Financial Institutions and Markets
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Lecture – 16
Financial Regulation in India

After the discussion on the preliminary issues related to Financial Institutions and Markets, we can start about the different issues which are quite important in terms of the particular financial system as a whole.

And one of the most important issues is the Financial Regulations. And there are different regulatory bodies which exist in India and as well as in different other countries. And we have to see that how this regulatory bodies function and what are those, what is the basic objective of having those regulatory bodies in the financial system as a whole.

So, before going to discuss about the functioning of the different regulatory bodies let us first understand why we need regulations? Why the financial regulations are required and what are the different types of regulations always we observe in the system? And is there any merits and demerits always involved in that particular regulation aspects. So, let us see that what do we mean by the regulation?

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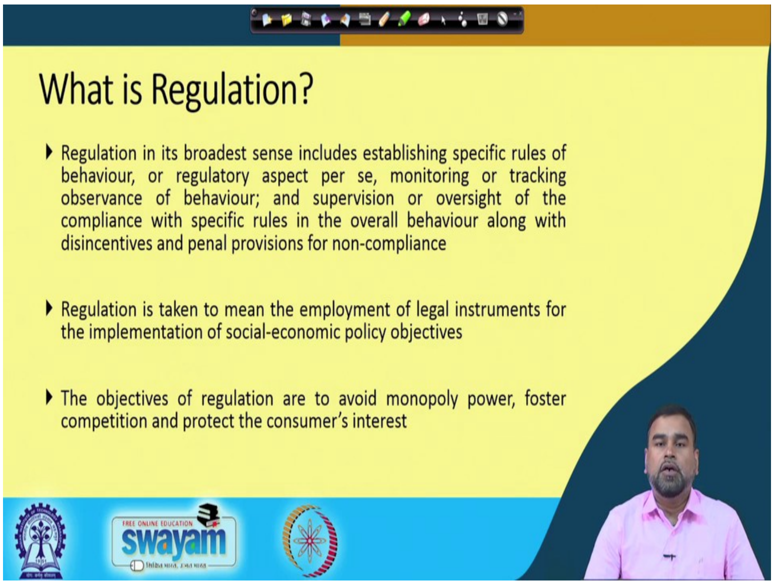

In general sense if you see the regulation is nothing but it is basically specifying the specific rules of the behaviour or monitoring or tracking the behaviour of the different organization or supervising the functioning of the organization. And let us see that whether the organizations are compliance with that specific rules whatever they already it is defined and whether the particular organizations are functioning in terms of their basic objectives or not.

So, overall regulation consists of three things; one is monitoring, then you have the supervision, then you have basically to see overall whether the rules and regulations is maintained by the particular bodies in the system or not. So, these are the major aspects which is basically involved in terms of the regulations. The regulation basically another objective of regulation is to ensure that the social and economic policy objectives are fulfilled. If you take for example, the banks should be regulated.

And as all of us know that the Reserve Bank of India is the regulated body for the commercial banks. So, what is the basic job of the regulatory body? The regulatory body tries to see that whether the particular commercial banks are following the rules and regulations what they supposed to follow number one. And whether what kind of functioning or whatever way the particular organizations are functioning they are basically comply with this guidelines which is given by the regulatory bodies or not; whether this customer grievances are addressed by the organization or not and whether the organization is working in terms of the benefit of the society as a whole or not.

So, these are the different issues or different things as a whole always we observe in terms of the regulation. So, the regulatory bodies the basics job is to see whether the rules and regulations are followed or not, number 1. Number 2, whether whatever functioning the particular organization is doing or whatever job is the particular organization is doing whether it is going towards the overall benefits of the social sector or not. So, these are the different issues or different things always we ensure all should be taken care of by the regulatory bodies.

And another basic job of the regulatory bodies is to avoid the monopoly power foster the competition and protect the consumer’s interest. Just now already I told you that if there is a single body or already you might have idea about the monopoly market and perfect market. So, here what we are trying to see if one individual organization exists and the particular services are provided by that particular organization only; then what will happen they will ensure always they will feel that they can use their monopoly power, and by that they can increase their profit. But, even if they are increasing the profit it is basically affecting adversely to the consumers.

