

Financial Institutions and Markets
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Lecture – 16
Financial Regulation in India

After the discussion on the preliminary issues related to Financial Institutions and Markets, we can start about the different issues which are quite important in terms of the particular financial system as the whole.

And one of the most important issues is the Financial Regulations. And there are different regulatory bodies which exist in India and as well as in different other countries. And we have to see that how this regulatory bodies function and what are those, what is the basic objective of having those regulatory bodies in the financial system as a whole.

So, before going to discuss about the functioning of the different regulatory bodies let us first understand why we need regulations? Why the financial regulations are required and what are the different types of regulations always we observe in the system? And is there any merits and demerits always involved in that particular regulation aspects. So, let us see that what do we mean by the regulation?

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What is Regulation?

- ▶ Regulation in its broadest sense includes establishing specific rules of behaviour, or regulatory aspect per se, monitoring or tracking observance of behaviour; and supervision or oversight of the compliance with specific rules in the overall behaviour along with disincentives and penal provisions for non-compliance
- ▶ Regulation is taken to mean the employment of legal instruments for the implementation of social-economic policy objectives
- ▶ The objectives of regulation are to avoid monopoly power, foster competition and protect the consumer's interest

  



In general sense if you see the regulation is nothing but it is basically specifying the specific rules of the behaviour or monitoring or tracking the behaviour of the different organization or supervising the functioning of the organization. And let us see that whether the organizations are compliance with that specific rules whatever they already it is defined and whether the particular organizations are functioning in terms of their basic objectives or not.

So, overall regulation consists of three things; one is monitoring, then you have the supervision, then you have basically to see overall whether the rules and regulations is maintained by the particular bodies in the system or not. So, these are the major aspects which is basically involved in terms of the regulations. The regulation basically another objective of regulation is to ensure that the social and economic policy objectives are fulfilled. If you take this example for example, the banks should be regulated.

And as all of us know that the Reserve Bank of India is the regulated body for the commercial banks. So, what is the basic job of the regulatory body? The regulatory body tries to see that whether the particular commercial banks are following the rules and regulations what they supposed to follow number one. And whether what kind of functioning or whatever way the particular organizations are functioning they are basically comply with this guidelines which is given by the regulatory bodies or not; whether this customer grievances are addressed by the organization or not and whether the organization is working in terms of the benefit of the society as a whole or not.

So, these are the different issues or different things as a whole always we observe in terms of the regulation. So, the regulatory bodies the basics job is to see whether the rules and regulations are followed or not, number 1. Number 2, whether whatever functioning the particular organization is doing or whatever job is the particular organization is doing whether it is going towards the overall benefits of the social sector or not. So, these are the different issues or different things always we ensure all should be taken care of by the regulatory bodies.

And another basic job of the regulatory bodies is to avoid the monopoly power foster the competition and protect the consumers interest. Just now already I told you that if there is a single body or any kind of already you might have idea about the monopoly market and perfect market. So, here what we are trying to see if one individual organization

exists and the particular services are provided by that particular organization only; then what will happen they will ensure always they will feel that they can use their monopoly power, and by that they can increase their profit. But, even if they are increasing the profit it is basically affecting adversely to the consumers.

So, what these regulatory bodies try to ensure try to ensure that they should not utilize their monopoly power and they should make certain guidelines certain policies by that the market can be competitive and the consumer interest can be protected. So, these are another objective of the regulation always we can observe or we can see in the financial system.

So, there are three things you keep in the mind monopoly power reduction of the monopoly power fostering the competition in the system and also to protect the consumers interest. These are the three things always we keep in the mind or the regulatory bodies always keep in mind while regulating these financial institutions in the overall financial system in a particular country.

