A Growth-Friendly Regulatory Framework

chapter 6

CURRENT REGULATORY FRAMEWORK

Sixteen years of reforms have created a fairly sound regulatory framework. There has been a convergence towards global best practices in areas like prudential regulation of the banking system, securities regulation, and insurance regulation. Substantial deregulation of interest rates, the shift from merit-based regulation to disclosure-based regulation of securities offerings, and the move towards de-tariffing of insurance products are significant steps towards the creation of a modern regulatory framework for the financial sector. Though the task is by no means complete, the groundwork that has been laid will allow us to move rapidly towards the regulatory architecture that is appropriate for a country of India's size and aspirations. While building on past successes, it is also important to remember there are deficiencies in the current regulatory system.

Low tolerance for innovation and excessive micro-management

A number of problems exemplify the substantial road that still has to be travelled in achieving an adequate financial regulatory and supervisory structure. First, the pace of innovation is very slow. Products that are sought to be introduced in India (though well established elsewhere in the world) take several years to see the light of day. The following examples illustrate the long delay from serious proposal by a potential innovator to actual successful launch:

- Index futures were proposed in early/mid-1990s and launched in 2000.
- Gold Exchange Traded Funds were proposed in 2002 and launched in 2007.
- Interest rate futures were proposed in 2003 (and there was also an abortive launch of an unviable variant) but have yet to be permitted in a viable form.

Second, attempts to exercise unduly strict control over the market and over financial institutions result in excessive regulatory micro-management, which leads to a counter-productive interaction between the regulator and the regulated. The regulated respond to the needs and opportunities in the market place while attempting to comply only with the letter of the law. The regulator then attempts to stamp out violations of the spirit through new rules and the regulated find new ways to get around them.

The Committee believes that low tolerance for innovation and excessive micro-management themselves stem from deeper rooted problems in the regulatory structure:

- Regulators often have unclear, sometimes mutually inconsistent, and infeasible objectives as in the case of the RBI's mandate regarding exchange rates, inflation, and growth. Objectives have not kept pace with changes in the economy.
- Regulators also suffer from conflicts of interest, some explicit (such as the one between monetary policy and management of the public debt, which is being resolved by separation of function) and some implicit, such as a widely perceived desire to protect certain kinds of institutions and certain forms of ownership.
- Regulated entities sense pervasive risk aversion on the part of the regulators, reflected in 'zero tolerance by the regulator for deviation from letter of law', and potential regulatory prohibition even if the activity is currently permitted by the letter

of the law. This could be partly due to the limited capacity, experience, and skills of regulatory staff. But it is also partly due to the atmosphere of distrust associated with vigilance processes in the government, and the open ended nature of parliamentary investigation into alleged or real regulatory lapses.

- Regulators confront immense heterogeneity in the entities they regulate, as well as in the investors and customers whom they protect. This heterogeneity is in terms of experience, capital, capabilities, as well as honesty. Regulators respond to this heterogeneity by targeting their regulations at the lowest common denominator.
- Frank communication between the regulator and the regulated could improve the regulatory environment, but all too frequently it is inadequate. The regulated have little incentive to be frank for fear it might elicit more micromanagement.
- Given difficult objectives, regulatory risk aversion, heterogenous regulated entities, as well as a legacy of command and control and substantial discretionary powers, regulators appear to protect themselves through a resistance to innovation, aversion to risk, as well as through micromanagement, even if the costs are obvious.[1]

The combination is a recipe for sometimes excessive, and excessively conservative, regulation, inhibiting innovation and growth. In some cases, the regulated have recourse to an appellate body (like the Securities Appellate Tribunal in the case of SEBI) and therefore regulatory excess can be publicly corrected. In other cases, regulatory overreach is neither identified nor corrected. With no mechanism for attenuating overreach, the constant fear of regulatory interventions distorts activity in the financial sector.

Regulatory gaps and overlaps

As may be seen from Figure 1 in a report by the World Bank, the current system involves half a dozen apex regulatory agencies, apart from several ministries in the government that retain direct regulatory powers. This structure leads to major regulatory overlaps and regulatory gaps.

Some examples of regulatory overlap include:

- Overlap between SEBI and MCA in the regulation of issuer companies.
- Overlap between SEBI and RBI in the regulation of foreign institutional investors as well as in exchange traded currency and interest rate products.
- Overlap between RBI and state governments in the regulation of cooperative banks.

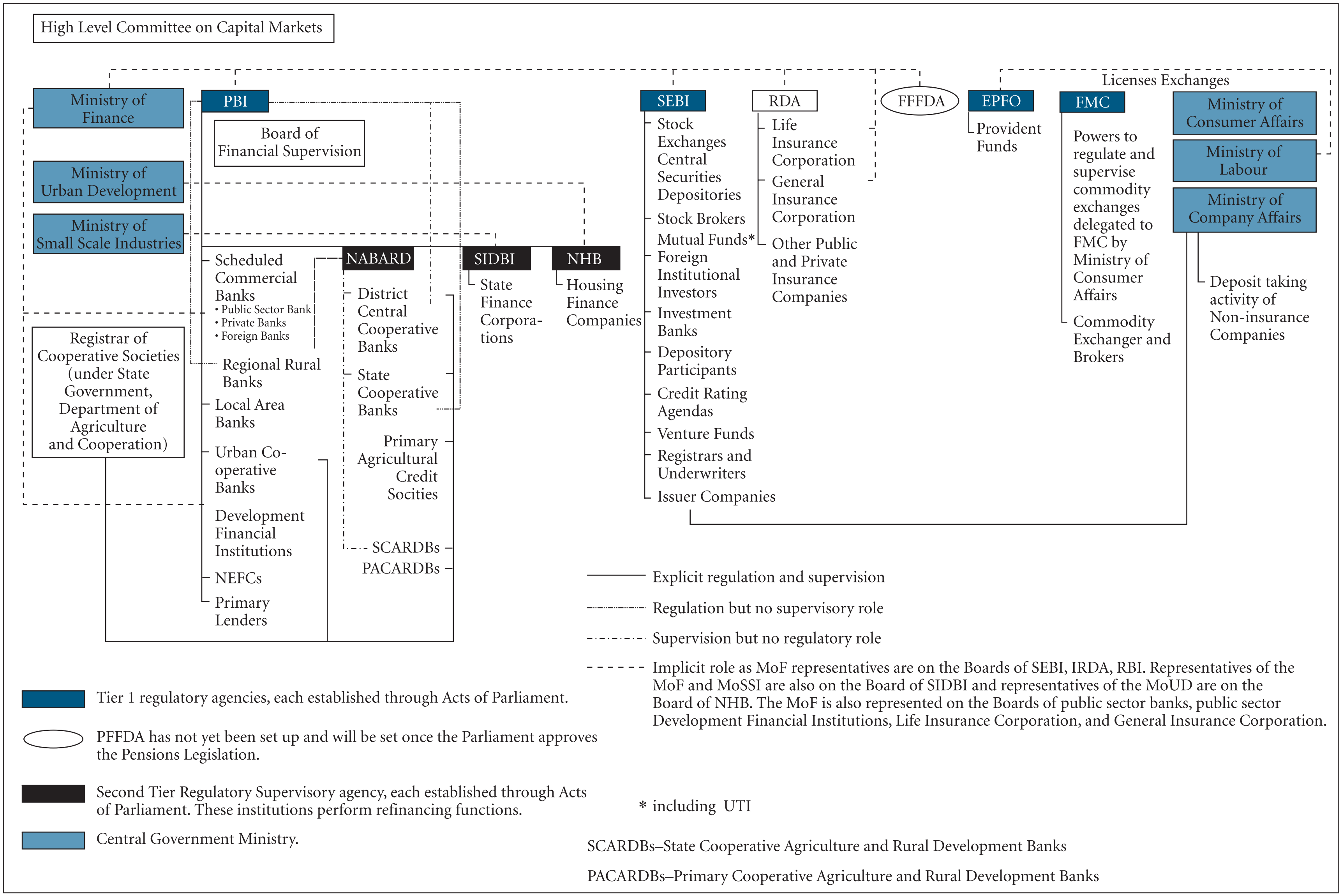
Some examples of regulatory gaps include:

- Absence of any mechanism for regulatory review of corporate accounting statements for compliance with disclosure requirements.
- The growing number of credit cooperative societies and MFIs involved in deposit taking or gathering, with little oversight.
- Absence of supervision of cross-market activities.
- Inadequate regulation of financial planners and advisors.

Sometimes the structure can also lead to regulatory arbitrage as similar financial services may be offered by institutions that come under different regulators and are therefore subject to different regulatory requirements. For example, investment linked insurance products include fund management services similar to that offered by mutual funds, but under completely different regulatory requirements regarding capital, expenses and disclosure. Competition is not bad if it eventually results in the right institution undertaking the activity. It becomes a problem when one institution has an advantage only because the other is excessively constrained by its regulator. With excess regulation in India, this is a real danger.

The overlapping regulatory structure also becomes a barrier to innovation as any new product might need approval from more than one regulator. In some cases, it is not even clear which regulator has primary jurisdiction over the product. While competition between regulators creates

Figure 1: Current Regulatory Architecture



space for innovation, as discussed above, competition with uncertain jurisdiction does not.

Balkanization and capture

Where jurisdiction is clear, regulators require activity to be carried out in separate subsidiaries of a financial conglomerate, each of which is separately regulated. This increases costs, reduces scope economies and makes it difficult to offer customers a one stop solution to their financial needs.

Another problem with the current regulatory structure is that it is much more vulnerable to regulatory capture because each regulator regulates only a narrow set of intermediaries. A narrow regulator is more easily persuaded to adopt regulations that shield its regulated entities from competition. A unified regulator is less vulnerable to this kind of capture because it faces countervailing pressure from different segments of the regulated.

Multiplicity of regulators creates severe problems in inter-agency coordination. Experience around the world suggests that this problem is very difficult to solve even with strong structural mechanisms for coordination. In India, these coordination mechanisms are also quite weak. Coordination problems are aggravated by the variation in skills and experience across regulators (sometimes related to novelty of area being regulated).

While the Committee will not propose India moves towards an integrated regulator and supervisor, it will suggest some new structures than can help improve coordination as well as eliminate regulatory gaps.

