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FINANCIAL REGULATORY ARCHITECTURE: A REVIEW OF LITERATURE

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ABSTRACT
Sound Financial regulatory architecture is a pre-requisite for creating an efficient, vibrant and mature financial market. In this paper, we review important committee reports including their observations and recommendations for developing various elements of financial regulatory system. The committee reports deal with Indian financial system and also with financial systems of other countries. The paper also critically reviews the academic papers and identifies important research gaps on the subject. The discussion in the paper is highly useful for policy makers, existing market regulators, financial institutitons, market players as well as the academic community. It highlights the key issues that should be kept in mind while developing a comprehensive financial regulatroy architecture in India.

KEYWORDS
capital market, financial regulation, principle based regulation, SEBI.

INTRODUCTION
Supervision and regulation of the financial markets, has been an important area of discussion and research amongst the academicians as well as policy makers. There has been intense study worldwide on the optimal institutional structure of the financial supervision and regulation. This is because it is important to design the structure of responsibility, accountability and powers that synchronises with the overall objectives of regulation and ensures efficient operation of the financial markets.

In the present paper, an attempt has been made to present a review of literature on various issues relating to financial regulatory architecture. The literature on the subject is available in the form of committee reports and research papers. In view of this, the paper has been divided into two section. While Section –I covers the observations and remmendations of various committees on financial regulation in India, Section –II provides critical review of research papers on the subject.

SECTION I
A number of committees have dwelled on various issues relating to financial regulatory architecture. Some of these have been constituted by Government of India whereas others deal with similar issues for other countries.

1.1. COMMITTEE REPORTS IN INDIA: OBSERVATIONS AND RECOMMENDATIONS
There is a need to fill in the increasing gap which has come about between the requirements of the financial system and the present legal and regulatory arrangements. There have been several studies by committees appointed by Government of India with the objective of reforming the overall financial system in India. These reports dedicate special efforts on why and how the regulatory architecture needs to be reformed to ensure development of a modern financial system that India needs. In the following section, we summarize the principal recommendations of these recent committee reports on the financial regulatory architecture in India.

1.1.1. MUMBAI - AN INTERNATIONAL FINANCIAL CENTRE REPORT, 2007
1. Shift towards Principle based Regulation: The report maintains that the rules-based approach followed in India currently faces variety of drawbacks as finance companies find ways to exploit the loopholes in the rules and regulations code. Moreover, the rigidity of the rules based approach blinds the regulators to the specific nature of the firm's business
2. The committee recommended two alternative paths to regulatory structure, both emphasising on some level of consolidation of regulatory agencies:
   a. *Alternative 1: Consolidation of regulatory functions to four regulators*

Under this path proposed by the committee proposed regulatory functions would be consolidated down to four regulators covering finance with one each for:

   i. banking with a regulator separate from the monetary authority;
   ii. capital markets, with a merger of securities markets functions on the fixed income, currency and commodity markets into a single securities and derivatives market regulator;
   iii. pensions with the consolidation of pension regulation into a single pensions regulator;
   iv. insurance regulator for the insurance space.

   b. *Alternative 2: Integration of all financial regulation into a single agency*

The other path the committee suggested was to integrate all financial regulation under a single agency. The principle of the single regulatory agency is that it is able to take a complete view of all activities of all finance companies and a holistic view of trends in financial market development.

3. Shift away from "entity-based regulation" towards "domain based regulation": The committee strongly recommended moving towards domain-based regulation, and away from the present entity-based regulation. This would entail, for example, that the banking regulator regulates the business of banking, but does not regulate all the activities of a financial firm that chooses to call itself a "bank".

1.1.2. THE COMMITTEE ON FINANCIAL SECTOR REFORMS REPORT, 2008
The draft report of the Committee on Financial Sector Reforms, chaired by Raghuram Rajan in 2008 titled as "A Hundred Small Steps": (Committee on Financial Sector Reforms, 2008) maintains that this framework is suboptimal due to three kinds of problems:

a. It induces a loss of economies of scope and economies of scale for the government, exchanges, financial firm, and customers. There are strong commonalities between all kinds of trading.
b. It fragments liquidity, and encourages regulatory gaming. Arbitrage tightly binds all financial securities related to a given underlying asset. However, fragmentation of regulation of financial securities creates all sorts of gaming opportunities for participants, as well as turf issues among regulators in favouring one or other venue for the firms they regulate, that leads to a loss of liquidity, price efficiency, and even stability.
c. Loss of competitive pressure. At present, Indian markets are carved into three silos, each regulated (and protected) by a separate regulator. An exchange or a clearing corporation or a depository working in one silo is prohibited from competing with entities in other silos. India's interests would be served far better if all these entities were in a unified industry with vigorous competition and innovation.