So, what these regulatory bodies try to ensure that they should not utilize their monopoly power and they should make certain guidelines certain policies by that the market can be competitive and the consumer interest can be protected. So, these are another objective of the regulation always we can observe or we can see in the financial system.

So, there are three things you keep in the mind reduction of the monopoly power, fostering the competition in the system and also to protect the consumers interest. These are the three things always we keep in the mind or the regulatory bodies always keep in mind while regulating these financial institutions in the overall financial system in a particular country.

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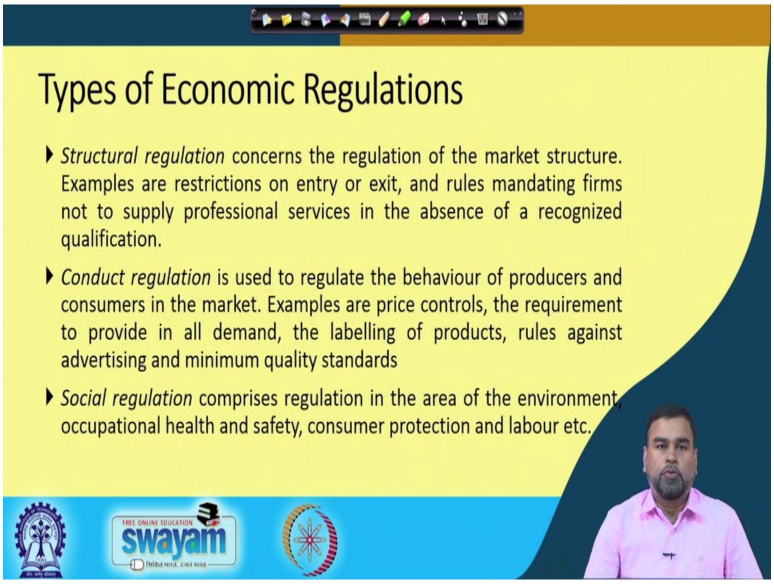

So, then we will see that what are the different types of economic regulations? You see the regulations are different ways defined this is what basically we just now discussed that is basically the objective of the regulation. Why the regulation is required or why the financial institutions or markets should be regulated? But, if you see the different type of regulation, we can define it either it is a structural regulation or it can be a conduct regulations or it can be social regulation. So, what do you mean by the structural regulation?

The structural regulation basically deals with the regulation of the market structure. What does it mean? It means that it controls the entry and exit and rules the mandating firms not to supply the professional services in the absence of recognized qualification. What does it mean? It basically you know every market has a structure, how the market basically functions they have a structure. The structure in the sense, who can enter into the market and when this particular organization can exit the market. So, those things basically if you any kind of regulatory norms we are preparing or we are trying to regulate those things into the system then that comes under the structural regulation.

So, thats why the structural regulation deals with the market structure of that particular system particular in terms of the entry and exit and whether the rules and regulations are followed by that particular organization whenever they are operating in that particular system. Whenever we are talking about the conduct of regulation this is basically is used to regulate the behavior of the producers and the consumers in the market. For example, it deals with the price control, it also deals with the requirement to provide or create the demand in the system.

And they should ensure that what kind of advertisement and other kind of things which are done by the firms they are following the actual ethical standards. And if the ethical standards and practices are not followed by them then that basically we can that that organization is not going for advertisement in the ethical way. So, if you bring the financial market into the picture for example, if you go back the structural regulation whenever you deal with the financial market.

For example, you take the stock market, there is a market structure how the trading takes place? When this investor can take the positions? What are the different type of orders exist in that particular system like limit order you have the or we can say that whether the market is a quote driven market or the order driven market, when the settlements should takes place and what are the settlement cycle all kinds of issues comes under the structural part.

But whenever you talk about the conduct part what basically we are trying to see in the conduct for example, you are talking about insider trading in the stock market. So, if the particular organization is going for insider trading then it will affect the price. And the regulatory bodies always ensure that the insider trading should not takes place which means which is unethical practice. And to stop the insider trading some of the regulatory norms has been created the regulatory norms which have been created by the regulatory bodies.

