Issues in Choosing Between Single and Multiple Regulators of Financial System•

Respected Chairman, Dr. Patel, Dr. Isher Ahluwalia and distinguished participants.

I am here in fulfillment of a promise made to Mrs.Isher Ahluwalia some time back to make a presentation at this prestigious institute. Needless to say it is a privilege to be here; and I am thankful to the organizers for giving me freedom to choose the subject of the day. My fascination for this subject is only about four yours old. Dr. Rangarajan, the then Governor deputed me to attend the fourth Central Bank Governors Symposium in London on my way to the annual meeting of Bank for International Settlements at Basle. The broader issue of financial regulation and the contemporary issue of single regulator had then just been decided upon in United Kingdom. In view of recent interest in the subject in India, I thought that I should share my thoughts on the choice between single and multiple regulators for our financial system. It is a great personal honour to me that Dr.I.G. Patel is presiding over this session as his scholarship, statesmanship, sage counsel, and outstanding leadership are admired by all of us.

I have divided this presentation into five parts. First, the institutional structure for regulation needs to be considered with an initial broad understanding of the rationale for regulation, regulatory coverage, policy frame and the operational aspects. Second, the structural aspects of regulation are presented encompassing the reasons for recent interest in the subject, pros and cons of single *versus* multiple regulators, the international experience and the developing countries' perspective. Third, the current status of the regulatory structure. Fourth, the contours of the current debate on the subject. Fifth part, the issues for consideration. It is argued that the historical context, the state of development of financial markets and the level of skills available should be considered in making a choice. It is also argued that apart from single and multiple regulators, hybrid arrangements can be explored to suit the requirements of our country. While change from the current status appears desirable, the issue is not only one of choosing an appropriate model, but also one of managing the process of change and sensitizing all participants to the changing circumstances. In any case, an ideal structure by itself does not guarantee optimal regulation, and in any structure, coordination among all wings involved, including the Government, is critical.

Financial Regulation

There are several theories that attempt to explain regulation in general and financial sector regulation in particular. These include theory of competition for regulation and theory of regulatory capture on the one hand and public interest theory aimed at correcting market failures on the other. Since there are virtually no takers for frontier capitalism, the rationale for regulation lies in the search for a public policy that makes markets work better, while avoiding the dangers of excessive burden by treating regulation as a free good and the scope for regulatory capture by the few suppliers compared to the large dispersed consumers. More generally, the objectives of regulation are to avoid monopoly power, foster competition and protect the consumer's interest.

In regard to financial regulation, however, there is a slight change in emphasis in the objectives of regulation in the sense that the focus is on maintaining systemic stability and protecting the interest of the customer. Maintaining systemic stability is important because social costs of financial distress are high in the form of the contagion effect. A wholesale customer, such as a corporate or large net worth individual, should be in a position to have the capacity and resources to make informed choices. But, a retail customer, such as small saver or small borrower, cannot incur the cost of getting information, acquire or employ skills to analyse, have large enough volumes to learn from experience, big enough portfolio to spread risks, and as such will be unequal in relation to the financial intermediary. Above all, economies of scale are likely in monitoring of information on a collective basis. In brief, the why of financial regulation should be considered essentially in the light of the primary objectives, namely, maintaining systemic stability and giving an impression of protecting interests of the retail customer; and implicitly other objectives will have to be secondary.

In India the regulation of financial sector has evolved as an instrument of planned development. In such a situation the objectives are mobilisation of savings, and allocation of investible resources mainly through public sector and or administered prices of financial products. There has been an implicit sovereign guarantee of maintaining systemic stability and in the process giving an impression of protecting interests of all participants. The management of the financial sector, therefore, contained a variety of objectives and to this end many financial institutions were nationalised (banks) or created

(Industrial Development Bank of India or Unit Trust of India) to subserve ends of planned development, thus relegating the role of competition as an instrument of efficiency to a secondary position. Furthermore, co-ordination among the financial institutions took precedence over arms length relationships or checks and balances, thus introducing what may be called a joint-family approach to financial transactions, which undermined both the degree of transparency and the extent of accountability.

