Regulatory Mechanism for financial markets:

Emerging trends and Managerial implications

Dr. Anil K. Sharma & Mr. Ashutosh Vashishtha

ABSTRACT

Financial markets have significantly developed in the last decade around the globe and cross border capital flows have increased many folds as a result of liberalization and globalization of these markets. Regulatory failures causing financial crisis have also occurred with greater frequency in the last ten years or so in both advanced and emerging economies. This has created a need for a strong institutional regulatory mechanism capable of handling the challenges of globalization and arrests the incidences of financial irregularities and scams. In this background the present paper is an attempt to address the issues pertaining to financial sector regulation, examining the emerging trends and mechanism of financial markets around the world, proposing a regulatory model for Indian financial markets and highlighting it's managerial implications.

INTRODUCTION

In recent years, the financial sector in most countries around the world has undergone major changes. Deregulation, liberalization and technological and financial innovation have thrown new challenges to regulators and policy makers around the world. The traditional frontiers between banking, securities and insurance sectors are rapidly disappearing. In order to remain competitive, financial institutions have merged with each other giving rise to financial conglomerates.

India's financial sector has also seen major changes over the past decade. Banks have begun to move towards universal banking structure as frontiers between banking, securities and insurance sectors have become thin and blurred. Moreover, competitive pressures have resulted in a growing number of mergers, resulting in the emergence of financial conglomerates.

These changes have redefined the financial services and products. These changes have important implications for the players who deliver financial services and products and also for the regulators who supervise the sector. As financial institutions become larger and more complex, and as they begin to operate across multiple national jurisdictions, the task of regulating them becomes more daunting. Stock market scams, the UTI story and problems with cooperative banks, GTB Bank crisis underline the importance of enhancing supervision and governance. Moreover, as the financial sector becomes more open, the challenge facing India's regulators will become ever greater. Debate on various regulatory structures has already started to plug loopholes in the existing regulatory structure.

This paper highlights the various complex issues facing Indian financial regulators and proposes a regulatory model to address the same. Emerging trends in international financial regulations and their implications have been discussed. A critical study of alternative regulatory structures has been presented to bring out their complexities and effectiveness.

RATIONALE AND OBJECTIVES OF THE STUDY

In recent years, the financial sector in most countries around the world, has undergone major changes. Deregulation, liberalization and technological and financial innovation have thrown open new challenges to regulators and policy makers around the world. The traditional frontiers between banking, securities and insurance sectors are rapidly disappearing. In order to remain competitive, financial institutions have merged with each other giving rise to financial conglomerates. As financial institutions become larger and more complex, and as they begin to operate across multiple national jurisdictions, the task of regulating them becomes more daunting and the challenge facing India's regulators become ever greater. Debate on various regulatory structures has already begun to plug loopholes in the existing regulatory structure. There is an urgent need to clarify the objectives of regulation, and to define more clearly the role and responsibility of regulatory agencies. It is in this context that present study assumes special significance and relevance. Certain important issues have been tried to be identified and highlighted in this paper, which may be of immense use to policy makers, regulators and various participants in the financial system.

The main objectives of the study are:

1. To study the existing models for financial markets regulation and supervision around the world.
2. To identify pros and cons existing in various models.
3. To identify the emerging trends in financial regulatory practices globally.
4. To examine the existing regulatory mechanism for Indian financial markets.
5. To develop a financial sector regulatory model for Indian financial markets and identify its managerial implications.

DATA AND METHODOLOGY

For analyzing the various relevant issues, this study has used relevant available information and employed simple quantitative techniques to draw graphs and figures, wherever necessary. Data and information have been collected from both primary and secondary sources of information. Research papers published in various journals, Books, reports and surveys, and published speeches of experts have been extensively referred for the purpose of study. Personal discussions with the experts and people from industry have immensely contributed towards making worthwhile conclusions and suggestions. Studies and surveys conducted by the World Bank on alternate regulatory models and RBI report on currency and finance have been important sources of information.

DISCUSSION, CONCLUSION AND SUGGESTIONS

Objectives and Importance of Financial Regulations.

Financial markets differ from other markets of the economy in several ways. They are inherently inter-temporal. They involve lending today in the expectation of a return in the future. It introduces an element of risk, which is usually very large relatively to non-financial transactions. Secondly, financial markets are characterized by the problem of asymmetric information immensely. The borrower is likely to be better informed about the probability that he will be in a position to service his debt in the future than the lender. This may lead to adverse selection, a situation in which those selected for lending may not necessarily be those having the best probability of repayment. Finally, there is the problem of moral hazard (Williamson, 1988). The lender may some times succumb to the temptation to unduly rely on an explicit or implicit guarantee of some third party rather than make those loans on risk return considerations. Moral hazard may also arise due to distorted intentions of the borrower's himself. He or she may, at one stage, believe that there is no need to service the debt because the courts will procrastinate the matter.

The focus of financial regulation is two fold. At the macro level, financial regulation is concerned with maintaining systematic stability. It is perceived to be crucial for the financial sector because social costs of financial distress, which has a contagion effect, are heavy. The East Asian experience and the more recent experiences in Turkey and Argentina, amply demonstrate this. At the micro level, on the other hand, the concern is about protecting consumer interest. A retail investor is unable to afford the cost of getting necessary information, acquiring or employing analytical expertise and learning from the experience of others. In view of these factors and the far more complex nature of financial markets, the need for their regulation is far more as compared to other markets.