Lessons from the ongoing financial market turmoil

Any discussion of regulation has to take cognizance of the recent turmoil in financial markets in industrial countries. While it is too early to draw strong lessons, a number of issues seem apparent:

1. It is not sufficient for regulators to only look at the part of the system under their immediate purview. Because markets are integrated, any unregulated participant can infect markets and thus contaminate regulated sectors also. For instance, there is some evidence that unregulated mortgage brokers originated worse loans than regulated ones, contaminating the securitization process. While the immediate conclusion is not to regulate everyone to the same degree, it does suggest regulators have to be alert to entities that could have systemic consequences, including on markets.
2. Capital regulation is no substitute for ensuring the incentives of financial institution management are adequate—that the spirit of the regulation is being obeyed rather than just the rule. For example, the off-balance sheet entities of the major banks, including the structured investment vehicles (SIVs), met the rules of being off-balance sheet (and hence did not require a charge on capital), but in practice turned out to be effectively on-balance sheet. Indeed, there is increasing debate about whether the Basel II capital norms are adequate, both in good times in preventing excessive risk taking, and in bad times when strict capital norms can hold back bank lending and result in a downward spiral.
3. In a market-based system, banks are not the only source of illiquidity risk. Any entity that has mismatched assets and liabilities (mismatched in terms of duration or liquidity) is subject to the risk of becoming illiquid. To the extent that that entity is of systemic importance—either too big, too interlinked, or too many investors to fail—it will have a call on public funds. To the extent that regulators are likely to provide either liquidity or solvency support (and the line between these is very thin), they owe it to the public to monitor these entities and ensure the charge on the taxpayer is limited. Moreover, systems will have to be evolved to assess and maintain the overall liquidity position of the financial system, over and above its capital adequacy.
4. Deep markets with varied participants can absorb overall risk better. While indeed the risk that has infected world

markets started in the US sub-prime sector, in part because of excessive financial exuberance, despite its proximity and exposure the United States financial system has weathered the losses thus far surprisingly well. Indeed, US equity markets have held up better than the Indian stock markets! Part of the reason has to be its openness and variety. US banks could raise capital quickly by tapping into sovereign wealth funds elsewhere. Even while banks are hamstrung by overloaded balance sheets, hedge funds and private equity players are entering the markets for illiquid assets and establishing a bottom.

5. Consumer protection is important. Not every household is fully cognizant of the transactions they enter into. While the line between excessive paternalism and appropriate individual responsibility is always hard to draw, in a developing country like ours, it may well veer to a little more paternalism in interactions between financial firms and less-sophisticated households. It is important to improve consumer literacy, the transparency of products that are sold, and in some cases, limit sales of certain products in certain jurisdictions, especially if they have prudential consequences.
6. There is no perfect regulatory system. The problems with Northern Rock in the United Kingdom are being attributed to the fact that the United Kingdom had moved to a single supervisor, the Financial Services Authority (FSA), with the monetary authority having no supervisory powers. At the same time, the Bear Stearns debacle in the United States is being attributed to the absence of a single supervisor. What is essential is effective cooperation between all the concerned authorities, which transcends the specifics of organizational architecture.

In summary

In sum then, the Committee believes that there is no room for complacency. The imperatives of the need to grow the economy and improve inclusion will necessarily create more risk. The regulators cannot stand in the way, they have to monitor and manage the greater risk, and the public has to be more tolerant of regulators in that more losses are part and parcel of the greater risk. At the same time, we have to become more clever about managing the risks, focusing efforts better at warding off the really big ones, and making participants cooperate more in the process rather than making them adversaries. Furthermore, financial sector development can help the risk management process, both by reducing risks, and by shifting them to where they can be borne better, a theme through much of this report. This chapter therefore focuses on:

1. A better risk management process for regulators and the regulated, addressing both the environment in which they operate, as well as the way they tackle risks, while allowing the innovation needed to spur growth.
2. A more streamlined regulatory architecture that reduces regulatory costs, overlaps, silos, and gaps.
3. Better coordination between regulators so that systemic risks are recognized early and tackled in a coordinated way.
4. A coordinated process to protect consumer interests as well as raise literacy levels.
5. Strengthening procedures that reduce the level of financial risk—for example, through prompt corrective action.

TOWARDS THE SPIRIT RATHER THAN THE LETTER

A strength of the vibrant Indian financial market and its institutions is their ability to develop decentralized innovative solutions to India's vast problems. One-size-fits-all risk-averse micro-management by a regulator will deny the financial sector these very strengths. An analogy may be useful here. Think of the financial sector as water flowing downhill, that has to be channelled to irrigate the economy. It is best to allow water to find its natural course, rather than impose a centralized solution that fails to make best use of the topology. And when the regulator believes there is a better path, it is best for him to nudge the water slightly with gentle banks, using the water's natural propensities. Setting up roadblocks or dams will only ensure flooding and destruction, as the water finds disruptive ways around the block.

Principles vs. rules

These concerns would suggest a move from an exclusively 'rule-based' regulatory system to one with a greater share of 'principles-based' regulation. In the 'principles-based' system, entities would not be evaluated on their adherence to the letter of regulation. Instead, they would have far more latitude in making their business decisions, but would be held responsible by the regulator for the quality of their 'output', i.e. their fulfilment of certain pre-specified principles of sound and ethical business.

A regulatory system with greater emphasis on principles would avoid the centralized micro-management of the day-to-day operations of enterprises, increasing their efficiency and endowing them with greater nimbleness and agility to deal with a dynamic business landscape. It would help promote greater innovation in financial firms operating in India, an increasingly necessary feature for survival and success in the new world economy.

More focus on principles would also make better use of regulatory capacity. By shifting the onus of providing positive outcomes to the regulated, an emphasis on principles can generate a range of best practices from the regulated that would far outweigh the innovative capacity of the regulator. Indeed, its greatest benefits will come when the regulator learns from the regulated instead of imposing its own, more limited, views. Moreover, the time spent in 'box-checking' supervision and compliance, which eats up substantial capacity, can be devoted instead to understanding deviations that truly matter. Self regulation and confession by the regulated, a natural consequence of the shift in responsibility for regulatory outcomes to the regulated, would reduce the strains on regulatory capacity, and allow regulators to permit far more entry and growth in the system. As the relationship between the regulator and the regulated becomes more cooperative, efficiency and stability in the system will improve.

Concerns with a principles-based system

Can a 'principles-based' system work in India? Does it assume more capacity, trust, and probity among regulators and regulated than available in India? Is it a pipe-dream?

It should be understood that a 'principles-based' system is no magic solution. Indeed, it can have more rules written in than a rules-based system (see Box 1 on FSA). What is important is a change in mindset on the part of the regulator and the regulated. The principles based system offers a framework under which that change in mindset can take place, but it is no substitute.

It should also be recognized that 'rule-based' regulation is not merely reflective of the statute books of the nation, but is also reflective of the approach adopted by the regulator. A regulator that adopts a 'rule-based' approach pursues every minor breach of a rule, irrespective of its import in the larger scheme of things. This 'rule-based' mindset is further fuelled by the disinclination of the Indian regulator to admit that the accused may sometimes actually be innocent in principle. For example, SEBI very rarely, if at all, acquits a concern which has been issued a show cause notice, regardless of the severity of the violation. It may well be that the regulator's fear that an acquittal may result in a possible vigilance commission inquiry leads to this emphasis on the 'rule-based' approach.

By contrast, when adopting a 'principle-based' approach, a regulator may ignore a minor violation of positive law, so long as the spirit of the laws is retained.[2] It may therefore be better to term the 'principles-based' approach as an approach based on getting the regulated to adhere to the spirit of the regulation while a 'rules-based' approach is intent on the regulated obeying the letter of the regulation. Given the extensive outside use of the terms 'principles' and 'rules', we will however continue to use them.

'Principles-based' regulation is thus more than changing the statutes, the details of implementation matter. And there are indeed concerns with any implementation. Overly broad principles may not provide enough guidance to either the regulator or the regulated in terms of acceptable behaviour. The regulators' freedom to interpret broad rules may endow them with excessive powers and may lead to a fear psychosis among market participants. Ad-hoc application or disputed interpretation of principles may also lead to litigation, which, particularly given India's slow judicial process, may prove to be a major hindrance to efficiency. A more 'principles-based' system necessitates a certain level of trust between the regulators and the players and this can probably develop only with time as the regulated entities' perception of the regulators' fairness and even-handedness emerges, and as regulators develop a comfort level with the capabilities and probity of the regulated. Till such time, rules, or at least indicative quantitative norms, may provide safe harbours to which either party can resort to when in need.

Principles will also require adequate capacity on both sides. A low-level supervisor, accustomed to ticking boxes, is unlikely to suddenly have the ability to comprehend the overall risk management strategy of the regulated firm, or the confidence to sign off on it. Similar issues will apply to the regulated. Skills and capacity have to be built on both sides, and when coupled with experience and precedents, will result in the emergence of confidence.

This discussion suggests it would not be sensible to roll out such a system across the board. Indeed the entities that would most benefit from, and have the skills to manage, a principles based system, are large complex financial firms. And senior regulators who would deal with these firms have the authority to set precedents, have the experience to see the bigger picture, and can draw on the necessary skills to have a fruitful dialogue. We would thus advocate institutional change from the top, moving steadily down over time.

More generally, while a long-run switch to a more 'principles-based' regulatory approach is certainly the right prescription for a dynamic and increasingly market oriented economy like India, in view of these concerns, the transition must happen in a gradual and well-planned manner. Even as an end-objective, a more 'principles-based' regulatory regime does not mean the complete absence of rules. No system in the world is exclusively 'principles-based.'

The transition

Rule-based regulation starts from the statutes governing regulators and the financial sector (such as the Reserve Bank of India Act and the Banking Regulation Act) and the regulations specifying the regulator's powers and obligations under these statutes. For instance, the requirement that banks obtain regulatory approval for a range of routine business matters, including opening branches, remuneration to board members and even payment of fees to investment bankers managing equity capital offerings, is enshrined in the Banking Regulation Act. The obligations imposed on regulators under statute further leads them to frame regulations that are formulaic and result in micro-management of regulated entities.