The next question is, what constitutes regulation. Regulation in its broadest sense includes establishing specific rules of behaviour, or regulatory aspect *per se*, monitoring or tracking observance of behaviour; and supervision or oversight of the compliance with specific rules in the overall behaviour along with disincentives and penal provisions for non-compliance. There are some arguments in favour of formally separating the regulatory aspects from supervisory aspects but the current international practice favours the two functions being viewed together. In this presentation, the functions are not viewed differently, and the terms regulation and supervision are used interchangeably to cover all three functions, unless otherwise indicated. The Reserve Bank of India (RBI) is generally looked at *inter alia* through three angles, viz., (i) monetary authority (ii) regulatory authority (iii) supervisory authority. It is clearly possible to separate the monetary function from the other two though such a separation between regulation and supervision could pose problems. The impression that the supervisory function needs to be segregated from the regulatory responsibility has been reinforced by the recommendations of the Narasimham Committee (1998) to the effect that the supervisory function be removed from the central bank and be made autonomous. In operational terms, however, supervision is an integral part of the regulatory framework. In India, in some instances, regulation, monitoring and supervision are combined with business or commercial relationship as in the case of National Bank for Agriculture and Development (NABARD) or Small Industries Development Bank of India (SIDBI). It is not uncommon to find such apex supervisory institutions competing or jointly financing with the institutions that they regulate and refinance some of them as in the case of state-level industrial corporations. Thus developmental objectives are pursued jointly by national and state-level public-sector financial intermediaries, some of which, like Industrial

Development Bank of India (IDBI) have private-shareholding also, and in the process, the distinction between regulator and participant in the business gets blurred.

The objective of regulation may be institution based or function based or even product or market oriented. In other words, a regulator may regulate banks though banks may involve themselves in other activities such as being an intermediary in capital markets. Alternatively, the capital market regulator may regulate all activities relating to public issue or trading in securities whether those functions are performed by banks or non-banks. Similarly, all institutions which take public deposits may be regulated by one regulator. Yet another approach is to consider regulation in terms of markets say government securities, or money market or forex. In India, capital markets and insurance activities were regulated by Ministry of Finance till the Securities Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA) were set up recently while Development Financial Institutions (DFIs) have recently begun to be regulated / supervised by RBI. While most banks are regulated by the RBI, some are under dual control of government and RBI. Department of Company Affairs (DCA) regulates deposit taking activities of corporates other than banks and non-banking financial companies registered under companies Act, but not those which are under separate statutes. Thus, the object of regulation itself is susceptible to some overlap, but the major issue in this regard relates to the regulation of banks, namely whether banks should be necessarily treated as a separate and special group of institution for regulatory purposes.

There has been significant debate on whether banks are special, and should be treated as such. The rapid development of capital markets, increasing importance of non-bank sources of financial intermediation and the emergence of universal banking have led to the erosion of importance as well as uniqueness of banks as financial institutions. There are, however, three major reasons adduced for treating them as special. First, they are participants in the payments system and hence are the backbone of the financial system. The systemic risks of any one bank being affected either on account of its banking operations or on account of non-banking operations are high. Second, the banks contract for liquid deposits to acquire illiquid assets and hence are vulnerable to liquidity crisis. This would underline the need for a lender of last resort. Third, the banks are the

major service providers for retail customers and are, therefore, on a separate footing in terms of consumer protection, especially since the customers of a bank are typically risk-averse. In other words, while retaining incentive for banks to be always solvent, there is constructive ambiguity in extending liquidity by lender of last resort. Thus, banks, particularly those with access to payments system are generally treated as a separate class in a regulatory framework – particularly in developing countries. In India, all banks are subject to RBI's regulation but the framework is not uniform in the sense that public sector banks, cooperative banks, and private banks are governed by significant differences and not all of them have access to the payments system. The RBI is a regulator of banks but is also the dominant owner of the largest commercial bank. Such close links were considered essential for effective coordination in financial sector as part of the early endeavours of planned development and the channeling of credit.

Regulation policy should recognize and admit that the fact of regulation does not guarantee that there will be no risk of failure or insolvency of a regulated unit. In fact, a zero failure system is likely to be sub-optimal. There is always a danger that people perceive that mere act of an entity being regulated provides a guarantee from the regulator that it is risk free to transact business with the unit. The risks arise due to several problems, mainly related to lack of information. First, it is difficult to precisely assess even for the regulator how good the internal controls in a regulated entity are on an on-going basis. Frauds that occur in connivance with the management of the bank are even more difficult to detect if they occur between two inspections as the offsite surveillance may not throw up this information. Second, there is no way of perfect and continuous assessment of adherence to the external rules imposed by the regulator. Third, even under most prudent circumstances, there is a residual risk.

