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CUTS INTERNATIONAL

COMMENTS ON THE RECOMMENDATIONS OF FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION

Background

The Financial Sector Legislative Reforms Commission (FSLRC) was set up in March 2011, and was tasked with the role of rewriting and harmonising financial sector legislations. It came out with a report (FSLRC report) and the draft Indian Financial Code (IFC) in March 2013. Prior to making its final recommendations, FSLRC had issued an approach paper in October 2012, to which Consumer Unity & Trust Society (CUTS) had provided comments in November 2012 (CUTS comments on approach paper, available at (http://cuts-ccier.org/pdf/CUTS-Comments_on_the_Approach_Paper_of_the_Financial_Sector_Legislative_Reforms_Commission.pdf).

CUTS broad-level comments on the FSRLC recommendations are set out below –

Financial regulatory architecture

The FSLRC has proposed creation of two principal regulators for the financial sector viz.; the Reserve Bank for banking and payments services and the Unified Financial Authority for all other financial services. The FSLRC has not adopted the twin peaks model that focuses on twin regulatory objectives of 'consumer protection' and 'prudential regulation', by separate regulators, but has attempted to retain the sector specific model wherein each regulator is expected to focus on both these objectives. While doing so, FSLRC has also recommended creation of Financial Sector Appellate Tribunal (FSAT – an extension of the existing Securities Appellate Tribunal), creation of a new Financial Redress Agency, creation of an independent Resolution Corporation, creation of a Public Debt Management Agency, and modification of the existing Financial Stability and Development Council (FSDC).

The model suggested by FSLRC is inappropriate for following reasons –

- The half-baked approach adopted by FSLRC, by neither fully adopting the twin peaks model, nor the sector specific model, would lead to uncertainty and confusion in regulation of entities that provide banking as well as insurance services simultaneously. Currently as well there seems to be a disagreement between IRDA and RBI on regulation of bancassurance services. This would remain unresolved in FSLRC model also. Further, while both the regulators proposed by FSLRC are expected to focus on consumer protection and prudential regulation, a situation like this, when consumer protection and prudential regulation norms are to tested upon a single entity, difference in opinion and varied approach adopted by the regulators would create regulatory inconsistency, increase costs of doing business for entities, and ultimately hamper consumer protection.

- While unifying one aspect of regulatory architecture, FSLRC fragments another, by creation of a whole new lot of financial agencies. As observed in the CUTS comments on approach paper, the issue of staffing the new agencies with right talent needs detailed examination in view of the paucity of domain expertise. There will also be a huge requirement of capacity building in these new agencies, wherein the staff would need to internalise the broad-level principles adopted in the IFC for making adequate regulations focusing on consumer protection and prudential regulation. This is a humongous task, for which the financial sector seems to be unprepared.

- As observed in the CUTS comments on the approach paper, the Deepak Parekh Advisory Group on Securities Market Regulation had recommended that a system for sharing market information automatically for the different regulatory bodies be devised to avoid the need for creation of an entirely new system, now being proposed. Similarly, YV Reddy, former RBI governor, had also preferred an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the jurisdiction of existing regulators. What he favoured was regulatory coordination rather than unification. While FSLRC has mentioned the need for coordination between regulatory bodies, the lack of greater emphasis on the same in the haste of creating new institutions, is regrettable.

Regulation of conglomerates

As mentioned in the CUTS comments on approach paper of the FSLRC, detailed mechanism for regulation and supervision of financial conglomerates is needed. Financial conglomerates can arise within a particular regulatory jurisdiction (a NBFC providing insurance services – under supervision of UFA), intra-regulatory jurisdiction (a bank providing insurance services – under supervision of RBI), and also within jurisdiction and a financial and a non-financial regulator (a FMCG major providing banking services). There is a need for comprehensive regulation of such entities which expand across financial sector, and at times, wider. Absence of clear regulation to deal with financial conglomerates is a gaping hole in the FSLRC recommendations.

