FSLRC: A New Institutional Framework for Financial Sector

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Abstract

Recommendations of the FSLRC aim to provide a holistic philosophy and process for regulating the financial sector. Through a non-sectoral approach based on the twin pillar of consumer protection and systemic stability FSLRC recommendations try to host financial market regulation on to a new trajectory so that a well-governed financial sector could play the catalytic role to support an aspirational India.

Background

Current system of financial regulation in India is sectoral. There are separate laws for regulation of banking, insurance, securities, commodity derivatives and pensions. Different regulatory authorities administer these enactments: RBI for banking, SEBI for securities, IRDA for insurance, PFRDA for pensions, and FMC for commodity futures [This will become part of SEBI's mandate shortly as FMC is being merged with SEBI: first step towards limited convergence of markets and regulation]. Our approach to financial market regulation has been in bits and pieces, evolved as episodic responses to market pressures and related developments over several decades. Such an episodic approach could not foster a cohesive philosophy of regulation, which would define the shape and design of institutional structures. Different institutional forms generate differing behaviour in terms of incentives and propel the markets in varying directions. Such processes and practices created under-regulated, over-regulated and grey areas and cocktails of regulatory approaches over time.

It is a realisation of the limitations of such a sectoral approach to financial sector regulation and development that led to the setting up of the Financial Sector Legislative Reforms Commission [FSLRC]. Chaired by Justice B N Srikrishna, the FSLRC had eminent Members, each of them having several decades of experience in the areas of law, economics, finance, public administration, market regulation etc. The Report submitted to the Government of India in March, 2013 consists of two volumes: Volume-I, outlining the analysis and recommendations and Volume-II, a draft law which would convert the recommendations into statutory provisions.

Drafting the law by the Commission itself was particularly significant, because it could capture the spirit of the recommendations behind the law. While a few expert committees in the past had drawn up very ambitious path for modernising the financial sector institutional- regulatory structures the absence of a draft law was a limitation in implementing the holistic reforms. The draft law given by the FSLRC titled the Indian Financial Code [IFC] proposes repeal of a number of existing financial sector legislations, which were the products of different times spread over a century.

What the FSLRC has done is to draw a big-picture institutional architecture which binds financial sector institutional process to some basic principles. To implement these there are seven financial agencies, two of them pure regulatory agencies. The sweeping changes in institutional architecture proposed in the FSLRC report is founded on many pillars, supporting a complete edifice.

New thinking on Regulatory governance

Statutorily independent regulatory authorities [IRAs] are a relatively new breed of institutions evolved in the second half of the last century. Specialised financial agencies such as for resolution, financial stability etc. are of still recent vintage. They are different from the extended arms of the Executive such as the field agencies for providing particular services like vehicle registration or driving licences. The IRAs are like mini-States that they are empowered with legislative, judicial and administrative responsibilities, even blurring the doctrine of separation of powers enshrined in democratic constitutions.

Creation of such powerful IRAs and other financial agencies is, however, a deliberate decision of the Parliament. They agencies have to address complex tasks of market failure emanating from information asymmetry and market power. They have to protect millions of financial consumers, minimise the failure of financial firms, resolve them smoothly when some of them actually fail and prevent large-scale failure of firms that would lead to crises in the system as a whole. Many of their actions at times involve cross-border coordination and hence a proper understanding of and net-working with the systems in other jurisdictions. To cap it all, these agencies have to act fast as *speed* of action is the essence of maintaining trust and confidence in a financial system.