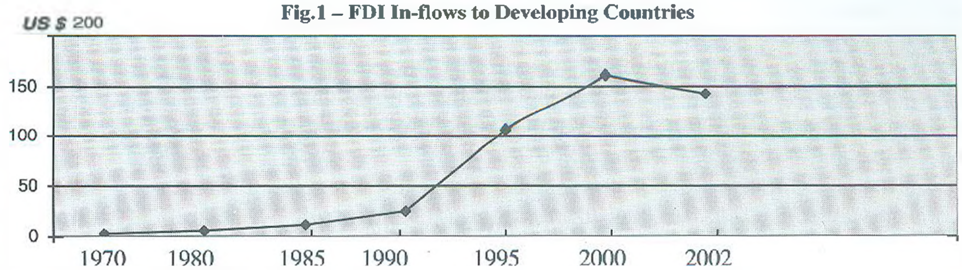
Financial regulation has assumed added importance in recent times. This is due to certain factors. There has been rapid growth of financial sector over the last decade or so. Whereas FDI inflows to developing countries, taken together, increased from $ 24.1 billion in 1990 to $ 143 billion in 2002, a six-times increase (Table1and Fig. 1), in case of India, these inflows increased from $ 7.1 billion to $ 12.1 billion over the same period (Table 2 and Fig. 2). A cursory look at the composition of total net capital inflows to India would show that during the first five years there was a phenomenal increase in the proportion of portfolio investment (in percentage terms) and it was much above that of FDI. But after 1995 it started declining and even fell much below that of FDI. So much so, it assumed even a negative value in 1998. The only exception in this regard was the year 1999 when it again increased abruptly surpassing FDI. During 2002, FDI and portfolio investments, as proportions of total net inflows constituted 38.1 percent and 8.1 percent, respectively. The irregularity in the behavior of these two components brings out the fact that the Indian financial market is yet to acquire necessary strength and maturity, in terms of sound practices and over all credibility, for attracting and, more significantly, sustaining foreign capital.

Table 1: Net External Capital Inflows to Developing Countries (US $ billion)

Region	1970	1980	1985	1990	1995	2000	2002
1	2	3	4	5	6	7	8
All developing countries							
FDI	2.2	5.3	12.5	24.1	105.4	160.6	143.0
Portfolio	---	---	---	4.5	20.2	26.0	9.4
Debt	6.4	96.0	44.8	58.0	151.7	-1.0	7.2
East Asia & Pacific							
FDI	0.2	1.3	2.9	10.3	51.3	44.0	57.0
Portfolio	---	---	---	1.6	9.1	19.3	5.4
Debt	1.0	11.9	9.6	19.0	54.2	18.0	8.3
Europe & Central Asia							
FDI	0.1	---	0.1	1.2	17.0	29.2	29.0
Portfolio	---	---	---	0.3	1.7	1.2	1.4
Debt	0.5	13.5	5.6	2.3	23.4	22.0	11.2
Latin America & Caribbean							
FDI	1.2	6.4	6.0	8.2	30.5	75.8	42.0
Portfolio	---	---	---	2.5	4.8	-0.4	1.0
Debt	2.8	46.1	5.8	20.4	61.3	-1.1	3.5
Middle East & North Africa							
FDI	0.3	-2.8	2.1	2.8	-0.6	2.5	3.0
Portfolio	---	---	---	---	0.1	0.2	--
Debt	0.5	8.7	12.8	0.8	2.7	-6.5	-0.3
South Asia							
FDI	0.1	0.2	0.3	0.5	2.9	3.1	5.0
Portfolio	---	---	---	0.1	1.6	1.7	0.8
Debt	0.8	5.8	5.7	8.4	2.5	3.4	0.9
Sub-Saharan Africa							
FDI	0.4	0.1	1.0	1.0	4.3	6.1	7.0
Portfolio	---	---	---	---	2.9	4.0	0.7
Debt	0.9	10.1	5.3	7.1	7.6	-0.9	0.2
Middle Income							
FDI	1.9	4.8	10.5	21.5	91.4	154.9	-
Portfolio	---	---	---	4.0	17.1	25.6	-
Debt	4.1	76.6	31.1	34.1	132.5	-2.5	-
--- Nil / Negligible	**-: Not**	**ailable**					

Source: Global Development Finance, Word Bank Report, 2003

Fig.1 – FDI In-flows to Developing Countries



There is yet another reason for the increased significance of financial regulations. A concomitant of growth of financial sector in India is the substantial emergence of diverse overlapping- financial institutions. This has blurred the distinction between banking, securities and insurance activities. Even if the institutions and the activities are treated distinctly and risks are considered separable, as far as possible, the close linkages between the constituents of financial sectors make it impossible to contain the contagion effects (of erosion of credibility of these institutions) in the absence of effective regulatory system. Financial crisis in the East Asian and Latin American countries is a glaring example of this strong possibility.

Finally, growth of multi- dimensional conglomerates on the Indian financial scene also necessitates financial regulation with more open and international approach (Sisodia, 2004).