We have to ensure that those particular markets or the particular companies who are going under this particular system they should always follow this norms which are made by this regulatory body in that particular economy. So, that is basically a part of the conduct regulations which deals with the pricing which deals with the approach or the behavior of the producers and the consumers, and I have given the example of insider trading whenever we talk about the financial market or particularly the stock market.

Then we have another type of regulation that is called the social regulation; so what exactly the social regulation means? The social regulation means that whether the firm which is operating or the company who is doing the business they are following this environmental norms or occupational or health issues which may arise, because of the operations or business of that particular firm where the laborers or consumers are protected. So, all kind of real sector issues or the factor which are affecting environment factor, affecting health factor, affecting safety all kind of issues should be basically always addressed by the social revolution.

So, any company whenever they operates or any kind of financial organization or any other organization when they operate in a system they have to ensure that they should abide by the rules and regulations related to the environment protection. And any kind of hazards or any kind of health issues which may arise, because of the operations of that particular company and also they should ensure that the consumers are protected or consumers are safe. So, in this context if you see broadly there are three types of regulations always we observe.

One is structural second one is conduct and third one is the social. So, these three things always the financial organization have to follow and always the regulatory bodies ensure that this system always work in this direction.

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Then if you talk about the theories of regulation that already all of us know that every kind of operational and practical aspects come from the theory there should be some theoretical motivations. There should be some theoretical understanding always we should have whenever you operate in a particular system. Like that in the regulatory aspects also in the regulation also there should be some kind of theoretical understanding what do you mean by this theoretical understanding?

If you see mostly there are two board theories which always work in this particular direction; what are those two broad theories one is public interest theories of regulation another one is the Chicago theory of regulation because, the Chicago school of thought has given that particular theory. So, in name of that particular school this particular theory's name has been given that Chicago theory of regulation. So, what do you mean by this public interest theory?

The public interest theory basically ensures or always deals with the regulation of firms and other economic units or economic agents which contribute to the promotion of the public interest. That means, in a layman perspective if you try to understand what it exactly means, it means that the firms and other regulatory or the other economic agents should be regulated in the interest of the public. That means, the regulatory norm should be created in such a way that the social welfare can be maximized the social welfare can be maximized or the public interest can be protected. So, any regulation what we are making that should not be in the benefit of the producer or not on the benefit of the firms and whatever regulations we are making that should be for the benefit of the public or for the maximization of the social welfare.

So, this is basically given by the, which is called as the public interest theory of regulation. And another theory is basically called the Chicago theory which will basically also says little bit different. So, according to this theory the regulation is basically a rule which is acquired or which basically should be designed primarily for the benefit of that particular economic agent.

Little bit biased theory what basically here we are trying to say the regulation also should be made; that means, here if you combine both the theories basically both the theories are relevant from the regulation point of view. The regulation should be made in such a way that the public interest also should be taken care and as well as the firm or the particular economic agent which is operating in that particular system their interest also should be taken care.

So, here these regulatory norms should be designed in such a way that the interest of both the stakeholder can be taken care. So, that is why one of the theory cannot be only applicable whenever we talk about the practicality of that particular concept. So, we have to ensure that the regulation can consist of or can be derived from the thought of both the theories which takes care of the public interest and as well as the other interest on the own acquired by the industry and design and operated primary for its benefits. So, this is what basically we call it a Chicago theory of regulation.

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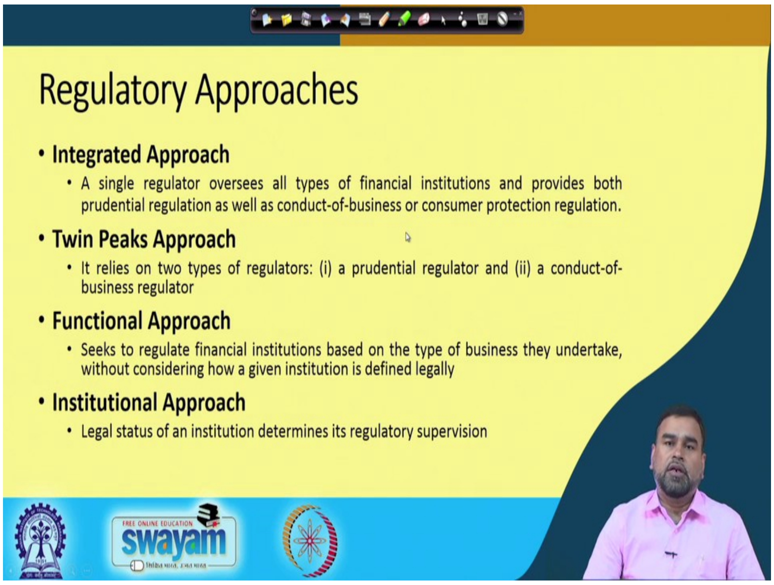

