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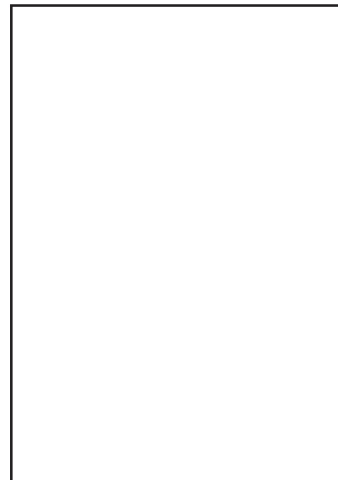
REGULATORY STRUCTURE FOR FINANCIAL SECTOR
Emerging Trends

MANAS CHAKRAVARTY



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Regulatory Structure for Financial Sector : Emerging Trends
By Manas Chakravarty

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Apt. E-5, Qutab Hotel, Shaheed Jeet Singh Marg
New Delhi - 110 016, India
Phones : 91-11-6856117, 6856113
Telefax : 91-11-6856113
Email : aitd@vsnl.com; aitd@bol.net.in

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Foreword

Liberalisation has perhaps had the most telling effect on the financial system in India. The financial system, once the epitome of state control, has been rapidly freed of many of its constraints. Interest rates have been freed; the private sector has been allowed into areas hitherto reserved for the state; and the pre-emption of resources by the state has been curtailed. Markets have changed beyond recognition.

While these changes have ushered in a new era of opportunity for entities in the financial services sector, it has also exposed the system to higher risks. The development financial institutions no longer have access to long-term low-interest funds provided by the government. Competition has dramatically increased. New kinds of players have appeared, such as the non-banking financial companies, the housing companies, the foreign institutional investors, and overseas corporate bodies.

The dismantling of controls has increased the need for effective regulation. Unfortunately, our regulatory system has been caught napping several times in the last decade. Indeed, it would appear that the authorities were not fully aware of the sort of systemic risks that the reforms would introduce. Had they been, it seems likely that the frequency and intensity of the meltdowns witnessed during the last decade would have been greatly mitigated.

There is no gainsaying the fact that the management of the transition has been woefully inadequate. Also, there does not appear to be sufficient appreciation of the financial system's fiduciary responsibility to the depositors. The common perception that the public sector institutions are safe for investment, since they are owned by the government, has turned out to be a false one.

In the circumstances, there is an urgent need to work out the kind of regulatory structure we need, with a view to anticipate and defuse the brewing problems in the financial sector. Over the years, developments in the financial sector have led to the formation of financial conglomerates, whose activities overlap the current regulatory jurisdictions. Such developments in several countries have led to the setting up of a single regulator for the entire financial services industry.

In this monograph, Manas Chakravarty, an erudite scholar and a well-known analyst of the financial sector, has examined the worldwide trends towards evolving the institution of a super-regulator which can provide a road map for the Indian financial system. I am confident that the monograph will prove to be a valuable contribution to the delineation of a regulatory structure for financial sector in India.

K. L. Thapar
Director

Introduction

The Indian financial system is going through a process of massive change. Long divided into watertight compartments, various segments of the system are merging into one another, and financial conglomerates have made their appearance on the scene. Commercial banking, insurance, investment banking, asset management, leasing, housing finance, credit card issuance, lending for infrastructure development, and lending to the stock market, are all activities that are increasingly being carried out by single institutions, or a group of affiliated firms. Liberalisation has freed participants in this sector from many of the restrictions of the past, and, as a result, they have diversified into new products and services, on the one hand, while venturing into new areas of activity, on the other.

These developments in the Indian financial services are part of a worldwide trend towards consolidation in the industry, the essence of which can be summed up in two words – universal banking. The main driver of this change has been the extremely rapid change in technology that has taken place in the last decade. Walter Wriston, a prominent banker, who had witnessed this change, candidly observed: "The new system was not built by politicians or economists. It was built by technology. In some respects the new world financial system is the accidental by-product of communication satellites and of engineers learning how to use the electromagnetic spectrum upto 300 gigahertz." The growth in telecommunications was complemented by an explosive growth in computing, a power which transformed the industry, enabling it to use information in many new ways, and also making possible the design of innovative products.

But it was not technology alone that was the reason for this change. As a matter of fact, globalisation of finance was also a product of underlying trends and pressures in the economies of the

advanced countries, one of which was the increasing importance of finance capital. The power of finance capital was a major reason for the breaking down of barriers to the free flow of international capital, on the one hand, and of removing the fetters on its expansion within national economies, on the other. Add to that a change in the intellectual climate, which led to the freeing of markets, and the withdrawal of many restrictions on private initiative.

However, the transformation of the industry was not immediately accompanied by a concomitant change in the method of regulation. Consolidation has resulted in firms in the industry getting bigger, and this trend, together with the introduction of new products, such as derivatives, has increased risk in the financial system. It is not just banks that are too big to fail these days, but some securities firms as well – the best example being that of Long Term Capital Management, the high-profile securities firm set up by Nobel Prize winning economists, a rescue for which was arranged by the US Federal Reserve. The threat of contagion has since increased manifold. Also, the increasing reliance on the market has led to the scrapping of direct controls, making it all the more necessary for a new kind of regulation to be put in its place.

A debate on the kind of regulation best suited to the new environment is raging throughout the world – in finance ministries, in central banks, and in international institutions, such as the Bank for International Settlements. Several countries have veered round to the view that the only way to effectively supervise the financial system of a country is to have a single regulator for all financial services. There are many arguments for and against such a super-regulator, which have been brought out in this monograph, but the simplest one in favour is that if firms in the sector diversify into various activities, the regulator must be enabled to regulate all those activities. Only then will the regulator be able to take a holistic view of the risk the firm is bearing. More importantly, it is now recognised that there is a need for an agency that is able not

only to keep abreast of the changes in the sector but also to anticipate and plan the regulation of change, so that there are no regulatory loopholes that can be a source of risk.

In India, the picture is complicated by the fact that the financial system is still dominated by huge public sector institutions, and recent events have shown that some of them have feet of clay. Such a structure lays the system open to moral hazard, as lending to or entrusting funds to them is perceived by the public as having a kind of implicit sovereign guarantee. In order for such a system to work, the relationship between the government and public sector institutions not only needs to be at an arm's length, but must also be seen by all concerned to be so.

This monograph is an attempt to address all these issues. It looks at the systems of financial regulation in vogue, the advantages and disadvantages of the super-regulator concept, and argues that there are certain critical regulatory functions in today's complex and networked financial systems that only a super-regulator can tackle. The example of the Financial Services Authority in the UK is examined in some detail.

The monograph also probes the arguments against having such a regulator in developing countries, and the related contention that the central bank is best suited for such a task in a developing financial system. However, it concludes that both these arguments are flawed, and a super-regulator is essential for taking a holistic view of the entire financial system and for dealing with the grey areas on the regulatory map.

Manas Chakravarty

1

Changing Financial Services Milieu

Backdrop

The rapid development of the Indian financial system is posing new challenges for regulators. There has been a shift from the earlier reliance on administered interest rates, control over capital issues, and tightly controlled financial markets. This has resulted in a greater degree of freedom for market participants. At the same time, there have been new players in the financial system, such as new private banks, foreign institutional investors, private mutual funds and the non-banking financial companies. The state has announced its intention of lowering its stake in banks, markets have been liberalised, and participants have to rely more on market signals than administrative fiat. Furthermore, the rapid advance of technology, especially in computing and telecommunications, has created new challenges.

It is a moot point whether the development financial institutions, which dominated the financial system in the days of the controlled economy, have any role to play in today's altered circumstances. The government has stopped supplying them with cheap long-term funds besides making credit guarantees more stringent. As a consequence, these institutions have been forced to move away from their exclusive mandate of advancing long-term loans, and have ventured into short-term loans. Faced with the high cost of raising resources, they have diversified, set up banks, mutual funds, and have even entered the securities business. One such financial institution, ICICI Ltd, now describes itself, together with its subsidiaries and affiliates, as "a virtual universal bank."

The Indian financial markets have historically been rigidly compartmentalised, with very weak linkages between the various segments. To take just one instance, the rates of return on money advanced in the stock markets (through the carry-forward system, now banned) bore no relation to interest rates prevailing elsewhere in the system.

But all that is changing rapidly. The money and foreign exchange markets are now closely integrated, perhaps because the set of players in both the markets are the same. The government securities market has become very vibrant, despite to the lack of individual investors. The government has lowered the rate of return on its small savings schemes to be more in tune with interest rates prevailing elsewhere in the system.

Market players have also spread their wings in response to the liberalisation of the Indian financial sector. Banks have expanded into areas far beyond commercial banking. They have set up asset management companies, housing subsidiaries, and a host of subsidiaries and affiliates dealing with securities trading, primary dealership, credit card business, merchant banking, custodial services *et al*. Recently, some banks have set up affiliates for getting into the insurance business. Non-banking finance companies (NBFCs) are keen on setting up banks, and one has already done so. In short, there is a remarkable degree of overlap of activities of players who hitherto stuck to their respective niches. This move towards universal banking has obviously created problems for regulators.

Financial services players are today facing far more complex risks – the distinction between sectors in finance, such as banking and securities business, is blurring, and there has been extraordinarily rapid integration in global financial markets. For regulators, this poses several challenges. Those who are presently responsible for financial stability have to consider far more parameters and have to be prepared for shocks from many more quarters. The manner in which supervisory activities affect firms

has changed dramatically and in complex ways. Rules have, therefore, to be devised that are consistent across sectors, leave no gaps, and are implemented effectively and fairly. Otherwise, the regulators will be exposed to the danger of regulatory arbitrage. This occurs when a financial conglomerate moves away from strictly regulated sectors to ones which are comparatively lightly regulated. It could lead, for example, to a focus away from banking, which is usually highly regulated, to securities trading, where the regulatory environment may be less restrictive.

There can be two approaches to the issues raised by the blurring of financial services sectors and the regulatory challenges that it throws up. One approach would be to try and come to grips with the new reality, with all the concomitant changes in regulatory institutions and practices that this implies. This approach would be an attempt to reshape the regulatory environment to conform to the new market realities. However, there could also be a second method of dealing with the changed circumstances. The regulator may try and restrict change so that it is compatible with existing regulatory frameworks. In short, the effort here would be to ensure that change does not affect the overall objective of stability as defined by the regulator. This second method may indeed be feasible in economies that have not opened up. An obvious example is provided by India's foreign exchange markets, where the market has been pulverised, hedged around with very severe restrictions, and prevented from growing under the excuse of stamping out speculation. But this method need not necessarily be a head-in-the sand approach or a refusal to see the changing reality. It may very well be an attempt to consciously compartmentalise the financial system so that it is more easily managed. This seems to be the real reason for the Reserve Bank of India's refusal to liberalise the foreign exchange markets.

A related reason sometimes cited as justification for such restraints on the financial markets is the presence of supervisory and infrastructural constraints in emerging markets. The argument is that financial activities need to be liberalised in a manner

consistent with such constraints of an economy. There is merit in this line of reasoning, as is amply evident from the Asian crisis, where rapid opening up of the financial sector, without putting the necessary regulatory structure and processes in place, was one of the causes of the meltdown. However, this approach involves substantial costs, and it may be difficult to continue with such a strategy for very long, given the consensus of international opinion in favour of the reorganisation of the financial sector.