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The slide is titled "Types of Economic Regulations" and features a yellow background with a dark blue curved border on the right side. At the top, there is a navigation bar with various icons. The main content consists of three bullet points, each starting with a right-pointing triangle. The first bullet point discusses structural regulation, the second discusses conduct regulation, and the third discusses social regulation. At the bottom of the slide, there are three logos: the Swayam logo (a gear with a person inside), the Swayam logo (the word "swayam" in blue with a graduation cap icon), and the Swayam logo (a circular emblem with a person and text). A small video inset of a man in a pink shirt is visible in the bottom right corner of the slide.

Types of Economic Regulations

- ▶ *Structural regulation* concerns the regulation of the market structure. Examples are restrictions on entry or exit, and rules mandating firms not to supply professional services in the absence of a recognized qualification.
- ▶ *Conduct regulation* is used to regulate the behaviour of producers and consumers in the market. Examples are price controls, the requirement to provide in all demand, the labelling of products, rules against advertising and minimum quality standards
- ▶ *Social regulation* comprises regulation in the area of the environment, occupational health and safety, consumer protection and labour etc.

So, then we will see that what are the different types of economic regulations? You see the regulations are different ways defined this is what basically we just now discussed that is basically the objective of the regulation. Why the regulation is required or why the financial institutions or markets should be regulated? But, if you see the different type of regulation in the context of different type of regulation we can define it either it is a

structural regulation or it can be a conduct regulations or it can be social regulation. So, what do you mean by the structural regulation?

The structural regulation basically deals with the regulation of the market structure. What does it mean? It means that it controls the entry and exit and rules the mandating firms not to supply the professional services in the absence of recognized qualification. What does it mean? It basically you know every market has a structure how the market basically functions they have a structure. The structure in the sense who can enter into the market who can when the market when this particular organization can exit the market. So, those things basically if you any kind of for regulatory norms we are preparing or we are trying to regulate those things into the system then that comes under the structural regulation.

So, that why the structural regulation deals with the market structure of that particular system particular in terms of the entry and exit and whether the rules and regulations are followed by that particular organization whenever they are operating in that particular system. Whenever we are talking about the conduct regulation this is basically is used to regulate the behavior of the producers and the consumers in the market. For example, it deals with the price control, it also deals with the requirement to provide or create the demand in the system.

And they should ensure that what kind of advertisement and other kind of things which are done by the firms they are following the actual ethical standards. And if the ethical standards and practices are not followed by them then that basically we can that that organization is not going for advertisement in the ethical way. So, if you bring the financial market into the picture the financial market for example, if you go back the structural regulation the financial whenever you deal with the financial market.

For example, you take the stock market; the stock market there is a market structure how the trading takes place? When this how this investor can take the positions? What are the different type of orders exist in that particular system like limit order you have the or we can say that whether the market is a quote driven market or the order driven market, when the settlements should takes place and what are the settlement cycle all kinds of issues comes under the structural part.

But whenever you talk about the conduct part what basically we are trying to see in the conduct for example, you are talking about insider trading in the stock market. So, if the particular organization is going for insider trading then it will affect the price. And the regulatory body always ensure that the insider trading should not takes place which means which is unethical insider trading is a type or is a unethical practice. And to stop the insider trading some of the regulatory norms has been created the regulatory norms which have been created by the regulatory bodies.

We have to ensure that those particular markets or the particular companies who are going under this particular system they should always follow this norms made by this regulatory body in that particular economy. So, that is basically a part of the conduct regulations which deals with the pricing which deals with the approach or the behavior of the producers and the consumers, and I have given the example of insider trading whenever we talk about the financial market or particular the stock market.

Then we have another type of regulation that is called the social regulation; so what exactly the social regulation means? The social regulation means that whether the firm which is operating or the company who is doing the business they are following this environmental norms or occupational or health issues which may arise, because of the operations or business of that particular firm where the laborers or consumers are protected. So, all of real issues or the factor which are affecting environment factor affecting health factor affecting safety all kind of issues should be basically always addressed by the social revolution.