Then, there are let us come to the concept of the approaches to the regulation there are various regulatory approaches, what are those regulatory approaches? There are different approaches the regulatory body follows we will come to that the other aspect is also there in the terms of the approach. But the first approach is basically in terms of you might have heard this debate between whether this particular system should have a single regulator or should have a multiple regulators.

So, keeping that thing in the mind there are different approaches have been established, have been created. So, if you see that the first approach is called the integrated approach. So, what do you mean by this integrated approach? The integrated approach tells that there should be a single regulator who oversees all type of financial institutions. And market and provides both prudential regulation as well as the conduct of business and consumer protect regulation.

What does it mean? It means that there should be a single regulatory body, if you observe that here; what we are trying to say that whenever we talk about this different approaches if you observe that whenever we talk about the single regulatory bodies should take care of both the prudential regulation and as well as the conduct of the business or the consumer protection regulation. What does it mean? It means that the regulatory bodies should create the norms should create the rules and regulations for the conduct of that particular or functioning of that particular organization and as well as they should make those certain kind of rules and regulation which helps the consumer for the benefit for participating in that particular process.

That means it takes care of both supervision and as well as the prudential regulation the two things will be integrated and one regulatory body or single regulatory body is good enough for operating in that particular system. And another type of approach is twin peaks approach. What do you mean by this twin peaks approach? The twin peaks approach basically relies on two types of regulator; one is a prudential regulator and another one is a conduct of business regulator what does it mean?

That means, there are two types of regulatory bodies; one type of regulatory body will be responsible for creating the prudential norms and another regulator should ensure that whether the norms are followed or not and the different economic units are functioning in the whatever way the regulatory bodies have guided that. So, the conduct and their prudential norms which are created by them that should be basically overseen by the two regulatory bodies and that should not be taken care of by single regulatory body.

One regulatory body will make the prudential norms and another regulatory body will see whether the prudential norms are basically followed by these particular economic agents or not. So, that is basically popularly known as twin peaks approach then we have another approach called the functional approach. So, what this functional approach means? The functional approach basically seeks to regulate the financial institutions based on the type of business they undertake without considering how a given institution is defined legally. What does it mean? The regulation should be made on the basis of the functioning of that particular organization or what kind of business the organization is doing.

This particular; that means, the functional part of the organization should be regulated legally, what kind of business this particular company is doing that should not be basically considered. So, the functions should be ethical or the operations procedure of the particular company should be ethical and the public interest has been taken care. That basically should be ensured by the regulatory bodies whenever we are or any regulatory body is following the functional approach. That is what basically always we observe or we can define in terms of the functional form.

And another approach is called the institutional approach; that means, the legal status of an institution determines its regulatory supervision. You see whenever any organization is made that basically is made on the basis of certain acts or certain laws. So, we have to ensure from the beginning whatever acts and laws has been used to establish that organization with a certain objective, whether the organization is fulfilling that objective or not whether this particular objective of that particular organization is followed by the functional operation of that particular organization in the system. So, that is called the institutional approach.

So, the regulatory supervision is basically determined on the basis of the legal status of that particular company in the system, but if you combine these are very much theoretical in nature. And theoretically those kind of approaches give you the idea what kind of regulatory bodies we should have or what should be the focus of, the regulatory bodies in the system, that is what the basic job of the regulatory approaches, but whenever we come to the practical sense.