Traditional Method of Regulation

The traditional method of regulating financial services is the "entity" approach in which the regulator regulates everything that the "entity" does. Under this approach, you have a regulator for banks, one for insurance companies, one for stock brokers, and so on; in short, one regulator for each market segment. As mentioned above the fragmented structure of the regulation of financial services, based on sectoral divisions, has become increasingly outdated. Banks, for instance, have moved into insurance, what's known as the bancassurance model. Many of them have their own asset management subsidiaries or associates in the securities business, housing finance or merchant banking. The entity approach to regulation will, under these circumstances, result in overlapping of regulatory functions. If a stock market entity moves into deposit taking, then the stock market regulator will have to regulate a function usually reserved for the central bank. Conversely, if a bank starts an asset management subsidiary, the central bank will have to start regulating the stock market operations of the banking group. Similar issues will arise if a bank moves into the insurance business. Under such circumstances, there are increasing costs to companies as a consequence of the need to deal with multiple and overlapping regulators imposing different regimes of regulation. Consumers, too, face a confusing array of regulators and dispute resolution mechanisms.

What has been the reason for the explosive change in the financial sector? One main cause has been the revolution in

telecommunications and information processing sectors. The financial sector is information intensive, and the greatest innovations of recent years have been in the processing and transmission of information. Obviously, it is the financial sector that has been the most affected, with billions of dollars flowing around the world in seconds. The phenomenal increase in computing power has made possible the growth of new risk management products. It has permitted independent pricing of risk factors that were previously bundled together in the same instrument. The ability to deconstruct and re-combine risks has enabled financial intermediaries to expand and compete effectively in sectors beyond their own. Another cause has been the fact that earlier the financial sector was among the most heavily regulated sectors, with most countries having, until as recently as 20 years ago, extensive controls on prices, entry to the industry, competitive practices, and portfolio composition. And still another cause has been the innovations in financial technology, such as the process of securitisation, which has led to tremendous growth in business for financial services players.

But it's not just the positive factors that have led to a sea change in the financial services industry. Competition has had a lot to do with it, apart from the need for firms to try and find new sources of income. As this year's IMF survey on International Capital Markets points out, universal banking firms may be less affected when companies bypass banks and raise funds directly in the capital markets, because the decline in their lending activities may be offset by an increase in their securities activities. Similarly, the direct sale of mutual funds may compensate for the drain of deposits that also characterises the bank disintermediation process.

The survey also points out that "the drive toward universal banking can be understood by appealing to either demand or supply forces. On the demand side, customers may find complementarities arising from reductions in consumer and search costs. For instance, retail customers may find the convenience of one-stop shopping for their commercial banking and securities brokerage needs; corporate customers may prefer to reveal their private information to a single

consolidated entity that meets their commercial and investment banking needs. On the supply side, benefits could derive from synergistic gains and revenue diversification. Synergistic gains could be obtained by spreading fixed costs or by the reusability of information obtained through a banking relationship, which lower the costs of providing ancillary securities and insurance services. Alternatively, integrating imperfectly correlated banking, securities, and insurance activities may reduce the universal bank's risk exposure, thereby allowing the institution to economise on risk management costs. Indeed, studies show that the integration of financial services activities appears to bring about larger revenue efficiency than cost efficiency gains and that most of the gains appear to be linked to benefits from risk diversification".

That's not all. It is debatable whether a regulator that supervises banks has the necessary knowledge and expertise to also supervise stockbroking activities. The same goes for market regulators that have to supervise banking activities. Clearly, the entity approach is unsuited to a world where the barriers between financial services are fast being dismantled. Advances in risk management are enabling institutions to offer hybrid products that cut across the traditional business boundaries. For example, banks are able to offer capital protection and guaranteed return mutual funds. Insurance companies are offering life insurance products that are linked with investment products. Commercial banks need no longer keep loans extended by them on their books. They can either securitise or sell these loans. Moreover, with the use of credit derivatives, banks can minimise the credit risk of their loan portfolio.

Regulation, therefore, must not only follow those it seeks to regulate into new territories, but must also adapt to a new environment. Consider, for example, the changes that have been ushered in by the Internet. While Internet offers the potential for massive cost savings for banks themselves, it also opens up many opportunities for individual customers, whether corporate or private, to manage their finances more actively. They can now shop around far more effectively, and this trend could result in finally

eliminating the intermediary altogether, or bringing entirely new types of intermediaries. Selling financial products on the Internet calls for a new set of regulations. That's apart from addressing the locational problems posed by the Net and advanced telecommunications, where national borders can often be bypassed with impunity.

Regulation of the Indian Financial Sector

Regulation of the Indian financial sector too has been in consonance with its compartmentalised financial system. The Reserve Bank of India, the country's central bank, is responsible for a large chunk of regulation and supervision, directly and indirectly. The RBI's Board for Financial Supervision is in charge of supervising commercial banks, the development financial institutions that have an all-India character, and the NBFCs. The responsibility for supervising NBFCs was a hotly debated topic after a scam in one of them a few years ago (the CRB scam), and the RBI assumed the responsibility of regulating them thereafter. Some of the all-India financial institutions, in turn, supervise other institutions in the financial sector. For example, regional rural banks (RRBs) and central and state cooperative banks are supervised by the RBI through the National Bank for Agriculture and Rural Development (NABARD), state financial corporations by the Small Industries Development Bank of India (SIDBI), and housing finance companies by the National Housing Bank (NHB).

But here too there are several grey areas. For example, RBI officials have pointed out that the ministry of finance continues to play a role, albeit sometimes a tacit one. Most importantly, the government continues to hold the trump card through its control over top appointments. To take a concrete example, the RBI-NABARD relationship has different aspects. On behalf of the RBI, NABARD supervises the banks in the rural cooperative segment, viz. the state and central cooperative banks. The banks in this sector are not supervised by the Board for Financial Supervision – the supervisory arm of the RBI. NABARD also supervises the RRBs which are in part regulated by the RBI. The RBI currently

The Growth of Universal Banking

In a sample of 54 developed and emerging markets surveyed by the Institute of International Bankers in 1998, the majority of countries allowed universal banking-that is, banks were allowed to conduct both banking and securities businesses, including underwriting, dealing, and brokering all kinds of securities within the same financial institution. The largest banks in Latin America are taking advantage of the economies of scope derived from the universal banking paradigm and nontraditional banking activities are growing much faster than lending activities. Analysts estimate that the competitive landscape of the financial industry in Latin America will be more similar to that of Europe than to that of the United States, with one very important difference: many countries in the region have privatised their pension fund systems, creating large opportunities for the integration of banking, insurance, and asset management. Banks in many countries are the largest managers and distributors of mutual funds, own the largest pension funds, and are increasingly involved in the sale of insurance products.55 The so-called triangle of finance is most advanced in Mexico, where banks can own pension funds and insurance companies.

Excluding Brazil, Mexican financial institutions have the most developed bancassurance operations in the region. In Argentina, banks can only own up to 12 percent of insurance companies, but banks are circumventing the regulation by setting up financial holding companies. In Brazil, the relationship between banking, insurance, and asset management has been in place for many years. However, the lack of a private pension system limits the potential synergies and growth, particularly between insurance and asset management.

In Asia, banks are generally permitted to undertake securities and insurance activities, but bancassurance is just slowly taking hold. Banks in the financial centers of Hong Kong SAR and Singapore are increasingly focusing their growth strategies on fee-income-generating activities, such as asset management, credit cards, and mutual fund distribution, taking advantage of the authorities' moves to develop these activities. In the Republic of Korea, the approval of the FHC Act has opened the field to pure financial holding companies, which are allowed to manage securities, insurance, and other financial companies. Viewed as supportive of the trend toward universal banking, the FHC Act could provide five main advantages to medium and small banks: (i) the ability to cross-sell several financial products; (ii) tax savings by avoiding double taxation; (iii) cost savings through the integration of IT platforms and reductions of overlapping branches and staff; (iv) better capital management; (v) facilitatation of joint ventures with foreign institutions. Since June 2000, Malaysia banking institutions have been

Contd....

allowed to cross-sell financial products and services of entities within the same group, including those belonging to their subsidiaries, or appoint the subsidiaries as their agents to cross-sell their financial products and services. Together with Singapore, Malaysia has been at the forefront of developing bancassurance products in the region. By contrast, the Republic of Korea has extended regulations prohibiting non-insurance financial institutions from applying for insurance agent licenses until August 2003.

(From the IMF's International Capital Markets :Developments, Prospects, and Key Policy Issues By a Staff Team led by Donald J. Mathieson and Garry J. Schinasi, July 2001)

licenses and regulates Local Area Banks which are treated as commercial banks. Although state-level financial institutions are the supervisory responsibility of SIDBI, there is extensive interference by the state governments.

Cooperative banks are also another grey area so far as regulation is concerned. The registrars of cooperatives (ROCs) of different states form a joint regulator for both urban and rural banks in the cooperative sector (For multi-state institutions, the main regulator is the central ROC under the ministry of agriculture. While the RBI, either directly or through NABARD, is concerned with the banking function performed by these cooperative societies, the management control rests with the central or state government. This dual control adversely affects the supervision of both the RBI and NABARD over institutions in this sector, and has been responsible, at least in part, for the recent stock market scam.

The Securities and Exchange Board of India (SEBI) regulates the capital markets and supervises several institutions, such as the stock exchanges, mutual funds and other asset management companies, securities dealers and brokers, merchant bankers and credit rating agencies. Significantly, however, the Unit Trust of India (UTI), the country's largest mutual fund, does not come under the supervision of SEBI, but is directly under the control of the ministry of finance. As a result, SEBI has been powerless in ensuring that the UTI's Unit-64 scheme discloses its

net asset value, which has been in large part responsible for the crisis in that fund. SEBI also regulates venture capital funds. Companies in the insurance sector are regulated by Insurance Regulatory and Development Authority (IRDA). The department of company affairs (DCA) regulates the deposit-taking and some other activities of NBFCs.

As the above discussion indicates, financial regulation in India has been somewhat of a patchwork quilt. While the broad contours of regulation have been clearly defined, there exist many grey areas, and some institutions have escaped regulation by specialised regulators altogether. The pattern of regulation and supervision has been evolving in recent years, not proactively but in an ad hoc manner, as a reaction to various market scandals and crises. There has been no well-thought-out blueprint or philosophy of regulation.

For instance, during the 1992 securities scandal, it was funds from the commercial banks that found their way into the stock markets, thanks to a weak settlement system in the government securities markets. The response was to tighten regulation for the commercial banks and put in place a proper settlement system. During the MS Shoes scam, a few years later, the manner of making initial public offerings (IPO) was found to be susceptible to fraud, and thus the response was to tighten the IPO regime. After the CRB scam, it was the NBFCs that were found to have duped depositors. At that time, both RBI and SEBI sought to avoid responsibility for the regulation of NBFCs. The response to this crisis was to place both these organisations firmly under the RBI's control. We also had the problem of vanishing companies, with several companies that had raised money from the capital markets disappearing with cash and companies professing to invest in plantations and promising abnormally high returns hoodwinking the investors. The point is that our approach to financial regulation has been reactive and piecemeal, attempting to fix problems as they occur, rather than taking a proactive stance, anticipating where the next problem could crop up and taking steps accordingly.

This ad hoc approach is, of course, not confined to the Indian regulatory system. Howard Davies, chairman of the Financial Services Authority (FSA), the UK's super-regulator, aptly summed up the state of affairs in that country by pointing out that financial regulation had in the past been influenced by the "dangerous dog" phenomenon, whereby extensions in regulation had been imposed in response to individual crises and scandals. The parallels with the Indian experience are obvious.

