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# A NEW REGULATORY ARCHITECTURE FOR INDIA

Since the reforms in the early 90s, the financial sector in India has achieved considerable diversification and maturity. Banking, insurance, securities, pensions- all have been major focus of reforms, restructuring and institutional innovations. One of the main steps in this endeavour has been in strengthening/ restructuring the regulatory mechanism. Others include new players and new products in the markets, consolidation through M&A, strategic tie ups and so on.

Securities markets, probably, has witnessed the most spectacular gains in the last 15 years. Apart from having an empowered, independent statutory regulator, this market has evolved in terms of diversity of intermediaries in the form of modern exchanges, depositories, clearing corporations, custodians, corporate brokers and product innovations, particularly on derivatives. National Stock Exchange of India and Bombay Stock Exchange are amongst the largest in the world in terms of trading volumes, single stock futures clock the largest volumes at NSE.

The following table gives a snapshot of the strength of the securities markets in terms of the stakeholder participation.

| **Market Participants** | **Number** (as on March 31,2007) |
|---|---|
| Depositories | 2 |
| **Stock Exchanges** | |
| with equities trading | 22 |
| with debt market segment | 2 |
| with derivative trading | 2 |
| Brokers | 9443 |
| Corporate Brokers | 4076 |
| Sub-brokers | 27894 |
| FIIs | 996 |
| Portfolio Managers | 158 |
| Custodians | 11 |
| Registrars to issue & Share Transfer Agents | 82 |
| Primary Dealers | 17 |
| Merchant Bankers | 152 |
| Bankers to issue | 47 |
| Debentures Trustees | 30 |
| Underwriters | 45 |
| Venture Capital Funds | 90 |
| Foreign Venture Capital Investors | 78 |
| Mutual Funds | 40 |

Source: Indian securities markets-A review: National Stock Exchange of India Ltd.

While, the market intermediaries exhibit considerable diversification and maturity it is generally felt that further consolidation requires a re-look at the regulatory architecture, both in terms of an enabling framework as well as in terms of impact cost. While the securities market is a segment of the financial market this segment itself is under four regulatory authorities-, Ministry of Finance, Ministry of Corporate Affairs, Reserve Bank of India and the Securities and Exchange Boards of India. With banking under the RBI, insurance under the IRDA and pensions under the PFRDA the financial sector market regulators are 4 in number. Add commodity derivatives we have one more market regulator and a policy ministry getting into the picture. This highlights the importance of regulatory co-ordination, co-operation and eventually convergence as the regulatory architecture of the financial sector or sub sectors are complexly interlinked resulting in regulatory overlaps and twilight zones.

Several committees and independent analysts have looked at this issue. One of the recent of committees, in its report on Making Mumbai an international Financial Centre, has been the most forth coming on this issue while calling for a complete legislative/policy integration of the financial sector through a unified Financial Services Modernisation Act. However, it should be noted that even this report did not call for one super financial sector regulator for India. Further this committee recommends a shift form rule/ prescriptive regulation to a principle based regulation. Others, like the Committee of Financial Sector Reforms (CFSR) were less vocal on the issue of full convergence but still emphasise partial convergence such as on organised financial trading. All of them, including the recent Committee of Financial Sector Assessment, emphasises greater regulatory cooperation. The idea of convergence has to be seen also in the context of globalisation of the financial sector. We cannot have a fragmented domestic financial regulatory architecture, while talking of global regulatory coordination.

India has an impressive array of statutory regulators overseeing the financial markets and some of the infrastructure sectors, consequent to an ambitious drive of building/restructuring of institutions mainly since the reforms of the early 1990s. Regulators on banking, securities markets, insurance, commodity *futures* market, telecom and power are now well established. Others, in the area of competition policy, petroleum & natural gas and pension are at different stages of formation and still some others (civil aviation, railways) are in the pipeline.

