CHAPTER III

REGULATORY FRAMEWORK FOR FINANCIAL SECTOR

In the last chapter, an analysis of the Indian financial sector and its constituents was made to give broad understanding of the same for the appreciation of the subject matter of this thesis. The present chapter analyses the importance and the need for having a framework of regulatory structure for the financial sector, the definition of Regulation, various methods of regulation, difference between supervision and regulation and key elements that are essential for the efficient functioning of a regulatory framework. It also outlines different approaches of regulation in financial market and highlights the importance of independence of Regulator.

The increasing pace of technological progress and innovations of sophisticated financial products bring about attendant risks and complexities in the market economy. As a result, there is a plethora of financial entities having their tentacles spread over various types of financial operations. The rapidity of these developments at times throw up problems of regulation over such products and entities which conduct business in those products. This gives rise to the need for a very strong regulatory framework encompassing all the areas of financial activities in order to ensure that there is a fair play and equity in their conduct. This would ensure that the end users of those products are given a fair deal and deal errant players with iron hand, if required with deterrent penal system.

Thus financial regulation should be guided by the following objectives, namely,

a. It should infuse the market with high level of confidence
b. It should secure a high degree of consumer protection.
c. It should contribute to the protection and enhancement of the financial system.
d. It should aim to reduce financial crimes in the financial markets.
3.1 UNDERSTANDING REGULATORY FRAMEWORK:

The study of regulatory framework in financial sector, its evolution over a period of time, the dynamic changes that take place in regulatory structure with the resultant problems make an interesting study in itself. The regulatory framework for financial sector has also been developing as part of general jurisprudence over a period of time through extensive legislations, rules, regulations, guidelines and also based on the opinions, views of the market experts, regulators and voluminous texts of various reports expert committees, directives and standards laid down by the International Monetary Fund, World Bank, international benchmarks laid down by agencies such as Bank for International Settlements, Central Banks and Regulators of various countries.

The term “Regulation” refers to a set of binding rules issued by a private or public body with the necessary authority to supervise compliance with them and apply sanctions in response to violation of them”. Generally, these can be defined as those rules that are applied by all regulators in the fulfillment of their functions; in the financial services area, they include such prudential rules as those influencing the conditions of access to the market (intended to prevent the emergence of entities with doubtful reputation or without financial capacity necessary for the operations they intend to implement) and those aimed at controlling the risks associated with financial activities, corporate governance and internal control systems, conduct-of-business rules, and methods of supervision. These rules are applied to the players in the market who have to conform to the same to be eligible to operate in the system. The objectives of such regulations are directed for protection of the investors/consumers, to ensure that the healthy growth of the markets takes place in a fair, transparent and efficient manner through the development of sound market practices which

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26 *Id*, at 46-48
are acceptable on par with international standards. Further they are also expected to play a vital role in reduction of systemic risks, maintenance of customers’ confidence in the financial system, prevention of market abuses and fraudulent activities that are detrimental to the customers and to discipline the wrongdoers through penal provisions. Another important objective of a Regulation for a financial sector is to protect the systemic or financial stability. The reduction of geographical boundaries on account of rapid development and globalization of economies, have further added to the complexities of regulation of financial sector.

In most of the jurisdictions, the regulatory framework is generally supported by a substantive legislation and subordinate law viz. rule making powers to the regulator flowing out of the substantive laws. While the substantive law provides a broader framework of the regulation, the subordinate law provides the scope for operational framework for the regulator to implement the stated objectives of the main legislation. It is also supplemented by rules, guidelines, directives, codes and policy framework issued by the regulator.

In other words, the regulator has to ensure that the legislation within which it operates as an umpire or arbitrator of the players in the free market, gives it every freedom and scope to achieve the avowed objectives.

3.2 STRUCTURING REGULATORY FRAMEWORK:

Before structuring an ideal model or models of a regulatory framework of a financial system for any jurisdictions, the policy makers need to take into account various factors such as the size of the financial system, the business growth of any market sought to be regulated, whether the regulation should be product or instrument based or entity based, the kind of role a regulator is expected to play in the market. Similarly another question that arises is whether the policy framework includes both regulation and supervision. There is a
difference between a regulator and supervisor. While a regulator is mainly concerned with formulating and issuing rules, regulations directives, etc and promote an atmosphere of compliance of those rules and regulations, a supervisor may undertake onsite and offsite supervisions of the entities. In some jurisdictions, these powers rest with single structure.