Principles based approach

As observed by Dr. P.J. Nayak, "*the Commission strives to choose an imaginative and bold approach in adopting a principles-based approach towards formulating law for the financial sector. It is necessary however to also put this approach to the test of pragmatism in the Indian context, particularly as most financial sector law has hitherto been rules-based.*"

The principles based approach has the risk of leading to uncertainty, conflicting regulatory interpretation, over-reliance on judicial process and ambiguity in markets till some clarity is provided either by the highest court of the land or the legislature. This, as could be deduced, is self-defeating and unnecessary. It would not only lead to wastage of huge amount resources of the market participants as well as of the regulators but also lead to loss of precious time involved.

In addition, the FSRLC envisages that market participants need to comply with the high-level principles and not just the regulations framed. This would be quite a cumbersome task wherein lack of clear regulations could deter even the good-intentioned market players from taking necessary risks in the financial sector.

Principles based regulation also leaves the scope of regulatory overreach by proactive regulators. Proactive regulators may make cumbersome regulations adding costs of doing business in the name of upholding and justifying adherence to the high level principles, as interpreted by the respective regulators. Thus, there is a danger of stifling risk taking and innovation in the market in order to comply with uncertain principles.

Capital controls

The FSLRC has recommended that capital inflows be regulated by the Central Government and capital outflows be regulated by the Reserve Bank. The rationale behind such distinction is not clear and it seems that this recommendation is only to deviate from status-quo.

While the issues of foreign direct investment in India and outward direct investment by residents need to be under the regulation of the Central Government, as they involve national security related issues, all other kind of capital flows may be regulated by the Reserve Bank, as it is better equipped to gauge the issues prevailing in the market, being closer to the market participants and having specialisation and domain knowledge.

Financial Stability and Development Council

Under the FSLRC framework, the role FSDC is to provide a coordination platform between regulators, with the objective to adopt a birds-eye view at the macro-economic situation of the country. FSDC also has the power to suggest certain macro-economic counter cyclical buffers. However, worrying to note is that FSDC is chaired by the Finance Minister, who has otherwise no role in the financial sector regulation (other than a minimal role in regulating capital controls). This is even surprising when seen in the light of FSLRC chest-beating approach to provide independence and autonomy to financial regulators. This recommendation is highly unfortunate and needs to be rethought. It would be advisable if the chair of FSDC is rotated amongst financial sector regulators, i.e. members of FSDC.

Corporate governance

As mentioned in the CUTS comments on approach paper, the FSLRC report and the IFC does not address the ethical and corporate governance issues facing the financial sector but focus more on complaint redressal and systemic and financial risks affecting the sector. Creation of a mandatory code of ethics and governance framework for financial institutions and intermediaries, with punitive actions for non-compliance, would have been much appreciated and welcomed by the industry and the consumers alike. FSLRC has lost this opportunity to provide a long-term corporate governance framework to the industry.

Transition issues

While the FSLRC report has dedicated an entire section on transition, it misses on clearly specifying the methodology to move from pre-to-post FSLRC regulations. The FSLRC report provides, "***Law + 2 years:*** *Regulations existing before the passage of the draft code will lapse. By this time, the Board must have replaced the entire subsidiary legislation and consolidated all subsumed agencies.*"

The time provided for consolidation of regulators, capacity building and coming out with entire gamut of regulations, does not seem to be sufficient. Moreover, it is not clear if all the pre-FSLRC regulations would be repealed at once (after the two-year period is over) and at that time all the proposed regulations would come into effect, or this will be a continuous process, wherein, as soon as a regulation is ready, it will be issued for public comment, and upon finalisation, the existing regulation will be replaced by the new regulation.

Further, as the FSLRC has adopted a principle based approach, the regulations to be issued by the regulators could be expected to be far more comprehensive, detailed, and, consequently, complex.

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