The starting point for any transition therefore has to be with the legislation governing the regulators. This has to be re-written with clear objectives and regulatory principles outlined. However, this would have to be drafted carefully, as Indian courts are not likely to look upon excessive delegation favourably. The Supreme Court of India has held that the 'essential legislative function' cannot be delegated and a statutory delegate cannot be given an unguided or uncanalized power. It would be necessary for the draftsman to therefore formulate the

Box 1: The Financial Services Authority in the United Kingdom

The Financial Services Authority ('FSA'), the main statutory regulator for the UK, was set up on 20 May 1997. The Securities and Investment Board ('SIB') formally changed its name to the 'Financial Services Authority' in October 1997. By virtue of the Bank of England Act, 1998, the responsibility of banking supervision was transferred to the FSA, and through the Financial Services and Markets Act, 2000 ('FSM Act') the FSA took over the responsibilities of several other regulatory and self-regulating organizations. The FSA is financed by the financial services industry and regulates 29,000 firms ranging from global investment banks to very small businesses, and around 165,000 individuals.

The FSA formally gained its powers under the FSM Act on 1 December 2001. Additionally, the FSM Act also gave the FSA new responsibilities, e.g. taking action to prevent 'market abuse'. Since the FSM Act, Parliament has extended the responsibilities of the FSA to include mortgage lending and insurance broking. The members of the FSA board are appointed by the Treasury. The Board sets the overall policy of the FSA, but day-to-day decisions and management of the staff are the responsibility of the executive.

The regulatory objectives of the FSA are described as follows by the FSM Act: (*a*) market confidence; (*b*) public awareness; (*c*) the protection of consumers; and (*d*) the reduction of financial crime.

In discharging these functions, the FSA must have regard to certain principles, e.g. the principle that a burden or restriction which is imposed on a person, or on the carrying on of any activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

The FSA's general functions are: (*a*) making rules, (*b*) preparing and issuing codes, (*c*) giving general guidance, (*d*) determining the general policy and principles by reference to which it performs particular functions, (*e*) issuing statements/giving directions.

There are provisions in the FSM Act which regulate insurance, business transfer schemes, banking, the listing of securities, and 'market abuse'. The FSA may take disciplinary action against errant entities either by publishing a statement against the entity, or by imposing a penalty against the entity, or both.

'Principle-based regulation' means placing greater reliance on principles and outcome focused, high-level rules as a means to drive the regulatory aims that the FSA wants to achieve, as opposed to prescriptive rules. Under the risk-based approach adopted by the FSA, the FSA does not pursue every rule breach. Minor problems are usually resolved through the day-to-day relationships that the FSA has with regulated firms, without the need for any formal regulatory action to be taken. The FSA accordingly selects cases to investigate according to their seriousness and how they fit in with the FSA's priorities. This approach is underpinned by the principle that it is neither possible nor desirable to write a rule to cover every specific situation or need for decision that a regulated firm might encounter.

Over the last few years, the FSA has increasingly taken a principle-based approach. The FSA still relies heavily on a large number of detailed rules, and often specific process requirements. The FSA accepts that as an inevitable result of amalgamating the rulebooks of all its predecessor regulators, the FSA rulebook is a large document (which is popularly said to cover several bookshelves!).

'Principle-Based Regulation': The FSA Handbook lists the following as Principles For Businesses:

1. Integrity: A firm must conduct its business with integrity.
2. Skill, care and diligence: A firm must conduct its business with skill, care and diligence.
3. Management and control: A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial prudence: A firm must maintain adequate financial resources.
5. Market conduct: A firm must observe proper standards of market conduct.
6. Customers' interests: A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of interest: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers relationships of trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. Clients' assets: A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with regulators: A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

legislation as a binding rule of conduct. What should be left to the regulator is the ancillary function of providing the details. At the same time, it would have to be borne in mind that regulatory law is penal in nature, and vague penal law has been found by Indian courts to be void. Keeping this in mind, a 'principle-based' approach could be achieved by outlining principles which the regulator is to be governed by, in the statute itself. In the Indian context, these cannot be as broad as those of the FSA (see Box 1) but would probably have to contain further specificity.

In what follows, we attempt to sketch what 'principles-based' securities legislation might look like for a specific regulator, SEBI. It is important to note that 'principle-based' regulation even in India would not be an entirely new phenomenon. SEBI, for example, has devised several codes of conduct (for instance, in insider trading law) which operate on principles rather than in an excessively rule-based manner.

We take as given our recommendation (see section 'Consolidation of all market regulation and supervision under SEBI') that all organized financial trading, spanning currencies, fixed income, equities, commodity futures, exotics (such as weather and decision markets), and spanning all trading venues and forms of trading should come under a single regulator, the SEBI.

In order to widen the ambit and functions of SEBI, the SEBI Act should be amended by the insertion of chapters which confer upon it the powers of other regulators to the extent that such other regulators regulate trading. Each of the amendment acts would concurrently repeal the statute governing the regulator sought to be integrated, or divest the regulator of some of these powers, and would either itself contain provisions for integration of personnel etc., of such other regulators or leave such matters to a statutory delegate.

SEBI's mandate should be devised at the level of principles, starting at the broadest level with overall objectives such as stability. At one level, this means that in devising the statutes, to the extent possible details about products/securities, players, institutions, market platforms and market mechanisms must be left out of the legislation, to be filled in dynamically by the regulator.

More specifically:

- Repeal the Securities Contracts (Regulation) Act, 1956; the RBI (Amendment) Act, 2006; and the Forward Contracts (Regulation) Act, 1952;
- Through a permissive, enabling framework, all organized financial trading must be brought within the ambit of SEBI. For this purpose, Section 412 of the United Kingdom's Financial Services Modernization Act is instructive, as it permits a statutory delegate to specify contracts that are exempt from wagering restrictions (and thus come under the ambit of securities trading and regulation). For our purposes, this may be better achieved through a negative, rather than a positive, list;
- The regulator must recognize that traditional trading venues can be transformed, with trading taking place in venues ranging from existing public exchanges such as the NSE and BSE (requiring full investor protection norms) to innovative Internet-based trading platforms for Qualified Institutional Buyers (the professional exchanges discussed in Chapter 5) and the Over The Counter markets, where required investor protection may be different. In order to facilitate innovation in trading platforms in the future, details about trading mechanisms should not be written into the legislation.

The transition to a more 'principles-based' regulatory system is a multi-dimensional and complex process. It is possible to be so overwhelmed by the task that one never starts. The status quo should be seen as an unacceptable drag on India's growth, which is why we must not delay. The next few sections will outline a number of other changes, which undertaken carefully, will take us to our goal. These include changing the incentive structure and talent pool in the regulator so that the regulatory mindset can change, as well as changes in the oversight process over the regulator so that regulatory powers do not go unchecked. It also includes changes in the structure of the regulatory architecture so that silos are broken down and gaps are reduced.

IMPROVING THE QUALITY OF THE REGULATOR

A move towards principles will require capable, motivated, regulators, who have the vision to focus on important essentials rather than on bureaucratic box-checking. Clearly, there are such regulators to be found in our system, but how do we ensure they are the norm?

Incentives

The quality of regulatory output is influenced by the overall environment in which the regulator operates, the consequent incentives they face, and the performance standards they are held to. In fact, the perceived inadequacies in the quality of regulatory output may have more to do with incentives and environment than with fundamental deficiencies in the quality of talent that regulators attract (though this is not always inconsequential).

Regulators at the highest level constantly run the risk of having to face roving enquiries that second guess specific decisions with the benefit of hindsight. As long as this risk is not eliminated, the response of regulators to the need for innovation and proactive behaviour will not change. The starting point for protecting regulators from open ended demands is a clear written directive from the government, acting in pursuance of the legislative mandate, specifying with the maximum possible clarity the principles the regulator will be held accountable for. Existing law has provisions that enable government authorities to do so. The fact that these provisions have not been used so far is sometimes held out as an example of the maturity of the actors involved. More likely, this is probably a reflection of inadequacy. We now specify how such a directive could be developed.

Accountability

An independent regulator can be held accountable only through a process of independent evaluation, given pre-specified objectives or principles. This Committee recommends that all financial regulators should be subject to a periodic external evaluation. In a parliamentary system of government, the ultimate locus of accountability is the parliament. Therefore, all financial regulators should be accountable to a standing Committee of parliament (possibly, the Standing Committee on Finance).

- Once in five years, a body of reputed outside experts (including possibly regulators elsewhere) would be constituted to propose guidelines for the evaluation of the regulator for the next five years, given the legislative mandate.
- Based on the report of experts, the government, in consultation with the Parliamentary Committee and the regulator, would finalize the specific principles (the 'remit') the regulator would be held accountable for, including any parameters for annual evaluation.
- The regulator would submit an annual report to parliament (this does happen currently for many regulators). This report would include the progress on pre-agreed evaluation parameters and would be discussed in the parliamentary Committee.
- The parliamentary Committee would be guided by the remit in its discussions with the regulator.
- The annual report, the statement of the regulator to the Committee, and a transcript of the Committee discussions with the regulator should be made widely accessible to the public.

Appellate tribunal

Checks on regulatory excess are necessary for any regulator but they are even more important for 'principles-based' regulators because of the greater discretionary powers that they enjoy.

This Committee recommends that there should be an appellate tribunal for all major regulators including the RBI. This should be a single tribunal which might through its own rules and processes create benches specializing in different aspects of financial regulation. The Securities Appellate Tribunal (SAT) that hears appeals from SEBI has served a very useful purpose and the proposed Financial Sector Appellate Tribunal should have similar scope, powers and processes and should subsume SAT.

Staffing

Of all the staffing decisions relating to the regulators, the most important is the choice of the head of the body. As at present, the respective statutes provide that the heads of these bodies are to be appointed by the government. The credibility of the selection process could be greatly enhanced by stipulating that selection Committees, with credible expert participation (including from the private sector), should prepare a short list from which the final selection can be made by the government.

The selection Committee should also recommend the remuneration package that should be provided; the statutory protection against variation of the conditions during the term of office should continue. Government should offer this recommended package as a matter of course.