EMERGING TRENDS IN FINANCIAL REGULATIONS

As a result of cropping up financial institutions having business in diverse overlapping activities, recurrence of accounting and auditing scams, investor's growing mistrust in the functioning of financial institutions, emergence of global financial institutions, the need for overhauling financial regulatory arrangements has been widely realised world over. The emerging trends in international financial regulation may be specified briefly as follows:

Table 2: Composition of Net Capital Flows to India

Variable		1990-91	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
1		2	3	4	5	6	7	8	9	10
Total Capital Inflows (Net) (US $ Billion):		07.1	04.1	12.0	09.8	08.4	10.4	10.0	10.6	12.1
Composition of Capital Flows (% to)										
1.	Non-debt Creating Inflows	01.5	117.5	51.3	54.8	28.6	49.7	67.8	77.1	46.6
	(a) Foreign Direct Investment	01.4	52.4	23.7	36.2	29.4	20.7	40.2	58.0	38.5
	(b) Portfolio Investment	00.1	65.1	27.6	18.6	-0.8	29.0	27.6	19.1	08.1
2.	Debt Creating Inflows	83.3	57.7	61.7	52.4	54.4	23.1	59.4	09.2	-10.6
	(a) External Assistance	31.3	21.6	09.2	09.2	09.7	08.6	04.3	11.4	-20.0
	(b) External Commercial Borrowing#	31.9	31.2	23.7	40.6	51.7	03.0	37.2	-14.9	-19.4
	(c) Short-term Credits	15.2	12.0	07.0	-1.0	-8.9	03.6	01.0	-8.4	08.1
	(d) NRI Deposits	21.8	27.0	27.9	11.4	11.4	14.7	23.1	26.0	24.6
	(e) Rupee Debt Service	-16.9	-23.3	-6.1	-7.8	-9.5	-6.8	-6.2	-4.9	-3.9
3.	Other Capital@	15.2	-75.2	-13.0	-7.2	17.0	27.2	-27.2	13.7	64.0
4.	**Total (1 to 3)**	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo: Stable Flows*		84.7	33.7	65.4	82.4	109.7	67.4	71.4	89.3	83.8

\# : Refers to medium of long term borrowings:
@ : Includes leads and lags in exports (difference between the custom and the banking channel data), banking capital (assets and liabilities of bank excluding NRI deposits), loans to non-residents by residents, Indian investment abroad, India's subscription to international institutions and quota payment to IMF.
* : Stable flows are defined to represent all capital flows excluding portfolio flows and short-term credits.

Source: Report on Currency and Finance 2002-03, Reserve Bank of India.

1. *Decline of self regulation:* A series of accounting and auditing scams that have occurred in many countries around the world and which have spelled the doom of world's two biggest companies, Enron and Arthur Anderson, a number of countries have been prompted to set up statutory bodies to regulate financial transactions, a job which was previously left to self-regulation (Davis, 2004).

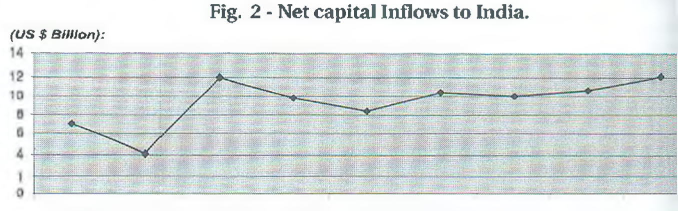
2. *Investor's excessive reliance on self regulators*: Financial market products are becoming more and more diversified, innovative and competitive. Investors now have access to derivatives and a range of leveraged investments like hedge funds. Investor's awareness of various aspects of new financial instruments is much less than required. They have started believing that if things go wrong the regulator will bale them out.

3. *Regulatory integration:* In view of growth of financial institutions having diverse activities, various countries, such as, UK, Japan, South Korea, Germany, Belgium and Austria have started taking a rational approach to financial regulation by setting up single regulatory body as it is difficult for various sectoral regulators to deal with institutions which are at the same time under control of other regulatory bodies as well.

4. *International regulatory approach:* The growth of global financial institutions has made it imperative for a regulator in any country to realise that it is no longer adequate to focus only on domestic accounting and auditing standards. The need for ensuring compatibility of these standards with the internationally agreed codes and adopting a somewhat more open and internationally oriented cooperative approach is being increasingly recognised. After all the interests of investors in a branch of an international financial institution in any country are ultimately influenced by the quality of supervision of the parent organisation (Diamond and Dybvig, 1983).

As a result of these emerging trends in financial regulation

Fig. 2 - Net capital Inflows to India.



regulatory structures around the world have undergone significant changes and diverse regulatory models have been developed and adopted.

ALTERNATIVE REGULATORY MODELS

Financial regulation around the world is governed by standards set by three main groups of regulators (Davi

2004). For banking, it is the ***Basel Committee***, set up under the auspices of the BIS. For securities firms and markets it is the ***International Organization of Securities Commissions*** (IOSCO), and for insurance companies it is ***the International Association of Insurance Supervisors*** (IAIS). All three organizations have established principles of good regulatory practice, to which most countries in the world are, at least nominally, signed up. These principles describe the appropriate structures for regulation, with basic requirement of independence from political interference.