Thus, the Committee recommended the unification of all regulatory and supervisory functions connected with organized financial trading into a single agency under SEBI with some coordination with RBI in some markets, such as the government debt market or the currency futures market.

Further, the report reiterated Narasimham Committee Report's suggestion to consolidate supervision of all banks and any other deposit taking entities should come under one supervisor. This would require a considerable increase in central regulatory capacity, as well as political initiatives and efforts. In addition to consolidating supervision, the system of prompt corrective action and resolution of weak banks should be strengthened and made more explicit, possibly under a revamped consolidated deposit insurer.

The current approach to protection of market participants is very different— various transactions, markets and participants are simply banned. This brings one to the heart of needed reform. India can progress by building on its demonstrated success of creating modern, efficient markets in financial instruments. The report provides clear and blunt guidance in this area: encourage the introduction of missing markets; stop creating investor uncertainty by banning markets; have consolidated membership of exchanges for qualified investors; encourage the setting up of "professional" markets and exchanges for sophisticated products and investors; and create a more innovation-friendly environment, speeding up the process for approval of new financial products.

Similarly, there are several recommendations for modifying the current regulatory architecture, designed to improve coordination, coverage and quality. A key idea is the reduction of micromanagement. The report contains following pointers on the regulatory structure:

a. *Principles versus rules-based regulation:* The report contends that the current rules-based system in India displays "low tolerance for innovation and excessive micro-management" (chapter 6, page 2) wherein financial institutions are required to follow a plethora of rules. It reiterated the recommendation by Percy Mistry Committee Report (Report of the High Powered Expert Committee, 2007) to have a gradual but time bound movement in the direction of principles-based regulation the way it is followed by The Financial Services Authority (FSA) in the UK. FSA has been engaged in putting into operation a principles-based system of regulation for the UK financial system since 2001. But before extrapolating the UK experience to other countries, it is best to remember two special circumstances prevailing in the UK – firstly, a strong tradition of oral convention and unwritten legislation (even the Constitution is largely unwritten) and secondly, an already existing risk-based and evidence-based system of regulation, for the principles-based system to be built upon. (Nachane, 2008) However, principle based approach often brings in ambiguity as the interpretation of the principles lies largely with the regulator.
b. Regulatory and Supervisory Independence
c. To avoid regulatory arbitrage, it is important that institutions serving essentially the same function face the same set of regulations whether they have a banking licence or not. For example, all deposit taking institutions should face same rules. Regulations should be in accordance to functions, not historical classification of institutions.

1.1.3. THE FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION REPORT[1]

The Financial Sector Legislative Reforms Commission was set up to review, simplify and rewrite the legislations affecting financial markets in India. It was asked to make legislations to bring them in tune with the changing financial landscape in India and the world. The commission, headed by former Supreme Court Judge Justice Srikrishna, has been deliberating since April 2011, and consulting with a spectrum of experts and stakeholders in the financial sector and regulators.

Until now, the approach in Indian finance has been to give permissions for some products or markets. The rest of the financial products and markets for which no explicit permission is given, are banned. This approach has restricted innovation in financial markets unlike the modern approach followed in for example Australia where the emphasis is on the objective of regulation is to protect consumers. This envisages that the regulator's objectives are clearly defined, his powers are clearly enumerated and that his decisions are appealable.

The FSLRC envisages creation of a new resolution agency for smooth firm resolution, with a view to protecting consumers and improving microprudential regulation of financial firms, the FSLRC has discussed a consumer protection law and a microprudential law which would outline the basic principles on the basis of which regulators would write regulations.

The UFA Act draws from some of the notable features of the US Dodd-Frank Act, the UK's Financial Services and Markets Act of 2000, financial liberalisation in South Korea and recent Indian government committee reports. In particular, FSLRC proposes:

1. Unified Financial Agency (UFA)

a. Under the Commission's proposed regulatory architecture, the Securities and Exchange Board of India (SEBI), Forward Markets Commission (FMC), Insurance Regulatory and Development Authority (IRDA) and Pension Fund Regulatory and Development Authority (PFRDA) would be merged into a new unified agency – a kind of super regulator – called the Unified Financial Regulatory Agency (UFRA).
b. The Reserve Bank of India (RBI) would be kept out of the purview of the UFRA.
c. Seven agencies should be set up — RBI, Unified Financial Agency (UFA), FSAT, Resolution Corporation, Financial Redressal Agency, Public Debt Management Agency and FSDC. The Reserve Bank will continue to exist with modified functions.
d. The existing Securities Appellate Tribunal should be subsumed into Financial Sector Appellate Tribunal (FSAT). The Financial Sector Development Council (FSDC) should also be given a statutory framework
e. A new Debt Management Office (DMO) should be set up and the existing Deposit Insurance and Credit Guarantee Corporation of India (DICGC) should be subsumed into the Resolution Corporation.
f. The existing laws which provide special privileges to entities like the State Bank of India (SBI) and Life Insurance Corporation (LIC) should be either amended or repealed "to create a level playing field between regulated entities, irrespective of their ownership structure".

2. Role of the Reserve Bank of India (RBI):

a) The actual functioning of the regulator should lie in three areas — regulation-making, executive functions and administrative law functions.
b) Any policy should be made not just by the RBI Governor but by a council comprising Governor and Deputy Governor from RBI and five more external members appointed by the Government.
c) The Government, in consultation with the Governor, should give the Central Bank quantifiable, measurable objectives; the RBI will need to state reasons why it has failed to achieve the objectives and what remedial action it will take to achieve the objectives.
d) The government and not the RBI should make rules with respect to capital inflows. This recommendation is irrespective of whether the inflows are FDI, FII, Forex loans or NRI deposits.
e) The RBI will also be the banking regulator but it won't have any control over non-bank finance companies (NBFCs).
f) The Reserve Bank of India should be responsible only for overseeing the banking industry and for monetary policy, while the management of the government's debt and of foreign remittances (thus far under the exclusive domain of the RBI) should be directly under the supervision of the government.
g) With regard to capital control, the Finance Ministry should make rules for inbound capital flows, while the onus of making rules for outbound capital flows should rest with the RBI.

A crucial element of the FSLRC approach is an emphasis on the governance of regulation. Regulators will be given independence under the law through the selection process, and mechanisms that determine the relationship between government and regulators. But they will be accountable. Accountability will be ensured through clear, well-defined objectives, avoiding conflicting objectives, a well-structured rule-making process involving a clear reference to the objective of the regulation being in sync with that of the law and to the appeals mechanism (through a newly created non-sectoral Financial Sector Appellate Tribunal that subsumes the present Securities Appellate Tribunal). All regulations made under the proposed Indian Financial Code, replacing existing financial laws, should be reviewed by a Unified Financial Agency (UFA) within three years of such regulations being issued. The review would consist of a cost-benefit analysis of regulations; an analysis of all interpretations of the regulations made by UFA, and judicial review of regulations by Financial Sector Appellate Tribunal (FSAT), any high court or the Supreme Court; and an analysis of the applicability of the regulations to any changes in circumstances since such regulations were issued.

1.2. COMMITTEE REPORTS ABROAD

Group 30 report (2008) reviews various national supervisory and regulatory approaches and place them within the context of the changing global financial system. The review of 17 major national supervisory systems has confirmed that while dealing with similar problems and challenges, such systems are fashioned through a process that includes a myriad of political, cultural, economic, and financial influences.

IMF report (2009) seeks to draw lessons for financial sector regulation and supervision and central bank liquidity management from the ongoing crisis, focusing principally on implications for the future rather than on immediate crisis management policies. Inadequacies in macroeconomic policies and the design of the international financial architecture exposed in the crisis will also have to be addressed to make the suggested changes in the regulatory framework effective.

[1] Report, The Financial Sector Legislative Reforms Commission (B. N. Srikrishna, Chairman), Mar 2013. Ministry of Finance, Government of India.

SECTION-II

2. REVIEW OF PRIOR RESEARCH

This section provides a critical review of different academic studies undertaken in the field of financial regulation in different countries.

Briault (1999) considers the rationale for establishing a single national financial services regulator. In describing the formation of the UK Financial Services Authority (FSA), it presents a case for a single regulator, which is independent of market developments. Author concludes that such a regulator, covering a broad range of financial services activities and spanning both prudential and conduct of business regulation, should be well placed to deliver effective, efficient and properly differentiated regulation in the current financial environment in the UK. Drawing on the Scandinavian experience, **Taylor and Fleming (1999)** address three policy-related issues associated with the integrated model: Under what conditions should (or should not) a country consider moving toward an integrated model of financial supervision? How should an integrated agency be structured, organized, and managed? How should the integration process be implemented? The authors suggest that for a small transition or developing economy, or an economy with a small financial sector, the economies of scale from establishing an integrated agency outweigh the costs of moving to such a model. Further, there is no single obviously correct organizational structure, and existing agencies are experimenting with a variety of forms. Whatever the structure, integrated supervision requires active management to secure the potential benefits that the approach offers. Once the decision has been made, implementation should take place as quickly as possible. A well-conceived change management process should aim to overcome the cultural barriers associated with the previous fragmented structure.