With a competent and respected individual of proven integrity at the head of a regulator, substantial freedom would have to be provided to this person to choose the best possible individuals for key positions, offering them terms that are in line with the market. The recent proposals by the 6th Pay Commission for hiking compensation for top regulators are a step in the right direction. The pay of the head regulator, while substantial, should not, however, become a ceiling for pay among regulators. It should be possible to carve out key positions in respect of which the terms and conditions of employment are left to be decided by the head of the organization, or a Committee of senior officials. A staffing and remuneration sub-Committee of the regulator's board should provide the necessary guidance in this regard. This would enable the induction of talented young employees, and also provide for lateral entry at all levels. Every effort should be made to allow mobility to and from the private sector, though each individual organization would have to take reasonable precautions against conflicts of interest arising out of prior or subsequent employment.

With a restructuring of the staffing process in the manner described above, processes relating to performance measurement, accountability, training, and human capital enhancement can be redesigned.

To summarize, low compensation is often seen as the main impediment in improving the quality of regulators. While compensation is an important factor in attracting the right talent, it is not the only, or even critical, factor. Key positions in the regulators would be attractive for very talented individuals, given the great satisfaction that would undoubtedly accrue from shaping public policy and taking decisions of tremendous import, as also the value placed by the market on such experience. It is thus important to structure responsibility and mobility appropriately. Experience also indicates that, to the limited extent to which regulators have been able to break out of rigid staff and pay structures, there has been no real difficulty in attracting the talent required, at least no more than in other professions in India.

STREAMLINING THE REGULATORY ARCHITECTURE

Should India move towards a single regulator and prudential supervisor?

As the boundaries between financial activities blur, it makes sense for the boundaries between regulators to blur, and eventually, for supervision of financial services to be consolidated. Eventual consolidation will reduce overlaps, costs, eliminate gaps in supervision, and improve regulatory and supervisory coordination. It will allow the unified supervisor to take an overall view of risks, including risk concentration and risk transfer, across different kinds of institutions. The unified supervisor will be better able to handle large complex financial institutions. And an integrated regulator will probably offer 'one-stop-shopping', which will speed up innovation, as well as ensure consistency in regulation and supervision across institutions.

An integrated regulator is not an unmitigated blessing. An integrated regulator may have conflicts between objectives. Moreover, there may be a need for a difference in emphasis in different situations—in the case of insurance and banking on prudential supervision, while in the case of markets on business conduct and integrity. Such differences may not sit well within an integrated regulator. Furthermore, since a unified regulator is likely to be formed by the merging of existing agencies, it may result in a mammoth bureaucracy that, while on paper a single entity, is likely to experience the same divisions that characterize the existing set of regulators. The older and more established regulators may dominate and overrule fledgling ones within the integrated whole, to the detriment of the overall system. This, coupled with regulatory monopoly, could potentially negate the possible sensitivity of a unified regulator to the needs and changing realities of the market and its participants. Finally, there may be a public perception that the integrated regulator will bear equal responsibility for all supervised institutions, extending the safety net enjoyed by depository institutions more widely, with ensuing moral hazard.

As the chart below shows, countries are fairly evenly distributed across regulatory architectures. On balance, the Committee feels it is premature to move fully towards a *single* regulator at the moment, given other pressing regulatory changes are needed. However, regulatory structures can be streamlined to avoid regulatory inconsistencies, gaps, overlap, and arbitrage. Steps in this direction should include a reduction in the number of regulators, defining their jurisdiction in terms of functions rather than the forms of the players, and ensuring a level playing field by making all players performing a function report to the same regulator regardless of their size or ownership. In addition, the Committee feels it is prudent to start the process of unifying regulation and supervision at certain levels, and will recommend a strengthening and consolidation of regulatory structures to deal with large complex, systemically important, financial conglomerates on the one hand, and with the consumer on the other.

Consolidation of all market regulation and supervision under SEBI

At present, in India, the regulation of organized financial trading is spread between three agencies: RBI (government bonds and

A Snapshot of International Regulatory Architectures

Unified regulators		*Partly-unified regulators*		*Institutional regulators*		
Unified model (separate from central bank)	*Unified model (within central bank)*	*Banking and securities*	*Banking and insurance*	*All non-banks*	*At least one for banks, securities firms and insurers*	
1. Austria	15. Bahrain*	26. Finland	30. Australia	42. Bolivia	51. Albania*	64. Hong Kong*
2. Denmark	16. Bermuda*	27. Luxembourg	31. Belgium	43. Bulgaria*	52. Argentina*	65. India*
3. Estonia	17. Cayman Islands*	28. Mexico	32. Canada	44. Chile	53. Bahamas*	66. Indonesia*
4. Germany	18. Ireland*	29. Switzerland	33. Colombia	45. Jamaica*	54. Barbados*	67. Israel*
5. Gibraltar	19. Kazakhstan*		34. Ecuador	46. Mauritius*	55. Botswana*	68. Italy*
6. Hungary	20. Malawi*		35. El Salvador	47. Slovakia*	56. Brazil*	69. Jordan*
7. Iceland	21. Maldives*		36. Guatemala	48. South Africa*	57. China	70. Lithuania*
8. Japan	22. Malta*		37. Malaysia*	49. Ukraine*	58. Croatia*	71. New Zealand*
9. Latvia	23. Singapore*		38. Peru	50. Namibia	59. Cyprus*	72. Panama
10. Nicaragua	24. UAE*		39. Venezuela		60. Dominican Republic*	73. Philippines*
11. Norway	25. Uruguay*		40. Netherlands		61. Egypt*	74. Poland*
12. S. Korea			41. Trinidad & Tobago		62. France	75. Portugal*
13. Sweden					63. Greece*	76. Russia*
14. UK						77. Slovenia*
						78. Sri Lanka*
						79. Spain*
						80. Thailand*
						81. Tunisia*
						82. Turkey
						83. Uganda*
						84. USA*

As per cent of all countries in sample

30%	5%	12%	10%	43%

Source: How Countries Supervise their Banks, Insurers, and Securities Markets, 2004, London, Freshfields.

Note: * Indicates that banking supervision is conducted by the central bank.

currencies), SEBI (equities and corporate bonds) and FMC (commodities, futures). This unusual framework is the product of historical legacy and is suboptimal. It induces three kinds of problems:

1. It induces a loss of economies of scope and economies of scale for the government, exchanges, financial firms, and customers. There are strong commonalities between all kinds of trading—an electronic order-matching system for currencies or index futures or gold futures or interest rate swaps is largely the same. Government, exchanges and financial firms would be able to harness economies of scale and economies of scope by undertaking, or dealing, with all organized financial trading under a single roof.
2. It fragments liquidity, and encourages regulatory gaming. Arbitrage tightly binds all financial securities related to a given underlying asset. For example, exchange-traded Nifty futures are strongly linked to OTC derivatives based on Nifty. It is best that all channels for trade be open, so that traders seek the best one, and that the regulatory regime not impose differential costs. However, at present, OTC trading is either banned (e.g., equity) or dealt within a fragmented way (OTC trading on interest rate derivatives is supervised by RBI while exchange-traded interest rate derivatives are supervised by SEBI). Fragmentation creates all sorts of gaming opportunities for participants, as well as turf issues among regulators in favouring one or other venue for the firms they regulate, that leads to a loss of liquidity, price efficiency, and even stability.
3. Loss of competitive pressure. At present, Indian markets are carved into three silos, each regulated (and protected) by a separate regulator. An exchange or a clearing corporation or a depository working in one silo is prohibited from competing with entities in other silos. India's interests would be served far better if all these entities were in a unified industry with vigorous competition and innovation.

The Committee was persuaded by the importance of these three considerations to recommend unification of all regulatory and supervisory functions connected with organized financial trading into a single agency. This would include equities, corporate debt, government bonds, currencies, commodities, and other kinds of products. This would include both spot contracts and derivatives, exchange-traded and OTC products.

SEBI is ideally suited for filling these roles for several reasons. First, the equity market (both spot and derivatives) is India's most sophisticated and most liquid market; hence, SEBI's knowledge is rooted in the strongest market. Second, the legal foundations of SEBI are relatively recent, and it is less subject to legacy issues. Finally, the vigorous pace at which the SEBI Act and SC(R)A have been amended in the last decade—in response to the requirements of the equity market—have helped position SEBI to take on new challenges.

Note that in some markets, such as the government debt market or the currency futures market, some coordination will be required between SEBI and other regulators that have an interest in the market. For example, the RBI may have an ongoing legitimate interest in determining who participates in these markets—it might continue to determine who the Primary Dealers would be in the government securities market. Similarly, it may have an ability to influence participation (by altering bank SLR requirements for example). While the logic of SEBI regulation of trading is clear (and this will help the RBI by reducing the conflicts of interest created when it both trades in, as well as regulates trading in, markets), it is imperative that the regulators work out respective responsibilities so that the functioning of the markets is not impeded.[3]

Simultaneously with the merger of regulation and supervision of organized financial trading at SEBI, a clear effort needs to be undertaken to limit the role to regulation and supervision, while distancing other services from the regulator. This is similar to the clarification of the role of the regulator in (say) telecom, where TRAI is the regulator, and erstwhile government service functions have been corporatized in MTNL, VSNL and BSNL. Applying this principle, the bond market depository within RBI (SGL) will need to be corporatized. It would then compete with NSDL and CDSL as a third depository. Similarly, the bond exchange (NDS) will need to be corporatized. It would then compete with other exchanges in the country. The CCIL and its exchange subsidiary would be brought under SEBI regulation as an exchange.

Once unification is achieved; full competition should prevail between the pool of exchanges, clearing corporations and depositories. Low entry barriers should ensure that new players can enter in each of these areas, including innovative professional exchanges which target sophisticated or institutional customers, and foreign exchanges. The goal should be to achieve securities infrastructure which has world class economies of scale, world class efficiency and low prices, and a world class pace of innovation.

The Committee further recommends that the unification of trading under one regulator be further accompanied by steps to break down unnecessary barriers that prevent trading across exchanges or products. All kinds of financial products should be represented in unified exchange screens, and a firm with multiple exchange memberships should be able to trade them seamlessly. Finally, the SEBI has been dealing with exchanges as self regulatory organizations (SROs). The exchanges therefore assist SEBI in regulatory matters that pertain to their activities. There is, however, a need for a regulatory structure to assist SEBI in supervising cross-exchange activity, which will increasingly become more important. Greater integration of market regulation under SEBI will create the conditions to set up such a structure.