Regulation is often perceived to be a free good, available at no cost, but it is not so. There are costs of administering regulation; of compliance; and there are also structural costs. Excessive or inappropriate regulation can stifle efficiency, and invite problems of what are known as moral hazard and adverse selection. It may even provide incentives for the over regulated business overtly or covertly depending on the nature of the business to move to entities which are not so regulated. Moreover, there are savers who are willing to have a portfolio with different degrees of risk and return and correspondingly there are

investment avenues. An efficient regulatory policy should provide avenues for a spectrum of risks and rewards, make it clear that regulation by itself does not guarantee risk-free transaction and ensure that overall benefits to the system are commensurate with the overall costs incurred. All failures of a regulated unit do not represent failure of regulation and a regulator cannot guarantee compensation for those affected by failures other than those covered by deposit insurance. But, a regulator has to maintain the credibility in terms of assurance of systemic stability and consumer protection, especially in terms of information availability in a timely and transparent manner particularly to retail customers. "Public policy arrangements should never eliminate the incentive for consumers of financial services to exercise due care" (Charles Goodhart, 1998).

It is useful to refer to some operational aspects of financial regulation, which impinge on effectiveness of regulation. First, how much of regulation through supervisory arm should be externally imposed by regulator and how much should be left to market discipline so as to make the behaviour of the regulated unit consistent with regulators intent. Second, whether intensity of regulation is such that it is considered to be the minimum with incentive for better behaviour by the regulated unit or is regulation such as to ensure mere compliance and no more. Third, how much of regulation should be off-site and how much on-site. Fourth, how much of regulation should be incentive based, which would include disincentives. Fifth, how far do consultations with market participants help enhanced efficiency and when does such consultation end up as capture of regulator by the regulated. Sixth, how much of findings of supervisory oversight be put in public domain and how much kept for communication between the regulator and the regulated. Seventh, how much of the supervisory oversight should be strictly rule based and how much of judgment of overall compliance acceptable. Briefly stated, the answer to all these questions lies in seeking and striking a right balance. These are several issues which need to be addressed irrespective of the structure of regulation. Of particular relevance to Indian conditions is the need to appreciate the difference between administering law or public welfare and regulation of financial entities and also not mixing up issues between the two roles. Similarly, process of deregulation or rationalization of regulation should not imply dilution in supervision and, in fact, should

be complemented by close monitoring and effective supervision, especially adequate and timely penal action as appropriate.

Finally an optimal regulatory framework ensures both autonomy and accountability of the regulator. To ensure these, regulatory objectives need to be spelt out clearly and full operational freedom granted to achieve the objectives through exercise of powers granted to the regulator over the regulated entities. At the same time, the regulators should be as transparent as possible and fully accountable. Accountability should no doubt be with reference to overall objectives and effectiveness. If individual actions of a regulator are subjected to external scrutiny, there may be a preference for regulatory inaction, just as, if individual case of inaction is subjected to such a scrutiny, there may be superfluous or even obnoxious regulatory actions. In brief, the credibility of a regulatory framework is enhanced by making it accountable for the overall performance in terms of well defined objectives. In India, many of the joint family approaches are not consistent with some of these principles. For example, the regulator has a nominee on the board of the regulated. The Government to whom a regulator is accountable has dominant presence on the board of a regulator, who has to exercise operational autonomy. These arrangements may give some advantages of coordination but have also disadvantages of role-conflict leading to inadequate regulatory focus and diffused accountability.

Structural Aspects of Financial Regulation

Recently, there has been significant attention to structural aspects of regulation. Thus, a unified regulator was announced in UK in 1997; changes have been considered in Australia and reform has been brought about in Japan. Further, legislative changes in the USA have to some extent diluted the compartmentalization of financial activities and regulatory framework, which had been described as "hotchpotch of different regulators for different bits of financial services industry, mainly for reasons of history rather than deliberate strategy" (The Economist, May 5, 2001). Irrespective of the actual policy preferences or reforms across the globe, the structural issue of financial regulation has recently gained attention for several reasons.

First, the growth of financial sector is characterised by the blurring of distinction between banking, securities and insurance activities.

Secondly, even if these institutions and activities are treated with a compartmental approach and even if risks are considered separable, the linkages are such that the contagion cannot be avoided.

Thirdly, globalisation has resulted in multifunctional global conglomerates warranting appropriate changes in structural aspects of domestic regulation.

Finally, it is argued that banks can still be treated separately for purposes of prudential requirements without necessarily linking them with the central bank, whose primary responsibility should be price stability.

In considering the pros and cons of single regulator or unified regulation and multiple regulators, a major issue that needs to be addressed is: should banks be supervised by central banks? A case for keeping supervision with the central bank is generally made out on the following grounds.

First, in order to assess the creditworthiness of the participants in the payments systems, the central bank needs to form a judgment on aspects of liquidity and solvency and prudent conduct of banks.

Secondly, supervision complements the central bank's market intelligence system with a detailed knowledge of the strengths and weaknesses of individual banks and, therefore, of the banking system as a whole.