So, any company whenever they operates or any kind of financial organization or any other organization when they operate in a system they have to ensure that they should abide by the rules and regulations related to the environment protection. And any kind of hazards or any kind of health issues which may arise, because of the operations of that particular company and also they should ensure that the consumers are protected or consumers are safe. So, in this context if you see broadly there are three types of regulations always we observe.

One is structural second one is conduct and third one is the social. So, these three things always the financial organization have to follow and always the regulatory bodies ensure that this system always work in this direction.

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Theories of Regulation

- *Public Interest Theories of Regulation:* the regulation of firms or other economic actors contributes to the promotion of the public interest
- *Chicago Theory of Regulation:* as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit

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Then if you talk about the theories of regulation that already all of us know that every kind of operational and practical aspects come from the theory there should be some theoretical motivations. There should be some theoretical understanding always we should have whenever you operate in a particular system. Like that in the regulatory aspects also in the regulation also there should be some kind of theoretical understanding what do you mean by this theoretical understanding?

If you see mostly there are two broad theories which always work in this particular direction; what are those two broad theories one is public interest theories of regulation another one is the Chicago theory of regulation because, the Chicago school of thought has given that particular theory. So, in name of that particular school this particular theory's name has been given that Chicago theory of regulation. So, what do you mean by this public interest?

The public interest theory basically ensures or always deals with the regulation of firms and other economic units or economic agents which contribute to the promotion of the public interest. That means, in a layman perspective if you try to understand what it exactly means it means that the firms and other regulatory or the other economic agents should be regulated in the interest of the public. That means, the regulatory norm should be created in such a way that the social welfare can be maximized the social welfare can be maximized or the public interest can be protected. So, any regulation what we are

making that should not be in the benefit of the producer or not on the benefit of the firms and whatever regulations we are making that should be the for the benefit of the public or for the maximization of the social welfare.

So, this is basically given by which is called as the public interest theory of regulation. And another theory is basically called the Chicago theory which will basically also says little bit different. So, this according to this theory the regulation is basically a rule which is acquired or which basically should be designed primarily for the benefit of that particular economic agent.

Little bit biased theory what basically here we are trying to say the regulation also should be made; that means, here if you combine both the theories basically both the theories are relevant whenever regulation from the regulation point of view. The regulation should be made in such a way that the public interest also should be taken care and as well as the firm or the particular economic agent which is operating in that particular system their interest also should be taken care.

So, here these regulatory norms should be designed in such a way that the interest of both the stakeholder can be taken care. So, that is why one of the theory cannot be only applicable whenever we talk about the practicality of that particular concept. So, we have to ensure that the regulation can consist of or can be derived from the thought of both the theories which takes care of the public interest and as well as the other interest on the own acquired by the industry and design and operated primary for its benefits. So, this is what basically we call it a Chicago theory of regulation.

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Regulatory Approaches

- **Integrated Approach**
 - A single regulator oversees all types of financial institutions and provides both prudential regulation as well as conduct-of-business or consumer protection regulation.
- **Twin Peaks Approach**
 - It relies on two types of regulators: (i) a prudential regulator and (ii) a conduct-of-business regulator
- **Functional Approach**
 - Seeks to regulate financial institutions based on the type of business they undertake, without considering how a given institution is defined legally
- **Institutional Approach**
 - Legal status of an institution determines its regulatory supervision

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Then, there are let us come to the concept of the approaches to the regulation there are various regulatory approaches, what are those regulatory approaches? There are different approaches the regulatory body follows we will come to that the other aspect is also there in the terms of the approach. But the first approach is basically the first approach is basically in terms of you might have heard this debate between whether this particular system should have a single regulator or should have a multiple regulators.

So, keeping that thing in the mind there are different approaches have been established have been created. So, if you see that the first approach is called the integrated approach. So, what do you mean by this integrated approach? The integrated approach tells that there should be a single regulator who oversees all type of financial institutions. And market and provides both prudential regulation as well as the conduct of business and consumer protect.

