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Financial Regulation – The Way Forward

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ABSTRACT:
Economic development is the mandate of a State and there are different useful models which the State can consider for development of the financial sector. Some of the models which the State could consider are Institution based Model or Market based Model, Wall Street or Main Street, Functional Perspective and Institutional Perspective. The State should select the most appropriate model which would enable and aid in the economic development. Having zeroed on the appropriate model for the economic development the State has to take a call on how much of regulation and how much of deregulation is needed. Economic Theory of Regulation by George J.Stigler, "efficient market" hypothesis propogated byEugene F. Fama and Robert J. Shiller who held exactly an opposite view on 'asset prices movement' are some of the theories which have profound influence on the State policy on regulations. The financial sector regulators on their part could be usefully guided by certain principles/norms/theories which would enable them to attain the mandate of the State. Rule based approach Vs Principle based approach, shareholders control Vs other stakeholders control enable the regulators to arrive at appropriate decisions. With increased financialisation, innovations in finance and financial engineering has led State to take another call on whether a sole monetary authority is to be entrusted with the task of formulating the monetary policy and be the regulator formulating the macro prudential policy and also the micro prudential policy. Alternatively, should there be three different authorities? The article examines some of the issues involved in this regard.

KEY WORDS: Financial regulation, economic development, regulation, deregulation, monetary policy, macro prudential policy, micro prudential policy

Introduction:

Financial Regulator: As the world economy evolved people used the 'barter system' to exchange commodities with commodities, thereby giving away their surplus goods and received goods which they did not possess. Trade and commerce was at its minimal. Later on "prior to the 17th century most money was commodity money,typically gold or silver. The Song Dynasty was the first to issue generally circulating paper currency, while the Yuan Dynasty was the first to use notes as the predominant circulating medium. The medieval European Knights Templar ran an early prototype of a central banking system, as their promises to pay were widely respected, and many regard their activities as having laid the basis for the modern banking system. The Bank of Amsterdam established in 1609 A.D is considered to be the precursor to modern central banks. The central bank of Sweden 'Sveriges Riksbank' founded in Stockholm in 1664 A.D was the earliest central bank. The establishment of the Bank of England, the model on which most modern central banks have been based, was devised by Charles Montagu, 1st Earl of Halifax, in 1694 A.D." (Wikipedia). It was with the evolution of paper currency which acted as a lubricant for trade and commerce that the need for central banking was felt. The central bank was the monetary authority and also the financial sector regulator.

Economic development is the mandate of a State and there are different useful models which the State can consider for development of the financial sector. There cannot be a formula by which one could select the appropriate model. Several factors have to be considered like stage of economic development, rate of growth required, financial literacy levels, inclusive growth, balanced growth, full employment, inflation, financilisation, dependence on external finance (forex reserves), balance of payments etc etc. The State should select the most appropriate model which would enable and aid in the economic development. Some of the models which the State could consider are –

Institution based Model Vs Market based Model: For economic growth of a country broadly two models is available – market based or institution based. "Some studies have suggested that financial structure did not matter for economic growth, the others studies establish that the structure of the financial system can matter for growth. In this debate, Rajan and Zingales (1998) observed that rather than the nature of financial structure, it is the financial system's overall level of development that matters for growth. Empirical research on the comparative merits of 'bank-based' and 'market-based' financial systems has centered on Germany and Japan as 'bank-based systems' and the United States and the United Kingdom as 'market-based systems'.

According to Reid (2010), some financial structures may be better suited to growth at certain stages of development but they may be less well suited in other circumstances. The above thinking points out to the fact that developments in the macroeconomic environment and structural changes in the economy are crucial variables that may decide the banking structure and the changes in it required from time to time" (RBI, 2013).

Which is the right model for economic development requires a deeper analysis. Market based systems could bring in faster economic growth. But a mandatory requirement could be financial literacy of the masses. The people should be able to appreciate the risk taken and have deeper pockets to face the volatility of the markets. India perhaps has adopted the financial institution/bank-based model as the literacy levels are low and financial literacy levels are abysmally low.

Main Street Vs Wall Street

"Main Street and Wall Street are metaphors now in common use to distinguish between two sharply contrasting economic models with sharply contrasting priorities, values, institutions, and interests.