Thirdly, knowledge of developments in the banks' balance sheets can be important in assessment of macroeconomic conditions.

Fourthly, lender of last resort function has a potential for moral hazard in the system and may cause banks to gamble for resurrection, requiring the central bank to ensure that banks are well supervised.

Fifthly, there are substantial economies of scale, especially when there is scarcity of skilled professionals in the area of finance.

Sixthly, independence of bank supervision is automatically provided if the central bank enjoys autonomy, thus avoiding politcisation of bank regulation. In other words, central banks do enjoy a tradition of independence and lesser politicisation.

There are, however, strong advocates of separation of monetary policy function and of banking supervision too. It is said that monetary policy independence would be compromised due to possible conflict between monetary policy and banking

regulation/supervision. For example, the central bank may relax monetary policy in times of extreme weaknesses in the banking system rather than for macroeconomic reasons. In fact, Dr.Rangarajan had stated "Therefore I feel that the responsibility of banking supervision being carried on to the central bank might make it more difficult in my opinion to gain the kind of independence that we are talking about" (Forrest Capie, Charles Goodhart, Stanley Fischer and Norbert Schnadt, 1994, page 357). Further, bank failures or weaknesses may undermine the credibility of the central bank.

Assuming that one has an open mind on the issue mentioned above, the arguments in favour of a single regulator can be summarized as follows:

First, there are economies of scale for the regulator since unification may permit cost savings on the basis of shared infrastructure, administration and support systems.

Secondly, the regulated units also benefit since unification mitigates the costs which supervised firms with diverse activities (i.e. financial conglomerates) bear for dealing with multiple regulators.

Thirdly, accountability is enhanced since complexity of the multiple supervisory system could lead to lack of clarity of roles and consequently lack of accountability.

Fourthly, regulatory arbitrage can be avoided in the case of a single regulator. In a multiple regulatory regime, fragmentation of supervision could lead to competitive inequalities as different units, possibly offering similar products or services, are supervised differently.

Fifthly, reducing the number of regulators could allow scarce supervisory resources especially in specialist areas to be pooled.

Sixthly, a single regulator can respond more effectively to market innovation and development as there would be no regulatory gray areas.

Finally, unification aids in international cooperation as there is a single contact point for all regulatory issues. In developing countries where banks dominate in banking insurance and securities business, there may be a case for unified regulation.

Not surprisingly, the arguments against the idea of a single regulator are equally strong.

First, unification could lead to lack of clarity in functioning as multiple regulators tend to have different objectives. This objective may be depositor protection for banks *vs* investor protection for capital markets *vs* consumer protection for other financial firms.

Second, concentration of power could vitiate democratic policies.

Third, there may actually be diseconomies of scale since monopolistic organizations can be more rigid and bureaucratic than specialist agencies because they would typically be large and too broad based structures for effective regulation of the entire system.

Fourth, there may be unintended consequence of public tending to assume that all creditors of supervised institutions will receive equal protection.

Finally, the focus of banks, securities and insurance supervisors being different, pooling of skills and objectives, pooling of resources may not produce the synergy that is expected.

One way of reconciling the idea of a single regulator with keeping bank supervision as a part of central bank is to have the central bank itself as a super regulator. A clear example of this unified supervision is the Monetary Authority of Singapore.

In USA, there are multiple regulators even for banks who are accountable to Federal Reserve, FDIC and State authorities.

In India, there is a separate agency for each main sector but there are examples of a variety of combinations such as combined securities and insurance regulators (Chile, South Africa); combined banking and securities regulators (Germany, France); and combined banking and insurance regulators (Australia, Canada). Currently, examples of unified regulator outside the central bank are UK. Japan, Korea and Sweden.

It is also necessary to recognize that several arrangements are possible whereby the single or multiple regulators can function while ensuring appropriate coordination, sharing of facilities, and where appropriate establishing clear cut division of responsibilities. It is possible to readily identify four of them: (1) Unified Oversight Board which leaves the existing structure in place but overlay it with a newly established oversight board comprising heads of different agencies (South Africa). (2) Unification of support services which keeps agencies as separate legal entities but provides shared infrastructure and support services. (3) Shared facilities with central bank which establishes unified supervisory agencies as a separate agency, but have it share the support services with the central bank (Finland). (4) Memorandum of Understanding (MoU) which establishes framework of cooperation between government, central bank and single regulator

(Memorandum of Understanding of UK 2001). The guiding principles of the MoU are accountability, transparency, no duplication and information exchange.