Consolidation of all deposit-taking entities under one banking supervisor

All banks and any other deposit taking entities should come under one supervisor as suggested by the Narasimham Committee Report on Banking Sector Reforms.

The RBI has historically been reluctant to take on the full responsibility for supervising cooperative banks and state governments have also been reluctant to give responsibility up. This is a potentially dangerous situation where no one really bears full responsibility for problems that might emerge. The recent trend towards memoranda of understanding (MOU) between state governments and the RBI to revitalize urban cooperatives while strengthening the powers of the RBI, is welcome. But given increasing competition and the wider powers that are proposed for banks, cooperative banks, whose managerial/administrative matters are currently partly under the State Registrar of Cooperative Societies, should be treated like commercial banks and brought completely under the banking supervisor over time. This will simply be a logical extension of the path currently being travelled with the MOUs.

This would require a considerable increase in central regulatory capacity, as well as political enterprise, but the alternative is to allow dangerous regulatory gaps to build. As this Committee repeatedly stresses, inadequacy of regulatory capacity cannot be acceptable as a long-term constraint on the financial system.

There is no point having a consolidated supervisor if that supervisor is weak. In addition to consolidating supervision, the system of prompt corrective action and resolution of weak banks should be strengthened and made more explicit, possibly under a revamped consolidated deposit insurer. It should be recognized that the continued existence of weak banks without resolution spreads weakness to the rest of the system, is a potential source of instability, and increases the regulator's reluctance to permit new entry.

Consolidation of monetary policy and banking supervision

The Committee considered carefully the question of whether responsibility for monetary policy and banking regulation and supervision should be separated, or consolidated under one roof. The arguments in favour of separation are strong. Any regulator tends to have sympathies for the entity it regulates, and not just because it has responsibility for the well-being of those entities. Monetary policy could be conducted with the intent of restoring the health of banks (as was arguably the case with Bank of Japan and Federal Reserve policy in the 1990s) to the detriment of inflation and growth objectives for the larger economy (in which bank health is just one, albeit important, component). Similarly, in an economy with fledgling markets, the incentive for the monetary authorities to intervene in markets so as to preserve the value of securities bought by banks can retard the growth of those markets and impair fair and transparent pricing, as well as information discovery.

In a financial sector dominated by banks, conflicts of interest may also go in the other direction. In order to achieve its monetary policy objectives, the central bank may use tools other than the short term interest rate, such as the Cash Reserve Ratio. Regardless of the debatable efficacy of such tools in achieving monetary policy goals, the problem is they have an asymmetric effect on institutions, affecting banks while leaving others like finance companies untouched. This is to be avoided for it tilts the playing field, giving undue advantage to some, creating competitive uncertainty, and inefficient allocation of resources. The use of prudential and supervisory tools to meet monetary policy objectives also reduces their effectiveness in enhancing stability, and their signalling value.

These concerns have to be set against the benefits of consolidation. The ability of the monetary authority to have intimate knowledge of the condition of banks can help it conduct monetary policy better, especially in times of distress when banks may be less effective conduits for transmission. And there may be occasions when the larger interests of the economy are served by using liquidity infusion and interest policy to help the banking system. A monetary authority with deep knowledge of the banking system will be best placed to undertake such intervention. There are also significant scope economies in the information needed for the conduct of monetary policy and for assessing bank health.

The international experience offers little guidance as to what might be best. The Bank of England does not supervise domestic banks, and neither does the Bank of Japan, but the Federal Reserve does supervise large bank holding companies. The European Central Bank does not supervise banks directly, but the heads of member central banks, which have regulatory and supervisory functions, sit on its monetary policy committee.

As with any issues to do with organizational structure, outcomes depend heavily on practice. Separation of powers can work well if the monetary authority and the regulatory & supervisory authority have clear responsibilities and strong channels of communication. Consolidation can work well if the monetary authority is transparent about its objectives and is sparing in its use of instruments other than the interest rate to achieve them.

In the final analysis, the Committee believes the move towards separation may be premature today, especially keeping in mind there are strong arguments to be made on both sides of the debate, as listed above. The rationale is as follows. First, the record of cooperation between regulators is mixed at best. Before separating functions, it would be sensible to make sure that we have a better understanding of what it will take to ensure seamless cooperation—it would be a recipe for systemic catastrophe if the monetary authority does not communicate with the banking supervisor. Second, we believe that important changes are warranted both in the monetary policy setting function (as outlined in Chapter 2) and in banking regulation and supervision. These changes are more pressing. Of course, one could argue that it is best to make all changes at once. The majority of the Committee believes that the area of banking supervision is probably one where changes should be measured rather than revolutionary, for the downside risks of turmoil here could be extremely detrimental to the economy.

Ultimately, as barriers between financial activities fall, India should move towards one consolidated prudential regulator and supervisor. Given this entity will be concerned with more institutions than only banks, it should be distinct from the monetary authority, but should cooperate closely with it. Thus separation of monetary policy and supervisory authority should likely emerge in the medium term.

Bring all financial intermediaries governed by special statutes under general statutes

Several of the key financial services intermediaries including SBI and its Associate Banks, Public Sector Banks, LIC, GIC, etc., are governed by their own statutes such as the SBI Act, the SBI (Subsidiary Banks) Act, the two Bank Nationalization Acts, the LIC Act and the GIC Act. These special statutes should be repealed, and statutory corporations should be corporatized or formed under the general statutes governing form of business enterprise (such as the Companies Act, 1956 or the proposed LLP law under consideration) and placed on a level playing field with all other financial services intermediaries (that are formed or organized under such general statutes governing form of business enterprise). The precedent exists for IFCI, UTI and IDBI, which previously operated under special statutes.

Consolidate regulation of pensions

While pension regulation is still in its formative stages, the aim should be to have a consolidated regulator for the industry.

Streamline tier 2 regulators

India has a number of regulators who are at a second tier, such as NABARD, SIDBI, and NHB. For example NABARD supervises Regional Rural Banks, as well as the state cooperative bank network (a shared responsibility with the state Registrar of Cooperative Societies). In addition, though, it plays a role in refinancing some of these organizations. Dual roles of this kind typically create conflicts of interest that impair effective regulation. The Committee would advocate focusing these bodies over time on the purely regulatory function (and consolidating these regulatory activities where possible with the single regulator for the function), and separating the refinancing and other commercial functions into a different body. Over time, markets should take up the commercial functions.

An improved system of audit for listed and unlisted companies

In India, annual accounts filed with the Registrar of Companies under the Department of Company Affairs in the Government of India. However there is no system of reviewing accounting reports even on a selective or sample basis. By contrast, in the USA, the Securities and Exchange Commission (SEC) has a division comprising hundreds of lawyers and accountants to review such annual reports and if necessary, seek clarifications from the companies in question.

The Committee believes that such a process of review is absolutely essential. To ensure that this does not add to red-tape, such review should not lead to any certification or clearance for the companies concerned. The reviews may be selective to begin with (perhaps starting with large listed companies) and the companies should be allowed to clarify questions. However if and when evidence of financial fraud is revealed, it should lead to penal actions against the offending companies. Given the additional regulatory capacity and personnel necessary to implement this, it may be desirable initially to have the review partially or fully outsourced to accounting or legal firms.

The Committee believes the responsibility for this oversight for unlisted companies should be with the Ministry of Corporate Affairs (MCA) because the statutory powers in respect of accounting statements under the Companies Act vests with the MCA. For listed companies, the Committee recommends vesting the review with the SEBI, which in any case reviews disclosure by companies when they issue securities.

In line with the Committee's general view that information technology can and should be leveraged to solve several problems in the financial sector, the Committee also recommends consideration of adoption of a standards-based way of communicating business and financial information to facilitate the regulatory review process. XBRL (Extensible Business Reporting Language) that has been adopted in several countries is one such platform. Use of such a format in the annual online filings of companies to MCA is likely to facilitate the review process considerably.

Oversight of audit firms is another area that needs significant improvement in India. Currently the auditors are largely governed by the Institute for Chartered Accountant of India (ICAI). An independent and credible body to oversee the audit industry—like the non-profit Public Company Accounting Oversight Board (PCAOB) introduced in the United States by the Sarbanes Oxley Act—would go a long way in enforcing high auditing standards and creating credibility in the corporate financial reports. Such a body could be set up by the authority regulating the accuracy of company accounts, and its members appointed by the SEBI Board in consultation with MCA. The Accounting Oversight Board should have a variety of functions, including moving towards international audit standards, verifying standards of transparency and governance of audits at public firms, and sustaining the capabilities of auditors at high levels. Care should be taken that appropriate powers move from ICAI to PCAOB so that there is no overlap in functions.

CONSOLIDATING REGULATION

As financial conglomerates begin to dominate the system, a consolidated system of supervision becomes more important. Moreover, spillovers between various aspects of the financial system necessitate constant communication between regulators at the highest levels. Even though our Committee recommends separate prudential regulators, it strongly recommends strengthening the ties between them and improving coordination, especially given the potential systemic consequences of regulatory gaps and unregulated entities on the financial system.

The Committee also notes the consumer faces an integrated portfolio of services. It is increasingly important for the consumer to have a 'one stop' source of redress for complaints. An integrated ombudsman for consumer issues may also be important for dealing with aspects like financial literacy and financial counselling that span regulators.

Current situation

The High Level Coordination Committee on Capital Markets (HLCC) was constituted by the Ministry of Finance to resolve any important regulatory and policy issues requiring consideration at a high level. The remit of this Committee has changed over time. At present, the HLCC is expected to consider only divergence in policy issues among different regulatory authorities. It does not have statutory backing, nor does it have a dedicated secretariat. Separately, the Ministry of Finance has constituted three separate technical Committees. Each Committee is headed by a senior level functionary in RBI, SEBI and IRDA and has representatives from other regulators or agencies. These technical Committees monitor developments in the markets and suggest action on early warning signals.

The Reserve Bank of India has now set up a system for conglomerate supervision as part of the activities of the Board for Financial Supervision. Data and information are now being regularly collected from the designated entities for the 12 financial conglomerates under its purview. These data are analyzed and semi-annual discussions are held with the CEOs of the designated entities in association with other regulators.