Main Street refers to local economies comprised of entrepreneurial local businesses and working people engaged in producing real goods and services to provide a livelihood for themselves, their families, and communities. Much like the diverse species of a healthy ecosystem, Main Street enterprises vary in their priorities and values. Their legal forms range from sole proprietorships and family businesses to cooperatives, worker and community owned corporations, and nonprofits. Generally, they share in common a commitment to creating meaningful livelihoods and contributing to the well-being of the community in which they are located.

The Wall Street capitalist economy is comprised of the institutions of big finance and the captive corporations that serve them. It is a world of pure finance and maximizing financial return is the name of the game. They may or may not contribute to the creation of useful goods and services, but these are more in the nature of incidental by-products of their profit seeking. The Wall Street economy, which is centrally planned and managed by a global syndicate of global corporations that hold a collective monopoly over the world's money, markets, and technology for the exclusive benefit of their managers and financiers, persistently violates market rules" (New economy working group).

Markets have two important functions to play. They provide price discovery and liquidity. For economic development of a country financial institutions and markets have a role to play. It is for the State to take a call on whether markets have to be encouraged or financial institutions need to be supported. Regulations of these sectors can play a very important role in the development of the markets or institutions. However, in an economy a healthy balance between the two is important. When the country is in the initial stage of development perhaps financial institutions need to be encouraged. However, at the growth stage ignoring the importance of markets would only retard economic growth.

Functional Perspective and Institutional Perspective:"There are two fundamentally different perspectives for analysis of financial systems. The institutional perspective takes the institutional structure of the financial system as given, and looks to define what can be done to make those institutions perform their particular financial functions more efficiently. In contrast to the institutional perspective, a functional approach to designing and managing financial system, as proposed by Professor Robert Merton (Harvard Business School) and Professor Zvi Bodie (Boston University) in various papers over the last two decades, takes the functions performed by financial systems to be given, and studies the institutional structure that would best perform these functions. Financial Markets and intermediaries have been rapidly evolving due to technological advances and integration of financial markets and intermediaries around the world. Financial innovation ensures that the structure of the financial system changes over time, but the functions per se of the financial system remain stable" (Rajendran).

Financial Regulation has two functions. One is to regulate and supervise the regulated. It also has a development function. Financial Regulation has to not only regulate but also develop and create environment

conducive for the financial sector to grow without impediments. For development of the financial sector the functional perspective would enable innovation. For e.g if financial inclusion is the agenda the regulator has to first decide what are components of financial inclusion. Suppose one of the components is remittances then this objective could be better served by non-bank institutions in addition to banks. "A Bank for International Settlement report on payments states that, in Japan, non-banks are allowed to provide funds transfers. In South Africa, non-banks can become designated clearing system participants and have full access to the clearing system provided that they meet the Central Bank's requirements" (Mor, 2014).

Once the State has selected the appropriate model for economic development it is for the financial sector regulators to frame appropriate regulations to take forward the endeavour of the State.

The financial sector regulators on their part could be usefully guided by certain principles/norms/theories which would enable them to attain the mandate of the State. These principles are driven by -

Economic Theory of Regulation: More or less George J.Stigler coined the word 'regulatory captor' when in a 1971 article he argued that governments may create monopolies. It was probably by design this happens. The business men use the regulation to prevent competition. This is comparable to the yester years 'license raj' when industrial licenses were held by few industrialists who would obtain licenses from the government and also many a time not use it. Sam Peltzman in 1976 and Gary Becker in 1983 also espoused similar views. In 1989 Sam Peltzman in 'The Economic Theory of Regulation after a Decade of Deregulation' stated "it was also a time when most of the ultimately successful legislative initiatives toward deregulation bore fruit. It is hard to treat the conjunction of the rightward shift in the political mood and deregulation as entirely coincidental. But it is also hard to push this, or any, special-purpose explanation too far"(Peltzman).

Probably the 'deregulation' in the United States was influenced by the 'economic theory of regulation'(ET).

Growth and Financial Regulation: Though regulations, particularly financial regulation, were important for orderly growth of the financial sector sometimes these regulations themselves were considered to be impediment to growth. "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 ……" (Rajan, 2009). Further, as pointed out by ET regulations also had unintended consequences.

