Single Regulator versus Multiple Regulators

The financial sector has witnessed significant changes world wide in recent decades, following globalisation, deregulation and technological advances. These developments, which are inter-related and mutually reinforcing, have, in turn, led to blurring of traditional distinctions which used to apply across types of firms, products and distribution channels on the one hand, and the emergence of financial conglomerates on the other. This concommitantly poses a regulatory challenge. The need for consistency or harmonisation in regulation has generated a debate about the appropriate regulatory/supervisory structures both in policy and academic circles.

The regulation of financial intermediaries the world over has traditionally been on institutional lines whereby regulation is directed at financial institutions, irrespective of the mix of business undertaken. As financial institutions normally specialised in a particular business activity, the distinction between institutional and functional regulation was not considered of much significance so that regulating an entity was the same thing as regulating its core business. For instance, regulating banks meant regulating the business of banking and regulating the insurance company meant the same thing as regulating the business of insurance. In the face of blurring of activities among financial service providers and emergence of financial conglomerates (*i.e.*, financial institutions undertaking a combination of activities), the institutional structure of supervision has become a major issue of policy debate in several countries.

Approaches to Supervision

The present institutional approach to regulation is being objected mainly on three grounds. The first is the competitive neutrality issue, ***i.e.***, different institution-based regulators might adopt different functional regulation for the same activity with associated costs of achieving compliance as well as supervisory arbitrage. Secondly, there could be a wasteful duplication of scarce supervisory resources, with each regulator applying business rules appropriate for every function, which would be hugely inefficient in terms of regulatory resources (Goodhart[1], *et al*, 1998). Finally, there is the issue of the solvency of the institution, which could be addressed only on a group-wide basis. To mitigate the problems posed by the blurring of activities among providers of various financial services and operations of financial conglomerates, the following four broad approaches have been suggested:

- function-specific regulation, in which the regulatory domain is defined by 'functions' performed by financial institutions rather than 'institutions'.
- objective-based regulation, such as systemic protection and consumer protection objectives such as in the twin-peak model (Taylor[2], 1996).
- super-regulator or unified regulation, with the responsibility for prudential supervision of all financial institutions besides being responsible for product regulation and competition policy in the financial sector, and

[1] Goodhart, C.A.E., P. Hartmann, D. Llewellyn, L. Rojas, Suarez, and S. Weisbrod (1998) – 'The Institutional Structure of Financial Regulation' in ***Financial Regulation, Why, How and Where Now?,*** Routledge Publication, London and New York.

[2] Taylor, M. (1996) – "Peak Practice: How to Reform the UK's Regulatory System", Centre for the Study of Financial Innovation, London, October.

- lead /umbrella regulator, in which one of the regulators is responsible for coordinating the regulation of the overall corporate group, with the individual operating entities within the group continuing to be regulated by the specialist regulators.

The regulatory practices in different countries vary according to institutional characteristics. Some countries have single regulators regulating all major segments of the financial sector, banking, insurance and insurance. Some other countries have two regulators for the banking sector and the securities market. Finally, some others (including India) go for separate regulators for each of the three segments. So far only 12 countries have set up combined or single regulators for regulating all the three activities. The survey of international practices does not prove the dominance of any particular model over the other. There has been undeniably a drift towards uniform supervision in recent years, beginning with Singapore (1984) followed by Norway (1986), Denmark (1988), Sweden (1988). The process gained momentum since the late 1990s, including Korea (1998), Japan and the UK. It is significant to note that within the 12 countries which have created unified structures, there are significant differences in their structures. Mega regulatory models could be broadly categorised into three categories,

- the Singaporean Model, in which the central bank is also the super regulator,
- the Scandinavian Model, in which unified regulation lies outside the central bank, and
- the Australian Model, in which there are two regulators with an overarching council above them.

Arguments in favour of unified supervision

There are, of course, strong arguments in favour of unified supervision.

- Fragmented supervision may raise concerns about the ability of the financial sector supervisors to form an overall risk assessment of the institution, operating domestically and often internationally, on a consolidated basis, as well as their ability to ensure that supervision is seamless and free of gaps. There are also group-wide risks that may not be adequately addressed by specialist regulators.

- As the lines of demarcation between products and institutions have blur, different regulators could set different regulations for the same activity for different players. Unified supervision could thus help achieve competitive neutrality.

- The unified approach allows for the development of regulatory arrangements that are more flexible. Whereas the effectiveness of a system of separate agencies can be impeded by 'turf wars' or a desire to 'pass the buck' or where respective enabling statutes leave doubts about their jurisdiction, these problems can be more easily limited and controlled in a unified organisation.