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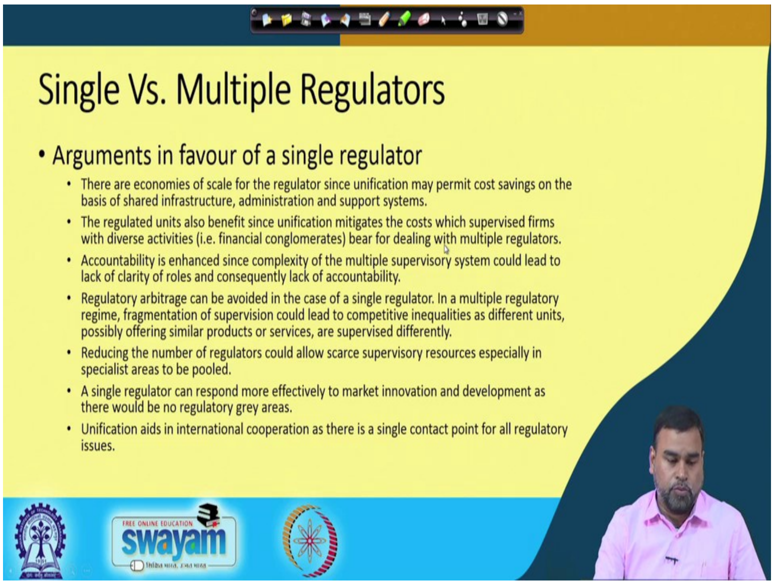

That is exactly how the regulatory bodies work in the system; we have a single regulatory body. There is a debate in India also the debate is still going on whether we should have a single regulatory body or we should have the multiple regulatory bodies. So, if you consider all those approaches. And the theoretical motivation behind the regulation they always deal with one thing that whether this particular regulation is made by a single regulatory body or we should have a multiple regulatory bodies who takes care of the different functional parts of the regulation. Like somebody can create prudential norms somebody can supervise somebody can see the functional form of operations of that particular economic unit's etcetera.

So, there are various arguments whether we should have a single regulatory body or we should have a multiple regulatory bodies. Whenever we see that if we see the arguments in favor of the single regulatory body, the people are the advocator of the single regulatory body is always assumed that because of single regulatory body there are economies of scale for the regulator.

Since unification may permit cost savings on the basis of shared infrastructure administration and support system cost. Basically we can reduce the cost. The man power will be less, more infrastructure is not required, administrative bodies people also will be less, and human resource requirement is also less. And we can have the single regulatory body who have the different branches and they can operate in efficient way, because it works with under same administration or same operational process that is basically number one advantage what basically they agreed.

Second argument what they gave the regulated units also benefits since unification mitigate the cost with supervised firms with diverse activities bear for dealing with the multiple regulators. Whenever we see the multiple regulators basically one regulator regulate one kind of market another regulator regulates another type of market.

So, then what will happen that whenever there is a chance if the two different markets are related, then there must be a conflict that whether it should be regulated by this particular regulatory body or that regulatory body which has happened in the Indian context, also whenever the banks basically provide this mutual fund services or insurance services. So, that time whether it should be regulated by the SEBI or regulated by RBI those kinds of confusion always arise. And another issue is accountability can be enhanced because since complexity of the multiple supervisory system could lead to lack of clarity of the roles and consequently lack of accountability.

Regulatory arbitrage can be avoided in case of single regulator. In a multiple regulatory regime fragmentation of supervision could lead to competitive inequalities in different units. It can also reduce the number of regulators which can allow this scarce supervisor resources especially in the specialist areas we may not need more regulatory persons whenever we have a single regulator. A single regulator can correspond more effectively to market innovation and development.

As there to be regulatory grey areas in the sense nobody can hide the information, because I do not know about what the other bodies is doing or other organization is doing, because every all the information is gathered through one unified body that is basically the single regulator. It is also aids and International Corporation as there is a single contact point for all regulatory issues in the globalised scenario whenever we are dealing with the multiple countries. So, that time it will not have any issues because the contact point of regulatory issues is basically one.