Given these high-order functions, financial agencies need to be statutorily tasked with clear objectives, and specified powers. Given such vast powers as well as the potential agency problem inherent in delegation their accountability also need to be clearly stated. Given that

they are not accountable to the public through elections like the Parliament they suffer from 'democratic deficit' which needs to be bridged through appropriate contracting, enforcing them to follow due legal processes in their actions. This include that while making regulations they mandatorily consult the public, do a cost-benefit analysis of proposed regulations, have internal checks and balances, external audit, a judicial appeal process and reporting to the public and Parliament. So the essence of regulatory governance is to provide independence to the IRAs for performing statutorily defined tasks, the process of exercising their powers and the system of accountability. This does not vary considerably from one IRA to another IRA or between other financial agencies and hence a uniform system of regulatory governance with a few specific variations provided in the IFC.

Principle-cum-rule based approach

Change is a constant feature of financial markets, with rapid innovations. Given this, financial sector laws are incomplete laws which have to adapt to fast paced changes. Like the Indian Contract Act, 1872, which provides templates for the varying types of contracts, the primary laws in the financial sector need to be based on principles. The primary laws cannot envision all the possible developments in the financial sector nor can they be changed by the Parliament as frequently or as fast as the changes happen in the financial world. Hence the primary law outlined in the draft IFC is primarily a principle-based law.

At the same time since considerable powers are delegated to the financial agencies the principles are amplified to provide for a rule-based approach to the regulations. The draft IFC is therefore both legally rigid and functionally flexible to provide the right degree of freedom to the regulators. This degree of freedom will get more defined and refined with experience and as administrative law evolves over time.

Consumer at the centre of financial regulation

The theory of market asserts that the consumer is king. While this dictum is considered far from reality, in financial markets, with their high information asymmetry, it is perhaps the farthest. Ironically, however, financial markets leave the consumers to their own wits with just a warning- *caveat emptor*, consumer beware! The FSLRC world would change this rather unsustainable position. The entire focus of financial regulation would hereafter devolve around the consumer, both directly and indirectly. Consumer protection is one of the two pillars as the primary tasks of the IRAs and their regulations is to protect them vis a vis financial products, services and service providers. Regulators also have to frame regulations for minimising failure of financial companies. IRAs need to provide different degree of protection to the different types of consumers. While all consumers need some degree of protection the small or retail consumers need a higher degree of protection. While the former are given some basic rights the latter are given these basic plus additional rights. Indirectly, in their pursuit to minimise failure of firms through prudential regulations, the IRAs are again helping the consumers.

Consumer protection is also addressed through a specialised redress mechanism, the Financial Redress Agency [FRA] as a single window external ombudsman mechanism of the IRAs. This is to avoid consumers of financial products running between multiple agencies in redressing their grievances as the present system draw turf boundaries leaving grey areas on consumer complaints. A regular system of feed-back from the FRA to the IRA based on grievance data analysis would help the latter from systemic prevention of large scale complaints on a product, service or service provider.

Mitigating systemic risk for greater stability

Though one of the major objectives of financial regulation is to prevent or mitigate failure of financial firms, in reality regulations cannot achieve a zero failure market. Failure of financial entities is part of the creative destruction of the market process even in regulated markets. Failure happens due to the failure of the management in foreseeing risks, due to the failure of their internal control mechanisms, due to sheer adventurism and due to exogenous factors, including regulatory actions. When failure happens on a large scale or when the affected entity is a conglomerate or a systemically important financial institution [SIFI] we have a larger problem than a firm failure.

Addressing systemic crisis need a pan-agency approach as SIFIs straddle between IRAs. Sometimes such crises could be coming from even non-financial conglomerates with or without having financial sector business. The sheer size of the treasury operations of some of the non-financial sector conglomerates is enough to trigger a system wide crisis and the financial sector IRAs have no supervisory/regulatory powers over them. We cannot have solution for systemic crisis from the vacuum: we need regular data flow and analysis of potential bubbles and problem spots and adequate powers to address that. This analysis is one of the major roles of the Financial Stability and Development Council [FSDC] and during a crisis it supports the government armed with this information. Since the executive committee FSDC is a collegium of the financial agencies, decisions at a pan-agency level becomes easier and get instantly institutionalized.