Abrams & Taylor (2000) analyze the costs and benefits of unified supervision covering each of the main types of financial institutions (banks, insurers and securities firms). The strongest arguments for unification are the enhanced oversight of financial conglomerates and the economies of scale they can potentially deliver. However, these advantages vary across countries and there are also a number of potentially serious disadvantages to unification, especially the risk that the change process will be mismanaged and will result in a reduction in regulatory capacity. They conclude that no one model of regulatory structure will be appropriate for all countries. The issue requires careful deliberation and ultimately depends on a matrix of factors, which vary in importance from country to country.

In the field of bank supervision, **Barth, Caprio, & Levine (2002)** conducted an empirical research using data for over 107 countries for examining studying the relationship between differences in bank regulation and supervision and bank performance and stability. The results raise a cautionary flag regarding government policies that rely excessively on direct government supervision and regulation of bank activities. They conclude that countries with policies that promote private monitoring of banks have better bank performance and more stability. Further, countries with more generous deposit insurance schemes tend to have poorer bank performance and more bank fragility. Moreover, diversification of income streams and loan portfolios - by not restricting bank activities - also tends to improve performance and stability. Countries in which banks are encouraged to diversify their portfolios domestically and internationally suffer fewer crises.

Martinez and Rose (2003) study the implementation related issues of integrated supervision of financial sector in a sample of 51 countries. Based on survey results they concluded that group of integrated supervisory agencies is not as homogeneous. Important differences arise with regard to the scope of regulatory and supervisory powers the agencies have been given. Another finding of study is that in most countries progress towards the harmonization of prudential regulation and supervision across financial intermediaries remains limited. Interestingly, the survey revealed that practically all countries believe they have achieved a higher degree of harmonization in the regulation and supervision of banks and securities companies than between banks and insurance firms.

Holopainen (2007) puts forward a case against integration of financial supervision and highlights its inherent issues and challenges. According to the report, the inherent characteristic of integrated supervision is the monopoly position of single authority in the supervision of financial industry. Consequently, careful consideration and design is needed to ensure the effective functioning of integrated supervision as such a move necessarily results to a situation where a plurality of tasks gets allocated to a single authority giving rise to several potential multi-tasking related challenges.

Borio (2003) defines and contrasts the macro- and micro prudential dimensions that inevitably coexist in financial regulatory and supervisory arrangements, examines the nature of financial instability against this background and draws conclusions about the broad outline of desirable policy efforts. The author argues that in order to improve the safeguards against financial instability, it may be desirable to strengthen further the macro prudential orientation of current prudential frameworks.

Masciandaro et. al (2008) analyse recent trends in, and determinants of, financial supervisory governance. They first calculate levels of supervisory independence and accountability in 55 countries. The econometric analysis using multinomial logit by taking macroeconomic variables and binary outcomes of risk and regulation provide the determinants indicates that the quality of public sector governance plays a decisive role in establishing accountability arrangements, more than independence arrangements. It also shows that decisions regarding levels of independence and accountability are not well-connected. The results also show that the likelihood of establishing adequate governance arrangements is higher when the supervisor is located outside the central bank.

Čihák and Tieman (2008) in their studyanalyze the quality of financial sector regulation and supervision around the globe. They employ data from IMF-World Bank assessments of compliance with international standards and codes. Incorporating supervisory implementation into the study provides an improved means of assessing countries' regulatory systems. They concluded that countries' regulatory frameworks score on average one notch below full compliance with the standards (on a 4-notch scale). There are substantial differences in the quality of regulatory and supervisory frameworks across countries, with the income level being a major factor.

Seelig and Novoa (2009) in their study summarize the results of a survey of financial supervisory agencies in IMF member countries conducted in 2007. Responses were received from 140 financial sector supervisors in 103 countries. A majority of these are separate stand-alone agencies, most of bank supervisors are part of a central bank. The survey asked respondents about their governance structure and practices, as well as practices and policies related to public transparency and accountability. Most agencies reported having operational independence. Bank supervisors were unique in viewing financial stability as part of their mandate. The study has great implications in terms of implementing the unified regulatory authority and provides detailed explanations of nature of modes-operandi in sample countries.