Financialisation: As world economy was evolving trade and commerce between different countries started growing, usage of 'finance' increased over a period of time. Finance started gaining importance. Its growth and importance was increasing day-by-day and its prominence was perceived more in settlement of international and intra-national trade and services transactions. The stature of finance increased from a facilitator of trade to be recognized as a sector by itself. With innovation in the finance world and financial engineering taking over, the derivatives market started growing which tracked the value of underlying assets. The finance world emerged much larger and attracted the best of the talent in country leading to financial engineering. Finance had grown to such an extent that it led to 'financialisation of commodities'.

Financial Regulation was increasingly important with the prominence of Finance, financial engineering and financialisation of commodities.

Financial Regulation and Perfect Markets: "Eugene F. Fama propogated the "efficient market" school of thought. According to him prices of stocks and other traded assets reflect all publicly available information on them. Also, since any new information is captured in the price instantly, there are hardly any opportunities for arbitrage. Fama's theory of rational and efficient markets contributed to the decline of financial regulation. Since markets are efficient and all information was reflected in the price this view propagated deregulation. Even the rising home prices in the 2000s in United States were justified by the view that prices are inherently rational. Perhaps the regulators were convinced that deregulation of the financial sector would lead to faster economic growth"(Times).

"Economist Robert J. Shiller introduced in the early 1980s an important limitation on the idea that markets operate efficiently and price changes occur for reasons other than asset-specific information. The resultant mispricing he attributed to "animal spirits", which led investors to oscillate from irrational exuberance to deep mistrust and loss of confidence. He held that financial markets to be naturally prone to bubbles and in 2005 described the rapid rise of housing prices as a bubble and warned that prices could fall. Five years later Shiller was proved right" (Businessline).

"Possibly in hind sight Janet L. Yellen Chair of Fed, stated the central bank needs to reconsider its traditional view that bubbles cannot be spotted and should not be popped — or restrained from growing too large"

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(Times). Shiller's theory seems to have been accepted by the regulator.

Rule based approach Vs Principle based approach: There are two approaches to regulation – 'rule-based' and 'principle-based'. "A regulator that adopts a 'rule-based' approach will seek to prosecute every minor breach of a rule, irrespective of its import in the larger scheme of things."

"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. 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 fulfillment of certain pre-specified principles of sound and ethical business."

Regulations with greater emphasis on principles would avoid the 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. (Rajan, 2009).

Hence good regulation should be 'principle based' rather than 'rule based' and never 'discretion based'.

Corporate Governance Vs Financial Stability*:* "Corporate governance is one key element in improving growth and ensuring market integrity and financial stability. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring" (Board).

"Given the important financial intermediation role of banks in an economy, the public and the market have a high degree of sensitivity to any difficulties potentially arising from any corporate governance shortcomings in banks. Corporate governance is thus of great relevance both to individual banking organisations and to the international financial system as a whole, and merits targeted supervisory guidance" (BIS).

Financial institution operations are prone to risk-taking due to their high leverage, too-big-to fail guarantees and increase the risks of assets by changing the funding strategy which is often quick and opaque.

The real economy is affected by large systemic bank failures. Corporate governance needs to increase efficiency of the bank and also reduce the risk.

Stakeholder control: "Besides shareholders bank stakeholders include creditors and taxpayers.(who may need to fund a bailout or suffer from the impact of a financial crisis on the real economy). Bank shareholders are relatively minor (in terms of notional exposure) stakeholders, who nevertheless exercise most control over the bank, can impose on a bank their high risk preferences that are at odds with the interests of other stakeholders.

A way to make stakeholder control more effective may be …… The control may primarily be exercised by bank creditors.

Clearly implementing creditor control of distressed banks has challenges. Bank creditors may experience a collective action problem. A divided board (shareholders Vs other stakeholders) may be indecisive. Bank creditors may reduce risk too rapidly damaging the bank's long-term value, or be over cautious in lending, compromising the provision of credit to the real economy" (Luc Laeven).

However, stakeholder control over financial institutions requires deeper analysis and discussion. It could be a very effective tool in reigning in exuberant risk taking by management which has a perverse incentive structure.