Financial agencies and a non-sectoral law

'Financial agencies' are defined in the IFC. They are defined in the primary law itself in order to avoid any potential ambiguity. There are seven of them as of now; any change in this number in future has to be through an amendment to the IFC. The organisational matrix of the financial agencies emanates from the pillars of the institutional edifice explained in the preceding sections of this article.

It is often stated that the creating structures is easy but

creating culture is difficult. An elaborate legal process coupled with clear tasks, powers and accountability would provide that desired regulatory culture to evolve as the agencies are not conflicted in their objectives or they can invoke powers from the vacuum. At the same time they have the statutory independence to perform their assigned tasks. Hence the organisational structure consisting of 2 IRAs and 5 other financial agencies as follows:

The RBI, as the monetary authority and regulator of banking and payments system and an Unified Regulatory Authority [UFA] as the regulator of all other financial service providers. The monetary policy function will be performed by a Monetary Policy Committee [MPC], which is chaired by the Chairperson of the RBI. In addition, the RBI has the traditional functions as issuer of legal tender, lender of last resort, banker to government, custodian of foreign exchange, specified functions on capital controls etc. Both the RBI and the UFA will perform certain developmental functions as well.

This is a deliberate 360 degree approach to regulating all entities as one of the premises of the FSLRC is that all financial service providers must be on the radar of a financial regulator to avoid the pitfalls of unregulated and under regulated entities parading the financial horizon at great cost to the consumers and putting the system at risk. At the same time the FSLRC acknowledges the need for promoting innovations and accordingly provides for a system of proportional regulation [proportional to the degree of risk to the system or to the retail consumers].

Out of the 5 other financial agencies, three perform very specific functions. A Resolution Corporation operates the deposit insurance and manages the smooth resolution of failing firms; a Financial Redress Agency [FRA] dealing with redress of all financial consumer grievances; a Public Debt Management Agency [PDMA] that would run a cost-efficient office for managing the borrowing programme and for managing the cash flow of the central government.

The sixth agency is a pan-regulatory Council, the FSDC, which will act as a coordinator between the financial agencies, resolve inter-agency disputes and performs specified functions on systemic risk, financial development, data management etc. FSDC is neither a regulator nor it would act in an area assigned to any of the other agency. Rather in its own functioning it would assign the operational role to other agencies based on matching the primary task of the agencies and the task that would be assigned.

The last one is a judicial agency, the Financial Sector Appellate Tribunal [FSAT] which would hear appeals on the orders by the RBI for its regulatory functions, UFA, FRA, and specified orders of the Resolution Corporation.

A special feature built in by the FSLRC in its draft code is the non-sectoral approach to regulation of financial markets as well as the simplicity of amending the IFC to make changes in the organisational mandate. For example if banking regulation is to be transferred to the UFA or insurance regulation from UFA to the RBI in future, it needs only deleting/adding one provision from the functions of the RBI and the UFA. Because micro-prudential regulation and consumer protection laws are not sector specific and can be done by any agency as empowered by law.

Developments post- FSLRC Recommendations

Given the sweep of the recommendations of FSLRC they are being implemented on different fronts, in parallel. Governance enhancing aspects of the recommendations are being implemented by the regulators. These include the process of regulation making, transparency, internal governance etc. of the regulators.

As a first step in regulatory convergence it has been decided to merge regulation of commodity derivatives trading with securities trading repealing the Forward Contract [Regulation] Act, 1952 and amending the Securities Contract Regulation Act, 1956 and merging FMC with SEBI.

The Ministry of Finance and the RBI have signed an agreement on monetary policy framework [MPFA], providing greater clarity and quantitative target for monetary policy.

The government has initiated a project based approach to building new financial agencies and for upgrading the existing ones so that they become ready to take on the mandate at any time in future.

In the Budget speech of 2015-16 the Finance Minister announced the hope, to introduce the IFC in Parliament for consideration sooner rather than later.