The international status in regard to the regulatory structures has been reviewed by the International Monetary Fund (IMF, December 2000). The study notes that in approximately half of the countries examined in a recent study, the revealed preference is for a regulatory structure based on specialised agencies. The study shows that 35 countries have separate agencies for each main sector, 3 have combined securities and insurance regulators, 9 have combined banking and securities regulators, 13 have central banking and insurance regulators, 3 have unified supervision (in central bank) and 10 have unified supervision (outside central bank).

It will be interesting to explore further the countries that adopted the unified model. The ten countries classified as having adopted this organizational form are Australia, Canada, Denmark, Iceland, Japan, Norway, the Republic of Korea, Singapore, Sweden, and the United Kingdom. In at least two cases – Australia and Canada – the regulatory structure is not fully unified, as securities regulation is conducted separately from banking and insurance regulation. As mentioned already, in Singapore's case, regulation has been unified within the central bank. This leaves only seven countries that have fully unified regulatory agencies separate from the central bank. Over half these are in Nordic countries. In brief, while there is a significant global interest in examining the desirability of unified financial sector supervision – combining banking, insurance and securities regulation, the practitioners continue to be very few so far.

While there are only a few practitioners of unified model, it is noteworthy that almost all of them are developed economies. In examining this issue, it may be useful to consider the organizational status of banking supervision since banking is more special in developing countries. The Financial Stability Institute's publication on the subject (Occasional Paper 1), makes interesting observations : "The evidence appears to be that the weight of argument is moving towards the adoption of a separate unified supervisory body within more developed economies. But does that same balance hold for emerging and transitional countries?" The publication notes that in view of the Asian crisis, "it is possible that international pressures, e.g. through the IMF, will interact with domestic forces to lead towards better funded, more skilled and more independent supervisory

bodies irrespective of how these are structurally organized". The conclusion is instructive : "If so, then structure may come not to be an important issue for the conduct of banking supervision. Perhaps, but for the time being, the balance of argument would suggest that in less developed and transitional economies it would be safer and better to integrate banking supervision into the ambit of the Central Bank".

Mr.Howard Davies, in the Tenth C.D.Deshmukh Memorial Lecture "International Financial Regulation : The Quiet Revolution" makes a valid point of relevance to India: "in countries where the central bank is well established as an independent institution, and where the interplay between the banking system and the government's finances, perhaps because of state ownership, or state run programmes of lending, is close, then one can see a stronger argument for central bank involvement in banking supervision".

The reasons for caution in advocating unified model for developing countries have been articulated very well by Professor Charles Goodhart in the Eleventh C.D.Deshmukh Memorial Lecture "Whither Central Banking?": "I doubt whether the pressures to establish a unified, specialist, supervisory agency are quite so strong in most developing countries. The financial system is less complex, and dividing lines less blurred. Commercial banks remain the key players. Moreover, the Central Bank in most developing countries is relatively well placed for funding, is a centre of technical excellence, and can maintain greater independence from the lobbying of commercial and political interests on behalf of certain favoured institutions. If the supervisory agency is placed under the aegis of the Central Bank, it should share in these benefits of better funding, technical skills and independence. There are too many cases of supervisory bodies, outside Central Banks, failing in such respects. For such reasons I do not believe that the case for separation, which has become stronger in developed countries, should be transposed also to developing countries". It is, however, necessary to recognize that there may be a variety of systems, even among developing countries. However, in most cases, systems are underdeveloped in terms of coping mechanisms (such as good governance practices), which makes them fragile and more vulnerable. Besides, in developing economies, there is concentration of economic activity with few economic players. To deal with situations from such scenario, therefore, function specific supervision may be

necessary but not adequate unless there is an institutional framework for effective overall coordination.

Perhaps, one should also examine the possibility of unified supervision under central bank itself in the case of developing countries. On this, Dr Chandavarkar, who made an outstanding analysis of *Central Banking in Developing Countries* (1996) has this to state: "Although the case for the central bank's supervisory role is, on balance, stronger, this does not imply that there is necessarily a case for merger of existing autonomous supervisory agencies with central banks, which can continue, provided there is effective coordination between the agency and the central bank".

Current Status in India

In India, as in the case of many other countries, there are several agencies entrusted with the task of regulation and supervision of different institutions and market participants in the financial sector. While the specific objective may vary from depositor protection and investor protection to market regulation, their common concern is maintaining financial stability. The RBI regulates and supervises the major part of the financial system through its various departments. The supervisory role covers Commercial Banks, Non-Banking Financial Companies (NBFCs), Urban Cooperative Banks (UCBs) and some All-India Financial Institutions (AIFIs). Some of these AIFIs in turn regulate and/or supervise other institutions in the financial sector, viz., Regional Rural Banks (RRBs) and Central and State Cooperative Banks are supervised by the RBI through National Bank for Agriculture and Rural Development (NABARD); State Financial Corporations (SFCs) by Industrial Development Bank of India (IDBI) (to be transferred to SIDBI) and Housing Finance Companies by National Housing Bank (NHB).