There, are, however, arrangements in place for coordination between regulators. Y V Reddy, Deputy Governor of the Reserve Bank of India, has listed the various means: "First, there is exchange of information on a routine basis and on occasions through special request. Secondly, a nominee of RBI is on the Board of SEBI. Thirdly, there is a High Level Committee on Capital Markets presided over by the Governor, RBI with which the Finance Secretary, Chairman SEBI and more recently, Chairman IRDA are associated as members. The High Level Committee has constituted a Standing Working Group to enable coordination between Ministry of Finance, RBI and SEBI at the operating level and assist the Committee in its deliberations. Finally, while nominees of Ministry of Finance and Department of Company Affairs are on the Board of SEBI along with a Deputy Governor of RBI, the Finance Secretary is a member (without voting rights) of the Board of Directors of RBI."

However, Reddy admits: "A predominant role for regulatory and supervisory coordination remains with Ministry of Finance for several reasons such as statutory basis of many financial intermediaries performing commercial functions, powers of appointment and dismissal of board level functionaries in public sector finance institutions, predominance of public sector ownership of financial intermediaries themselves, and above all the accountability to Parliament through the Ministry."

But the recent scam in the stock markets has highlighted the fact that this system of exchanging information, while all right on paper, has not really worked in practice. At the crux of the scam lies the sourcing

of funds by stockbrokers from cooperative banks. And the reason for the cooperative banks being inadequately supervised is because they serve two masters: the RBI on the one hand, and the state registrar of cooperative banks on the other. More fundamentally, the issue is a lack of coordination between regulators. The *modus operandi* of the scam makes that amply clear. One of the methods used was to transfer funds from cooperative banks via brokers to the stock markets. For the scam to be nipped in the bud, therefore, regulation between the central bank, the registrar of cooperative banks and SEBI was essential.

Another lesson from the recurring crises is that the financial system cannot be divided into watertight compartments. It is interconnected, and its strength depends on the strength of its weakest link. In the current scandal, the cooperative banks formed the weakest link. But there are other weak links in the system which, if not adequately regulated now, could sow the seeds of future crises. For instance, the next scam waiting to happen may be in the regional rural banks or in the deposit-taking companies that on-lend to the stock markets. The state-run financial institutions, many of them with negative net worth, could also be a scandal waiting to explode.

It is increasingly recognised that for a regulator to take a holistic view of the financial system, there needs to be some agency that feels that the entire financial system is its responsibility. The specialist regulators may individually be doing an excellent job in the areas they supervise. But there could be critical areas that are untouched. There could also be an insufficient appreciation of the linkages between various institutions. Lax supervision by a regulator can, via these linkages, create problems for other regulators. For a super-regulator, on the other hand, it would be its foremost job to view the entire financial system as an interconnected whole, which is the first step towards devising a proactive policy of regulation.

Moreover, as the walls that separate different types of

financial products come tumbling down, the question naturally arises: why shouldn't the same be true of the government bodies that regulate them? And if financial players are entering into financial supermarkets with nationwide reach, why shouldn't their activities be overseen by a single national financial regulator?

2

New Regulatory Paradigm

The World Moving to one Regulator

The entire world is moving towards a unified regulatory authority for financial services. A trend towards national integrated regulators or super-regulators, covering deposit-taking, banking and other financial activities, such as insurance, pensions and/or securities dealers, is emerging. The United Kingdom, Sweden, Norway, Denmark, Mexico and Hungary have adopted the super-regulator concept, and it has also been considered for such diverse countries as Korea, Singapore and Latvia. Perhaps the most publicised move in this direction was taken by the United Kingdom in May 1997, shortly after the election of Tony Blair as Prime Minister. In one of his first official acts, Blair not only combined supervision of banking, securities and insurance operations in a single agency, the Financial Services Authority (FSA), but also split off the banking supervisory function from the Bank of England. Even the United States has moved in the direction of consolidated supervision, though less aggressively. Under the new financial modernisation legislation, the Federal Reserve has been given the equivalent of backstop consolidated regulatory authority, but not frontline responsibility for regulating and supervising non-banking affiliates of banks.

The super-regulator has been adopted in some Asian countries as well. On July 1, 2000, the Japanese government introduced a single regulator, the Financial Services Agency, covering banking, securities and insurance, as did Korea in April 1998 with the new Financial Supervisory Service, which was modelled explicitly on the UK's FSA.

However, it would be easy to exaggerate the move towards a super-regulator. Most of the countries throughout the world continue to have multiple regulators. In the USA, for instance, there are multiple regulators even for banks which are accountable to Federal Reserve, FDIC and state authorities.

There are other hybrid arrangements that combine two or more areas of regulation under a single regulator. For instance, there are combined regulators for securities and insurance in Chile and South Africa, for banking and securities in Germany and France, and for banking and insurance in Australia and Canada.

There are also varying modes of coordination among regulators, the government and other stakeholders in the regulatory process. In the case of the Unified Oversight Board, South Africa, the existing structure of regulatory agencies continues, but has been overlaid with a newly established oversight board comprising heads of different agencies. Another model unifies support services, keeping agencies as separate legal entities but providing shared infrastructure and support services. In Finland, unified supervisory agencies are separate but they share support services with the central bank. There is also the memorandum of understanding route which lays down the framework of cooperation between the government, central bank and single regulator, e.g. Memorandum of Understanding of UK, 2001.

At the same time, there is little doubt that more and more countries have adopted the super-regulator model in recent times, and even among others that are yet to move towards a unified regulator, a debate is raging on its merits.

Twin Peaks Model

There are many who argue for a system of regulation that recognises the distinction between systemic protection and consumer protection as objectives. This is known as the "Twin Peaks" model. In this model, one regulator is charged with the

responsibility of prudential supervision of banks, securities dealers and insurance companies, while another with the regulation of the conduct of business between financial institutions and retail customers. For example, one regulator will handle the oversight of prudential norms for banks, while another will be in charge of laying down the principles by which financial advisors disclose their position while recommending specific financial products. In addition to these, a "third peak" or "watchdog" agency has sometimes been suggested to detect and prosecute financial crime.

In its 1997 report, the Wallis Inquiry Committee recommended that three regulatory agencies should assume responsibility for the smooth and efficient operation of Australia's financial system: It recommended the creation of the Australian Prudential Regulatory Authority (APRA) to take up the responsibility of the prudential regulation of deposit-taking institutions, life and general insurance and superannuation funds. It also recommended that the Reserve Bank of Australia should be responsible for systemic financial stability, regulation of the payments system and the conduct of monetary policy. And finally, it suggested that the Corporations and Financial Services Commission should be responsible for corporate behaviour, consumer protection and market integrity.

There has, however, been much criticism of this model. Practically speaking, the emergence of conglomerates has resulted in over-regulation of firms that are engaged in multiple functional activities, and one of the main reasons of moving towards a single regulator model is to streamline regulation. The "twin peaks" model would generate significant inefficiencies, as conglomerate firms require both conduct of business and prudential regulation, and would, therefore, continue to deal with multiple agencies. Furthermore, the likelihood of communication, coordination and consistency problems would be more prevalent. It is also argued that there is in any case a significant overlap of "conduct of business" and "prudential" regulation, both of which go towards making up the compliance culture of the firm. Senior management

typically allocates responsibility for compliance in respect of both peaks. Undoubtedly, executives would prefer to deal with a single regulatory authority, rather than engage in repetitive consultations with multiple specialist regulators. Similarly, regulators adopting a risk-based approach would prefer to regulate the activities of the firm as a whole in order to better assess the stability of the financial system.

Using a different argument, Prof. Charles Goodhart criticises the twin peaks model and, by inference, the single regulator regime, by stating that such systems do not take into account the significant difference between institutions and types of business.

Functional Regulation

There is, broad consensus that the changes in the financial markets and players make the old entity-based mode of regulation obsolete. But what is to be put in its place? The move has generally been towards functional regulation, rather than an all-embracing single regulator. Under functional regulation, different agencies are in charge of regulating different functions. A regulator supervises not the entity but the functions that it performs. If it performs multiple functions, that would call for several regulators, each supervising its own niche. In other words, different parts of a conglomerate's business would be supervised by different regulators. If a bank ventures into selling mutual funds, for example, it will be the securities market regulator that will be responsible for overseeing the mutual funds part of the group's business, while the central bank will continue to supervise the banking business. Under a functional regulation scheme, bank regulators would supervise only the bank, and there would be no consolidated supervision of the entire entity. Although called functional regulation, the approach essentially involves having different regulators for different financial products and services.

It has been argued that functional regulation would provide investor protection. For example, functional regulation of bank securities activities would further investor protection by subjecting

all securities activities to a single set of standards, consistently applied by one expert regulator – in marked contrast to the fragmented system currently in place. Banks and broker-dealers alike would be subject to the same requirements with respect to training, supervision, sales practices, financial responsibility, etc. Banks that advise investment companies, like all other registered investment advisers, would be completely subject to oversight and other requirements designed to guard against conflicts of interest.

Proponents of functional regulation contend that it would also eliminate duplicate regulation. Under the existing US law, for example, bank-affiliated securities firms and investment companies must comply with overlapping and potentially inconsistent regulatory requirements. This duplication confuses the industry, imposes unnecessary costs, impairs industry competitiveness, and wastes scarce government resources. Replacement of the existing regulatory scheme with a system of functional regulation should relieve financial services providers (and the markets as a whole) from many of the burdens of duplicate regulation. Of course, with financial services reform and the expansion of bank securities activities, there will be an ever greater need for cooperation among regulators.

This appears, on the surface, clean and efficient, reflecting the benefits of specialisation and division of labour among regulators. But there are serious theoretical lacunae in the system. To take the most serious objection first, it is completely out of step with emerging risk management practices in financial services firms and also with norms for global banks and financial services firms around the world. Banking organisations are increasingly managing risks without regard to legal entities. For them, to do otherwise, would mean ignoring the powerful concepts of portfolio theory and the gains they can achieve both from diversification and managing risks on a consolidated basis. If financial services firms engage in consolidated risk management, regulators must insist on some measure of consolidated regulation that permits effective oversight of the consolidated entity.

Apart from the serious objection pointed out above, there is, of course, the entire matter of duplication of supervisory resources, the inability of any individual regulator to view the system as a whole, and the fact that financial institutions in the market will continue to face the requirements of multiple regulators. Questions of coordination between the various regulators and the turf battles between them have also to be resolved.

Super-Regulator in Developing Countries

In December 2000, the International Monetary Fund (IMF) reviewed the international status in regard to financial regulatory structures. The results have not been flattering to those who favour the super-regulator concept. The study points out that in about half of the countries examined, preference is for a regulatory structure based on specialised agencies. It further shows that 35 countries have separate agencies for each main sector, 3 have combined securities and insurance regulators, 9 have combined banking and securities regulators, 13 have central banking and insurance regulators, 3 have unified supervision within the central bank, while 10 have unified supervision outside the central bank.

The study brings out that while there is undoubtedly an interest in and a debate on the super-regulator model, and while it is true that a number of countries in recent years have opted for a single financial regulator, tht total number of such countries continues to be small. However, that proves absolutely nothing. The results of the IMF study may very well show that the vested interests holding back the creation of a super regulator are strong in many countries, and that the specialist regulators in these jurisdictions are adept at protecting their own turf from encroachment.