"The responsibility for using resources of societies (made up of members' funds and borrowings) efficiently and prudently, must be left to democratically elected managements, accountable to members**.** At present, most institutions of the Cooperative Credit Structure restrict membership, with full voting rights to borrowers.Depositors are categorised as nominal members without voting rights, or are not given any membership status.This is not only inconsistent with cooperative principles and democratic functioning. It is also logically inconsistent, as those whose money is intermediated have no say in the management of their own money. It is, therefore, essential that all users – **depositors and borrowers –be made full members with equal voting rights.** This is also essential to

strengthen the mechanisms of internal supervision and enforcement of credit discipline" (Institutions).

It is, therefore, essential that depositors (and other stake holders) also have a say in the risk taking and incentive structures of financial institutions. This would face challenges in implementation and legal hurdles. The theory also calls for the view of the judiciary on the issue. However, the courts are not powerless and 'lifting the corporate veil' could be a remedy available against the wrong doers.

Disincentives to perverse compensation structure, higher capital requirement, stakeholder control etc may lend support to the supervisor but cannot be a substitute for effective supervision.

With increased financialisation, innovations in finance and financial engineering has led State to take another call on whether a sole monetary authority is to entrusted with the task of formulating the monetary policy and be the regulator formulating the macro prudential policy and also the micro prudential policy. Alternatively, should there be three different authorities or entrust macro and micro prudential regulations to one authority. Here too there cannot be a straight fit formula and several factors have to be considered by the State. However, it would be useful to consider the three policies – monetary, macro prudential and micro prudential – the objectives and tools used.

Monetary Policy, Macro Prudential Policy and Micro Prudential Policy: (MP, MPP, MiPP) MP, MPP and MiPP are the three pillars on which the economic stability and financial stability rest. Economic stability is the larger circle within which the smaller circle of financial stability rests. Financial instability may lead to economic instability if it is systemic and is not ring fenced. So also economic instability may lead to financial instability if the financial sector/financial institutions are not ring fenced from the contagion. The financial sector regulator has a responsibility to safeguard the financial institutions from systemic risk caused within the financial sector and also from the contagion risk in an economy. The systemic risk could be caused by financial institutions within an economy and at times by external financial institutions. The contagion could spread through different channels – the financial channel and the trade channel. Financial channel includes equity markets, money markets, forex markets and credit markets etc. Trade channel includes exports of goods and services.

Monetary policy is the process by which the monetary authority of a country controls the supply of money. The objective of monetary policy is economic stability and growth and inflation control. The tool used often is the rate of interest. The official goals usually include relatively stable prices and low unemployment. Other monetary policy tools include increase/decrease in cash reserve ratio(CRR), statutory liquidity ratio(SLR), repurchase option(repo), reverse-repo, liquidity adjustment facility (LAF), marginal standing facility (MAF), open market operations (OMO).

"Macro prudential regulation objective is to mitigate the risk of the financial system as a whole particularly systemic risk. The ultimate objective of macro prudential policy is to avoid output and wealth losses in the long run by limiting the buildup of system-wide financial risk. It also aims to mitigate risks linked to financial sector concentration and interconnectedness.The macro prudential authority focuses on herd behavior and shifts in overall risk appetite. For example, individual institutional risk often appears to be low, or falling, at a time when system-wide risk is actually rising. The tools in this regard include capital surcharge for systemically important financial institutions, counter cyclical buffer etc." (IMF).

"Micro prudential policy focuses on the health of individual financial institutions. Micro prudential policies examine the responses of an individual bank to exogenous risks and do not incorporate endogenous risk and the interconnectedness with the rest of the system. Similarly, the micro prudential authority is concerned with risk concentration within individual institutions, while the macro prudential authority is concerned with similar portfolio holdings among institutions in the system. The tools used include minimum capital requirements for individual institution, capital conservation buffer, risk management standards etc.

Overlap of macro and micro prudential tools include leverage ratio, large exposure limits, capital to risk weighted assets etc" (IMF).

