Report proposes revamp of financial sector framework

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

The 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 global standards. Two years later, a report has been released which advocates a comprehensive overhaul of the regulatory framework, including replacing a substantial body of existing laws with an Indian Financial Code drafted by the FSLRC.

The FSLRC has suggested the creation of a Unified Financial Agency (UFA), which would be entrusted with micro-prudential regulation and consumer protection for all financial sectors other than banking and payment systems. The agency would subsume the existing regulators for capital markets (Securities and Exchange Board of India), forward markets (Forward Markets Commission), insurance (Insurance Regulatory and Development Authority) and pensions (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. (Currently 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 a Public Debt Management Agency, an independent body which would take over the handling of governmental market borrowings from the RBI, and would additionally manage the government's cash and contingent liabilities.

The Financial Stability and Development Council, which currently comprises various sectoral regulators and officials of the Ministry of Finance, would become a statutory body responsible for managing systemic risks and coordinating among 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 systematically important financial institutions or those having strong links to consumers (such as banks, insurance companies and pension funds).

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

A few brickbats

The FSLRC's recommendations have attracted criticism – the report itself features four notes of dissent. A recurring theme is the absence of clinching evidence of the superiority of the super-regulatory model, with the UK being the latest to abandon this experiment. Given how the Indian economic system seems to have escaped the worst excesses of the global financial crisis, domestic regulators may feel hard done by.

The division of labour between the UFA and the RBI is based on the premise that consumer protection can be achieved 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, the proposed exclusion of NBFCs from the purview of the RBI seems inconsistent with this logic as NBFCs pose a systemic risk due to banks' significant exposure to them.

Another key talking point has been the proposed dispersal of regulatory powers in relation to external liabilities, namely monetary policy (RBI), capital control (central government) and balance of payments (shared between the RBI and the cental government). This division seems artificial and may prove detrimental to effective management if implemented.

Conclusions

The FSLRC's recommendations for a financial regulatory structure independent of sectoral limits could help solve issues of regulatory arbitrage and lack of regulatory coordination. However, a lot depends on finding adequate human resources to staff such agencies, as well as the successful integration of existing bodies into a new system.

The Finance Ministry is currently examining the recommendations of the FSLRC and, while the timeline and the final form of their implementation are uncertain, there is undoubtedly much merit in a system which touts the primacy of consumer welfare.

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