Part of the debate on the single regulator revolves around the issue whether such a regulator is appropriate for developing countries. As Dr Reddy has pointed out, it is noteworthy that

almost all the practitioners of the unified model are developed economies. He quotes the Financial Stability Institute's publication on the subject (Occasional Paper 1): "The evidence appears to be that the weight of argument is moving towards the adoption of a separate unified supervisory body within more developed economies. But does that same balance hold for emerging and transitional countries?" The publication notes that in view of the Asian crisis, "it is possible that international pressures, e.g. through the IMF, will interact with domestic forces to lead towards better funded, more skilled and more independent supervisory bodies irrespective of how these are structurally organised". The conclusion is noteworthy: "If so, then structure may come not to be an important issue for the conduct of banking supervision. Perhaps, but for the time being, the balance of argument would suggest that in less developed and transitional economies it would be safer and better to integrate banking supervision into the ambit of the Central Bank".

There are two strands to this contention. One, that the developing economies are still not mature enough, and two, that linkages between their different financial markets have still not developed enough to warrant the introduction of a super-regulator. However, this view misses the point that it is sometimes precisely the absence of a common regulator that prevents market participants from branching off into new areas of business. In India, for instance, the restrictions on universal banking by the Reserve Bank of India have prevented a merger of financial institutions with the banks they control. This is true for the ICICI and ICICI Bank. It is also true for the IDBI and IDBI Bank, which too would have considered a merger if the regulatory regime had been more congenial. The HDFC group has said that its move to become a universal bank hinged on a single regulator. Its chairman, Mr Deepak Parekh, has stated that there is a multiplicity of regulators in the financial sector now – with banks being regulated by the RBI, housing finance companies by the NHB, and mutual funds by SEBI – and that "we could think of a merger if there is just a single

regulator for the financial sector." The upshot is: higher costs for these entities as a result of duplicate administration and their inability to pool risks, and higher costs of financial services for consumers.

More importantly, this approach ignores the links between different parts of the financial system, links that are exposed most clearly when there are scandals. The securities scam of 1992, as well as this year's, are not just market scams; they are also banking scandals. Banks, as sources of funds for the market, have a special place in the financial system. But there are other sources of funds as well. Stock market manipulation, for instance, has often been done at the behest of and in connivance with, company managements. Insider trading is practised on a wide scale by company promoters and officials. In short, it is not enough to supervise banks, stock markets, and companies separately; it is also necessary for regulators to keep a wary eye on the links between these market participants.

In practice, this job of coordination between different agencies has been performed in India by the ministry of finance. It is doubtful, however, whether that is an efficacious solution, although it may be a democratic one. That is because solutions proposed by the finance ministry will be political in nature, rather than what may actually be required. Bail-out of institutions is a case in point. In 1999, the Indian government mounted a bail-out operation for the Unit Trust of India in response to a run on that institution. Critics have pointed out that this bail-out increased moral hazard, bred complacency in UTI, and sowed the seeds of the current crisis gripping that institution.

Making the ministry of finance the coordinating or apex agency of supervision also has another drawback. In India, bureaucrats are typically drawn from a generalist background, and they are often unable to appreciate the finer points of the financial system. This is particularly so since financial products and services have become increasingly complex. Understanding the nature and

extent of the risks involved is a pre-requisite for effective regulation.

And finally, implicit in the argument that developing countries need a special regulatory regime is the view that the financial sector in these countries is very different from that in the developed countries. In India, there is undoubtedly a lot of compartmentalisation between the various financial markets, and funds have difficulty in moving from one market to the other. This defect is in itself a result of regulatory choice, rather than a feature that is somehow unique to underdeveloped markets. Restrictions on bank lending against the security of stocks, for instance, have inhibited the growth of margin trading in India, with the result that one avenue for the free flow of funds to the stock markets has been blocked. So far as financial products and market microstructure are concerned, it may be noted that some developing country markets have had the advantage of being able to leapfrog ahead and put in place systems that are comparable to the most advanced in the world. India's stock markets are a case in point, where screen-based trading, dematerialisation of scrips and modern settlement systems have all been adopted in the last decade.

Furthermore, the introduction of derivatives trading in developing country markets shows that there is little difference in sophistication between products. It may also be noted that sometimes, as in the case of derivative products for the banking sector, it is again the regulatory constraints that have hampered their introduction and usage. The argument for having specialist regulators in developing countries is, therefore, in essence, a plea to keep these markets underdeveloped, or influence the development of these markets in ways that are different from the wishes of the market participants.

The second strand of the argument is that it is the banking sector that is dominant in developing countries, accounting for the lion's share of financial resources. Therefore, if a super-regulator is to be appointed, it should be the central bank of the country.

The Transformation of Financial Services

Let me note six characteristics of this transformation that have important implications for supervision and regulation. These characteristics have many common strands and channels of interaction.

First, firms are running more complex (and sometimes opaque) risks. Advances in the processing of information and in finance theory have permitted the independent pricing of risk factors that were previously bundled together in the same instrument. At the same time, the intensification of financial intermediation has given rise to an explosion in the demand for hedging (and position-taking) instruments. The good news is that the new financial instruments have enormously improved the technology of risk-management. The downside is that these same instruments, if not properly understood and used, increase the potential for loss, whether resulting from inadequate understanding or deliberate leveraged bets.

Second, sectoral distinctions are becoming blurred. To a degree, this reflects the greater willingness to accept a free market philosophy. But more importantly, the ability to deconstruct and re-combine risks has enabled financial intermediaries to expand and compete effectively in sectors beyond their own. And they can do so under the regulatory umbrella or framework that provides the greatest benefit and flexibility. To be sure, this can helpfully expose regulatory and economic inefficiencies. But where it is motivated principally by regulatory arbitrage, the authorities need to guard against it leading to a system wide reduction in capital adequacy or undue risk concentration.

A third related characteristic is greatly enhanced competition. This has been a prime objective of much of the deregulation and privatisation that has taken place in the financial industry. But the competitive climate has been sharpened by other developments, too. A greater focus on shareholder value has induced banks' managements to pay more attention to the rate of return on equity. This is good news in that the financial industry is induced to use its capital more efficiently and financial services have become cheaper to end-users. But it also means that the cushion against bad luck or bad judgement is thinner. Franchise values are much smaller, so that an erosion of capital more quickly leads to the threat of failure (and the temptation to take unwarranted risks to stay in business).

Fourth, the source of financial disturbances has become more become more unpredictable. One cause is capital market integration, which affects a country's financial markets and institutions whether or not the economy is entirely integrated. We have seen that capital flows can be volatile and unpredictable. Contagion means that the problems of neighbouring or more distant economies can rapidly become one's own.

Contd....

Another aspect is the much greater diversity of actors in the financial markets. In the 1970s and 80s, most financial intermediation was conducted through banks, with insurance companies and investment vehicles having well defined roles. But many different types of institution, including non-financial firms are now involved in both wholesale and retail markets. And financial institutions based outside the major centres have come to play a more important role in international markets.

A fifth characteristic is that financial systems appear to have become more pro-cyclical than before, capable of amplifying credit growth and leveraging market positions more intensely than before. In essence, the "marginal" risk that financial actors willingly engage is greater than before. To a degree, this is a result of innovations in financial technology, including the process of securitisation, which allow risks to be better distributed and managed. The more widespread use and trading of collateral is also a factor. But it also reflects the intensification of competition, and perhaps a view among firms that they will be able to get out of risky engagements before they sour. Of course, pro-cyclicality works in both directions: once the downturn sets in, the financial system seems more prone to liquidity erosions and reduced credit supply than in previous episodes of stress.

The final characteristic to which I would like to draw attention is the greatly increased speed of developments in the financial sector. The speed of transmission of news in the financial sector has always been high relative to other sectors. Nowadays, market communication and execution can be almost instantaneous. But what is also speeding up is financial sector actors' judgement of strategic opportunities in their environment and their moves to take advantage of them. New and cheaper technology, as well as deregulation, has greatly helped this. Business models get adopted and discarded more quickly. This will test regulators and supervisors, for whom the challenge will be to create rules of the game that are robust to fad, fashions and arbitrage.

Andrew Crockett: Issues in global financial supervision. From remarks by Mr Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, at the 36th SEACEN Governors' Conference held in Singapore, 1 June 2001.

Reasons for Having a Super-Regulator

Before we consider whether a central bank should assume the responsibility of a super-regulator, let's probe the reasons why we should have a super-regulator.

The expansion of the securities business and tighter linkages among financial sub-sectors have posed additional challenges for

systemic stability. Banks have increasingly shifted from traditional lending to "off-balance-sheet" business (including securities and derivatives operations), while securities houses offer products that compete directly with those of banks. Hybrid products, such as annuities and derivatives, cut across the old categories. Accordingly, there are a whole lot of reasons why we need a super-regulator and a rather comprehensive list is given below:

- The fragmented structure of the regulation of financial services was based on sectoral divisions, which have increasingly become outdated and, as such, do not respond well to dynamic markets.
- Since the existing financial architecture has stemmed from a set of ad hoc policy initiatives associated with banking crises and dislocation, a more coherent structure is called for.
- Technology is an important factor that must be taken into account. For instance, traditionally, stock market regulation has been carried out through self-regulatory organisations, such as stock exchanges. Regulators have relied on such gateway institutions for grassroots supervision, and successfully leveraged their resources to meet regulatory goals. With new technology, however, new trading platforms have developed that can bypass stock exchanges altogether. Platforms such as Reuters' Instinet proudly advertise that they "allow nothing to come between the customer and the best price". The self-regulatory model has been undermined by these new developments. Who is to regulate these new platforms?
- Unquestionably, the most important advance in technology in recent years has been the Internet. Intermediaries, which have also served as the regulatory agents, are those most at risk in the Internet environment. That's not all. The Internet space has allowed financial products to be offered by software firms, telecom companies, retail chains, etc. The question is: who is there to regulate them?

- The Internet is also unique in that it transcends all geographical barriers. Traditionally, financial regulation has been either national or regional. The globalisation of financial services has thrown a challenge to that comfortable paradigm, and the Internet is likely, in due course of time, to deliver the *coup de grace* to purely national regulation. The Internet is no respecter of national frontiers. Often, it is very difficult to know where a website, or the company owning a website, is actually located. And it is similarly difficult to know whom its offerings are targeted at. Increasing coordination among national regulators is, therefore, a necessity today. It would help matters tremendously if a single nodal agency from each country has the mandate to negotiate.

- The increasing complexity of financial entities and activities is complicating financial supervision. The near failure of Long-Term Capital Management in the United States, a highly leveraged hedge fund, underscores this development. The consolidation of financial services adds further complications. Some "mega" institutions may now be so large as to be "too big to fail" or, more precisely, too big for regulators to risk letting creditors take a loss for fear of sparking a run on many institutions of similar, or smaller, size. In India, the Unit Trust of India's Unit-64 scheme is one on which a similar debate has been continuing.

- Currently, the product complexity well exceeds the ability of inexperienced investors to understand the risks of the products they are taking up. And that is a lesson of general application. On the one hand, we have more and more individuals seeking to make direct savings provision, and quite reasonably take advantage of the more exciting returns available in equity-related products, rather than putting their money in a building society or a savings account. On the other hand, their understanding of financial matters does not match the standard needed to find one's way through a maze

of competing products, often of great complexity. Indeed, products often seem designed expressly to be complicated and confusing. Since these are competing products, there is a need for one agency that can supervise all of them and their modes of selling, thus ensuring that false claims are not made, there are proper disclosures, and consumer grievances are redressed.