What does it mean? It means that there should be a single regulatory body that single if you observe that here; what we are trying to say that that whenever we talk about this different approaches if you observe that whenever we talk about the single regulatory bodies should take care of both the prudential regulation and as well as the conduct of the business or the consumer protection regulation. What does it mean? It means that the regulatory bodies should create the norms should create the rules and regulations for the conduct of that particular or functioning of that particular organization and as well as

they should make those certain kind of rules and regulation which helps the consumer for the benefit for participating in that particular process.

That means it takes care of both supervision and as well as the prudential regulation the two things will be integrated and one regulatory body or single regulatory body is good enough for operating in that particular system. And another type of approach is twin peaks approach. What do you mean by this twin peaks approach? The twin peaks approach basically tells it relies on two types of regulator it relies on the two types of regular regulators; one is a prudential regulator and another one is a conduct of business regulator what does it mean?

That means, there are two types of regulatory bodies; one type of regulatory body will be responsible for creating the prudential norms and another regulator should ensure that whether the norms are followed or not and whether the firms. And the different economic units are how this whether the functioning in the particular way whatever way the regulatory bodies have guided that. So, the conduct and their prudential norms which are created by them that should be basically overseen by the two regulatory bodies that should not be taken care of by single regulatory body.

One regulatory body will make the prudential norms another regulatory body will see whether the prudential norms are basically followed by these particular economic agents or not. So, that is basically popularly known as twin peaks approach then we have another approach called the functional approach. So, what this functional approach means? The functional approach basically seeks to regulate the financial institutions based on the type of business they undertake without considering how a given institution is defined legally. What does it mean? The regulation should be made on the basis of the functioning of that particular organization or what kind of business the organization is doing.

This particular; that means, the functional part of the organization should be regulated legally what kind of business this particular company is doing that should not be basically considered. So, the functions should be ethical or the operations procedure of the particular company should be ethical and the public interest has been taken care that basically should be ensured by the regulatory bodies whenever we are or any regulatory

body is following the functional approach that is what basically always we observe or we can define in terms of the functional firm.

And another approach is called the institutional approach; that means, the legal status of an institution is determines its regulatory supervision. You see whenever any organization is made that basically is made on the basis of certain acts or certain laws. So, we have to ensure from the beginning whatever acts and laws has been used to establish that organization with a certain objective whether the organization is fulfilling that objective or not whether this particular objective of that particular organization is followed by the functional operation of that particular organization in the system. So, that is called the institutional approach.

So, the regulatory supervision is basically determined on the basis of the legal starters of that particular company in the system, but if you combine these are very much theoretical in nature. And theoretically those kind of approaches give you the idea what kind of regulatory bodies we should have or what should be the focus of, the regulatory bodies in the system, that is what the basic job of the regulatory approaches, but whenever we come to the practical sense.

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The slide is titled "Single Vs. Multiple Regulators" and is presented in a yellow and blue color scheme. It features a list of arguments in favour of a single regulator. At the bottom of the slide, there are logos for "swayam" and "THINK WISE, LEARN WELL". A small inset image of a man in a pink shirt is visible in the bottom right corner of the slide.

Single Vs. Multiple Regulators

- Arguments in favour of a single regulator
 - There are economies of scale for the regulator since unification may permit cost savings on the basis of shared infrastructure, administration and support systems.
 - The regulated units also benefit since unification mitigates the costs which supervised firms with diverse activities (i.e. financial conglomerates) bear for dealing with multiple regulators.
 - Accountability is enhanced since complexity of the multiple supervisory system could lead to lack of clarity of roles and consequently lack of accountability.
 - 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 could 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.
 - Unification aids in international cooperation as there is a single contact point for all regulatory issues.

That what exactly how the regulatory bodies work in the system; we have a single there is a debate in India also the debate is still going on whether we should have a single regulatory body or we should have the multiple regulatory bodies. So, if you consider all

those approaches. And the theoretical motivation behind the regulation they always deal with one thing that whether this particular regulation is made by a single regulatory body or we should have a multiple regulatory bodies who takes care of the different functional parts of the regulation. Like somebody can create prudential norms somebody can supervise somebody can see the functional form of operations of that particular economic unit's etcetera etcetera.