There is also some operational coordination amongst different regulators. For instance, SEBI's guidelines relating to the government securities market have been issued after consultation with the RBI.

Despite these structures, the general feeling among regulators the Committee spoke with was that coordination and communication was not as effective as it could be. For instance, meetings of the HLCC were often thought to be formulaic, with little of substance really being discussed. We believe this to be a worrisome state of affairs, which needs to be remedied.

Improving coordination and supervising conglomerates

There are essentially three broad sets of activities that need to be carried out in an integrated manner:

1. Coordination amongst regulators so as to remove gaps and overlaps, and to remove inconsistencies in approach;
2. Integrated regulation and supervision of systemically important financial conglomerates and organizations;
3. Overall monitoring of the entire financial sector and initiation of prompt and coordinated corrective action.

The need to establish the coordination mechanism on a firmer footing has been felt even earlier. The Advisory Group on Securities Market Regulation, 2001 (Chairman Shri Deepak Parekh) felt that there would be merit in formalizing the HLCC by giving it a legal status. It also felt that the HLCC needs to meet more frequently and its functioning made more transparent. Another view is that an umbrella regulatory legislation creating an apex regulatory authority, without disturbing the existing jurisdiction, is necessary. In this view, the apex authority would have, by law, jurisdiction to assign regulatory gaps to one of the agencies, arbitrate on regulatory overlaps, and ensure regulatory coordination (what is known as the Reddy formula).

The consensus of our Committee is that there is a need for a Financial Sector Oversight Agency (FSOA) that is set up by statute. The FSOA's focus will be both macro-prudential as well as supervisory; the FSOA will develop periodic assessments of macroeconomic risks, risk concentrations, as well as risk exposures in the economy; it will monitor the functioning of large, systemically important, financial conglomerates as well as large systemically important financial institutions that would otherwise be unregulated;[4] anticipating potential risks, it will initiate balanced supervisory action to support the action by the concerned regulator to address those risks; it will address and defuse inter-regulatory conflicts. The FSOA will take over the work now done by the HLCC as well as the technical Committees.

The FSOA should be comprised of chiefs of the regulatory bodies (with a chair, typically the senior-most regulator, appointed from amongst them by the government), and should also include the Finance Secretary as a permanent invitee. The FSOA should have a permanent secretariat comprised of staff including those on deputation from the various regulators. There should be a prescribed minimum frequency of meetings of the FSOA. All issues of regulatory coordination, and supervision of systemically important financial conglomerates and organizations will be taken up by the FSOA.

The FSOA should not lead to fractured responsibility, nor should it add, as far as possible, an additional layer of regulation. The FSOA will have a periodic 'principles-based' discussion with the managements of these systemically important financial organizations on the basis of material put together by the lead regulator for that entity, together with staff from other regulators. This will be the primary high-level discussions between the management of the institutions and the regulators, and should be attended by all regulators at a high level. However, while attempting to avoid repetitive discussions that cover the same ground already covered by the FSOA, each regulator will continue to have full responsibility for the portion of the conglomerate that falls under their purview.

The FSOA will also undertake periodic system wide stress tests of the financial system to assess the levels of liquidity, capital, and the build-up of risk concentration.

Care must be taken to ensure that the FSOA does not impose undue additional regulatory burdens on financial conglomerates and does not put entities within such a conglomerate at an undue competitive disadvantage vis-à-vis standalone competitors. The identification of financial conglomerates must also be strengthened and clarified, and all significant groups, whether or not they include deposit-taking entities, must be considered for supervision by this mechanism.

In addition, there is merit in setting up a Working Group on Financial Sector Reforms with the Finance Minister as the Chairman. The main focus of this working group would be to monitor progress on financial sector reforms (such as the proposals of the Patil, Parekh, Mistry, and this committee), and to initiate needed action. The working group's membership would include the regulators, as well as ministries on as-needed basis. The working group would be supported by a secretariat inside the Finance Ministry.

Finally, steps could be taken to improve the channels of communication between regulators. Cross board membership would be an important step (and not just between SEBI and RBI). Moreover, the necessary laws should be amended so that information can be shared between all regulators without violating secrecy rules.

An integrated ombudsman

Consumers typically face a range of products, not a single product. They have to choose between equity linked insurance products and mutual funds, each regulated by a different entity. Regulatory differences may create different levels of product transparency to the detriment of the customer. Similarly, many products contribute to their overall debt level, some that might come from banks, others that might come from their broker. Whether it be in improving consumer awareness of over-indebtedness, taking up grievances about excessive zeal in debt-collection, or encouraging amicable negotiation between an over-indebted individual and his creditors, no single regulator has the overall picture. This Committee believes there is a need for an Office of the Financial Ombudsman (OFO) to take over the disparate efforts at consumer literacy, protection, counselling, and arbitration, by replacing existing such efforts at the regulators.

The Committee envisages a number of functions for this office:

1. Take responsibility for improving financial literacy in the country using funds that are accumulating unused at the various regulators for this purpose. The OFO can conduct integrated educational and advertising campaigns that no single regulator can.
2. Monitor selling of different products, the degree of transparency about their pricing, risks, and other attributes, and their suitability for targeted customers.
3. Serve as the primary 'catchment' for consumer grievances that are not addressed through communication between consumer and firm, and serve as liaison between consumers and firm, and between firm and regulator, on repeated grievances.
4. Arbitrate compromises between over-indebted borrowers and creditors, heading off more costly conflict.
5. License investment advisors and the variety of other financial service counsellors who interact with retail customers.

The OFO should take over all the activities by current regulators that overlap with 1–5. The Committee was mindful of the need to not create a costly new bureaucracy that would simply increase layers of regulation. At the same time, it recognized that without a reasonable and responsive structure to govern interactions between firms and customers, there was an increasing risk of outcomes that was in neither group's interest. It therefore suggests an organization that has much of the characteristics of a self-regulatory organization, with only a small permanent staff, and the rest on temporary deputation from existing regulators and industry. The OFO should establish strong links to NGOs and pillars of the community (for example, retired accountants, lawyers, judges, and bankers) for the broader educational, counselling, and arbitration activities it will need to undertake. It should work as a complement to consumer courts, resolving a number of situations directly and at low cost. And it should make maximum use of technology to expand its reach.

It is beyond the remit of this Committee to suggest the precise design of the OFO. That will depend on the ingenuity of the person(s) charged with setting it up. But it does emphasize the need for some such organization, especially as financial services expand their coverage and reach the weaker sections of the population.

PREVENTING CRISIS AND DEALING WITH FAILURE

One of the most important aspects of the stability of a financial system is the mechanism for preventing financial failure and the means through which the failure of financial firms is resolved. Clearly, both macroeconomic policy as well as prudential supervision will play a role, and we discuss those aspects elsewhere. In this section, we discuss the prevailing framework for corrective action and resolution, and proposals for reform.

When does failure of financial firms have public policy implications?

A healthy competitive dynamic economy is one in which there is a steady flow of entry of new firms and the exit or failure of weak firms. Under this 'Schumpeterian creative destruction', exit by weak firms frees up resources that are better utilized by strong firms, thus leading to the maximal growth of the country. Some failures of financial firms, while not actually to be welcomed, should be deemed as a necessary accompaniment to competitive dynamic conditions, and indeed a salutary reflection of those conditions.

So it is necessary to ask whether the failure of financial firms pose more public policy concerns than the failure of industrial firms, which would then necessitate greater efforts at prevention and resolution. Indeed, in some cases, failure raises no special concern. As an example, when a fund manager is the agent of a customer, and the losses of the portfolio are transparently and continually borne by the customer, negative portfolio returns are not a problem. Even if there is an extreme event and the fund manager goes out of business, this need not significantly affect the customer, for his assets can then be transferred to another fund manager (or returned to the customer) by the resolution agency.

Four broad concerns do arise, however, with financial firms. First, the fear of failure of a financial firm could lead to a run that actually causes the firm to fail. This has historically been the rationale for deposit insurance. Second, the failure of one financial firm could disrupt liquidity conditions in the market, which then causes other financial firms to fail—a rationale for liquidity regulation. Third, financial firms could be the repository of knowledge about small and medium borrowers, and their failure could disrupt credit, a critical input, to a vulnerable section of the local economy. Finally, in a developing country like India, 'buyer beware', which places the entire responsibility for judging the soundness of a financial firm upon a household, may not be an entirely feasible economic or political strategy. There will be a demand for a few products to be identified as safe (e.g., demand deposits), with the government implicitly guaranteeing their return.[5]

In general, this Committee believes that every effort should be made to narrow what is guaranteed by the government to the bare minimum. This is another reason to reduce the public sector presence in the financial sector, for that presence implies an implicit guarantee the government can ill afford, and places private players at a disadvantage. It is also a reason for regulators to pay particular attention to entities that are not just large but also service many customers, for those entities may have too many customers to fail. Finally, it is important for regulators to create awareness that the fact an entity is regulated does not imply its safety and continued existence is guaranteed.

Despite all attempts to ring fence the costs of failure and preventing it from spilling over into the public domain, the regulator/government will have to intervene in some cases. The role of prudential supervision is thus to minimize the probability of such occurrences, as well as the public costs when they occur, without unduly hampering growth. It is important to achieve the right balance between prudential caution and growth, for the surest (and clearly wrong) way to minimize failure is to ban all activities that imply any risk. A regulator who targets zero risk of failure may not be hitting the right balance.

Minimizing risk: Exchange traded vs. OTC

The first step in preventing financial system risk spillovers is to adopt preventative methods. We do not have the space in this report to address the many ways of risk mitigation and prevention, but illustrate with some examples from counter-party risk.

For simple derivatives—such as currency forwards—the exchange is a superior method for organizing the market as compared with the Over The Counter (OTC) market. Electronic trading on the exchange reduces the cost of search for counterparties; trading on an exchange involves transparency of both orders and trades; order matching by price-time priority ensures that buying is done from the lowest-cost order and avoids the potential of malfeasance where a dealer buys from an accomplice at a higher price. From the perspective of failure, however, the critical edge of exchange-traded derivatives lies in the risk management services of the clearing corporation. The clearing corporation becomes the legal counterparty for the net settlement obligations of all clearing members. Thus, if one clearing member fails, nobody else is affected because their exposures are against the clearing corporation and not the failed firm.