- New entrants have come into the financial services field in the hope of cross-selling functional products to their existing customers, not only to increase their market share, but also to generate fresh business not targeted by larger financial institutions. Marks & Spencer in the United Kingdom and General Electric in the United States are two conspicuous examples. Who will regulate these new entities? Which activities of these entities should be subject to oversight by financial regulators?

- Goodhart, Taylor and others have argued that there is a clear need for consolidated regulation of financial conglomerates as there may be "risks arising within the group...that are not adequately addressed by any of the specialist prudential supervisory agencies that undertake their work on a solo basis." In addition, many of the solvency risks of the institution can only be properly assessed on a group-wide basis. Briault states that, in addition to assessing the group's capital adequacy, the quality of its systems and controls for managing risks and the calibre of its senior management must be considered on the whole.

- A coordinated emergency response mechanism is required to resolve problems that threaten financial stability or pose a contagion risk to the health of the conglomerate and other financial institutions. Therefore, given timely access to cross-functional information, a consolidated financial services regulator would be best positioned to monitor, prevent and resolve such risks.

- Consolidation of individual functional regulators, given a clear statutory mandate, would bring about significant economies of scale and scope in the administration of the regulatory regime. Primarily, consolidation would achieve economies of scale through the elimination of duplicate services existing among functional regulators. Management policy, financial accounting, information technology and support staff could be amalgamated. Information systems and network platforms could be standardised, centrally maintained and better protected from espionage. There would be significant reduction in costs on account of bulk purchase of systems, while at the same time it could be ensured that systems and databases are in a position to "talk to each other." The ability to acquire the latest upgrades too would be significantly enhanced. Such information systems could be designed as will provide uniform registration and licensing procedures for both institutions and employees of the institutions and will serve as a common filing depot for legal and other documents.

  However, Goodhart has raised the point that consolidation will not necessarily deliver the economies described above. Specialist divisions will continue to exist in isolation from the greater consolidated culture, thus creating potential problems in information sharing, coordination and consistency.

- A consolidated regulatory authority, given clear statutory objectives, will operate in a more accountable and transparent manner than the sum of its specialist regulator parts. Performance of such an authority may be measured against its statutory objectives, regulatory policies and procedures, costs of regulation, discipline and review mechanisms and regulatory failures. There will no longer be any grey areas for which specialist agencies refuse to take responsibility.

- The regulated units also benefit since unification mitigates the costs that supervised firms with diverse activities (i.e. financial conglomerates) bear for dealing with multiple regulators.
- Regulatory arbitrage can be avoided in the case of a single regulator. In a multiple regulatory regime, fragmentation of supervision could lead to competitive inequalities as different units, possibly offering similar products or services, are supervised differently.
- Reducing the number of regulators would allow scarce supervisory resources especially in specialist areas to be pooled.
- A single regulator can respond more effectively to market innovation and development as there would be no regulatory grey areas.

The biggest spur to the creation of a super-regulator in recent times has come from the integration of insurance and banking. The emergence of "bancassurance" business created new financial conglomerates, combining banking and insurance activities. The need to supervise such financial conglomerates was a powerful reason underlying integrated supervision. That was because: (i) insurance companies played a vital role as investment brokers with growing cooperation between banking and insurance business; (ii) both the legislative framework and supervision of banking and insurance activities shared common characteristics; (iii) licensing and other structural tasks would be better coordinated under an integrated regulatory system.

Another motive for combined regulation is the need to limit risk transference among related affiliates. Links among related entities can make the health of one subsidiary dependent on the fortunes of another. A prudential bank regulator will want to enforce limits on lending from government-insured banks to non-bank subsidiaries or affiliates as a means of limiting the abuse of

government safety net protection by subsidiaries and affiliates. Rules must allow regulators to enforce inter-affiliate lending restrictions to prevent banks from extending too much credit to weakened affiliates.

An added benefit of regulatory monopoly is the avoidance of regulatory “turf wars”, such as the struggle in the United States between the Treasury Department and the Federal Reserve over the appropriate location of non-banking operations (whether in bank or holding company subsidiaries) or the haggling between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) over the range of products that fall under the purview of each authority. Such turf battles create undesirable regulatory risks which raise the costs of financial services (by limiting the activities banks are willing to pursue in their subsidiaries or by encouraging complicated offshore booking of transactions to avoid regulatory risks in the over-the-counter market).

A single regulator would be best placed to resolve efficiently and effectively the conflicts which inevitably emerge between the different objectives of regulation. This is because a single management structure would be better able to identify, decide upon and implement a collectively agreed resolution in response to conflicts which arise.

Goodhart and Taylor argue that it may be either easier or more appropriate to resolve conflicts of interest (between different objectives or responsibilities, or between different regulators) at a political level than within a single regulator. At one level, it is difficult to argue against this essentially democratic approach, but it must also be recognised that, in practice, governments have been slow and ineffective in resolving these types of conflict; that some of the conflicts of interest between multiple specialist regulators arise because they either do not have clear objectives and responsibilities, or because these were set at different times and are inconsistent with one another; and that a single regulator can have

clear and consistent objectives and responsibilities which should generate fewer conflicts in the first place, and can operate within a clear system of accountability. Thus, even if all specialist regulators are focused effectively on delivering their own specific mandates, the sum of the parts need not add up to a coherent and consistent overall outcome.

Fragmentation of regulation can also lead to excessive bureaucratisation and inflexibility. Media and communications in the UK, for example, are regulated by at least 11 bodies, and in a rapidly changing industry this can stifle innovation and development. Also, it should be noted that fragmentation of regulation does not simply mean a series of discrete independent regulators but a network of interdependent agencies. This regulatory complexity raises the question: "how do you hold a network accountable?"

And, finally, perhaps the most important perspective on this issue is provided by consumers. Consumers actively supported the idea of a proactive regulator – one which tried to anticipate and head off consumer problems in advance, rather than as has sadly been the case too often under the old system, coming along later to clear up the mess.

3

INDIAN CONTEXT

New Regulatory Structure

As mentioned earlier, the need for a super-regulator has arisen in India mainly as a result of lacunae in specialist regulation, exposed in the various financial crises. Another spur has been the change in the development financial institutions which have been trying to find a new role more in tune with the times, and have, therefore, been drawn towards universal banking.

The concept of a super-regulator was propounded by the working group for harmonising the role and operations of DFIs and banks. The group recommended, as one of the options, the establishment of a super-regulator to supervise and coordinate the activities of the multiple regulators in order to ensure uniformity in regulatory treatment. A discussion paper on the subject was released by the RBI in January 1999. Among other things, it observed that the question whether the supervisory responsibility should lie solely with the Reserve Bank of India's Board For Financial supervision or with a separate supervisory system to be devised for the purpose would need to be considered in due course. But the Reserve Bank of India has ruled out the possibility of a super-regulator for universal banking as recommended by the Khan committee report. Although in its report on the "Trend and Progress in Banking", the RBI has pointed out that "any conglomerate, in which a bank is present, should be subject to a consolidated approach to supervision and regulation", the RBI has elsewhere reiterated its stand on universal banking, stating that development financial institutions (DFIs) planning to transform into a universal bank can do so "provided the prudential norms as applicable to banks are fully satisfied". That makes for a powerful

disincentive, as the financial institutions will then have to comply with the regulations relating to the maintenance of statutory reserves.

The RBI has said that a DFI would need to prepare a transition path in order to fully comply with the regulatory requirement of a bank and consult the RBI about the transition agreements. Furthermore, it has reserved all discretion for itself, instead of deciding in favour of transparent rules. The central bank has said that it will consider such requests on a case-by-case basis. Accordingly, ICICI has made a presentation to the RBI in connection with its proposed transition towards universal banking through the reverse merger of ICICI and ICICI Bank.

In April 1998, the report of the Committee on Banking Sector Reforms under the chairmanship of M Narasimham, also went some way in recommending a super-regulator. It suggested the restructuring of the existing Board for Financial Supervision within the RBI. The Committee recommended that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks, financial institutions and NBFCs. It also recommended that Section 58 of the RBI Act should be amended to enable the RBI Central Board to frame regulations to set up a separate and distinct Board for Financial Regulation and Supervision (BFRS). The Board's exclusive task would be to regulate and supervise banks, financial institutions and NBFCs so as to ensure a sound financial system.

The SEBI chairman, D R Mehta, in the context of the current stock exchange crisis, has observed, "Multiple government agencies – including the RBI, the Department of Company Affairs and the police – oversee the financial markets, so no one body can be held accountable for a misdemeanour." Only last year, the erstwhile UTI chief had called for the creation of a super-regulator in India. Recently, the ushering in of a unified command at the finance ministry to oversee the functioning of the financial sector means that a unified regulatory system may not be far away. At the

very least, it will mean fresh thinking at the highest government level independent of the views of the multiple regulators.

The report of the Advisory Group on Banking Supervision also made certain recommendations on the subject. Many authors have pointed to the anomaly inherent in the central bank being the owner of banks (the State Bank of India), working as the government's agent (in managing the public debt) and playing a role in the monetary policy. The report pointed out: "Because of Reserve Bank of India/Government ownership of the banks (in the public sector), there is some overlap in the role of the Reserve Bank of India as owner/owner's representative and as the regulator/supervisor. This overlap needs to be corrected so that Reserve Bank of India can perform its regulatory /supervisory role without any hindrance. Government ownership of banks is not conducive to any serious and urgent corrective action by the regulator against any one of them. The limitations of the legal process have also come in the way even where corrective action like removal of the incompetent management is contemplated".

The Advisory Group on Securities Market Regulation, chaired by Deepak Parekh, also referred, in May 2001, to the problem posed by different regulatory authorities when it said: "the regulatory responsibility of the securities market is vested in the SEBI, the RBI and two government departments – Department of Company Affairs and Department of Economic Affairs. Investigative agencies, such as Economic Offences Wing of the government and consumer grievance redressal forums also play a role". The Group put forward an interesting suggestion. It said that the High Level Group on Capital Markets (HLGCM), which has representatives of the RBI, SEBI, the IRDA and the finance ministry, and is chaired by the RBI governor, should be accorded legal status and made the apex coordinator for the financial system. Towards that objective, it suggested "....the HLGCM needs to meet more frequently and its functioning needs to be made more transparent. Also, a system needs to be devised to allow designated

functionaries (not necessarily only at the top level) to share specified market information on a routine and automatic basis”.

Apart from the recommendation of the formal committees and pronouncements of market participants and regulators, there has also been a stream of technical papers that have examined the need for coordination and information-sharing among the various regulatory and supervisory agencies. The technical paper on regulation of debt markets prepared by the RBI and submitted to the ministry of finance in 1999 considered such issues. Acting on one of its recommendations, the Government of India issued a notification under Section 29 A of the Securities Contract Regulations Act, formally demarcating the regulatory jurisdiction over money and government securities markets.

Issues of coordination among regulators in combating financial crimes have also been studied by the Reserve Bank of India. These issues have been considered during various discussions held in the government fora on topics such as the setting up of a Serious Frauds Office (SFO), introduction of Suspicious Activities Reporting (SAR) and the establishment of a Credit Information Bureau.