The Board for Financial Supervision, which operates as a Committee of the Central Board of Directors of the RBI functions as an oversight supervisory body in respect of banks, NBFCs and AIFIs. It may be noted that while NBFCs have been brought under a firm regulatory framework through legal enactments, supervisory role in respect of AIFIs is of more recent origin. The AIFIs continue to be large in size but with significant direct links with the Ministry of Finance. The RBI-NABARD relationship has many different facets. On behalf of the RBI, NABARD supervises the banks in the rural cooperative

segment, viz., the State and Central Cooperative Banks. The banks in this sector are not supervised by the BFS. It also supervises the RRBs which are in part regulated by the RBI. The RBI currently licences and regulates Local Area Banks (LABs), which are treated as commercial banks, but the supervisory responsibility of these is with the RBI. Statutory provisions govern the supervisory responsibilities of Housing Finance Companies by NHB and SFCs by IDBI /SIDBI.

The Registrars of Cooperatives (ROC) of different states are a joint regulator for the banks in the cooperative sector, both urban and rural. (For multi-state institutions, the Central ROC under the Ministry of Agriculture is the main regulator). While RBI/NABARD are concerned with the banking function performed by them, the management control rests with the State/Central Governments. This dual control impacts the supervision of both RBI and NABARD over institutions in this sector.

SEBI regulates the capital markets and supervises several institutions such as the Stock Exchanges, Mutual Funds and other Asset Management Companies, securities dealers and brokers, Merchant Bankers and Credit Rating Agencies. SEBI regulates venture capital funds also. Companies in the insurance sector are regulated by IRDA. Banks are permitted to be involved in insurance activity through joint ventures / equity participation/selling agency type arrangements.

The Department of Company Affairs (DCA) regulates the deposit taking activities of non-banking non-financial companies and also some activities of NBFCs.

It is necessary to recognize that there are several mechanisms by which coordination among the regulators in the financial system is ensured.

First, there is exchange of information on a routine basis and on occasions through special request.

Secondly, a nominee of RBI is on the Board of SEBI.

Thirdly, there is a High Level Committee on Capital Markets presided over the Governor RBI with which the Finance Secretary, Chairman SEBI and more recently, Chairman IRDA are associated as members. The High Level Committee has constituted a Standing Working Group to enable coordination between Ministry of Finance, RBI and SEBI at the operating level and assist the Committee in its deliberations.

Finally, while nominees of Ministry of Finance and Department of Company Affairs are on the Board of SEBI along with a Deputy Governor of RBI, the Finance Secretary is a member (without voting rights) of the Board of Directors of RBI.

It must, however, be recognized that a predominant role for regulatory and supervisory coordination remains with Ministry of Finance for several reasons such as statutory basis of many financial intermediaries performing commercial functions, powers of appointment and dismissal of board level functionaries in public sector finance institutions, predominance of public sector ownership of financial intermediaries themselves, and above all the accountability to Parliament through the Ministry.

Current Debate in India

In India, the Committee on the Financial System, 1991 (Chairman : M. Narasimham) had strongly recommended that the "duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance should end and that the Reserve Bank should be the primary agency for the regulation of the banking system" (pp.130). Thus, the supervisory function of banks (and other financial institutions) was hived off to a separate authority as an autonomous body under the aegis of the Reserve Bank. The BFS was constituted in 1994 with the Governor, RBI as Chairman. The concept of a Super Regulator was raised in the Report of the Working Group for Harmonising the Role and Operations of DFIs and Banks (Chairman : S.H.Khan). The Group recommended as one of the options, the establishment of a Super Regulator to supervise and coordinate the activities of the multiple regulators in order to ensure uniformity in regulatory treatment. The Discussion Paper on the subject released by the RBI in January 1999 observed that the question whether the supervisory responsibility should lie solely with the BFS or with a separate supervisory system to be devised for the purpose would need to be considered in due course.

The Report of the Committee on Banking Sector Reforms, (April 1998) (Chairman:M.Narasimham) recommended restructuring of the existing BFS. The Committee recommended that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of the banks, financial institutions and NBFCs. It also recommended that the RBI Act Section 58 should be amended to enable the RBI Central Board to frame regulations to set up a separate and distinct Board for

Financial Regulation and Supervision (BFRS). The Board's exclusive task would be to regulate and supervise banks, financial institutions and NBFCs so as to ensure the soundness of the financial system.