Black & Jacobzone (2009) provides a comparative perspective on the application of quality regulation principles to financial sector regulators, in the US, Canada, Australia, the UK and France. The report analyses the independence and accountability of the regulators, as well as their powers. The analysis focuses on requirements for ex ante and ex post regulatory impact analyses, including burden reduction; for transparency and communication of decision making, as well as co-ordination and regulatory review; for improving the regulatory system over time and for regulating conflicts of interest. The report finds variation in the formal arrangements, and respective practices. The report points to a number of areas relating to regulatory practice where principles could be further developed, especially related to risk management and the need for a detailed understanding of the financial system.

Pellerin, Walter, & Wescott (2009) reviews the advantages and disadvantages of regulatory consolidation, explore the effects of consolidation on the regulators incentives in the context of USA and evaluates which entity is best suited for this role. It also examines the transition to consolidated regulation that took place in Germany, UK, Japan, and Australia and evaluates each one of them in the light of multiple factors playing role in each economy. Another proposition examined in this paper is whether to transfer the regulatory authority from the central bank leads to a desirable situation or not.

Masciandaro and Quintyn (2010) is based on updated information on 102 countries for the period 1998-2009 and evaluates both the existing settings and the proposals of reform in the US and at the level of the EU in the backdrop of crisis. It addresses two crucial questions: Which are the main features of the reshaping of the supervisory architectures? Which is the role central banks are taking in the changing environment of the financial supervision? They concluded that the inspection of this database highlights a trend of supervisory consolidation outside the central banks, where the outliers usually are central banks without the monopoly in monetary policy responsibilities.

Vermorken & Vermorken (2011) compare two opposite approaches of regulation systems i.e., Basel III and the Eurocodes and identifies how one system regulates financial institutions and the other civil engineering design. The paper shows that the financial regulation uses a cause-based approach to regulation, in which the causes of a crisis are found and controlled. The Eurocodes in civil engineering make no specific attempt to understand the specific causes of a failure; however, they provide a framework, which transfers full responsibility onto the designer if the designer decides not to adhere to a set of codes of practice. It is the trade-off between less regulation and increased responsibility. The paper shows how financial regulation in reality has limitations, which are its inherent weakness.

Grosse (2012) analyses the financial crisis of 2008- 2009 using a behavioural view and draws attention of regulators towards designing responses to the behaviours of market participants. It identifies that crisis cannot be prevented from happening completely, so focus should be on creating proper framework of rules to discourage non-rational behaviour, which exaggerate the crisis. The main factors identified here are anchoring, herd and hubris behaviour, over optimism as the elements of crisis. The author suggests that supervision of all the credit-extending agencies should come under the fed supervision, enhanced transparency, raising standards and limits for various financial institutions, identifying sources of systemic risks and managing them as far as possible.

Vashishtha & Sharma (2012) conducted a study based on a survey administered to three distinct interest-groups, namely, regulators, financial institutions and investors. Authors observed that unified model emerges as the consensus model, driven by its ability to ensure, communication and coordination among regulators for dealing with some of the major problems, in particular, regulatory arbitrage, posed by modern complex financial markets. Based on the analysis employing the logit model, the evidence from results suggests a shift in the direction of structural unification, or at least, establishment of some central 'lead' authority for ensuring communication and coordination among regulators until structural unification proposition is empirically validated.

SECTION-III

3. CONCLUSION

The above review of literature on financial regulatory architecture helps us in identifying important research gaps on the subject.

Given the vast scope of the field of financial regulation, the existing literature has covered multiple dimensions of financial regulation. They include the study on relation between regulation and performance, the determinants of the quality of regulation, different approaches to the regulatory architecture, study of the importance of country specific factors, as well as the study of effectiveness of regulation in the backdrop of recent financial crisis. A large number of studies focus on the rationale, advantages and drawbacks of integrated regulatory structure. There is no absolute case for or against unification. Moreover, the choice of a regulatory approach and its implementation varies across countries based on the characteristics of their financial markets.

There are still some research gaps in the existing literature. It seems that there is virually no research that focuses on Indian Financial Regulatory System. There is a need to study the state of current multi-regulatory system in India. Further, as the policy makers are inclined towards the proposed unified regulatory structure in India, it is important to gauge the impact of the framework from the perspective of the academicians, regulators, policy makers as well as those bearing direct impact of the change, that is, the financial services industry. It is also important to include these participants towards deciding on the operational and administrative structure of such unified regulator.

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