There exist different models of Regulatory framework for financial markets such as regulation by objectives, functional regulation, institutional regulation (regulation by silos) and a single regulator. In a regulation by objective model, the regulatory model is created with an intent to achieve certain explicit objectives by giving one or more of them to specific regulatory bodies that exist solely for that purpose. Examples of this model are Central Bank responsible for monetary policy, central authority for regulation of competition.\(^{27}\)

In a functional regulation, the objective is to regulate the type of activities undertaken by a financial entity than the entity itself. This presupposes that the rules relating to functions would be applied uniformly across the market irrespective of the type of businesses.

Examples of functional activity that can be regulated across all business sectors are client assets and all-conduct of business issues. Australia for instance has a “twin peaks” regulatory model adopting a functional regulation approach.\(^{28}\)

In the case of an institutional regulation model, the regulation is each single category of financial services business by a different authority, agency or

\(^{27}\) Kenneth Kaoma Mwenda, LEGAL ASPECTS OF FINANCIAL SERVICES REGULATIONS AND CONCEPT OF UNIFIED REGULATOR, World Bank Publications- Business & Economics (January 1, 2006)

\(^{28}\) Supra note 7, at 41
division which is usually referred to as "regulation by silos" or by markets regulatory model".\textsuperscript{29} For example, in India this model is adopted.

A single regulator, referred to as an Unified regulator is one which as a single regulator regulates different institutions, financial entities and functions under a single umbrella. In 1997, UK adopted the unified regulatory model by creation of Financial Services Authority. Sweden and Denmark are the other examples.\textsuperscript{30} This is also called as 'Christmas tree approach" model.

In the ultimate analysis the design, objective and framework of the regulatory architecture of a jurisdiction are broadly driven by the size of the economy, political and cultural factors prevailing in each jurisdiction and as such cannot be a straight jacket or any prescriptive model that could be adopted for any jurisdiction.

In order to understand the financial regulation in proper perspective, it is essential that the financial landscape of a jurisdiction is understood properly.

The regulatory framework for each country would therefore differ based on its economic, political and social conditions. However, there are certain fundamental principles that underline its functioning across the jurisdictions. The same are detailed as follows:

\textsuperscript{29} Id.

3.3 POLICY FRAMEWORK FOR AN EFFICIENT FINANCIAL REGULATION

The policy framework of the financial regulator should in reality reflect the clear understanding of the financial system of the jurisdiction. Following are the key elements that identify the fundamental concepts of the financial market regulations

a. The role of financial system in the economy and its key functions in managing, pooling and transferring the risks in the financial markets

b. The linkages between the financial systems and macro economy and the global and integrated nature of financial and economic systems and

c. The complexity and evolution of the financial systems, the convergence of the markets, products, institutions and global financial entities.

As the financial regulation is one of the policy instruments that is available to a government in the smooth conduct of the economy, it should be so identified and adopted to address macro and micro economic problems as effectively and efficiently as possible with least disturbance and least costly manner. While adopting it, its adverse impact including spillover effect on the national and international markets should also be considered.

A regulation involves establishment of principles and systems that seek to affect or control the behavior and actions of entities and individuals with the overall objective of achieving desired outcomes.

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31 OECD, POLICY FRAMEWORK FOR EFFECTIVE AND EFFICIENT FINANCIAL REGULATION (2010).
Keeping this concept of regulation, OECD has stipulated ten key elements of financial regulation for efficient and effective implementation of Financial Regulation.\textsuperscript{32}

1. Precaution: A pre-cautionary approach is the most primary and significant attribute wherein the Policy makers should anticipate well in advance the emerging problems or risks in a market but not be reactive to such risks.

2. Risk-based: Financial regulation framework should focus on risks, prioritise its energy resources to counter the same especially those which could have a major impact on the economy. In that process, the regulation should actively promote establishment of very good risk management systems, introduce incentive system to promote good behavior and prudent financial management.