Regulators are organizations entrusted with legislative, executive and judicial functions simultaneously. More precisely they discharge quasi-judicial, quasi-legislative and administrative/executive functions in specific areas of responsibility. They license, regulate, supervise and promote activities in their domain. They also punish the wrong doers, mainly through monetary penalties. Location of regulators as institutions of fusion should be clearly understood to avoid confusion emanating from the doctrine of separation of powers as well as in avoiding inter-institutional bargaining. There are also judicial pronouncements, relating to their constitutional permissibility and validity.

The argument for separate regulators to discharge specific functions emanates from the economics of regulation via transactions costs. Information asymmetry, externalities and scale economies (and natural monopolies) are the core reasons for regulation. It does not, however, matter who regulates, govt or a governmental body or a separate empowered agency unless the transaction cost angle is brought in. Then one could argue that the system or agency closest to the point of contact and the most flexible should discharge the function. Thus emerges the economic or functional logic of statutory regulatory authorities (SRAs).

While the economic and administrative reasoning/logic of having regulatory authorities as well as the source of their statutory background is the same, it appears illogical to see a large number of them clouding the landscape, that too with a high degree of variability in their designs, not necessarily dictated by any peculiarity of the domain being regulated. Such variability of design in turn affects their constitution, powers and functions, which is creating lot of avoidable confusion. For instance, there is no general agreement even on the issue of tenure, re-appointment, age limit, etc.

It is also important to bring out a crucial difference in the basic mandate between financial sector regulators and infrastructural regulators. While the former is basically to address the crucial information asymmetry in markets the latter is to deal with externalities. The degree of expectation from these two sets of regulators would, therefore, vary as the speed of response as well as impact required is totally different.

One of the crucial areas of policy balancing relates to the interface between statutory regulators and the executive (Government) while accountability to the legislature and the judiciary are spelt out in macro terms. There are operational issues regarding the accountability arrangements with the Government. While the Government prescribes/decides prescription of rules on eligibility, terms & conditions, process of appointment/removal, source and application of funds, facilitation of parliamentary interface, interaction with foreign governments etc the degree of accountability of the regulatory agencies to the Executive is not fully codified.

From the above analysis, it is obvious that the financial sub sectors have progressed under a fragmented regulatory architecture-a sort of regulatory constraint. Issues of coordination have been dealt by an arrangement called High Level Coordination Committee on Financial Markets (HLCCFM), chaired by the RBI Governor and represented by the Finance Secretary and Chairpersons of all financial sector regulators. Inter-regulatory coordination, though taken care of partially by such an umbrella structure, is still a real issue when it comes to matters of details and fine tuning. Experience with fostering the markets on corporate debt, currency derivatives, and operational rules relating to foreign venture capital, FIIs, private equity and a host of other issues get into these legacy constraints of fragmented regulation that would invariably stunt the natural development of a seamless market under a coherent regulatory frame.

Yet another issue is that of streamlining accountability of regulators, particularly vis-à-vis the executive. Since the executive is still accountable to legislature, executive interface with a regulator is at times interpreted as interference in their autonomy. Such a notion has to be dispelled either by making the SRAs directly accountable to the legislature or by institutionalizing their interface with the legislature, executive and the judiciary in terms of concrete accountability arrangements. Moreover information seeking consultation and prior policy discussions cannot be construed as violating autonomy as that is the spirit on which the various autonomous branches of the State (between the federal government and state governments, between the various ministries and departments and even between the legislature, executive and judiciary) function harmoniously in a federal, multi-institutional environment. After all, regulation is about setting standards, gathering information and modifying behaviour of participants bench-marked on the pre-set standards.

Designing regulatory architecture is a political-economy issue. As such there are many forces and countervailing forces at work. No wonder we have various types of regulatory models in existence globally-from the fully converged UK model to the highly fragmented, complex US model. India comes in between. But in charting a holistic architecture we need a regulatory vision. Regulatory autonomy, accountability and structure have to be built in to the frame in a coherent manner while looking at the overarching institutional issues. It is equally important to design the structure to minimize the transaction costs- the very reason for this institutional innovation. Here it appears logical to have a converged regulatory structure while dealing with the interlinked markets to facilitate greater and better engagement with a seamless, globalised financial market.

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