The clearing corporation, in turn, is a specialized risk management institution with a professional focus on measuring and controlling the credit risk of clearing members, in part through margin requirements. India has two successful clearing corporations—NSCC and CCIL.

While both OTC derivatives and exchange-traded derivatives undoubtedly have a role to play in a sophisticated financial system, there is merit in encouraging the migration of trading in standardized products to the exchange so as to mitigate risk. There is certainly no case for biasing public policy *against* exchange-traded, and in favour of, OTC.

Complex derivatives, because they are not standardized, must be transacted on the OTC market. Internationally, these have traditionally involved bilateral exposures. These can induce a 'domino effect' when one financial firm fails. However, for these transactions also, it is possible to engage the risk management services of a clearing corporation. Here, a clearing corporation would earn a fee by becoming the legal counterparty to both sides of a complex OTC derivative. It would impose margin requirements, and collect a daily mark-to-market margin, from both counterparties.

India was a pioneer in embarking on such thinking, with the Clearing Corporation of India (CCIL) playing such roles on the OTC derivatives market, such as the currency forward market. This method of risk mitigation needs to be strengthened and extended considerably. As an example, in the United States, the NYMEX clearing house has encoded hundreds of structures of OTC derivative contracts, and levies margins taking into account the entire portfolio of exchange-traded and OTC-derivatives positions of its clearing members. This is beneficial for the members, who benefit from the reduced margins on the aggregate portfolio (in contrast to the higher margin necessary if the member had to post margins on each individual position). This is also beneficial for NYMEX, which is able to have a sustained engagement with the OTC market, understanding the product structures that are successful on that market, which could then be launched on the exchange. Clever risk mitigation can thus be a source of substantial profits, as well as stability.

In sum then, India is likely to witness the explosive growth of derivatives positions, given the growing importance of risk management, the growing size of exposures by financial and non-financial firms, and the growing sophistication of financial firms. In order to control the associated systemic risks, a two-pronged strategy needs to contemplated. First, standardized products should be encouraged to migrate to exchanges. Second, clearing corporations such as NSCC and CCIL must be encouraged to offer risk management services for the OTC market. If these two strategies are applied fully, systemic risk will then be limited to the small class of OTC derivatives positions which are not understood by the clearing corporations. Finally, note that a market regulator can work to mitigating these risks only if they see the whole picture across all markets, another reason for integrating market regulation under one roof.

Minimizing risk: Related party transactions

The bane of any financial system is related party transactions. One way to ensure that related party transactions are limited is to ensure widespread ownership, or ownership by an entity that is unlikely to suffer serious conflicts of interest. Indeed, this has been one of the underlying rationales for the RBI's guidelines for ownership of banks. This Committee endorses those guidelines, while suggesting that an exception can be made in the case of a strategic stake held by a diversely owned financial company (where the voting share could go up to 20 per cent, with the permission of the RBI), and in the case of a stake held by a diversely held parent holding company.

The Committee also believes it is premature to allow industrial houses to own banks. This prohibition on the 'banking and commerce' combine still exists in the United States today, and is certainly necessary in India till private governance and regulatory capacity improve.

There are, however, fewer restrictions on ownership in other segments of the financial sector. Regulators should be more alert in those segments to possible conflicts of interest, and to related party transactions. For instance, it might be possible for a mutual fund to own a significant stake in companies owned by its promoter. While a blanket ban on such ownership might be excessive, strict limits on ownership should be enforced at all times, as should guidelines on excessive trading or trading before key announcements. More generally, promoters should not just be enjoined to follow a strict code of conduct but also have clear rules of disclosure for related party transactions (along the lines of Caesar's wife should be above suspicion).

Minimizing risk: Management and director education

The financial sector has developed enormously over the last few decades. Most senior managers, directors, and regulators, however, received their education when very few of the products that exist today were available. Moreover, India was a closed economy then, and many of the issues related to an open economy that need to be understood by senior players simply were not on the horizon then.

Some senior managers have kept abreast of developments through their own curiosity, reading, and experience. They are also not afraid to ask questions of their subordinates when they do not know. Others are not so bold, and they continue to fall further behind. This is not only a concern in India, it is a concern worldwide, and is often a factor in why boards and management do not question rogue operations in their institutions.

It is not easy for senior managers or officials to admit to a lack of knowledge, and to sign up to basic courses in finance and open-economy macroeconomics. Moreover, even if the institution is far-thinking and organizes education programmes for senior managers/directors, there is little immediate reward for the sceptical to pay attention. Yet these are precisely the people who can place the firm at the greatest risk through their lack of awareness.

There is merit for regulators in considering whether a basic certification should be required for all directors of financial institutions above a certain size (including both technical knowledge as well as material about director responsibilities), and all senior managers and regulators. The value of a blanket mandate will be that there will be no stigma attached to signing up (though participants could have the option of taking a test and opting out of some, or all, of the coursework). The regulator could cooperate with academia, industry groups and institutions, and regulators elsewhere in tailoring the course material to the needs of the particular sector (and the level) of the official. There could also be scale economies in running the programme for the entire industry, as well as little stigma for specific firms when they send participants to the programme. Finally, to avoid this becoming merely another industry conference in a nice location, it is important that there be a test of the knowledge acquired and a certificate at the end of the programme. As senior officials get re-educated, it will set an example for more junior officials to keep abreast of developments, and be an important factor in improving the governance of risk taking in the system.

Increasing buffers: Capital and liquidity

Another way to reduce spillovers is to ensure that buffers are maintained by the financial firm. Two important buffers are capital and liquidity. While we do not have the space to examine each in detail, a few points are worth noting.

Start first with capital. Capital is meant to accomplish a number of things. First, it is a buffer against losses, giving time for the firm to raise more capital, for regulators to take stock, and for counterparties to react. Second, it is an entry ticket to participate in financial activities—if a firm loses money but is not recapitalized by its shareholders, it has to curtail activities. As such, it is a requirement from regulators for the market to vote its confidence in the financial firm. Third, it constrains risk taking by requiring that the available capital be enough to meet the requirements of the risk that is being undertaken. The second and third objective leads to the fourth—a capital requirement serves to incentivize firm management to manage risk for they know they will be forced to shrink, or even close down, if they take too much risk and incur losses that the market is unwilling to recapitalize.

One reason this issue is important in India is because a substantial portion of the financial sector is state-owned. It is useful to ask whether any of the objectives capital is intended to achieve other than the first—serve as a buffer—really have any import in state-owned firms. To the extent that state owned firms are not allowed to go out of business, and to the extent they are automatically recapitalized, the role of a capital requirement is much diminished.

State-owned firms have other reasons to not take on excessive risk. However, it is important to recognize that, other things equal, state-owned financial firms cannot be given the same incentives through capital regulation as private financial firms because the former have an unlimited claim on the public exchequer. As we push state-owned institutions to do exactly what private institutions do, they could become an increasing source of risk, that can only be limited if the government is willing to insist that all new capital come from public issues, or it lets go of its majority stake.

A second concern about the use of prudential capital requirements in India is the increasing tendency to use risk weights to reward or penalize activities that are viewed as national priorities (such as infrastructure or small loans). This is an aberration that should cease. If the authorities want to encourage activities, they should subsidize them more directly (see Chapter 3) instead of tampering with prudential norms.

The recent turbulence in financial markets has renewed the focus on mandatory liquidity holdings by banks. While the appropriate quantum and mode of maintaining such buffers will be debated in the years to come, the time has come to limit requirements of statutory holdings of high quality securities or cash reserves to only prudential purposes, and not for the purposes of funding government debt or for attempting to conduct monetary policy. Regardless of their efficacy for these other purposes, their use tends to distort the playing field—being a burden only on banks—and tends to diminish the signal sent when prudential measures ought to be taken. While it is not in this Committee's remit to specify the technical factors that should determine appropriate regulatory levels, the norms in other countries suggest a lower level than the current ones in India. Indeed, the RBI seems to implicitly have recognized this by cutting SLR norms for small urban cooperatives in order to improve their profitability.

Resolution of distress in banks

At present, in India, the 'Deposit Insurance and Credit Guarantee Corporation' (DICGC) supplies deposit insurance. A generous limit of Rs. 100,000 per person (summed across all kinds of accounts) is protected. In practice, over 98 per cent of the deposits of most banks are protected since they fall below this limit. In other words, there is a very extensive safety net protecting unsophisticated consumers who utilize the services of a bank. DICGC does not distinguish between the soundness of different banks and charges a flat insurance premium of 0.05 per cent for all banks. While DICGC is technically a separate corporation, in practice, it is a department of RBI.

There are three difficulties with the present situation:

1. As measures of the failure probability of Indian banks suggest (see Box 2), the insurance premium of 0.05 per cent is an underestimate compared with the market price of a credit derivative against the failure of most Indian banks. By comparison, the premium in Indonesia is risk based and varies from 0.1 to 0.6 per cent, in Korea from 0.1 to 0.3 per cent, in Malaysia 0.5 per cent, in Phillippines 0.2 per cent, and in Hong Kong risk based, 0.05 per cent to 0.14 per cent. The extensive safety net at a low price constitutes a subsidy for banks. It is particularly inappropriate in India, where (as the graph in the box suggests) there is a substantial variation in the failure probability across banks. A uniform insurance premium tends to reduce incentives for weak banks to maintain soundness. By contrast, higher insurance premia for higher risk generates better discipline.
2. DICGC lacks the financial capital required to cope with the failure of one or more large bank in a business cycle downturn. It lacks the operational capability to close down a bank swiftly, cleanly and preemptively.

   The key principles that should guide the resolution mechanism for banks are as follows:

   - *A bank must be given the chance to recapitalize while it is still solvent, or closed otherwise.* If the DICGC waits too long, the net worth of a weak bank can become deeply negative, with substantial cost to the public exchequer. If the DICGC steps in early to resolve a bank that cannot raise capital from the market, the cost of resolution is much lower.