Several recent studies (most notably by the IMF and World Bank) have attempted to summarise international trends in regulatory structure (Llewellyn, 2004). Where previously, the focus of most studies was on regulatory amalgamations in the UK, Japan, Canada, Australia and Scandinavia more recent studies have turned to the growing number of amalgamations in emerging-market countries as well as changes within some of the more traditional powerhouses of the EU, including Germany and the Netherlands. For the purpose of our discussion regulatory model may be defined as an agency consisting of group of agencies and set of measures embodied in legislation, which aims to mould or control the behavior of financial institutions operating within a national economy (Currie, 2002). According to the most recent World Bank study, there are 6 main regulatory structures found throughout the world (Martinez and Rose, 2003). A summarized view of these models is given in the following part:

THE INSTITUTIONAL REGULATORS MODEL

Under this model, there is a separate regulator for each group of institutions, keeping regulatory culture separate. For instance, the central bank may regulate only the banking institutions in the country. This kind of model is in operation in about 30 countries (Table 3) in the

Fig.3 – Institutional Model (Multiple Regulators)

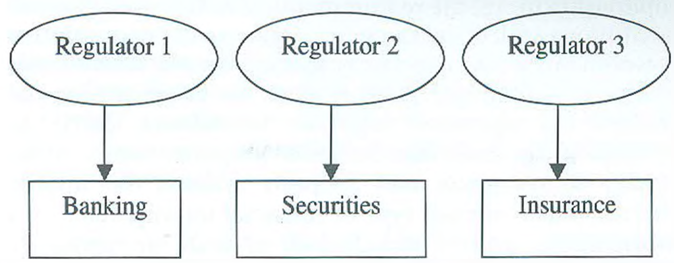


Table 3: Countries with Various Financial Markets Regulatory Structures in 2002

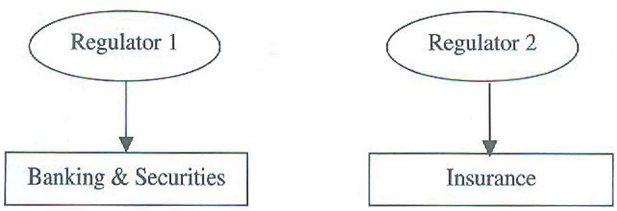
Single Supervisor for the Financial System	Agency Supervising 2 Types of Fin. Intermediaries			Multiple Supervisors (At least one for banks, one for securities firms and one for insurers)
	Banks and securities firms	Banks and insurers	Securities firms and insurers	
Austria	Dominican	Australia	Bolivia	Argentina
Bahrain	Republic	Belgium	Chile	Bahamas
Bermuda	Finland	Canada	Egypt	Barbados
Cayman Islands	Luxembourg	Colombia	Mauritius	Botswana
Denmark	Mexico	Ecuador	Slovakia	Brazil
Estonia	Switzerland	El Salvador	South Africa	Bulgaria
Germany	Uruguay	Guatemala	Ukraine	China
Gibraltar		Kazakhstan		Cyprus
Hungary		Malaysia		Egypt
Iceland		Peru		France
Ireland		Venezuela		Greece
Japan				Hong Kong
Latvia				India
Maldives				Indonesia
Malta				Israel
Nicaragua				Italy
Norway				Jordan
Singapore				Lithuania
S. Korea				Netherlands
Sweden				New Zealand
UAE				Panama
UK				Philippines
				Poland
				Portugal
				Russia
				Slovenia
				Sri Lanka
				Spain
				Thailand
				Turkey
				USA

Source: 'How Countries Supervise Their Banks, Insurers, and Securities Markets', Freshfields, 2003. London, world. This model best facilitates the tailoring of regulation/ supervision to suit the requirements of individual groups of institutions and, at the same time, contain concentration of power in any single regulatory agency. Several authors also believe that there are good reasons for keeping financial supervisory agencies separate (Goodhart, 2001) as specialized agencies may be better prepared than a single agency to recognize and properly address the unique characteristics of each type of financial intermediary. It's shortcoming mainly include lack of scale in regulatory agencies; high cost due to duplication of infrastructures; potential for regulatory gaps, over-laps and arbitrage; and little chance to extract the synergies from other regulatory mechanisms.

THE MEXICAN MODEL

It is in operation in 6 countries (Table 3) wherein banking and securities regulation rests in the hands of a single regulatory body. It provides some economies of scale and better career opportunities than the institutional model and does not allow over-concentration of power. It is also less costly and deals better with conglomerates as compared to the institutional model. Possibility of cultural clash between banking and securities regulatory requirements; and potential for regulatory gaps, over-laps and arbitrage are its major drawbacks.

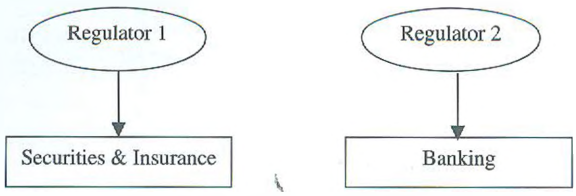
Fig.4 – Mexican Model (Unified regulator for Banking & Securities sector)



THE SOUTH AFRICAN MODEL

It is in existence in 7 countries (Table 3). Under this model, regulation of securities and insurance sectors is entrusted to a single agency, thus, leaving the regulation of banking sector to the care of the central bank. This is more appropriate arrangement considering the high priority, which needs to be assigned to banking regulation. Although, due to some similarities in the regulatory styles between insurance and securities regulation, synergies are likely to be better under this regulatory system as compared to the Mexican model, yet not as much as possibly from combining banking and insurance. Moreover, it requires greater co-ordination and co-operation, especially when financial conglomerates are present. And also, it leaves room for regulatory gaps, over-laps and arbitrage. Above all, there is the danger of central bank's reputational risk.

