Redistributing Regulatory Power

C. P. Chandrasekhar

In March this year, two years after its constitution, the Financial Sector Legislative Reforms Commission (FSLRC, chaired by Justice B. N. Srikrishna) submitted its two-volume report. While the Commission's title seems limited in terms of remit, its report is indeed far-reaching. Exploiting the rather wide and ambiguous terms of reference set for it, the Commission has chosen not to restrict itself to merely recommending amendments to existing legislation and the enactment of marginal new laws to modify the historically evolved legal framework. Such an exercise is indeed necessary to excise redundancies, address conflicting mandates, close gaps and accommodate new features in financial markets. However, the FSLRC has chosen to abjure piecemeal "amendments to the existing legislations" and design "a new institutional foundation for the aspiring, future Indian economy," involving "a full-scale revamp" of the framework of financial regulation.

The issue is not only one of scope. The problem is that the structure of financial regulation is too important a matter to be left to be decided by a Commission, despite its claims that it has consulted widely and relied on the best experts and research to arrive at its recommendations. This is particularly so because those recommendations amount to a fundamental redesign. In the process, some would argue, rather than render appropriate and make consistent legislation designed for a historically evolved architecture, the legislative frame that determines the objectives, scope and detail of regulation has been weakened, not strengthened.

Central to the Commission's redesign efforts are four elements: (i) a decision to adopt a "principle-based", rather than "rule-based", overarching legislative structure to be adopted by Parliament; (ii) an attempt to demarcate the main institutional elements of the regulatory architecture and define the role of each of these institutions; (iii) a case to give these institutions the independence and power to formulate subordinate legislation and issue rules and guidelines relating their areas of responsibility; and (iv) and a push to provide new powers to the Ministry of Finance.

The shift to a "principle-based" code enacted by parliament implies that the law "*will articulate broad principles that do not vary with financial or technological innovation. Regulators will write subordinated legislation that could either be in the form of detailed prescriptive rules or be principles-based, depending on the situation and the judgment of the regulator*." The regulator would then be responsible for administering these rules, with significant judicial powers as well. This, the Commission's admits, goes against the "separation of powers" doctrine—which requires separating legislative, executive and judicial powers—that is central to a liberal democracy. But that aberration is seen as corrected by setting up mechanisms to ensure accountability of the all-powerful regulators.

Implicit in all this is the erosion of powers of parliament when it comes to governing the financial sector. The ultimate elected body will not define the objectives that the financial sector must serve and the regulation it should be subjected to. Even when regulators are challenged, the interpretation of the law is left to judges:

"*When laws are written in terms of principles, there would be legitimate disagreements about the interpretation of principles. These are resolved by judges who build up the jurisprudence that clarifies what a principle means in the light of the continuous evolution of finance and technology. … The Commission has decided to build on India's success with the SAT, which will be subsumed in a FSAT (Financial Sector Appellate Tribunal) that will serve as an appellate authority for the entire financial system and will also review validity of rules and regulations on the touchstone of principles-based law. Rulings of the FSAT, and the Supreme Court, would build a living body of jurisprudence alongside the principles-based laws recommended by the Commission.*"

The regulators set the rules and the judiciary, when called upon to do so, decides whether they are in keeping with broad principles.

What would be the composition of these all powerful regulators and how would they be constituted? It will consist of a board responsible for oversight and governance led by a Chairperson supported by employees and an advisory committee, appointed by that Board. Members of the Board would be chosen by a Selection Committee consisting of a representative of the Government, the chairperson of the regulator, and three experts from a list maintained by the Government consisting of experts in the fields of finance, economics, law and public administration. Clearly the idea is to privilege "chosen experts" over elected representatives in deciding who would man the powerful boards.