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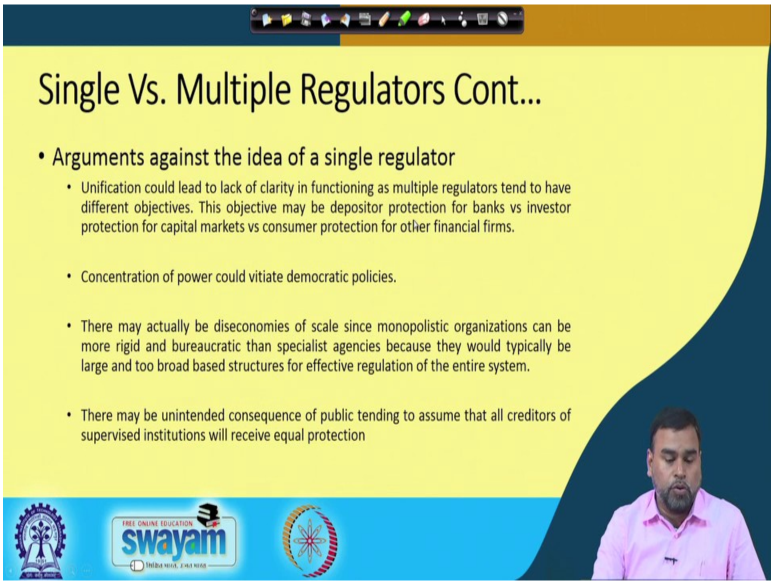

So, these are the different arguments in favor of the single regulator. But there are some demerits also. What are those arguments against this single regulator unification or would lead to the lack of clarity? In functioning of the multiple regulator tend to have a different objectives; the objective may be depositors' protection for banks versus investors' protection for capital markets versus consumers' protection for other financial firms. Which firm should be protected or which agent should be more protected which agent should be less protected? So, those kinds of confusion may arise if one body will regulate all kind of entities.

Concentration of the power could basically is a threat to the democratic policies it can also go against this policies whatever we have. There maybe actually the diseconomies of scale since monopolistic organizations can be more rigid and bureaucratic than the specialist agencies. Then, there may be a unintended consequences of public tending to assume that all creditors of supervise institutions will receive the equal protection, if one body is regulating or one body is making the rules for all kind of economic units or all kind of economic agents which are existing in the system, then maybe there is a conflict of interest arises that which particular agent or which particular unit is more protected which unit is less protected. So, these are the different arguments which are against the idea of single regulator.

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Another concept which has started after 2004 2005 in India and as well as other countries that is called the financial self regulation we have AMFI we have FIMMADA all kind of organization which comes under the self regulatory bodies. The self regulatory bodies basically feel that, our system is matured enough that we can regulate our self. As the association of that particular units can regulate themselves and their basic responsibilities are regulation of market transactions, regulation of market participants, dispute resolution and enforcement actions and pre commitment of the resources.

Like association of mutual funds, they try to dissolve the different conflicts which arise within that particular entity or within particular system and they always want that the burden of those particular regulatory bodies like SEBI can be controlled through or can be reduced through that. So, that is way there is self policing arrangements also can be made whenever the market become much matured and the system can work in that direction.

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But, there are certain regulations the self regulatory organizations might transform themselves into the cartels which may hamper to the competition in the system; short term tension between the managers and authorities responsible for the self regulatory organizations either discourage participation or diminish the long term confidence in the market. Scarcity of institutional and human resources, they may not have that much expertise to regulate themselves, or there must be some kind of less accountability for the functioning, or the operations of that particular system, lack of reasonably homogeneous institutions for a balanced structure within that particular regulatory bodies.

With limited competition in securities market self regulation may not be enough to ensure safe and efficient markets, whenever the market is inefficient then in that particular time the self regulatory bodies may not control or may not regulate the market efficiently.

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And here, there are some of the acts which are related to financial sector regulation in India starting with banking regulation act 1949 to the Companies Act 2013 then you have the IRD Act 1999 then you have the payment and settlement systems act 2007. So, there are different acts on which the regulations are based on the Indian system.

And here on the basis of these acts different regulatory bodies have been established mostly it is RBI SEBI PFRDA and we have another bodies called the IRDA Insurance Regulatory Development Authority. In the upcoming sessions we will be discussing the functioning and of these regulatory bodies and how they function and how they regulate the market in India.

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Please go through these particular references for this particular session.

Thank you.