- *Distance the DICGC from RBI.* There are considerable benefits in separating the resolution mechanism from either the central bank or the banking regulator. Distancing the DICGC from the central bank helps reduce the feeling on the part of the DICGC that it has access to unlimited resources. Distancing the DICGC from the banking regulator helps induce independence of thought on the part of the DICGC, which must make pre-emptive decisions about the closure of a bank without worrying whether this will signal its past failure.
- *Build DICGC's capability for swift and clean intervention so that impaired banks can be resolved without delay.* The DICGC should be able to enter an impaired bank, assess its needs and the various resolution options, and restore access to insured depositors within the span of days. For deposit insurance to be effective, such speedy resolution is imperative, else deposit insurance will be ineffective in preventing bank runs. The Committee has not been able to determine whether any such capability exists.
- *Consider automatic triggers for corrective action and for bank resolution.* Given the tremendous amount of political pressure that is brought to bear for regulators to forbear on weak institutions, automatic and objective triggers for bank resolution are worth considering and possibly enacting. There is reluctance on the part of regulatory authorities in making explicit the prompt corrective action regime. This allows too much flexibility to the authorities to exercise forbearance, which defeats the purpose of such a regime. The authorities ought to make such a regime transparent.
- In India, a weak private bank has, in the past, been merged into a PSU bank. The negative net worth of the defunct bank is hidden in the larger balance sheet of the PSU bank. The managers of PSU banks are unable to refuse when called upon to 'help' in resolving a 'crisis'. This practice needs to be questioned, if nothing else, on the grounds of corporate governance: such a merger is not necessarily in the interests of the public shareholders of PSU banks. More importantly, this practice offers an easy but detrimental alternative to genuinely confronting the problems of resolution. The recent auction of United Western Bank is a commendable step in the right direction.
- *Strengthen the information coming into DICGC.* Various information sources, especially from public securities markets, can be valuable to deposit insurers, both in assessing risks and in pricing insurance. The DICGC needs to draw on more of these sources, as well as develop a better understanding of what to draw from them (see Box 3).
- *Strengthen disclosure about bank assets and liabilities so as to assist the information processing of the securities markets.* For public markets to work well in assessing risk, information disclosure by banks (and other financial firms) needs to be improved. Banks need to report a P&L and balance sheet based on the marked-to-market value of all assets and positions, even if certain assets are permitted to be held-till-maturity by the regulator. Information about the currency and maturity composition of assets and liabilities needs to be disclosed every month, in a summary fashion that allows information about exposures to be understood by the market. More work needs to be done by the regulator in devising such summary measures, so that they reveal enough without imposing an undue burden of disclosure. When distressed assets are liquidated or sold, comprehensive data on recovery rates needs to be revealed to the public market. All these initiatives can easily be undertaken by SEBI as part of rules that all listed firms have to satisfy.
- *Hold the limit of Rs. 100,000 per person until per capita GDP exceeds Rs. 100,000.* India's safety net is unusually generous: in many countries, the limit does not exceed per capita GDP, and in most countries, over 98 per cent of deposits are not covered.

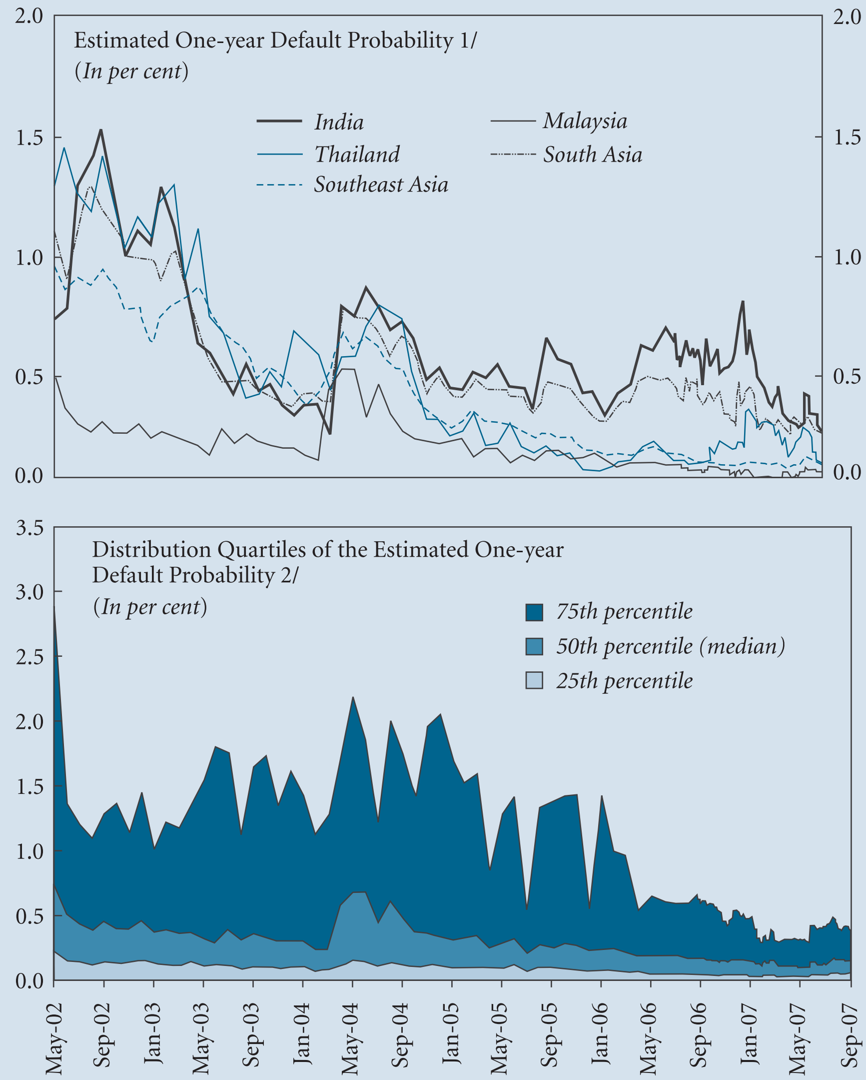
Box 2: How Risky are Indian Banks?

In recent years, there has been a heightened focus on measures of default risk that are derived from stock prices. The process of speculative price discovery on the stock market harnesses a diverse array of information—including information from within the company when insiders or their friends trade on the market—and reduces it into a publicly visible stock price. Using the analytical framework originating in Merton (1974), and extended by KMV Corporation, this strategy has come to prominence as one of the most effective ways for measuring credit risk. As an example, in the case of firms like Enron or IFCI, the stock price moved towards near-zero levels, thus signalling distress, well before traditional credit measures reported this.

This approach can be usefully applied to listed Indian banks in order to judge their failure probability. Some results on this subject, drawn from the IMF Article IV consultation report of February 2008 are illuminating. They are, in turn derived from Moody's KMV CreditEdge Plus.

The chart on the right shows the time-series of the failure probability on a one-year horizon of the average bank in the system. It shows that India (deep black line) has had a high failure probability when compared with many Asian countries.

The second chart, on the right, shows the cross-sectional dispersion amongst banks of this one-year failure probability. While the 25th percentile had always had low values of below 0.2 per cent, the 75th percentile has often taken values above 0.5 per cent, though it has come down in recent years. In other words, roughly a quarter of Indian banks have had a failure probability in excess of 0.5 per cent over the coming one year at all times over the 2002–07 period. With appropriate caveats on relying too much on one methodology, these substantial values for the failure probabilities of banks suggest that more thinking is required on reducing the probability of failure, and designing institutional mechanisms for coping with it.



Box 3: Source of Public Information about Bank Risk

As deposit insurance becomes more risk based, a variety of information sources can be used to supplement standard ratings in assessing premia. One good information source about distress is the public equity market. When a bank is in distress, the share price drops sharply. Good quality credit risk measures can be constructed from this share price and its volatility. RBI has made considerable progress in forcing large banks to be listed. This strategy needs to be pursued vigorously, with a requirement that at least 33 per cent of the shares of each bank be held by non-promoters. Bank bond spreads, where the corporate bond market to be liquid, could also provide valuable information about bank risk.

In addition, when the market develops, bank credit derivatives could be directly useful in pricing. A credit derivative can be defined as follows: *A security which pays Re1 in the event that the bank's subordinate bonds default over the next year*. For the top 20 banks, trading in these instruments could be initiated on NSE and BSE, and could be an input into determining the premia that are charged by the DICGC.

Note that such securities have been proposed elsewhere, but the lack of liquidity in the market for these securities has been a barrier. While DICGC could become an active participant in this market (thus insuring itself against bank default, and its consequent liability), that participation would have to be carefully managed so that DICGC does not become conflicted (between focusing on its portfolio of holdings of credit derivatives that increase in value when a bank defaults and its need to resolve a bank before failure becomes imminent).

When a bank has a significant failure probability, as judged by a combination of the three measures proposed above, as well as the subjective judgements of bank supervisors, many strictures can come into play before the DICGC decides to close down the bank. The most important stricture that should be employed is to require more equity capital, but limitations on business activity can also be imposed. Finally, a caveat: One should note that these securities are likely to be informative about the risk of private sector banks, but less so about the risk of public sector banks. Furthermore, a propensity for the authorities to bail out banks will render the risk measures far less informative.

NOTES

1. Chit funds have had much success in providing financial services to the poor, and in many ways are comparable to the microfinance industry in their record of reaching households underserved by mainstream banks (see Chapter 3). The Chit Fund Act, however, imposes substantial reporting requirements sometimes running into lakhs of documents that are required to be submitted annually. These levy enormous costs on the Chit Fund. Moreover, financial regulations, such as the need to post a security deposit for 100 per cent of the chit value, a ceiling of 40 per cent on the discount rate in chit auctions, and a fixed commission payable to the 'foreman' of the chit irrespective of general cost escalation have contributed to make the chit fund business essentially unviable. While chit funds need to be regulated because of their access to the very poor and the uneducated, the cost of regulation needs to be very carefully weighed against the benefits.
2. At a more basic level, every law is ennobled by a reason, and when the reason behind the law ceases, so does the law itself: cesante ratione legis cessat ipsa lex.
3. This is yet another reason to limit the use of changing SLR requirements as a tool of monetary policy.
4. For example, large non-deposit taking NBFCs may borrow from both banks and mutual funds, and are properly an inter-regulator concern, hence under the purview of FSOA.
5. In principle, there will be a constant pressure to expand this list to include products such as defined benefits pensions and life insurance. Of course, any such guaranteed products from the government reduces market discipline on providers, penalizes the healthy amongst them, and creates incentives for taking undue risk.