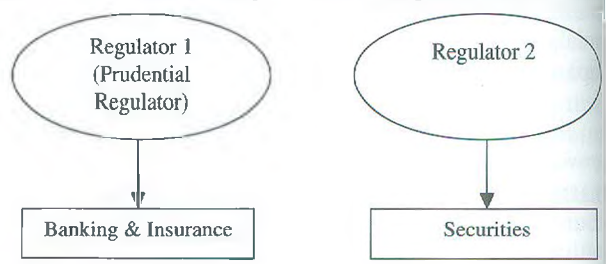
Fig.5 – South African Model (Unified regulator for Banking & Insurance sector)



THE CANADIAN MODEL

This model refers to the regulatory structure under which banking and insurance, and in many cases, pensions, too falls under a single regulatory agency separate from central bank. This arrangement has been adopted by 11 countries (Table 3). It is regarded as the best-align model as it minimises conflict between regulatory objectives. It provides sound scale economies in resource usage and maximises synergies by combining all regulatory practices of a similar style within one agency. As regards its major shortcomings, it involves some contradiction as it separates banking regulation from central bank and still requires co-ordination with, and co-operation of, the latter. Additionally, this model permits concentration of power with each regulator.

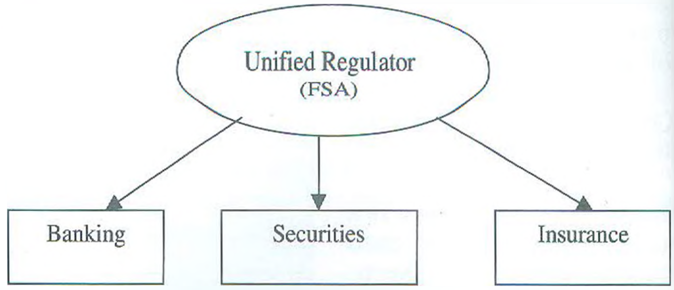
Fig. 6 – Canadian Model (Unified regulator for Banking & Securities sector)



THE UK MODEL

It seeks to combine all banking and non-banking regulation in an agency separate from central bank. This model has been followed by 22 countries (Table 3). Apparently, it may be expected to provide very broad career opportunities for the staff. Also, it facilitates co-ordination and co-operation within the institution, and a comprehensive framework for regulation of financial conglomerates, thus eliminating

Fig.7 – UK Model (Unified Regulator)

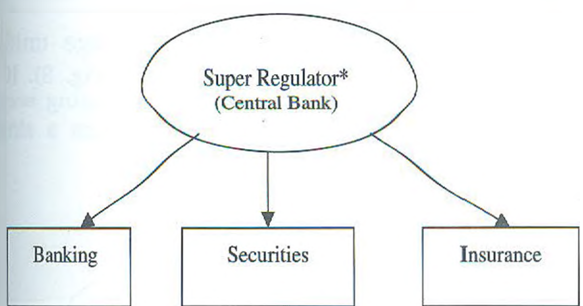


regulatory arbitrage. On the other side, it has the disadvantage of dangers associated with concentration of power in a single agency' and leaving scope for conflict between objectives of banking and insurance regulation.

THE SINGAPOREAN MODEL

It operates in 5 countries (Table 3) and its unique feature is that it entrusts the unified regulatory task, encompassing all banking and non-banking institutions, to a single agency, namely, the central bank. It armors the central bank with complete control of financial regulation thus ensuring not only greater stability in regulation but maximizing synergies in regulation, as well. As regards its negative features, it creates a very powerful central bank endowed with multiplicity of objectives, which may conflict at times. Secondly, it involves the highly dangerous potential of central bank deviating from its main role of monetary regulation.

Fig.8 – Singapore Model (Extremely Unified Regulatory Mode)



* Regulator also supervises the monetary policy. In all other models the monetary policy is regulated by Central Bank.

It is important to mention that these 6 models are not entirely exhaustive in terms of describing all possible regulatory combinations (Carmichael and Pomerleano, 2002). They refer to only some of the existing possibilities and references for creating still more possibilities in future. Also, there is no single regulatory structure that is ideal for all countries, or ideal even for a single country across all times and circumstances. Changing the institutional structure of regulation should not be viewed as a panacea or as a substitute for effective and efficient conduct of regulation. For the success, and effectiveness of any financial regulatory system it is necessary that it must enjoy independence, and at the same time, accountability; it must exhibit good governance; it must have adequate regulatory powers and skills; and lastly; it must possess complete financial independence in the sense that its resources are not put to risk by way of changes in the budgetary position of the Government or retaliation (from the Government) to its certain policy measures and decisions (Rosengren and Jordan, 2000). The regulatory structure should be viewed as a means to an end, not as an end in itself (Taylor, 1997).

CRITICAL ISSUES IN DESIGNING A REGULATORY MODEL

Before we attempt to design a regulatory model applicable to Indian financial markets after studying the existing models, it is pertinent to examine the critical issues required to be considered in designing an appropriate and effective regulatory model.