Having decided to give much power to these 'expert'-driven regulatory bodies the Commission has chosen to recommend a restructuring of the set of such institutions and their individual jurisdiction. Among the most important of the recommended changes are the following: (i) The decision to merge the roles of the Securities and Exchange Board of India, Forward Markets Commission, Insurance Regulatory and Development Authority and Pension Fund Regulatory and Development Authority into a single regulator called the Unified Financial Agency (UFA), on the grounds that all financial activity other than banking and the payments system, which would continue to be regulated by the RBI, should be brought under a single authority. (ii) The continuation of the Financial Stability Development Council (FSDC) with the mandate to monitor and address systemic risk, which is to be led by the Finance Ministry. (iii) The creation of a Resolution Corporation that would identify institutions that are threatened by insolvency and resolve the problem at an early stage. and (iv) The creation of a Public Debt Management Agency that would take the responsibility of public debt management away from the Reserve Bank of India (RBI).

The areas that the remit of these institutions would cover in terms of financial regulation aimed at addressing market failure are laid down in the form of nine responsibilities varying from "consumer protection" (which is to say that the financial sector merely provides services that are consumed), through prudential regulation and systemic risk management, to capital controls, and even 'redistribution' and monetary policy. The Commission has discussed in detail what needs to be done in most of these areas, making it clear that it not only believes that "independent", "expert"-driven regulatory bodies should be given the mandate for drafting subordinate legislation and making rules, but has strong views on how that mandate has to be exercised.

The Commission also recommends tweaking the existing division of powers between the RBI, the principal financial regulator currently, and the government, represented by the Finance Ministry. First, while micro-prudential regulation of particular institutions in different sectors is to be with the designated regulatory bodies, the task of monitoring systemic risk is with FSDC, which consists of the heads of the various regulatory agencies (each of whom individually is seen as lacking in system-wide expertise) and would be chaired by the Finance Minister. With this, the restriction of the RBI to prudential regulation of the banking sector and payments system is complete, and independent regulators meeting under the umbrella of the Ministry of Finance would address even systemic risk. Second, the Commission calls for splitting the regulation of cross-border capital movements into inflows and outflows and handing over the tasks of regulating inflows to the Finance Ministry, while leaving the power to regulate outflows with the RBI. Presumably the Commission believes that the exchange rate, which the RBI manages, should not be managed, or can be managed without having control over capital inflows. Further, the idea seems to be that rules on outflows can be formulated independently of those relating to inflows, which seems odd coming from a Commission that wants to resolve conflicting policies resulting from a fragmented system of regulation. Finally, public debt management is to be moved out of the ambit of the RBI to avoid 'conflicts of interest', with regard to interest rate policy for example, into a separate agency capable of taking a comprehensive view of the liabilities of the government and working out a strategy for low-cost financing.

In sum, the recommendations of the Commission, if implemented, would bring about three important changes in the regulatory architecture. It would shift power from Parliament and the elected representatives of the people to 'independent' bodies run by nominated experts and subject to scrutiny by a legal framework that might be capable of judging fairness of regulatory reach but not its appropriateness from the point of view of development. Second, all financial services other than banking and payments are to be regulated by a single UFA, which would be substantially influenced by what Argentine economist Arturo O'Connell has termed an 'epistemic community' of experts and others favouring finance. In principle, finance capital would be regulating itself, with consequences that can be damaging as suggested by the global crisis of 2008-09. Third, with neoliberal reform having separated fiscal policy from monetary policy and claiming to have made the central bank independent, the drive now is to remove the RBI from oversight of all financial sectors other than banking and give any residual powers that cannot rest with the epistemic community of finance to the Finance Ministry.

The Commission has combined its case for restructuring the financial architecture in this manner with a bias in favour of actual regulation that gives new freedoms and considerable flexibility to finance, in ways that cannot be addressed in the space available here. But what is clear is that this is no legislative reforms commission but a commission that is serving as a vehicle to legalise a regulatory structure suited to a liberalised financial sector. Some of these concerns have been expressed in the four notes of dissent submitted by members of the commission. But there is more to be concerned about than even they have pointed to.

Note: * This article was published in the Economic & Political Weekly, Vol. XLVIII No. 20, May 18, 2013, and is available at: http://www.epw.in/h-t-parkh-finance-column/redistributing-regulatory-power.html