Subsequently, the Report of the Advisory Group on Banking Supervision, September 2000 (Chairman M.S.Verma) made some elaborations on the subject. "Because of Reserve Bank of India/Government Ownership of the banks (in the public sector), there is some overlap in the role of the Reserve Bank of India as owner/owner's representative and as the regulator/supervisor. This overlap needs to be corrected so that Reserve Bank of India can perform its regulatory /supervisory role without any hindrance. Government ownership of banks is not conducive to any serious and urgent corrective action by the regulator against any one of them. The limitations of the legal process have also come in the way even where corrective action like removal of the incompetent management is contemplated".

The Advisory Group on Securities Market Regulation, May 2001 (Chairman Mr.Deepak Parekh) also referred to the diffusion of regulatory responsibilities when it stated "The regulatory responsibility of the securities market is vested in the SEBI, the RBI and two government departments – Department of Company Affairs and Department of Economic Affairs. Investigative agencies such as Economic Offences Wing of the government and consumer grievance redressal forums also play a role". It is interesting to note the suggestion made by the Deepak Parekh Group for greater coordination in regulation through the High Level Group on capital Markets (HLGCM) :. "There may be merit in formalizing the HLGCM by giving it a legal status. Besides, the HLGCM needs to meet more frequently and its functioning needs to be made more transparent. Also, a system needs to be devised to allow designated functionaries (not necessarily only at the top level) to share specified market information on a routine and automatic basis". This recommendation relating to giving a legal status to the HLGCM is in consonance to what came to be described as the Reddy Formula for handling the regulatory gaps and overlaps.

There have been several suggestions for improvements in regulatory mechanisms through technical papers and reports of working groups in RBI. For example, the Technical Paper on Regulation of Debt Markets prepared by RBI and submitted to Ministry of Finance in

1999 considered issues of concern, an overview of money and securities markets, existing regulatory framework, review of international practices and made several recommendations. As a follow up of one of the recommendations, the Government of India issued notification under Section 29 A of the Securities Contract Regulations Act formally demarcating clearly the regulatory jurisdiction over money, and government securities markets. The proposed Clearing Corporation is yet another follow up of these recommendations.

Recognising the criticality of formal coordination and information exchange mechanisms between RBI and other agencies, an internal Study Group was set up in 1998 to suggest an institutional framework for inter-agency coordination as part of the exercise of bridging gaps in compliance with Basle Core Principles. The Group had recommended that formal arrangement for sharing of information to be put in place between domestic regulators and as a first step, a Group drawn from RBI, SEBI, NHB, IRDA, NABARD and DCA could identify areas of concerns. It also recommended that a shared data base to serve the information needs between regulators and enforcement agencies be put in place, administered through an agency set up on the lines of FINCEN of USA.

The Report of the Group had been considered by the BFS of RBI which had taken the view that the Ministry of Finance should be asked to form a Technical Group to look into sharing of data between regulators. Each agency should outline what data it collects and what data it can share, which data is confidential and which is not, which data is collected on a routine basis and which by request. The BFS also indicated that this Technical Group could be a Standing Group and should be assigned all residuary work including formation of an agency for data collection and sharing. The BFS expressed that NABARD/NHB need not be part of the Group as they perform delegated supervision as agents of RBI. Regarding the information sharing between investigative agencies, it was suggested that the Technical Group could also look into this aspect after both the Foreign Exchange Management Act (FEMA) and Money Laundering Bills are passed. Accordingly, RBI took up the subject with Government in March 1999. These issues have been considered in different discussions held in the Government on topics such as the setting up of a Serious Frauds Office (SFO), introduction of Suspicious Activities Reporting (SAR) and the setting up of a Credit Information Bureau. It is hoped that the

information sharing between investigative agencies and SAR would be revisited after the agency to administer the proposed Money Laundering Legislation is identified.