- Unified supervision could generate economies of scale as a larger organization permits finer specialization of labour and a more intensive utilization of inputs and unification may permit cost savings on the basis of shared infrastructure, administration, and support systems. Unification may also permit the acquisition of information technologies, which become cost-effective only beyond a certain scale of operations and can avoid wasteful duplication of research and information-gathering efforts.

- A final argument in favour of unification is that it improves the accountability of regulation. Under a system of multiple regulatory agencies, it may be more difficult to hold regulators to account for their performance against their statutory objectives, for the costs of regulation, for their disciplinary policies, and for regulatory failures.

Arguments against unified supervision

A number of important countries continue to be persist with multiple regulators, though regulatory co-ordination has been increasing everywhere. The US, for example, has adopted a model, which blends functional regulation with umbrella supervision. For over 60 years, regulation of financial institutions in the US was divided among several different agencies. The Gramm-Leach-Bliley Act, enacted in November 1999, adheres to the principle of functional regulation whereby the primary regulators of insurance companies, investment companies and banks continue to be specialist regulators as earlier. However, the Federal Reserve Board is now entrusted with the role of the umbrella supervisor to regulate the financial holding companies subject to some limitations, which are collectively referred to as Fed-Lite provisions.

The persistence of separate regulators in most economies reflects the fact that there are equally compelling arguments against unified supervision. This includes:

- Given the diversity of objectives – ranging from guarding against systemic risk to protecting the individual consumer from fraud – it is possible that a single regulator might not have a clear focus on the objectives and rationale of regulation and might not be able to adequately differentiate between different types of institutions.

- A single unified regulator may also suffer from some diseconomies of scale. One source of inefficiency could arise because a unified agency is effectively a regulatory monopoly, which may give rise to the type of inefficiencies usually associated with monopolies. A particular concern about a monopoly regulator is that its functions could be more rigid and bureaucratic than these separate specialised agencies. It is argued that another source of diseconomies of scale is the tendency for unified agencies to be assigned an ever-increasing range of functions; sometimes called 'Christmas-tree effect.
- Some critics argue that the synergy gains from unification will not be very large, *i.e.*, economies of scope are likely to be much less significant than economies of scale. The cultures, focus, and skills of the various supervisors vary markedly. For example, it has been argued that the sources of risks at banks are on the asset side, while most of the risks at insurance companies are on the liability side.
- The public could tend to assume that all creditors of institutions supervised by a given supervisor will receive equal protection generating 'moral hazard'. Hence depositors and perhaps other creditors of all other financial

institutions supervised by the same regulatory authority may expect to be treated in an equivalent manner.

- Another serious disadvantage of a decision to create a unified supervisory agency can be the unpredictability of the change process itself. The first risk is that opening the issue for discussion will set in place a chain of events that will lead to the creation of a unified agency, whether or not it is appropriate to create. The second risk is legislation in that the creation of a unified agency will generally require new legislation, but this creates the possibility that the process will be exploited by special interests. The third risk is a possible reduction in regulating capacity through the loss of key personnel. Another risk is that the management process itself will go off track.

The Role of the Central Bank in Unified Supervision

The most crucial issue involved in the introduction of unified structure is related to the involvement of central bank in supervision. There are arguments for and against banking supervision within the central bank as also unified structure within the central bank. The main argument for banking supervision within the central bank is based on the premise that since banks are conduit through which changes in monetary policy are transmitted to the wider economy, the central bank needs to be concerned about their financial soundness as a precondition for an effective monetary policy. This argument is reinforced by other arguments including, (a) the synergies between the information required for the conduct of monetary policy on the one hand, and the supervision of the banking sector on the other; (b) the central bank's need to assess the creditworthiness of participants in the payment system, which will inevitably involve it in forming judgments about the solvency and prudent conduct of banks; and (c) the central bank's need to have access to information on the solvency and liquidity of individual banks in order to exercise its lender of last resort functions (Abrams and Taylor[3], 2000). Another reason why the supervision should be within the central bank relates to independence of the central bank. In many developing countries, the central bank could be singled out as the only institution with independence from political interference, and with the resources. Given this, the effectiveness of supervision in general and banking supervision in particular could be seriously compromised if the supervisory functions were separated from the central bank.

On the other hand, there are several general arguments for the separation of banking supervision and monetary policy, regardless of whether or not the separation arises out of unification of supervision. First, a central bank, which is also responsible for supervision, may err on the side of laxity if it fears that tight monetary conditions may lead to bank failures. Secondly, bank failures inevitably will occur and when they do, they will be blamed on the supervisor. If the supervisor is the central bank, its credibility will be undermined, and with it its credibility in the conduct of monetary policy (Abrams and Taylor, 2000). However, the arguments for separation of bank supervision and monetary policy do not find much support in the literature on the subject and in the official circles. The Central Bank's involvement in supervision does not necessarily weaken its stance on monetary policy; and consequently a Central

[3] Abrams, Richard K. and Michael W. Taylor (2000) - 'Issues in the Unification of Financial Sector Supervision',

Bank's inflation performance and its role in supervision are two, more or less, separate issues (Goodhart and Schoenmaker[4], 1993).

