

# Financial regulation should be more nimble

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Markets and insurance regulators should consider the expected outcomes of their moves and correct for unforeseen effects

Liberalisation and the free play of market forces warrants a monitoring authority empowered to lay down the ground rules to guide the behaviour of participants. The monitoring authorities so constituted are known as regulatory bodies.

Liberalisation of various industries, one after the other, has led to the creation of host of regulatory bodies across geographies with an open-market architecture. A regulator is a 'mini-state' with quasi-legislative, executive and quasi-judicial responsibilities. Legislation, including subordinate legislation, is an outcome of policy-think. Regulatory policies so conceived must lead to the efficacy of the markets and efficient outcomes.

Liberal markets enable greater individual freedom culminating in higher creativity and innovation. However, the ingenuity of market participants often unleashes exploitative approaches to profits arising out of kinks in the regulatory

process. The watchful eyes of the authority must enable it to take notice and deal with market misconduct appropriately, prevent injury to other participants and maintain the rhythm of the market.

## Flawed adherence

Multiplicity of misconduct and changing dynamics of the market have led to complex web of regulatory framework, which is becoming craftier by the day. Adherence to regulatory direction sometimes distorts the market and obstructs free play. It is, therefore, important for the regulatory authority to assess the propensity of enforcement before laying the regulation. The authority should also assess the possible consequences and ring-fence with safeguards to minimise the adverse impact. It will do well to recall, some widely known examples from our financial markets in this context.

Amidst fierce competition, the IRDA decided to de-tariff, so that the directed pricing regime of non-life industry was replaced by the free play of market forces. Unfortunately, however, it led to a race to the bottom in pricing. In addition to wiping out the profitability of the businesses, it unleashed some unethical practices in search of the topline. The regulatory authority has been at pains to bring order with a host of additional directions, which have added to the compliance burden without a semblance of stability in the market. Eventually, the return of the directed regime, albeit partially and vicariously by the GICRE's insistence on charging a base premium for some of the risks, has brought relief to the industry.

The PFRDA chose to seek bids from the aspiring fund managers for fees for the management of NPS funds. This introduced inadequately experienced fund managers in the system and adversely impacted the development of the pension market. To further the development of the pension business, the PFRDA has since been taking a host of measures with less-than-desired impact and increased cost. Eventually, the implementation of an expert committee's recommendations, albeit in diluted form, brought some succour to grumbling fund managers.

Similarly, the sudden banning of '*badla*' by SEBI led to the menace of '*Dabba* trading'— off-market speculation — which could be eliminated only with the introduction of derivatives trading and some serious enforcement actions.

## Identifying variables

While all these measures were well-timed and necessary in the interest of the customers and development of the market, striking a balance between regulation and enforcement was possibly not calibrated appropriately. This resulted in significant scope for flouting rather than observance of regulatory directions and distortion of the market.

The philosophical underpinning of laying down a regulatory framework is to influence and shape the conduct of the market participants. This, juxtaposed with the inherent attribute of self-aggrandisement, warrants deeper understanding of the incentives and the innumerable variables that influence market behaviour. The variables emanate from the globalised world, blurred boundaries of the market segments, the explosion of technology, human ingenuity *et al.*

It would, therefore, be appropriate for the regulators to first consider the expected outcome of the proposed regulation. The regulations in the financial markets are intended to influence pricing, competition, entry and exit, innovation, efficiency, prudent oversight etc. Once the outcome/s is identified, the possible impact of the regulation in the face of innumerable variables has to be evaluated. Sometimes there could be unintended consequences, as exemplified above, which have to be visualised. Further, along with the design of the regulation, contours of enforcement, the efficacy of processes and the cost of compliance should also be assessed. Unless such an exercise is undertaken, the regulations can become yet another burden on the market with enhanced cost, distorted pricing and reduced efficiencies.

Granted, financial markets regulators sometimes have to act in a hurry without the analysis of data, discussion and consultation to prevent a market failure and/or a systemic risk unleashing a tornado etc. In such cases, even though *ex-ante* exercise may not be possible, *ex-post* think must be organised to ensure that the tornado is not replaced by a hurricane.

India's financial market regulators, in particular, are uniquely placed. Unlike other jurisdictions, these have the added responsibility of market development. Unfortunately, however, often times the impact of new regulation and its enforcement on the development and growth/rhythm of the market and incentives to the participants to follow them scrupulously are not evaluated adequately; and the market suffers.

## Finding the balance

It might be worthwhile to re-engineer the approach to the regulatory policy design to what the Finance Minister has initiated in the 2019 Budget as 'outcome-based'. The journey of the new philosophy should begin with the identification of the problems, analysis and setting of policy objectives.

This should be followed by a widespread debate to examine various policy options including new regulation or re-engineering of the old regulation, etc. While laying down new and/or re-engineering regulation, it must also incorporate rewards and incentives for higher compliance with a provision for dialogue, restorative justice and responsive enforcement.

There is a need to nurture compliance capacity as a regulatory philosophy. Punitive enforcement should be used only when restorative justice fails. It is also desirable for the regulatory authority to assess periodically its own track record of enforcement so that desired balance is achieved between regulations and enforcement.

It is essential to explore the ‘why’ of non-compliance. The reason for non-compliance can be broadly grouped in three frames — inadequacy of knowledge, ability, and willingness of participants. The knowledge gap arises because of inadequate and/or inappropriate communication and prior consultation. The inability is caused by the complexity of regulation and cost of compliance. The willingness is influenced by factors like odds with market incentives, conflicts of interest, failure of deterrence and procedural injustice.

Restorative justice is a method of opting compliance strategies that respond to the challenges. In fact, there is enough evidence to suggest that restorative justice and responsive regulation are more effective in their impact than inflexible decision-making. The dynamics of Indian financial markets have undergone metamorphosis in the last decade. There is a case for re-engineering regulatory philosophy.

The writer is former chairman, SEBI and LIC

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