The Deepak Parekh Group’s suggestion of vesting super-regulatory powers in the High Level Group on Capital Markets is in line with the suggestions made by RBI Deputy Governor, Y V Reddy, and is referred to in the literature as the Reddy formula. In Reddy’s own words: “Since there is no point in creating bureaucracies, there are practical difficulties in massive redeployment of personnel, and expertise for regulation cannot be created overnight, some ways for filling up the regulatory gaps and overlaps should be found without disrupting the existing regulatory structures. I would propose that it is necessary to explore the feasibility of an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the existing jurisdiction. The features of the idea are : The BFS of the RBI can continue to supervise banks and non-banks but with the Deputy

Governor as Chairman; the insurance regulating authority will supervise insurance companies and SEBI will continue with its regulatory jurisdiction. The apex financial regulatory authority may be constituted by statute with the Governor of the Reserve Bank of India as Chairman and the members could be Chairmen of the three regulatory agencies. The apex body should also include some outside experts on a part-time basis. Finance Secretary could be a permanent special invitee or a regular member without voting rights as in the case of the RBI Board. The apex authority could have, by law, jurisdiction to assign regulatory gaps to one of the agencies; arbitrate on regulatory overlaps and ensure regulatory coordination. The apex authority could be serviced by a part-time secretariat of the RBI. In a way, the proposal improves and formalises the present informal arrangement into a legislative based authority. The idea could be debated as one of the options for regulatory reform" (Corporate Governance in Financial Sector, 1999).

Reddy further elaborates on the reasons why he feels that the RBI Governor should be the chairman of this authority. He argues that one leg of every transaction in the financial sector is placed in the cash/interbank market, in terms of ultimate payment or settlement. To put it differently, banks are the ultimate source of funds, and, therefore, present in every financial transaction. Moreover, the RBI as the ultimate provider of liquidity has to concern itself with stability in the functioning of all financial markets. The case for the Governor of the RBI to be the chairman of the apex financial regulatory authority rests on this overall responsibility on the part of RBI.

How persuasive is this approach to financial regulation? Critics have pointed out that the formation of such a "high-level committee" will only create another regulator superimposed on the current multiple regulatory structure. There is no guarantee that turf battles will cease once such a structure is put in place. In fact, they may intensify if the Governor of the RBI has greater powers than others. To take just one example, the IRDA chairman, N

Rangachary, had expressed his unhappiness at the RBI not including the IRDA in the Committee on Insurance Regulations appointed by the former. More than his reservations on certain recommendations of the Committee, his grievance that the IRDA was not included therein should cause concern.

The Reddy formula essentially suggests the setting up of a forum for cooperation among the various regulatory agencies. Much will depend on its mode of functioning, and whether the high-level committee is assigned responsibility for identifying future challenges for regulation, grey areas and anomalies in the present regulatory structure, and making recommendations to the government on allocating new areas of supervision to the existing regulators. At the practical level, the discharge of these functions will need a secretarial staff, drawn from various fields of specialisations. This secretariat could very well be the nucleus of future super-regulator and, in course of time, transform itself into something very much like a super-regulator.

It may be pointed out that some of the objections regarding bureaucratisation are rather overstretched. A super-regulator will not duplicate existing structures, but, instead, subsume existing regulators within itself. What is important is regulation of conglomerates as single entities, with a rational assessment of the risks they face from a holistic, consolidated perspective. This is the crux of the matter, and it cannot be addressed by merely having a high-level committee. Furthermore, the issue of market participants facing multiple regulators is left unaddressed by this approach, as also the question of reducing regulatory costs by sharing resources. And finally, there is the question of accountability. Will it be fair to make the central bank Governor accountable for every regulatory lapse?

Central Banks

Nevertheless, the idea of making the central bank the super-regulator has a long history. Reddy is a strong supporter, pointing

out that one way of reconciling the idea of a single regulator with keeping bank supervision as a part of central bank operation is to have the central bank itself as a super-regulator. A clear example of this unified supervision, he points out, is the Monetary Authority of Singapore.

But first, we need to debate a related question: should central banks also be the supervisory authority for banks? The conflict between the central bank's role as the maker of monetary policy could come in conflict with its other roles as manager of the government's debt or as the supervisor of the banking system. Reddy points out that the case for keeping supervision with the central bank is generally made out on the following grounds:

"First, in order to assess the creditworthiness of the participants in the payments systems, the central bank needs to form a judgment on aspects of liquidity and solvency and prudent conduct of banks. Secondly, supervision complements the central bank's market intelligence system with a detailed knowledge of the strengths and weaknesses of individual banks and, therefore, of the banking system as a whole. Thirdly, knowledge of developments in the banks' balance sheets can be important in assessment of macroeconomic conditions. Fourthly, lender of last resort function has a potential for moral hazard in the system and may cause banks to gamble for resurrection, requiring the central bank to ensure that banks are well supervised. Fifthly, there are substantial economies of scale, especially when there is scarcity of skilled professionals in the area of finance. Sixthly, independence of bank supervision is automatically provided if the central bank enjoys autonomy, thus avoiding politicisation of bank regulation. In other words, central banks do enjoy a tradition of independence and lesser politicisation."

Support for this viewpoint is provided by the US Federal Reserve. The Fed believes that such an active supervisory role is essential for it to conduct monetary policy and prevent or manage financial crises most effectively. For example, the information bank

examiners developed about the severity of the credit crunch in the early 1990s contributed to the Federal Reserve's decision to maintain an unusually stimulative monetary policy well into the current expansion. That policy, in turn, helped to support the economy while banking institutions were returning to health and re-establishing their ability to provide credit to support a healthy expansion. As the nation's central bank, the Federal Reserve also has critical responsibilities to prevent or resolve major problems in financial markets that cannot be adequately met without timely and in-depth knowledge of the operating practices, risk-management procedures and financial exposures of the banking system.

There is also the claimed need to have ready access to financial information about specific banks should they ask for lender-of-last-resort assistance. A related defence is that central banks will find it much easier to twist the arms of banks to lend to specific sectors (or firms) in the middle of a financial crisis when the banks know that they must also submit to the regulatory supervision of the central bank. A prime example is when the Federal Reserve strongly encouraged US banks to continue lending to large securities houses immediately after the October 1987 stock market crash.

There are, however, strong advocates of separation of monetary policy function and banking supervision. First, it is controversial whether central banks should be involved at all in extending credit to specific banks in a crisis. Many economists argue that the monetary authority can discharge its lender-of-last-resort responsibilities, without creating problems of moral hazard, by providing general liquidity support to the market as a whole through normal open market operations (which is what the US Federal Reserve did after the October 1987 stock market crash). In any case, faced with a tough super-regulator, banks are unlikely to ignore what it wants, whether it is a central bank or any other authority. And if the super-regulator needs financial information quickly about specific banks, such data is only a phone call away. In the United States, for example, the Fed could rely either on the

Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC) for such information. It is hard to believe that the Fed, or any other super-regulator, for that matter, would be denied such information by either organisation.

The central bank also has an inherent conflict of interest if it is charged both with conducting monetary policy and supervising financial institutions. As Clive Briault, director of central policy at the new Financial Services Authority in the United Kingdom, has persuasively argued, weakness in the financial sector can tempt a central bank with supervisory authority over financial institutions to pursue a looser monetary policy than it would otherwise follow, imparting an inflationary bias. Also, central banks may be tempted to use their regulatory authority as a macroeconomic tool and thereby compromise their proper regulatory objectives. For example, in the 1980s, many western banks held large amounts of developing-country debt, and it is widely believed that regulators were wary in applying capital standards because they feared the potential macroeconomic consequences of exposing the banks' financial weakness to the public. Again, some people believe that during the Brazilian crisis in 1998, large banks were pressured to rollover existing debts to reduce the risk of exchange rate collapse in Brazil, in pursuit of a wider macroeconomic objective.

A central bank's supervisory failings can detract from the credibility of its monetary policies. These failings can lead political authorities to rein in the independence of the central bank. On the heels of its embarrassing lapses in the failures of the Bank of Commerce and Credit International (BCCI) and of Barings Bank, the Bank of England may have anticipated such danger, which may explain its quiet acquiescence when its bank supervisory authority was transferred to the new Financial Services Authority. Meanwhile, in the United States, the Federal Reserve suffered unusually strong criticism from the Congress over its intervention in the rescue of LTCM. Had the Fed chairman, Alan Greenspan, not been held in such high esteem by the Congress, the President, and the public, the Congress might have been able to use that

intervention to support limiting some of Fed's cherished independence. After taking such criticism into account, Dr. C. Rangarajan, former Governor, Reserve Bank of India, had stated: "Therefore, I feel that the responsibility of banking supervision being carried on to the central bank might make it more difficult, in my opinion, to gain the kind of independence that we are talking about" (Forrest Capie, Charles Goodhart, Stanley Fischer and Norbert Schnadt, 1994, page 357).

But Briault (1997) found no evidence of any impact of either the BCCI or Barings Bank failures on the credibility of UK monetary policy (as measured by the term structure of inflation expectations), although this does not preclude the possibility that there was some damage to the prestige of the Bank of England. There is also no firm empirical evidence of the monetary authorities (whether independent central banks or governments) loosening monetary conditions simply in order to support banks or other financial institutions, with the exception of the United States in the 1980s.

Turning to the potential advantages of combining monetary policy and regulatory responsibilities in a single institution, Goodhart (1995) observes that the monetary authorities usually make the opposite mistake of taking too little account of conditions in the financial sector while setting monetary policy. For example, the credit channel literature provides an explanation of why monetary policy may need to be relaxed following an adverse shock to the banking industry's credit creation process. As expressed by the Governor of the Bank of England: "Monetary and financial stability are interrelated. It is inconceivable that the monetary authorities could quietly pursue their stability-oriented monetary policy objectives if the financial system through which policy is carried on – and which provides the link with the real economy – were collapsing around their ears. The liabilities of banks in particular are money, and you cannot be concerned with preserving the value of money without being concerned also with preserving public confidence in money in this broader sense.

Equally though, the financial system is much less likely to be collapsing around the ears of the monetary authorities in an environment of macro-economic stability than in one of exaggerated boom and bust and volatile asset values. This inter-relationship means that, whatever the precise institutional arrangements for financial regulation and supervision, central banks necessarily have a vital interest in the soundness of the financial system" (George 1994).

But what about having the central bank as super-regulator? Prof. Charles Goodhart in the Eleventh C D Deshmukh Memorial Lecture, "Whither Central Banking?" said: "I doubt whether the pressures to establish a unified, specialist, supervisory agency are quite so strong in most developing countries. The financial system is less complex, and dividing lines less blurred. Commercial banks remain the key players. Moreover, the Central Bank in most developing countries is relatively well placed for funding, is a centre of technical excellence, and can maintain greater independence from the lobbying of commercial and political interests on behalf of certain favoured institutions. If the supervisory agency is placed under the aegis of the Central Bank, it should share in these benefits of better funding, technical skills and independence. There are too many cases of supervisory bodies, outside Central Banks, failing in such respects. For such reasons I do not believe that the case for separation, which has become stronger in developed countries, should be transposed also to developing countries".

There are, however, several objections to the central bank performing the role of super-regulator. The danger exists that a banking agency might be tempted to stifle innovation and preclude new product developments by a securities affiliate on the ground that they may compromise the competitive standing of banks. For example, Prof John C Coffee, Jr observed that a single financial services regulator might have barred or restricted the growth of money market mutual funds in the 1970s because of the competition these funds posed to bank accounts. Such an outcome

not only would have been anti-competition, but also a notable disservice to consumers and the capital market. And most importantly, to the extent that central banks have any regulatory or supervisory expertise, it is confined to the banking industry.