1. *Conflict among regulatory objectives and cultures.* The major objectives of financial regulation are curtailing and controlling monopoly, fostering competition and protecting consumer interest (Freshfields, 2003). Regulatory agencies may have some other important objectives such as (i) Systematic stability (ii) Institutional safety (iii) Market fairness and (iv) Financial efficiency, which focuses on ensuring fair degree of competition among institutions falling under the control of regulatory agency, and the culture of competition regulation, which is necessary for the same (Allen and Gale, 1995). Therefore the central issue in designing a regulatory structure is whether conflict can be better handled within a single agency or between agencies having clearly defined objectives assigned to each one of them.
2. *Role of the central bank.* There are many arguments regarding the role of central bank. It is argued that banks are critical to systemic stability because of their role in the payments systems. Since central banks universally supervise the payments system, they should also supervise banks. On the opposite, those who favour the separation of banking regulation from central bank argue that objectives of monetary policy and banking regulation may, at times, generate conflicts, Further, central bank's credibility as a monetary regulator may also suffer as a result of weaknesses or failure of any or some of them. On the whole, the issue tends to settle in favour of central bank being assigned the role of banking regulator as well.

3. *Co-operation between regulatory agencies.* Liberalization and globalisation of financial markets and emergence of financial conglo-merates has created the need for increasing cooperation between regulatory agencies, both within the country and across the countries. No regulatory structure can survive in the absence of co-ordination and co-operation between different regulators.

4. *Country Size.* A consideration of the size of the country as well as of financial regulator is another critical issue in designing an appropriate regulatory structure. Small countries are pushed towards the large-size, more amalgamated regulatory structures so as to best utilise their scarce resources in the best possible manner and prevent regulatory capture by the industrial giants. Obviously, large countries tend to favour relatively small-size, more decen-tralised

regulatory structures so as to prevent concentration of power in a single all pervasive regulator. What kind of regulatory structure fits best to particular country depends on country's specific conditions. Nothing can be generalised or concluded, a priory, in this regard.

5. *Regulatory Arbitrage.* It is a fundamental requirement for efficient regulation that the possibility of arbitrage, as far as possible, should not be there. When a financial institution is able to choose among regulators, either by altering its corporate form, or its regulatory jurisdiction, or simply its institutional label, there is an incentive to arbitrage among potential regulators so as to minimise the regulatory burden. This problem is exacerbated in conglomerate situations where a heavily regulated parent may be able to reduce its regulatory burden by shifting business into an unregulated or much less regulated subsidiary (Rai, 2004).

VARIOUS REGULATORY OPTIONS FOR INDIA

Over the last one-decade or so there has been much debate and discussion over the various regulatory options and there effectiveness. Before tuning to this problem, we may briefly mention the broad contours of the present regulatory system, and the necessary considerations that need to be kept in mind while evaluating the various options.

First, under the existing regulatory arrangement adherence to the basic requirement of an effective regulatory system, namely, independence and accountability, is less than satisfactory. We have public sector representatives on both, regulatory boards as well as boards of financial institutions, many of which are state owned. Certainly, this is not in conformity with the above-mentioned basic requirement. *Secondly,* there are regulatory over-laps. The multiplicity of regulation often leads to problems of regulatory co-ordination, dilution of regulatory powers and lack of proper accountability. *Thirdly,* some financial institutions suffer from over-regulation by multiple regulators while others remain under-regulated. *Fourthly,* in the absence of a regulatory body, the problem of information gap is faced by different regulators as well as the state. This problem is due mainly to rapid diversification in the activities of financial institutions. This makes it difficult for one regulator to obtain necessary information regarding the activities of an entity, which is simultaneously under the domain of another regulator, as well. *Finally,* the financial sector is transiting fast towards globalisation. This is an important consideration to be born in mind while adopting any regulatory structure. This is necessary for aligning the regulatory architecture in order to facilitate smooth transition to globalisation.

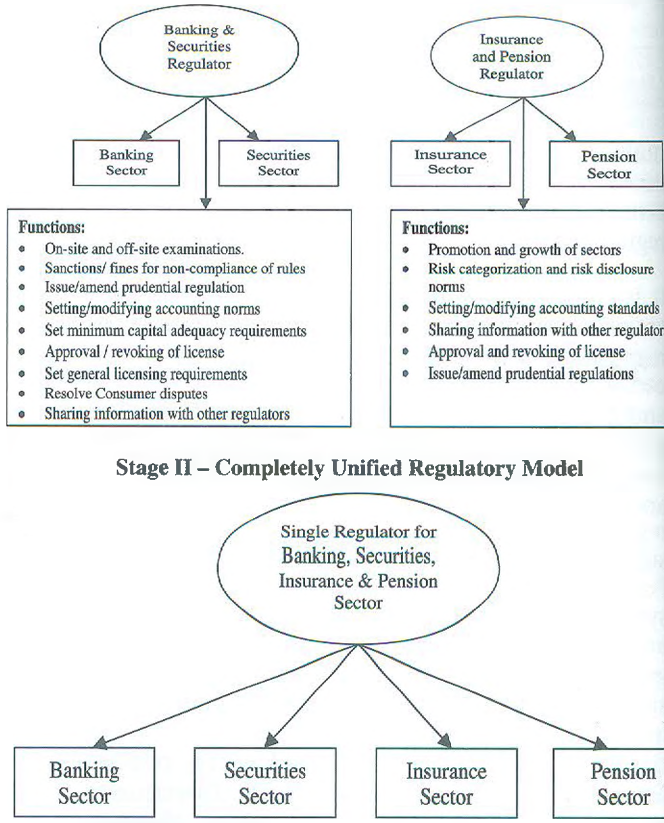
In the light of above discussion and after studying the major regulatory models, we are proposing a "*Two stage unified regulatory*" model for Indian financial markets, which, we feel, would correctly address the regulatory challenges confronting the Indian financial sector.