So, in this context and combinedly what we can say we have single or multiple. So, there are various arguments whether we should have a single regulatory body or we should have a multiple regulatory bodies. Whenever we see that if we see the arguments in favor of the single regulatory body the people are the advocator of the single regulatory body is always assumed that because of single regulatory body there are economies of scale for the regulator.

Since unification may permit cost savings on the basis of said infrastructure administration and support system cost basically we can reduce the cost the man power will be less more infrastructure is not required administrative bodies people also will be less human resource requirement is also less. And we can have the single regulatory body who have the different branches and they can operate in efficient way, because it works with under it works under a same administration or same operational process that is basically number one advantage for basically the argument.

Second argument what they gave the regulated units also benefits since unification mitigate the cost with supervised forms with diverse activities bear for dealing with the multiple regulators. If the multiple regulates whenever we see the multiple regulators basically one regulator basically go for one kind of they regulate one kind of market another regulator regulates another type of market.

So, then what will happen that whenever there is a chance if the two different markets are related, then their must be a conflict that whether it should be regulated by this particular regulatory body or that regulatory body which has happened in the Indian context also whenever the banks basically provide this mutual fund services or insurance services. So, that time whether it should be regulated by the SEBI or regulated by RBI those kinds of confusion always arise. And another issue is accountability can be

enhanced because since complexity of the multiple supervisory system could lead to lack of clarity of the roles and consequently lack of accountability.

Regulatory arbitrage can be avoided in case of single regulator. In a multiple regulatory regime fragmentation of supervision could lead to competitive inequalities in different units. It can also reduce the number of regulators which can allow this scarce supervisor resources especially in the specialist areas we may not need more regulatory persons whenever we have a single regulator. A single regulator can correspond more effectively to market innovation and development.

As there to be regulatory grey areas in the sense nobody can hide the information, because I do not know about what the other bodies is doing or other organization is doing, because every all the information is gathered through one unified body that is basically the single regulator. It is also aids and International Corporation as there is a single contact point for all regulatory issues whenever in the globalised scenario whenever we are dealing with the multiple countries. So, that time it will not have any issues because the contact point of regulatory issues is basically one.

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Single Vs. Multiple Regulators Cont...

- Arguments against the idea of a single regulator
 - 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.
 - Concentration of power could vitiate democratic policies.
 - There may actually be diseconomies of scale since monopolistic organizations 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.
 - There may be unintended consequence of public tending to assume that all creditors of supervised institutions will receive equal protection

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So, these are the different arguments in favor of the single regulator. But whenever you there are some demerits also what are those arguments against this single regulator unification or would lead to the lack of clarity. In functioning of the multiple regulator tend to have a different objectives; the objective may be depositors protection for banks

versus investor protection for capital markets versus consumer protection for other financial firms which firm should be protected or which agent should be more protected which agent should be less protected. So, those kinds of confusion may arise if one body will regulate all kind of entities.

Concentration of the power could basically is a threat to the democratic policies it can also go against this policies whatever we have. There maybe actually the diseconomies of scale since monopolistic organizations can be more rigid and bureaucratic than the specialist agencies. Then, there may be a unintended consequences of public attending to assume that all creditors of supervise institutions will receive the equal protection, if one body is regulating or one body is making the rules for all kind of economic units or all kind of economic agents which are existing in the system, then maybe there is a conflict of interest arises that which particular agent or which particular unit is more protected which unit is less protected. So, these are the different arguments against the idea of single regulator.

