of an independent Resolution Corporation; modification of the existing Financial Stability and Development Council (FSDC) and setting up of Financial Sector

Appellate Tribunal (FSAT) fragments one aspect of regulatory architecture while unifying another - that of SEBI, FMC, IRDA and PFRDA. Why not an umbrella regulatory legislation now itself rather than after 10 years? (Please read section 133 of the Approach Paper) The fact of staffing the new agencies with the right talent also needs detailed examination in view of the paucity of domain expertise. The new agencies would need protection from the phenomenon of sinecures widely prevalent.

4.4 Some critics point out regulatory arbitrage where institutions create products that fall outside the purview of a single regulator. How, for instance, forays in insurance by banks be regulated given the fact that regulating banking would remain with the RBI but IRDA would be under the UFA? One way to look at the issue is to regulate the product under the industry it falls and not in the sector (in the example given above insurance products of banks would fall under UFA and not RBI).

4.5 It is not clear which of the agencies referred in 4.3 above would look into aspects of interpretation. Take for example RBIs view that credit cards are basically a part of the 'payment mechanism.' It is clear that the purpose of a credit card is to provide credit and once provided, it is a matter of recovery of a 'loan' and not 'payment' – it is 'repayment.'

4.6 There is a one crucial gap in the paper's recommendations and that is the handling of the RBI. However, it does say that this should be revisited in five or ten years, which is not a practical suggestion. Given the number of institutions that the paper sets out to dissolve, the proposed new process might take five or ten years to complete. Thus, hypothetically speaking the next stage of financial regulation reform i.e. cover RBI will probably be three or four decades away.

V. Independence and Accountability

5.1 The approach paper clearly outlines the need for greater accountability for the regulatory process; however, the approach paper does not clearly address how such autonomy will flow to the system. The approach paper has suggested the need for a single regulator on the grounds that this would improve the accountability of regulation. But as global experience shows, the idea of a single regulator is yet to pick up pace, with only two major economies – the UK and Japan—being among the 15-odd countries that have one. Further, creating a regulatory monopoly could see it functioning in a more rigid and bureaucratic manner, resulting in diseconomies of scale. And, scale is certainly a problem in the Indian as there is little regulatory presence in States other than the four metros.

5.2 The paper does not specifically mention on how autonomy and independence of these regulatory bodies can be ensured. Although, FSLRS has stressed on the need for independence of regulators, how minimal government intervention can be achieved is still a grey area, which needs to be analysed.

VI. Noteworthy Principles

6.1 FSLRC has made extremely pertinent references to basic principles of financial sector regulation. Importantly, it has focussed on a broad financial consumer protection act where consumers are protected from fraud and there is a programme to ensure full disclosure. This coupled with FSLRCs stress on prevention and cure (micro prudential regulation) is also commendable. These are the cornerstones of the modern approach to financial sector regulation and countries such as Australia and Canada that had implemented the same proved resilient during the recent crisis.

6.2 Equally praiseworthy are the principles of resolution and redressal that the FSLRC has relied upon. That the issues of systemic risk and development have been brought to the fore is a welcome departure from regulation being reactive rather than proactive. Failure of firms must happen at minimum cost to the consumers is envisaged.

VII. Conclusion and Recommendations

7.1 The approach paper does not address the ethical and corporate governance issues facing the financial sector but focuses more on protecting consumer interests, complaint redressal and systemic and financial risks affecting the sector. FSLRC needs to constitute a mandatory code of ethics and governance framework for financial institutions and intermediaries, with punitive actions for non-compliance.

7.2 The approach paper does not list out the operational issues of merging the regulatory bodies' viz. SEBI, IRDA, PFRDA and FMC into a Unified Financial Agency (UFA). It is agreeable that a unified structure and an independent consumer redressal mechanism will be far better than the current vertical structure which allows for regulatory overlaps. But without a greater clarity on contentious issues such as those relating to regulatory functions, etc, the stakeholders will not have a clear idea on the effectiveness of such a framework.

7.3 There exists huge difference in underlying regulatory agenda of each of the regulatory bodies and bringing them under one umbrella might give rise to potential conflicts. Thus, if the existing institutions were to be merged then how these conflicts would be managed should be pondered over.

7.4 The present regulatory architecture consists of multiple regulators for banks, pensions, insurance, commodities and securities. Proponents of the single regulatory body argue that as more complex products and services are introduced, a single agency can help prevent any turf war between different regulatory bodies. But, the key issue to be pondered here is do we have the necessary skill-set to have one super regulator?

7.5 Also, the duration required for implementing the proposals will be a key concern. The proposals would work well, only if all the reforms mentioned in the paper are implemented simultaneously and not on a piece-meal basis.

7.6 Given the above views, it is advisable for India to continue with the existing framework of supervision by separate agencies and direct efforts towards effective regulatory coordination, sharing of information, etc amongst different regulators. There is a certainly a need to devise an institutional mechanism for conflict resolution. One had hoped that this new commission would develop a framework for regulators to consult on overlap matters as a mandatory duty and come up with a consensual solution, which it has failed to do so. Mandatory consultation among regulators is one of the most effective ways to avoid regulatory conflict/turf issues.

An opportunity for mandatory consultation will also ensure the independence and autonomy of the regulators. In the case of failed consultations, the matter can be referred to a High Powered Committee (HPC) consisting of secretaries of the various departments/ministries and headed by the Cabinet Secretary. Such a provision will be in line with the mandate of the apex court laid down in ONGC vs Collector of Central Excise, asking public bodies to resolve their disputes through an HPC, instead of coming to court at the cost of the public exchequer.

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CUTS International **02nd November 2012**