MP should also supplement and complement the MPP and MiPP because the objective of MP is economic stability, growth and inflation control. MPP objective is financial stability. MiPP objective is health of individual institutions. Economic stability would lead to financial stability and this in turn would lead to robust health of the financial institutions. Even in the reverse order to some extent healthy financial institutions will lead to financial stability and this in turn would result in economic stability.

The effect of monetary policy on macro and micro prudential regulations is to be appreciated "It was important to deal with sectoral exuberance through countercyclical policies (micro prudential) even as monetary policy, while dealing with inflation scenario, deals with generalised exuberance. Interest rate alone, being a blunt instrument, would not have been able to

handle the sectoral exuberance, or else, the cost to the economy would have been higher"(Sinha).
Similarly, "MPP, MiPP need to usually complement and reinforce each other in pursuit of their respective goals. For example, the health of individual institutions is a necessary, though not sufficient, condition for system-wide stability, while a stable system contributes to the health of individual institutions"(IMF).
If the objectives and effects of MP, MPP and MiPP are not understood properly it would lead to anomalous situation. In fact sometimes it is felt that the three could also be conflicting. For eg. If MP objective is to propel growth in the economy the tool used would be reduction of the interest rates, the regulator decreases the CRR/SLR thereby increasing the liquidity in the system. This would have a downward impact on the interest rates and enable financial institutions to reduce the funding rates. The hope of the monetary authority is that lower rates in the economy would increase growth. Entrepreneurs would be encouraged to take more risk if the interest rates are lowered. However, lower interest rates would also lead to excessive risk taking by the entrepreneurs and exuberant entrepreneurship would lead to instability of the financial institutions and further result in financial instability which will lead to economic instability. Once there is downward adjustment in the interest rates the financial regulator should closely monitor the complementary increase in credit growth in the sector.
As MP tools are broad in nature (CRR/SLR etc) they affect the entire economy. They are less directed towards particular sector. So the financial regulator needs to have a wide search and cast his net wider to assimilate the results. If the credit growth is not commensurate with the policy rates changes (many a times it is not proportional) it could mean the increased liquidity is seeping elsewhere. As markets are driven by liquidity (equity, bond, forex, commodity etc) probably the seepage could be reflected in the increased activity in the markets. As water flows as in a downward sloppy ground so also liquidity is attracted by the sector which offers the highest rate of return for a given amount of risk. Further, the excess liquidity provided by the monetary policy may even be attracted by the non-financial asset class like real estate, precious metals etc. Still worse the excess liquidity could be attracted by other economies with higher rates of interest. Hence monetary policy itself should be properly nuanced considering all the effects or otherwise. In addition, if the conditions elsewhere –markets, other asset class (financial and non-financial) and other economies are not conducive (and do not attract) the liquidity created then it may remain within the economy itself. What percentage would remain in the economy and how much would flow out depends on the other factors such as other sector regulations/policies (sometimes absence of), risk-return trade-off, financial literacy levels, other economies' MP, MPP, MiPP etc. There cannot be a formula or norm to fit these into a strait jacket and enable policy decision. The success of the MP or otherwise lies in the ability of the monetary policy authority to collate the signals as early as possible. In addition, the financial regulator should also be able to supplement and complement the MP with MPP and MiPP. In the case of reduced interest rates by MP and the signals warn of higher risk taking by the entrepreneurs resulting in excessive credit growth MPP and MiPP needs to be calibrated. MiPP has tools like exposure norms, loan-to-asset value (LTV), provisioning norms etc which need to be increased to reduce the risk at the micro level of the financial institution.

Policy	Objective	Tools
Monetary Policy	Economic stability and growth and inflation control. Official goals usually include relatively stable prices and low unemployment.	Cash Reserve Ratio(CRR), Statutory Liquidity Ratio(SLR), Repurchase option(repo), Reverse-repo, Liquidity Adjustment Facility (LAF), Marginal Standing Facility (MAF), Open Market Operations (OMO).
Macro Prudential Regulation	Mitigate the risk of the financial system as a whole particularly systemic risk. The ultimate objective of macro prudential policy is to avoid output and wealth losses in the long run by limiting the	The tools in this regard include capital surcharge for systemically important financial institutions, counter cyclical buffer etc.

	buildup of system-wide financial risk. It also aims to mitigate risks linked to financial sector concentration and interconnectedness.	
Micro Prudential Policy	Focus on the health of individual financial institutions. Micro prudential policies examine the responses of an individual bank to exogenous risks and do not incorporate endogenous risk and the interconnectedness with the rest of the system. Concerned with risk concentration within individual institutions, while the macro prudential authority is concerned with similar portfolio holdings among institutions in the system.	The tools used include minimum capital requirements for individual institution, capital conservation buffer, risk management standards, exposure norms, loan-to-asset value (LTV), provisioning norms etc.