PROPOSED "TWO STAGE UNIFIE[D] REGULATORY MODEL" FOR INDI[AN] FINANCIAL SECTOR

Present Indian financial regulatory syste[m] may be categorized as 'institution[al] model' whereby each financial market ha[s] its own regulator. Thus, RBI, SEBI and IRDA are th[e] institutional regulators for banking, securities and insuran[ce] sector financial intermediaries. The institutional model cou[ld] be considered a good candidate only in a context with rigid[ly] separated financial segments, and where no global players a[re] at stake(Giorgia and Noia, 2001). Nowadays, we think that th[e] picture does not apply to the Indian financial markets, wher[e] we observe high-level integration in financial markets an[d] intermediaries and a strong presence of financi[al] conglomerates.

Therefore we have recommended a two stage unifie[d] regulatory model for Indian financial sector (Fig. 9). It [is] proposed that in stage one, securities and banking sect[or] regulatory agencies should be merged to create a sing[le]

FIG. 9
Two Stage Regulatory Model for Indian Financial Sector
Stage I
Partially Unified Regulatory Model



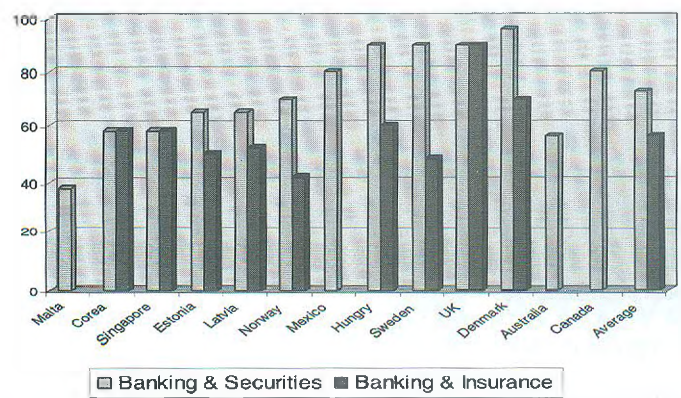
regulatory agency for these two sectors. There seems to b[e] high degree of integration between banking and securit[ies] supervision as compared to banking and insura[nce] supervision (Martinez and Rose, 2003). Figure 10 shows that integration of banking & securities supervision has been more harmonized as compared to integration of banking & insurance supervision. Moreover, the respective roles of capital markets and of banking institutions have been converging.

Capital or securities markets have made major inroads as mechanisms for allocating both funds and risks within the economy that were once primarily the domain of banking institutions or other regulated financial intermediaries (Knight, 2004).

Therefore, there is a strong case for creating a common regulator for these two important financial sectors. As of now, we feel that insurance and pension sector financial institutions should be regulated separately because these markets are still in the nascent stages of development and required to be monitored by an agency which conducts the development and regulatory role together. IRDA and proposed Pension Fund Regulatory and Development Authority (PFRDA) therefore, should be left alone to develop and regulate insurance and pension sector in India. Stage II of the model refers to a complete unification of existing regulatory agencies in a single regulatory agency for the entire financial sector. This single regulatory agency may have three distinct divisions to regulate banking, securities and insurance sector within the regulatory agency. The single-regulator supervisory model would be having just one financial regulator, separated from the central bank, and with responsibility over all markets and intermediaries regardless of whether in the banking, securities or insurance sector.

In the regulatory practices, the single regulatory supervisory model was in existence during the early stages of financial system development, when the central bank was the only institution that supervised the activity of financial intermediaries. In recent times with the onset of globalization and integration of the financial markets, this model came into being with the creation of the Financial Services Authority FSA (Briault, 1999). In Indian context, this model is likely to produce the economies of scale, reduction in the cost of regulation, elimination of regulatory arbitrage and better supervision of financial conglomerates. It has been observed that unified regulatory approach results in significant reduction of direct and indirect cost of regulation and therefore costs of supervision charged to the subjects regulated and/or to the taxpayer decreases accordingly (Franks, Schaefer and Staunton, 1997).

FIG10 : Integration of Bank and Securities Supervision Vs. Bank Insurance Supervision by Country



Source: Martinez, J. and Thomas A. Rose, T.A., 'International Survey of Integrated Supervision', World Bank Study, 2003, Washington DC.

We are aware that our proposed model is little ambitious and requires indeed a substantial amount of coordination among the different authorities. Another important obstacle is the institutional and political resistance of the existing national supervisory bodies that would not easily allow their powers to diminish or even abolish.

For such reasons, we have proposed complete unification of regulatory agencies in two stages whereby partial integration at stage I prepares the regulatory agencies for the next stage of unification. This kind of two-stage model would still be a good and more practical solution to implement, especially in the medium run. Once implemented, this model is likely to have some managerial implications also which are briefly discussed here:

MANAGERIAL IMPLICATION

The process of merging two or more supervisory agencies is a major managerial challenge, because the merged agencies have their own identity and well-established organizational structure.

Therefore, the challenge of merging different regulatory agencies should not be underestimated as, if the unification process is not managed properly, then it can go off the track. Some of the important managerial implications are:

1. One of the most difficult tasks of unifying regulatory agencies is to strike an appropriate balance between the different objectives of regulation.

