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Edit and Column - Column: Will a super regulator be superior?

A few weeks back, we had initiated our analysis of the Finance Ministry's proposal to have a super regulator for the financial services industry. In this second part, we will examine one key benefit derived from having a super regulator—the ability to respond to a financial system comprising financial conglomerates and products that span the banking, insurance and pensions sectors.

To understand this benefit, it is crucial to recognise that an effective financial regulatory structure consists of three essential components: (i) rules pertaining to business conduct that should serve to protect investors and promote efficient and transparent capital markets; (ii) prudential regulation that should ensure the safety and soundness of institutions; and (iii) an overarching focus on financial stability which translates into prudential oversight of the macro economy.

Each of these three components is brought into the limelight by the increasing interconnectedness across different segments of the financial markets. Over the last decade, many banks and financial institutions in India have transformed into financial conglomerates that are involved in banking as well as securities and insurance markets. Similarly, the financial products that have evolved have features that overlap across these markets. One such product is a Unit Linked Insurance Plan (ULIP), which combines the insurance and investment features together in one product. While mutual funds allege that ULIP's success emanates from insurance companies that have an unfair regulatory advantage, insurance companies deny any such advantage whatsoever.

Without taking sides about who is right in this instance, we should recognise the fact that such a dispute arises because this product straddles two markets that are regulated by different regulators. While apprehensions regarding competitive neutrality originate from the presence of such products and financial conglomerates, a more serious concern emerges from the risks engendered by such interrelatedness across market segments. Given the interconnectedness, the risk assumed by a financial conglomerate as a group may be higher than the sum total of risks assumed by its affiliates/subsidiaries. Far more importantly from a systemic perspective, connections between financial conglomerates considerably accentuate the systemic risk faced by the financial system.

Currently, regulatory supervision remains specialised to each market segment, which raises several concerns. First, as voiced in the report submitted by a recent Committee on Financial Sector Assessment, concerns remain with respect to regulators' ability to take a consolidated view and assess the overall risk a financial conglomerate is taking and, in turn, the systemic risk that the economy is exposed to. Second, the presence of financial conglomerates increases the importance of having a regulatory and supervisory framework that is consistent and free of gaps. Third, regulators need to respond on a conglomerate-wide basis should serious problems occur in any part of the conglomerate. While regulators attempt to make sure companies create firewalls between their different businesses, the effectiveness of such firewalls could be low in the event of financial problems.

To address these concerns, first, the supervisory bodies must have an effective system of information sharing with each other for each institution. Second, the supervisory bodies must develop a close working relationship that avoids turf wars and ensure that regulatory gaps are identified and closed. Third, for each institution, a clear agreement should be made that one supervisor takes the lead both in forming an overall risk assessment and forming a regulatory response should problems arise. Although the issues outlined above could be resolved by close cooperation of sectoral supervisors, an integrated supervisor may be in a much better position to address them. The received information may be more smoothly exchanged in one institution and more quickly and effectively utilised. By becoming the only contact point for all regulatory and supervisory issues, the additional burden associated with fragmented supervision may be minimised for the conglomerates. This can be done by minimising overlap and duplication in reporting and oversight, and simplifying the process of decision-making.

With respect to competitive neutrality, an integrated supervisor may be better equipped to ensure that similar financial products receive comparable regulatory treatment, levelling the playing field for all financial sector participants.

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