3. Sound incentives: It should seek to align the incentives of participants with objectives of the policies by conforming to the nature, form, strength of directive of the authority, compulsion, supervision and using other policy objectives wherever required. The enforcement and appropriate deterrence provides a basis for sound incentives. The regulations should also provide an appropriate framework for proper failure resolution mechanism.

4. Comprehensiveness: Financial regulation should also ensure that all market failures and broader economic and social needs are properly addressed at a domestic and global level involving the full use of all regulatory tools and mechanisms to achieve policy objectives, including through a combination of regulation with other policy instruments. The concept comprehensiveness should be taken to mean that all the financial system participants, products, services institutions, systems and markets are brought under the regulatory oversight, interconnected components of all segments of the financial system as also broader macroeconomic conditions are all brought together and subjected

\textsuperscript{32} Id
to overall global view to cover all the interrelated and contagion risks, identify them and take measures to address them suitably at micro and macroeconomic levels and all policy instruments/tools are aligned to ensure that the global and overall approach is adopted to all the regulation and supervisions of the participants in the financial system.

5. Consistency and competitive neutrality: All Financial regulations should be applied in a consistent "functionality equivalent' manner, that means to say that they are neutral from a product, institutional and market perspective in order to address all similar risks equivalently through regulation. There should be consistent and integrated forms of regulation across the products, systems, services, markets, entities and financial institutions.

6. High-quality, transparent decision-making and enforcement: Transparency and quality process for regulation should be established and followed. There should also exist a strong framework for enforcement of the regulatory directives which of course should also provide a methodology of actions in cases of exigencies.

7. Systematic review: The implementation mechanism, its quality and its likely impact on the system as a whole should continuously be reviewed by bridging the gaps wherever required by focusing on whether the regulations have achieved the desired objectives in a cost effective manner and whether there is a scope for enhancement of decision making process.

8. International coordination, convergence and implementation in policy and rule-making: The financial regulations should strive to be very comprehensive so as to ensure that it adheres to the international standards; wherever the framework is deficient, the time frame or road map for such convergences should be provided. Regulatory framework co-ordination and cooperation for
implementation should be such that there is a mechanism for prevention of regulatory arbitrage.

9. International coordination in the regulation of internationally active financial firms and groups: The rapid growth and huge size of some of the financial groups or entities could pose a big challenge to nation specific regulation and supervision from the viewpoint of conflict of laws such as insolvency, netting laws etc., To ensure that such problems are addressed without any hassles, it is essential that there exists a clear framework of international coordination amongst various jurisdictions.

10. Promotion of open, competitive and safe markets through the establishment of a level playing field and removal of unnecessary duplication, burdens, conflicts and barriers across countries. The laid down Financial Regulations should be vibrant enough to promote competitive environment, given to openness or transparent in its dealings with market participants and other stakeholders, avoid needless duplications and conflict situations across countries and ensure safety to the financial system.

3.4 INDEPENDENCE OF A FINANCIAL REGULATOR:

The independence of a Financial Regulator is “taken as given” for its efficient and effective functioning. While the term "independence" in its ordinary meaning, could entail the idea of not being influenced or controlled by others, the independence of any regulatory agency can be viewed from four related angles: regulator, supervisory, institutional, and budgetary.  

Regulatory independence in the financial sector means that regulators have wide autonomy in setting, at minimum, prudential regulations that follow from the special nature of financial intermediation. These regulations concern practices that financial institutions must adopt to maintain their safety and stability, including minimum capital adequacy ratios, exposure limits, and loan provisioning. It has been argued that regulators who are able to set these rules independently are more likely to be motivated to enforce them.\textsuperscript{34}

Generally the independence of a regulator is achieved through legal, financial and functional autonomy free from political and bureaucratic interferences.\textsuperscript{35}

While the statute creating them may provide for appointment and dismissal of regulators or its members, as also providing sufficient safe guards and protection to its officials or its members for discharging their duties, financial autonomy can be ensured where the Government does not provide any grant but the resources are raised through fees and charges. It can be argued that to the extent that fees are taken from the regulated entities, it may not clothe the regulator with full or absolute financial autonomy. It is again a question of stretching the yardsticks for the purpose of measuring the financial autonomy. Budgetary independence is another determinant of the independence of the Regulator.