In the context of the recommendations of Advisory Group on Securities Market Regulation (Chairman : Mr.Deepak Parekh), a reference was made to Reddy Formula, which represents the approach articulated in several speeches since 1997, and in greater detail in August 1999. The proposal was made after elaborating on the need for considering five features of institutional structure for regulation in India, and the need for a review. The proposal read as follows : "Since there is no point in creating bureaucracies, there are practical difficulties in massive redeployment of personnel, and expertise for regulation cannot be created overnight, some ways for filling up the regulatory gaps and overlaps should be found without disrupting the existing regulatory structures. I would propose that it is necessary to explore the feasibility of an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the existing jurisdiction. The features of the idea are : The BFS of the RBI can continue to supervise banks and non-banks but with the Deputy Governor as Chairman : the insurance regulating authority will supervise insurance companies and SEBI will continue with its regulatory jurisdiction. The apex financial regulatory authority may be constituted by statute with the Governor of the Reserve Bank of India as Chairman and the members could be Chairmen of the three regulatory agencies. The apex body should also include some outside experts on a part time basis. Finance Secretary could be a permanent special invitee or a regular member without voting rights as in the case of the RBI Board. The apex authority could have by law, jurisdiction to assign regulatory gaps to one of the agencies; arbitrate on regulatory overlaps and ensure regulatory coordination. The apex authority could be serviced by a part-time secretariat of the RBI. In a way the proposal improves and formalizes the present informal arrangement into a legislative based authority. The idea could be debated as one of the options for regulatory reform" (Corporate Governance in Financial Sector, 1999). Dr.R.H.Patil, Chairman of the Advisory Group on Corporate Governance too expressed his preference to what he also described as Reddy Formula. A legitimate question in this regard is the justification for Governor RBI to be the Chairman, even assuming that he/she is disassociated from supervision of banks. It will be appreciated that every transaction irrespective of the

market in which it takes place, has one leg in the cash/interbank market in terms of ultimate payment/settlement. Any problem in the market in which the transaction takes place has to impact the cash market. The RBI as the ultimate provider of liquidity (though may not be as regulator) has, therefore, to concern itself with the stability in the functioning of all financial markets. The case for the Governor of the RBI to be the Chairman of the apex financial regulatory authority rests on this overall responsibility on the part of RBI.

The regulatory and supervisory arrangements of institutions broadly under the aegis of the RBI are being reviewed to differentiate between financial intermediaries that are part of the payments system (in view of the criticality for systemic stability); that are cooperative in character (emphasizing voluntary participation and collective management and where appropriate retail depositors interests); and others which are intermediaries with primarily commercial orientation (other DFIs, NBFCs, etc. some of which have systemic implications while many, though not all mobilise retail deposits). A Technical Paper under preparation in the RBI on this subject will be finalised soon after consultations with all concerned.

Issues

The elaborate treatment accorded to the issues relevant to choice between single and multiple regulators brings out conclusions on somewhat expected lines. The subject needs to be viewed in the context of a country and the circumstances, especially the institutional history. The choice should not be made as a measure of “doing something” to meet pressing demands. The choice need not be made in extremes of single and multiple regulators since there are possibilities of hybrids and supplementing arrangements. Under any system, issues of information exchange and coordination are inevitable. In the final analysis, the regulatory objectives, coverage, skills, operational effectiveness and credibility are important and structures remain one element of financial regulation. In the Indian context, considering the current status and debate, a few issues could be raised.

First, should the subject be addressed now?

The answer is obviously yes. Dr.Bimal Jalan in his Monetary and Credit Policy Statement of April 19, 2001 stated "The recent experience in equity markets, and its aftermath, have thrown up new challenges for the regulatory system as well as for the conduct of monetary policy". Further, Mr.S.Subramanyam (The Hindu Business Line, April 5, 2001) urged : "The earlier the government thinks about this far-reaching issue of regulatory reforms, the better it will be for the accelerated growth of the financial services industry". Moreover, definitive suggestions have also been offered, as for example, by Mr. Tamal Bandyopadhyay (Business Standard, April 7, 2001) "Since the liquidity support has to come from the RBI – the lender of the last resort – to ward off any crisis, ideally RBI should be made the super regulator. However, before assuming this role, the central bank must put its house in order".

Second, should the option of changing the regulatory structure be a priority now?

The answer is not easy but clearly there are many areas of the regulatory system that need attention. Focusing entirely on regulatory structures may not be an adequate response to the current weaknesses, the changes needed in the objectives and coverage of regulation, and the emerging challenges for higher growth as well as greater openness in external sector. Perhaps, the debate has to go beyond the single or multiple regulators, or hybrid arrangements, while recognizing some urgency for putting in place effective arrangements for regulatory coordination.

Third, what appears to be the major areas for immediate attention in regard to financial regulatory system?

While it is difficult to be precise or comprehensive, the presentation made today invites attention to the need for clarity on regulation policy. The rationale, the scope, the limits the objectives and the instruments ought to be clarified to the extent possible since there is a paradigm shift in the role of the financial sector in economic growth and social justice. Expectations of public from regulation need to be clearly appreciated and if necessary moderated. At an operational level, arrangement for information exchange and coordination must be put in place and reviewed on a continuous basis. At a legislative level, changes to distinguish owners, regulators and market participants in the financial

system are essential. Above all, designing and managing all these changes require a combination of political will and professional skill.

Thank you.

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