The Role of the Central Bank in Supervision

And what of the rôle of the central bank? Here, again, I do not think that there is a general answer, applicable at all times and in all countries. We have reached the view that, in the UK's circumstances, it makes sense to separate banking supervision from the monetary authority. That is partly, indeed perhaps very largely, because we believe that banking, securities and insurance supervision should be put together. And securities supervision, particularly the investor protection dimensions, are not the natural habitat of central banks. The government also took the view that it would be easier for the Bank of England to establish its credibility as an independent monetary institution if it were not at the same time engaged in the messy, and sometimes mucky business of banking supervision! Bank failures there inevitably will be, even in the best regulated market - perhaps particularly in the best regulated market, I might add! (Since, following my earlier strictures about the rôle of markets, a financial system in which bank failure was impossible would be highly unlikely to be the most efficient and effective system available).

On the other hand, in countries where the central bank is well established as an independent institution, and where the interplay between the banking system and the government's finances, perhaps because of state ownership, or state run programmes of lending, is close, then one can see a stronger argument for central bank involvement in banking supervision.

I think it is fair to say that, internationally, there is a modest trend towards the separation of monetary and supervisory responsibilities, but that is certainly not true everywhere, and a recent paper from some academic enthusiasts for merging banking, securities and insurance supervision has argued that, in many developing countries, the central bank remains the most appropriate home for prudential supervision.

I would re-emphasise that, in my view, independence and the ability to take unpopular decisions and carry them through is far more important than the title of the institution, or its relationship with the central bank or ministry of finance.

Howard Davies, Chairman, Financial Services Authority, United Kingdom, C D Deshmukh Memorial Lecture, Mumbai, India, Monday, 7 February 2000.

4

Debate Continues

Arguments against Having a Super-Regulator

There are several arguments against having a super-regulator. First, unification could lead to lack of clarity in functioning as multiple regulators tend to have different objectives. This objective may be depositor protection for banks vs. investor protection for capital markets vs. consumer protection for other financial firms. Second, concentration of power could vitiate democratic policies. Third, there may actually be diseconomies of scale since monopolistic organisations can be more rigid and bureaucratic than specialist agencies because they would typically be large and too broad-based structures for effective regulation of the entire system. Fourth, there may be unintended consequence of the public tending to assume that all creditors of supervised institutions will receive equal protection. Finally, the focus of banks, securities and insurance supervisors being different, pooling of skills and objectives and resources may not produce the synergy that is expected.

One argument is that fragmentation promotes regulatory innovation through a process of "regulatory competition". Regulatory competition can take place between regulators in different countries, in different sectors of the same country or even within a sector. Proponents of regulatory competition argue that over-bureaucratisation and inflexibility will be reduced and only the best practices will survive and develop.

Some argue that supervision of the banking operations in a financial conglomerate does not necessarily require extensive

oversight of its affiliates, so long as regulators enforce bank capital standards and police inter-affiliate financial transactions. They also point to certain benefits of continuing regulatory competition, at least with respect to non-prudential matters, which they believe has enabled the financial regulatory system in the United States to be much more accommodating of market-driven changes than it otherwise would have been.

A more fundamental opposition comes from those who believe that the move towards universal banking is a mere flash in the pan, and will not last. Some have argued, for instance, that each of the big four UK clearing banks operating at the time of the Big Bang in 1986 has, since then, made an attempt to develop an investment bank alongside its commercial, small business and retail banking. But all four have subsequently pulled back, albeit in slightly different ways, and redefined their business in somewhat narrower terms. All of them have some capital market operations, but are not seeking to compete with the bulge-bracket US firms across a wide range of investment banking activities.

There are powerful arguments against vesting all regulatory authority in a single regulator. One regulator can become ossified in its approach to regulation, especially in a dynamic industry, such as the financial services industry. Thus, the problems associated with turf fights between regulators have to be weighed against the potential advantages of regulatory competition. Kenneth Scott has made a persuasive case even for dual bank regulation in the United States, which allows banks to choose between having a state or a national charter. He argues that competition between state and national regulators leads to more regulatory flexibility. Financial historians lend empirical support to that argument. Critics respond that competition between regulators might result in a "race to the bottom," or a so-called competition in laxity. This debate is still unsettled, at least in the academic literature.

A single financial services regulator can suffer from a "Christmas tree" effect. This is because it gets encumbered with a

heterogeneous array of responsibilities. As a consequence, it becomes overburdened with numerous functions attached to the agency's primary objective, but of which government departments wish to divest themselves.

There remain, and will remain for the foreseeable future, major differences between banks, securities, firms and insurance companies in the nature of their business, the type of contracts they issue, and hence the nature and form of asset transformation. Firms in all subsectors have diversified, but almost invariably their core business remains dominant. Risks are sufficiently different in nature to warrant a differentiated approach to prudential regulation. Goodhart favours a scheme with no less than six specialist regulators as in case of the following: systemic risk (banks), non-systemic prudential risk (insurance companies), retail conduct of business, wholesale conduct of business, financial exchange and competition.

Goodhart's logic is sound in that each regulator will have a clear statutory mandate, although he does not adequately address the inefficiencies and complications inherent in a multiple regulator regime. In addition, he fails to acknowledge that functional business lines are different from one another, in part, due to the regulatory restrictions placed upon each institution. As governments allow deregulation, competition increases and conglomeration becomes the norm, financial institutions will develop cross-functional expertise, albeit on a scaled learning curve, and will develop new core competencies to exploit an increasingly lucrative financial services marketplace. Therefore, as regulatory barriers are relaxed, the nature and risks of functional business lines will become increasingly intertwined.

The case in favour of regulatory competition, however, is especially strong for non-prudential supervision and regulation. Roberta Romano argues that in the areas of disclosure, professional standards, and the like, competition among regulators will produce

more efficient regulatory standards. Regulatees have strong incentives to choose efficient sets of rules, because doing so attracts more customers from competitors. In prudential regulation of government-insured banks, the same argument applies, but only so long as banks face market discipline that penalises choices of inefficient regulatory authorities. Where uninsured bank debt holders (and therefore banks) do not pay the price for the inadequacies of safety net regulation, a regulatory race to the bottom is conceivable if regulatory competition is allowed.

However, there are several pre-requisites for effective regulatory competition. Necessary conditions of regulatory competition are that the regulated must be able to move between regulatory regimes, have full information and regulations must be fully enforceable. Whilst some of the conditions may, in part, be fulfilled, all are unlikely to be achieved. Indeed, regulatory competition may prove to be destructive as regulators may attempt to outbid each other (for example, in price reviews), and it could also result in regulatory uncertainty leading to less favourable investment conditions.

The "regulatory competition" approach to explaining fragmentation is rather out of touch with reality. It makes sense only where concurrent regulatory regimes exist, which provide alternative "harbours" for the regulated to "anchor". This is the case with regard to the regulation of banking in the United States which might, to some extent, be developing now in Europe. Any bank registered and supervised in one member state of the European Union may branch out to other member countries with the result that a certain regulatory competition may develop.

For some, a high level of discretion is a virtue. They argue that limited ministerial powers and restricted role of laws and rules make for an effective, flexible and innovatory system. Another line of reasoning is skeptical about the idea of an optimal form of regulation developed by technical experts, but nevertheless still

supports discretion. It is argued that discretion provides scope for alternative objectives in regulation and would thus allow increased participation and accountability. The central point of this line of reasoning is that the British system has not been successful as discretion has created regulatory uncertainty which has raised the cost of capital.

Even if there is a strong case for an institution-wide overview of a financial conglomerate, is it necessary for this to be undertaken by a single regulator? Or could it be undertaken by a "lead" regulator (or "coordinator") appointed from among the "solo" regulators responsible for specialised aspects of the institution? This lead regulator would be responsible for taking a consolidated view of the capital adequacy and liquidity of the institution as a whole, taking a similarly group-wide view of more qualitative factors, such as the calibre of senior management and the high-level systems and controls of the financial conglomerate, and coordinating and encouraging the exchange of information among the relevant regulatory bodies, both routinely and in the event of an emergency. The Reddy formula has a lot of supporters.

Not all countries have the political will or the desire to create a "super-regulator" entity and take other steps to reap its advantages. First and foremost, they can work on improving cooperation between regulators. This relates to shared use of information provided by systemic analyses to detect risks which may breach regulatory boundaries. There needs to be shared use of information about financial conglomerates so that an effective strategy for supervising all of their financial activities can be developed. And most importantly, there must be an understanding of how the regulatory entities will function when risks are identified. Who will take the lead? What are the timing requirements for action? What is the planned supervisory action? Perhaps more importantly, however, as mentioned earlier, the "lead institution" approach is likely to exacerbate, rather than solve, conflicts of interest between multiple regulators.

Advantages of a Super-Regulator

Functional regulation and multiple regulators will not address the problem of regulating new financial products, or new technology that bypasses intermediaries. It will also not solve the problem of globalisation of business. There will still be a need for effective coordination between different functional regulators. And most importantly, it will not create an agency that could prepare for regulation of the future, nor will it tackle in a proactive manner the challenges posed by new technologies that effectively bypass regulated modes of doing business in financial services. It is to ensure all this that a super-regulator is required.

To take one example, demutualisation of stock exchanges and their replacement by profit-seeking corporate structures could result in conflict of interest between the need for profitability and the regulatory functions of stock exchanges. In London, for example, the super-regulator or the Financial Services Authority reached the conclusion that one exchange, which is competing with others, should not be the national listing authority. That function was accordingly transferred to the FSA from May last year. The chairman of the FSA confessed that he felt more comfortable with that responsibility in-house, particularly when there are considerable pressures to relax listing standards to take account of the particular circumstances of new economy stocks. As a matter of fact, the London Stock Exchange itself reached the same conclusion.

Streamlined oversight by a super-regulator is viewed as a mechanism to deliver improved supervision at a lower cost, and may better align supervisory bodies with financial and economic realities.

A super-regulator can improve supervision by enhancing its effectiveness and efficiency in a number of ways. A single regulatory body could provide diversified financial groups with better coordinated, more consistent supervision. Better

coordination and consistency are the result of the super-regulator's ability to operate on the basis of a single, rationally constructed set of principles and rules (in contrast to diverse supervisors developing and applying rules that may be duplicate, conflicting, and over-lapping). The development and application of a single set of rules should result in equal treatment – whether in the form of an authorisation or an enforcement or disciplinary decision – for financial intermediaries with similar risk characteristics and product lines, operating in similar markets. Of course, the super-regulator could also supplement the common rules as considered necessary with more specialised ones for particular markets. A single regulator can also operate more efficiently because it can take advantage of certain economies of scale, maximise scarce resources (particularly staff with specialised skills), centralise some functions (particularly such support services as personnel, recruiting, information technology, and accounting/finance), and avoid duplication of other services or initiatives.

5

Problems of Implementation

Challenges

The challenges posed by the "super-regulator" concept relate to bringing together existing supervisory agencies, in terms of both organisational structure and human resources. In most countries, initial staff for the super-regulator is transferred from a combination of its regulatory predecessors. The staff members bring with them considerable experience in their fields; however, there are also traditional biases that might need to be overcome in the new environment. A strong "change management" process and the creation of a new organisational culture are needed for the staff to integrate properly and promptly. Careful review and pragmatic decisions on how the organisation should be structured are critical to avoid an overly bureaucratic entity or one that maintains previous turf barriers.

Funding will be an issue where predecessor regulatory entities were covered by different schemes. The funding of the new regulator must be very carefully considered to ensure that appropriate budgets are worked out to allow the new entity to run efficiently with qualified staff. Establishing a single assessment or fee structure merits careful consideration to ensure that no supervised group is unduly affected.