Generally, the budget should not be seen as limiting the independence of a Regulator Functional autonomy is assured only when there is no interference either from the authorities or policymakers in the day to day functioning of the regulator either by way of issuing directives or instructions, oral or written, unless such directives or instructions flow in furtherance or advancement of the objective of the regulation. Finally the independence of a Regulator is the most

\textsuperscript{34} Id.

\textsuperscript{35} Id.
critical from the viewpoint of stability, transparency which is the most important factor in preventing systemic risks.

One important factor that determines the independence of the regulators is to find out to what extent they are allowed to operate free of any interference from the political set up or bureaucratic structure under which they operate. The key to the success of an independence of the regulator is to keep them from any kind of influence i.e. political or economical. Frequent instructions from the elected representative either directly or indirectly through bureaucrats could adversely affect the fairness of the decisions of the regulators. At times such politically influenced decisions by the regulators could lead to market crises or systemic risks leading to serious adverse impact on the financial market as a whole. This in turn could erode the confidence in the regulatory framework and act against the public interests. While this is one type of influence that could erode a regulator's independence, another equally serious and insidious factor that could compromise the independence of the regulator is the undue influence exercised by the regulated entities over regulator on account of financial support by way of fees or charges. It could also arise out of moral or ethical corruption that occurs when a regulator tending to act in the interests of specific group of the market or when a regulator's actions promote or advances the interests of some participants who dominate the markets as against the public interests for which it is created. This is called "Regulatory Capture"

Regulatory Capture, normally occurs, when business group or association of persons who have a very high stake on the type of policy or regulatory outcome in financial markets very actively focus their resources to shape the policies the way they want, so that they can be placed in gainful position in the market in which they operate while the same may be either neutral or detrimental to other small operators in the market.
The theory of Regulatory Capture has been well advanced by Nobel laureate economist George Stigler. A captured regulatory agency is as good as not having any regulator as it acts against public interest. One way of mitigating the effect of this problem is to ensure that there is increased transparency and accountability in the actions of the regulator. But the available data suggests that even with greater levels of transparency and well laid down regulatory structures in some of the most advanced economies of the Western countries, there were widespread instances of Regulatory Capture, Small is beautiful, at least in high income democracies; the distribution of policy-making and responsibility, electoral accountability, and incentives for rent extraction (world bank). Hence, there is a compelling need to prevent this kind of practice and ensure that the independence of the regulators is maintained.

The emerging trend in the international financial markets especially European, American and other developing countries is the increasing emphasis that are placed on the prevention of systemic risks in the financial market and to that end bodies like Bank for International Settlement, Brussels have come out with a number of measures such as Prudential Norms, Capital Adequacy Norms, Principles for Financial Market Infrastructures etc., for the purpose inuring against systemic risks. The Central Banks and other Regulators have acquired added responsibility in ensuring that the financial entities which operate in different jurisdictions do not spread the systemic risks. In conclusion, it is to be stated that the independence of Regulator alone will enable them to take informed decisions in a fair manner that would be in the best interests of the market that it serves and would enable it to insure against the systemic risks.

As regards, the Indian Regulatory structure, independence of regulator such as RBI has been very strong and robust. The instances of “regulatory capture” in India are almost non-existent.
While most of the financial activities that take place in the Indian financial market systems are more or less brought under the regulatory umbrella of sectoral regulators such as SEBI, RBI, IRDA, Pension Authorities India etc., there still exists activities that have major impact on the financial system that are outside the purview of the regulatory reach. The following table clearly shows the current regulatory architecture that is prevalent in India.

**FIGURE 1: CURRENT REGULATORY STRUCTURE IN INDIA**
In conclusion, it is to be observed that clear understanding of the concept of Regulations, the key element of policy framework of efficient regulatory systems, the need to maintain independence of regulator are to be clearly analyzed to structure a vibrant and strong regulatory model that could stand the test of time. The policy makers should take greater care while devising a regulatory model for the financial market taking into account the best of standards.