2. The loss of experienced personnel and demoralization of staff after regulatory agencies are merged or abolished.
3. There is considerable difficulty in developing a comprehensive plan to conduct the merger of different regulating agencies in a time bound manner.
4. It is tedious and frustrating to integrate the IT systems and other essential infrastructure elements of the merged entities.
5. An important risk of establishing an integrated agency is that, one approach of supervision may prevail over the other. This may happen when one particular type of financial intermediary usually commercial banks dominates the financial sector
6. There is a challenge of communicating to the market the objectives, policies and tools of the newly constituted unified regulator. It is imperative for the success of the integrated agency that all market participants understand the rationale for creating a unified supervisor and are willing to cooperate with it in maintaining financial sector stability.

Thus, Integration of different regulatory agencies should be carried out only after giving due consideration to above mentioned difficulties and challenges. Nonetheless, if a country wishes to strengthen the overall quality of regulation and supervision in the financial sector, these are important managerial implications that need to be addressed sooner or later.

CONCLUSION

There is no one simple institutional model which can be recommended for universal application and each country must assess the pros and cons of different structures, in the light of their own financial markets and political structures. What is crucial is to ensure that the regulatory institutions have the independence and authority to take firm, sometimes unpopular, timely decisions. A unified, independent and accountable financial system, as far as possible, is a better fit for India to cope with the regulation of conglomerates, eliminate, or at least, minimise regulatory gaps, over-laps and arbitrage; and achieve efficient use of regulatory resources. However, establishing a good regulatory architecture is only a part of the solution. There are other important aspects, too which need to be addressed. There is need for clarity on regulation policy. The issue of limits, objectives and instruments need to be clearly delineated (Pernia, 2004). Another important issue is that of information exchange and review. Further, there is the need for laws, which distinguish between owners, regulators and market participants. Sometimes this gets blurred because of the existing legal structure. There is also the need for highly professional skills. Unless those skills are available, real success may not be expected for realising the goals of regulation.

REFERENCES

1. Allen, F., D. Gale, (1995), *"Financial Markets, Intermediaries and Inter temporal Smoothing"*, Rodney L. White Center for Financial Research, Discussion Paper 5-95 Wharton School. Philadelphia.
2. Briault, Clive (1999), *"The Rationale for a Single National Financial Services Regulator", K, FSA Occasional Paper No.2.*
3. Carmichael, J. and Pomerleano, M., (2002), *"The Development and Regulation of Non-Bank Financial Institutions"*, Working Paper Series World Bank, Washington DC.
4. Currie, Carolyn (2003), *"Towards a General Theory of Financial Regulation: Predicting, Measuring and Preventing Financial Crises"*, Working Paper Series, No.132, School of Finance and Economics, University of Technology, Sydney.
5. Davis, Howard (2004) Conference Speech on *"The changing face of Financial Regulation"*, Securities and Exchange Board of India, March 23, Mumbai.
6. Davis, Howard (2004) Conference Speech on *"C D Deshmukh Memorial Lecture"*, Reserve Bank of India, February, Mumbai.
7. Diamond, D. and P. Dybvig (1983), *"Bank Runs, Deposit Insurance, and Liquidity"*, Journal of Political Economy 91(3): 401-19.
8. Franks J., Schaefer S. and Staunton, M. (1997), *"The Direct and Compliance Costs of Financial Regulation"*, Journal of Banking and Finance, n. 11
9. Freshfields, (2003), *"How Countries Supervise Their Banks, Insurers, and Securities Markets"*, Freshfields, 2003, London.
10. Giorgio, D. G. and Noia, C. D. (2001), *"Financial Regulation and Supervision in the Euro Area: A Four-Peak Proposal"*, The Working Paper Series, Wharton Financial Institutions Center, The Wharton School, University of Pennsylvania. USA
11. Goodhart, Charles (2001) *"The Organisational Structure of Banking Supervision"*, FSI Occasional Papers, No 1, Financial Stability Institute, Basel, Switzerland.
12. Knight, Malcolm (2004) *"Regulation and Supervision in Insurance and Banking: Greater Convergence, Shared Challenges"*, Conference Speech at the IAIS 11th Annual Conference in Amman, Jordan, 6 October.
13. Llewellyn, D., (2004), *"The Institutional Structure of Financial Regulation: The Basic Issues"*, World Bank, Washington DC.
14. Martínez, J. and Thomas A. Rose, T.A., (2003), *"International Survey of Integrated Supervision"*, World Bank Study, Washington DC.
15. Pernia, Joseph del Mar (2004), Speech on *"Aligning Financial Regulatory Architecture with Country Needs: Lessons From International Experience"*, World Bank Financial sector Conference, June 5 6, 2004, New Delhi.
16. Rai, Vinod (2004), Conference Speech on *"Aligning Financial Regulatory Architecture With Country Needs: Lessons From International Experience"*, World Bank Financial sector Conference, June 5 6, 2004, New Delhi.
17. Eric S. Rosengren, and John S. Jordan (2000), *"Building an Infrastructure for Financial Stability: An Overview"*, New England Economic Review, Federal Reserve Bank of Boston.
18. Sisodia, N.S. (2004), Conference Speech on *"Aligning Financial Regulatory Architecture With Country Needs: Lessons From International Experience"*, World Bank Financial sector Conference, June 5 6, 2004, New Delhi.
19. Taylor M., (1997), *"Redrawing the Regulatory Map: A Proposal for Reform"*, Journal of Financial Regulation, No.1.
20. Williamson, John (1988), *"Speeches, Testimony, Papers on Markets and Regulation"*, Nov 20-21, Institute for International Economics, University of California, Santa Cruz. USA.