Differences in existing methodologies of reporting and disclosure by financial entities must also be considered. Some of the difficulties involved in consolidated supervision are related to accounting deficiencies and the complexity of some of the new activities undertaken by banks. The lack of common reporting

within all industries on items such as investment valuation, performance presentation standards, bad debt provisioning and fee income recognition can create incompatibilities in information across various functions. Moreover, in order to have a consolidated view and assessment of the solvency of financial conglomerates, it is vital that the accounting statements are consolidated. Unfortunately, many emerging markets still do not have the rules regarding consolidation of accounts and balance sheets in place. This could lead to serious problems. For instance, it could lead to double or multiple gearing – that is, situations where the same capital is used simultaneously as a buffer against risk in two or more legal entities. Double gearing occurs whenever one entity (say, a bank) holds equity (or another form of regulatory capital, such as subordinated debt) issued by another entity (say, an insurance company), and the issuer is allowed to count the capital in its own balance sheet. Moreover, excessive leverage could result from situations where a parent company issues debt and downstreams the proceeds to an associate or a subsidiary in the form of equity. In such cases, when assessing the leverage of subsidiaries, not taking the indebtedness of the parent into account would give a wrong picture of the actual amount of leverage. Also, companies that access the capital market, either national or international, may use those funds to expand their affiliates. It is only by considering the consolidated balance sheet of the group as a whole that its actual financial position can be known.

Another important factor to be considered is the environment in which the regulator operates. No regulator operates in a vacuum, and weaknesses in the financial infrastructure can render useless the most careful supervisory oversight. Weak accounting and auditing practices, for instance, could scuttle the best plans of regulatory authorities. It is also no use blaming regulators if the laws are defective. To take just one example, improved insolvency arrangements are critical: the absence of satisfactory bankruptcy arrangements that permit the orderly restructuring of distressed corporate debt has been an important factor retarding market

development. This has certainly been the case in India, where there is at present no satisfactory exit policy for capital, and, as a consequence, billions of rupees are locked up in the non-performing assets of banks. Another area in which change is needed in the case of most emerging markets is that of corporate governance. In India, recent instances of the involvement of company managements in diverting funds to the stock markets in order to prop up their own stocks are clear examples of the kind of problems that need to be addressed. No amount of financial regulation can substitute for good corporate governance practices.

Finally, in most countries, changes in the regulatory structure require legislative action and extended time-frames. There may be other legal barriers, such as privacy laws and jurisdiction, created by law or convention, that must be addressed before a new super-regulator can be fully effective.

Financial Services Authority

How the super-regulator approach will work will be known only in the future, particularly when we have a track record of the functioning of the UK's super-regulator, the Financial Services Authority (FSA). The FSA will become the single regulator for financial services in the UK in the second half of 2001, when the Financial Services and Markets Act 2000 (FSMA) is implemented. So far, the FSA is still in the process of setting itself up. It has identified a set of 15 key risks to its statutory objectives and elaborated from these a common risk model – based on assessing the impact and probability of risks occurring to the FSA's statutory objectives – for use across the 10,000 firms it regulates. It has begun work on extending the model to non-firm-specific risks that have a potential impact across the industry as a whole, and on markets and consumers. It has also taken forward the identification and analysis of key regulatory themes – such as, e-commerce and the implications of a low inflation environment – which cut across different industry sectors and have wide-ranging implications for consumers.

In the final analysis, it is important to remember that regulation is ultimately for the consumer. It must, therefore, focus on the consumer of financial services and ensure that his interests are looked after. For that to happen, regulators must enter new areas, namely, the direct provision of information and the promotion of consumer education. For instance, the FSA has produced product league tables which will allow consumers to compare and contrast different product offerings. In other words, the FSA is seeking to counteract directly the information asymmetry in the market-place, by guiding people through the forest of sometimes confusing data offered by product providers and advisers.

Implementation

And finally, there is not much use having a super-regulator if its different departments do not communicate with one another. In a world where financial conglomerates span continents, and where the provision of financial services is global, coordination among the national super-regulators is also important. One important laboratory is the European Union, where consolidated regulation is already emerging on a national level and financial regulation and supervision may also at some point be consolidated at the EU level.

But, of course, a new institutional structure does not necessarily ensure that regulation remains market-sensitive, or effective. We can all think of large conglomerates, whether in the public sector or the private sector, which remain loose federations of functions or businesses, with little synergy between them. So, the big challenge for a super-regulator is to try to ensure that it did deliver more effective supervision, particularly of the largest financial institutions operating across sectors and borders.

The FSA is also experimenting with an even more integrated approach which it calls group supervision. Under this approach, the FSA would concentrate all the supervisory resources required to

supervise a whole financial group under teams within the same division. They have chosen six large firms on which to conduct this experiment with their agreement.

The transition to a super-regulator is not going to be easy. Resistance will arise from special interest groups which are better-off under the existing regime, or which are beneficiaries of subsidies. One example could be small-scale borrowers in India, who benefit from the mandated lending targets of the Reserve Bank of India. They might oppose change that will increase competition, although it is likely that the consumer will have more choice and lower prices. While the major financial institutions will embrace a consolidated regulator, smaller-sized institutions may oppose change on the ground that it is redundant, or that increased regulation might be the outcome. Resistance may also come from the segments that comprise the old multiple regulators, now part of the super-regulatory framework. They may resent their loss of power.

In order to avoid what Taylor calls "an over-mighty bully, a bureaucratic leviathan divorced from the industry it regulates," a consolidated regulator must not only be fair in going about its business, but must also appear to conduct its affairs in an open and fair manner. A monopolistic regulator must consult widely with functional businesses in the development and implementation of compliance standards. Not only will this facilitate a compliance culture as participants take ownership in rule-making, it will also draw on the result-oriented expertise of leading bankers, securities and insurance dealers. Similarly, a commitment to publish cost-benefit analyses and report cards from the academic community will further improve accountability.

Thankfully, there exists at least one comprehensive blueprint of the work that needs to be done by a super-regulator. The FSA experience can certainly prove very instructive. For example, it has allocated institutions to four impact bands – high, medium one,

medium two and low – using a number of measures to identify the impact. Out of the preliminary review of the firms they currently supervise the provisional results show that roughly 80 per cent of institutions are low impact, roughly 15 per cent medium two, roughly 4 per cent medium one, and less than 1 per cent high impact. The pilot probability assessments for high and medium impact firms show that only 0.5 per cent of these firms were rated in both high impact and high probability risk category bracket – that is probably just as well from a regulator's point of view because that is clearly the area one would worry most about, and a comforting 41 per cent are medium impact two and low probability.

The FSA has established, right at the start, a new Complex Groups Division to develop an integrated supervisory approach for the largest internationally active complex groups. Around 50 firms are supervised in that division which employs around 150 people. The definition of a complex group is broadly one with large-scale operations including at least two of the three main financial services activities (banking, securities and insurance), at least three different authorisations in the UK, a complex legal and management structure, a material international presence and involvement in complex or innovative products.

For all groups, the FSA is moving to a model of lead supervision. Within the FSA, one supervisor has direct management responsibility for all the banking and securities supervisors, and for coordinating the working arrangements with any other FSA supervisors which cover the group's activities. That means, for example, coordinating the work of those people who work on fund management, or indeed on the monitoring of retail sales practices. The lead supervisor is responsible for producing an overall group assessment which includes an evaluation of strategy, management capability, systems and controls, adequacy of resources and the economic environment in which the group operates. He or she must also produce a coordinated supervisory

programme, in consultation with the firm, and act as a central point of contact, both for the firm as also for the other regulators which deal with it.

The FSA is also experimenting with an even more integrated approach known as group supervision. Under group supervision, FSA's supervisory resources are concentrated to supervise a whole financial group under teams within the same division. They have initially chosen six large firms on which to conduct this experiment, with their agreement. And the FSA shall evaluate this approach over the next 12 months or so. Essentially, the FSA faces the same problem here as many corporates face in the organisation of their corporate finance activities. How to strike a balance between relationship managers and product specialists – whether to organise them all around client relationships, or to maintain separate pockets of expertise on which different relationship managers can draw.

Lastly, it is vital to have well-staffed, well-trained and well-paid financial regulators. It is indeed a struggle to maintain a strong cadre of regulators. While financial institutions complain about regulators, often rather vociferously, they also show an enormous appetite for recruiting and employing their staff. The right structures and disciplines are created if the regulator is as close as possible to the market-place and, in particular, if the regulator is paid for by financial institutions themselves. That is the case in UK. While it does not resolve all funding problems, it does mean that if the regulator needs to raise more funds because of rising salaries, then the institutions concerned can understand the point, and indeed have the basis to contest it if it is wrong. So, there is a strong body of opinion in favour of market-based funding systems for regulators, which put the incentives for economy and efficiency, on the one hand, and for maintaining appropriate levels of expertise on the other, in the right place. It also has the optical benefit of achieving a reduction in recorded levels of public expenditure, something which ministries of finance around the world are devoted to achieving.

What we have to remember is the fact that the ultimate purpose of this new approach is to achieve a more consistent form of regulation, and a more cost-effective allocation of finite regulatory resources across the whole range of financial services.

Conclusion

What will be the preferred financial regulatory structure of the future? The current trend is certainly towards having a super-regulator. But in regulation, as in everything else, it is competition between regulatory systems that is the best guarantee of progress. As the chairman of the FSA has said: "So regulators will themselves be, in a sense, in a competitive market place. We will need to demonstrate that the regime we offer is worth paying for, that it offers value for money. The product we offer is a complicated combination of some assurance of prudential soundness, some assurance that information provided to you is fair and honest, that there are certain protections built into the system like cooling off periods, or whatever, that there is a regulator to resolve disputes, perhaps, a compensation scheme and, in our case certainly, a robust complaints mechanism." Regulatory systems will have to prove themselves capable of giving financial services players the best environment in which to work.

On balance, however, in view of all the arguments mentioned above, several benefits are likely to accrue from the move towards a single super-regulator. As we have argued earlier, there is no case for considering developing countries as a separate category to which this logic does not apply. Nor would it be desirable to make central bank the super-regulator.

Will these normative considerations about the proper way to organise regulatory authority guide the actual process of regulation? Not really. Any regulatory authority will be a political compromise between contending forces. To take one example, the compromise reached in the US between the Treasury and the

Federal Reserve Board in October 1999 – which helped to pave the way for the financial modernisation bill enacted shortly thereafter – resolved the turf war between the two regulators over where new financial activities would be located and how they would be regulated on quasi-political grounds.

And finally, in the enthusiasm for a super-regulator, it will be well worth remembering the following points. First, the relationship between structure and effectiveness is loose. There is little evidence that structural reforms have been quickly followed by an enhancement of effectiveness of the activity in which those agencies are engaged. Unless the super-regulator is proactive, employs the right personnel, has its ear to the ground, and is market-savvy, no amount of integration is going to help. Secondly, a regulatory structure should follow the market structure which, in turn, responds to changing customer demand and new product availability, rather than seeking to dictate either. It is absolutely necessary to ask those whom we seek to regulate, as well as the consumers of financial services, about their preferences regarding regulatory structure. Rather than requiring market participants to fit in with a government-inspired or regulator-inspired view of how regulation should be organised, it must be ensured that the regulatory framework makes sense to consumers. After all, the objective of regulation is to benefit them.

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