The Indian Case

There is very little disagreement about the fact that the financial sector reforms undertaken in India since the 1990s have resulted in a blurring of distinctions between institutions. With the relaxation of balance sheet restrictions, existing institutions invest across a number of markets and products. Besides, a number of banks and financial institutions are gradually floating subsidiaries which enter into markets outside their dominant activity with a view to graduate into universal banks. At the same time, the pace of change has been reasonably gradual and the transformation is far from complete. It is useful to survey the changes that have taken place in the recent years:

The Deepak Parekh Advisory Group (DPAG) on Securities Market Regulation (2001) referring to the diffusion of regulatory responsibilities observed that there may be a merit in formalising the High Level Group on Capital Markets (HLGCM) by giving it a legal status. It also recommended that a system needs to be devised to allow designated functionaries to share specified market information on a routine and automatic basis. The issue of choosing between single and multiple regulators for financial system was dealt in detail for the first time in the Indian context by Dr. Y.V.

IMF Working Paper, WP/00/213, December.

[4] Goodhart, C.A.E. and D. Schoenmaker (1993) – 'Institutional Separation between Supervisory and Monetary Agencies', *LSE Financial Markets Group Special Paper* No.52.

Reddy in a speech in May 2001. However, Dr. Reddy also did not recommend the institution of a super regulator for the Indian Financial System. Instead, he wanted to explore the feasibility of an umbrella regulatory legislation, which creates an apex regulatory authority without disturbing the existing jurisdiction.

Having examined the issue of unified structure in general, it may be in order to examine whether there are sufficient grounds for radical overhaul of the existing system of supervision by separate agencies (mainly RBI, SEBI and IRDA) and create a unified structure in India. In the recent period, no doubt, the linkages between the banking, securities and insurance sectors have grown. Certain banks and DFIs are now operating both in the securities and insurance sectors. Banks are also participating directly in the capital market. Two DFIs have also set up their own banks. A mutual fund (UTI) has also set up a bank. Insurance companies have also entered the mutual fund business. However, it is felt that linkages have not yet grown to the extent so as to warrant a unified structure or a super regulator. While the blurring of distinctions between financial institutions pose a regulatory challenge, the balance of opinion has been in favour of regulatory co-ordination rather than unified supervision. The arguments against unified supervision in India broadly run on the following lines:

- We have not yet witnessed financial instruments of the kind witnessed by some countries. Most of the products being offered by various intermediaries are stand alone and do not combine features of bank deposits, insurance policies and investment. Banks' direct participation in the equity market is also very insignificant. Also, insurance companies are not yet allowed to set up banks which would require legislative changes.

- There are no significant regulatory overlaps, barring perhaps the case of co-operative banks. Regulation in India is by and large on institutional lines and institutions essentially report to a single regulator. One area of potential conflict could have been the regulation of the debt market, but the Government has already issued a notification in March 2000 delineating responsibilities between the RBI and SEBI.
- Banking supervision has historically been done by the Reserve Bank and as a result, a large volume of expertise has been built up in this area within the central bank. Besides, since ours is a bank-based economy and banks are the conduit for carrying monetary policy impulses to the real economy, it is necessary to keep bank supervision within the central bank.

Considering these facts, especially the given institutional settings in India, and the disadvantages of unified structure as outlined above, it is felt that the existing arrangement of supervision by separate agencies may continue. To take care of some overlaps, duplication *etc.*, however, there is a need to devise some formal mechanism among three major regulators to exchange information and coordinate their activities. This could be achieved in a variety of ways through micro-level and macro-level regulatory co-ordination:

- Micro-level co-ordination: In case of financial conglomerates, a lead regulator, identified on the basis of dominant economic activity, could be assigned the task of making an assessment of group capital adequacy, informing supervisors of constituent entities about developments affecting the viability of the group and coordinating the combined regulatory actions.

- *Macro-level coordination: There could some regulator-level institutional arrangements for co-ordination. While the Deepak Parekh Advisory Group on Securities Market Regulation has suggested formalising the High Level Committee on Capital Markets (HLCC) by according it legal status, it may be stated that HLCC was set up with the limited objective of ironing out differences among the regulators on policy matters, not all of which are of supervisory in nature. HLCC is not mandated to coordinate the activities among regulators either on a day to day basis or in crises situations. For coordinating the activities of regulators, there is a need for a separate body, which could be on the lines suggested by Dr Reddy in his speech 'Issues in Choosing Between Single and Multiple Regulators of Financial System'. DG(YVR) suggested an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the existing jurisdiction.*