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The slide is titled "Financial Self Regulation" and features a yellow background with a dark blue curved border on the right side. At the top, there is a navigation bar with various icons. The main content consists of a bulleted list:

- ▶ to enforce honest and prudent behaviour through *self-policing arrangement*
- ▶ regulatory policies that minimize interference with the functioning of the market
- ▶ Self-regulatory organizations (SROs) responsibilities could encompass:
 - regulation of market transactions
 - regulation of market participants
 - disputes resolution and enforcement actions
 - pre-commitment of resources

In the bottom right corner, there is a small video feed of a man in a pink shirt. At the bottom of the slide, there are three logos: the Swayam logo (a gear with a person), the Swayam logo (a gear with a person), and the Swayam logo (a gear with a person).

Another concept which has started after 2004 2005 in India and as well as other countries that is called the financial self regulation we have AMFI we have FIMMADA all kind of organization which comes under the self regulatory bodies. The self regulatory bodies basically what we feel that we have our system is matured enough that we can regulate our self. As the association of that particular units can regulate themselves and there their

basic responsibilities are regulation of market transactions, regulation of market participants, dispute resolution and enforcement actions and pre commitment of the resources.

Like association of mutual funds, they try to dissolve the different conflicts which arise within that particular entity or within particular system. And SEBI may not be they always want that the burden of those particular regulatory bodies like SEBI can be controlled through or can be reduced through that. So, that is way there is self policing arrangements also can be made whenever the market become very matured and the system can work in that direction.

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The slide is titled "Limitations of Financial Self-Regulation" and features a list of five bullet points. At the bottom right, there is a small video feed of a man in a pink shirt. The slide also includes logos for Swamyam and other educational institutions.

- SROs might transform themselves into cartels and jeopardize competition
- Short-term tensions between the managers and the authorities responsible for SROs either discourage participation or diminish long-term confidence in the market
- Scarcity of institutional and human resources
- Lack of reasonably homogenous institutions for a balanced structures within SROs
- With limited competition in securities markets, self-regulation may not be enough to ensure safe and efficient markets

But, there are certain regulations the self regulatory organizations might transform themselves into the cartels which may hamper to the computation to the system; short term tension between the managers and authorities responsible for the self regulatory organizations either discourage participation or diminish the long term confidence in the market. Scarcity of institutional and human resources they may not have that much expertise to regulate themselves, or there must be some kind of less accountability for the functioning, or the operations of that particular system lack of reasonably homogeneous institutions for a balanced structure within that particular regulatory bodies.

With limited competition in securities market self regulation may not be enough to ensure safe and efficient markets whenever the market is inefficient then in that

particular time the self regulatory bodies may not control or may not regulate the market efficiently.

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Acts Related to Financial Sector Regulations in India

- The Banking Regulation Act, 1949
- The Securities Contracts (Regulation) Act, 1956
- Securities and Exchange Board Act, 1992
- The Depositories Act, 1996
- The Foreign exchange Management Act, 1999
- Insurance Regulatory and Development Authority of India Act 1999
- The Competition Act, 2002
- The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002
- Prevention of Money Laundering Act, 2002
- The Micro, Small and Medium Enterprises Act, 2006
- Payment and Settlement Systems (PSS) Act, 2007
- Issue of Capital and Disclosure Requirements Regulations Act, 2009
- The Companies Act, 2013
- The Pension Fund Regulatory and Development Authority Act, 2013

The slide also features the Swamyam logo with the text 'FREE ONLINE EDUCATION swamyam' and the Indian government emblem.

And here, there are some of the acts which are related to financial sector regulation in India starting with banking regulation act 1949 to the Companies Act 2013 then you have the IRD Act 1919 1999 then you have the your payment and settlement systems act 2007. So, there are different acts on which the regulations are based on the Indian system.

And here on the basis of these acts different regulatory bodies have been established mostly it is RBI SEBI PFRDA and we have the another bodies called the IRDA Insurance Regulatory Development Authority in the upcoming classes upcoming sessions we will be discussing the functioning and of these regulatory bodies and how they function and how they regulate the market in India.

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Please go through these particular references for this particular session.

Thank you.