Use of Appropriate policy and tools: The financial regulator should use appropriate policy and having selected the policy the most appropriate/effective tool should be used.

"monetary policy faces significant limitations as a tool to promote financial stability. Its effects on financial vulnerabilities, such as excessive leverage and maturity transformation, are not well understood and are less direct than a regulatory or supervisory approach; **in addition, efforts to promote financial stability through adjustments in interest rates would increase the volatility of inflation and employment.** As a result a macro prudential approach to supervision and regulation needs to play the primary role."
….."it is critical for regulators to complete their efforts at implementing a macro prudential approach to enhance resilience within the financial system, which will minimize the likelihood that monetary policy will need to focus on financial stability issues rather than on price stability and full employment" (Yellen).
Therefore, monetary policy tools are different from macro prudential tools and micro prudential tools. For ensuring financial stability the regulator should use the macro prudential norms. Monetary policy should not be used for bringing about financial stability because these tools could hamper economic growth. **However, to rein in exuberant risk taking in the economy monetary policy tools can be used in exigencies**. Further, while formulating macro prudential norms regulator should have clarity in which risk taking is sought to be controlled - household or entrepreneurship. If entrepreneurship risk taking has an excessive leverage macro prudential norms should seek tode-risk only these. Improper understanding and a selection of inappropriate tools would have adverse impact. Also to ensure institutional stability appropriate micro prudential tools are to be used.
The regulator should use appropriate tools depending on the objective to be achieved as these tools have different impacts.

Monetary policy has a broader impact on the economy. It cannot be targeted at a particular sector. For eg. Increase of CRR/SLR has an impact on interest rates throughout the economy. Macro prudential regulations are focused and could be targeted to derisk certain sector. Micro prudential regulations are more focused. For eg. If there is excess risk taking in the housing sector the loan-to-asset value (LTV) for lending by banks can be suitably modified. Incidentally, LTV overlaps as a macro and micro prudential tool.
Some tools like capital risk weights and provisioning requirements overlap as a macro and micro prudential tool. But the financial regulator has to be careful in his selection. "Combination of risk weights and provisioning requirements for standard assets were used as countercyclical policies. It would appear, however, that varying the provisioning requirements may have been more effective than varying risk weights in moderating credit flow to the specific sectors. This is because, since the average capital adequacy ratio of banks operating in India has been well above12 per cent for the last many years (as on December 2010, it was above 14 per cent), risk weights may not always be effective in dampening the growth of credit as banks can continue to finance riskier sectors yielding higher returns by allowing their capital adequacy ratios to fall by a few basis points and still remain much above the regulatory requirements. To the extent higher risk weights translate into increase in interest rates, demand for credit may come down. On the other hand, varying provisioning requirement would be potentially more effective as it would impact the Profit and Loss account of banks to which banks are more sensitive"(Sinha).
Evolution of Monetary Policy, Macro Prudential Policy and Micro Prudential Policy: Monetary policy had an early origin. "The Reserve Bank of India Act,

1934 provides a broad legal mandate to RBI to secure monetary stability and generally to operate the currency and credit system of the country to its advantage. In practice this meant the dual objective of growth and price stability, the relative emphasis being dependent on the context. Since 2004, RBI has added **financial stability as an additional objective in view of the fast growing size and importance of the Indian financial sector"**(Sinha).

Though monetary policy, macro prudential and micro prudential policy, objectives and tools are different, these are still evolving to be concretized and compartmentalized. RBI in its monetary policy statement also covers macro and micro prudential regulations, perhaps as the monetary policy authority is also the macro prudential and micro prudential regulator.

"Macro-prudential approach to regulation and supervision involves a paradigm change. These are very early days and there is no doubt that over a period of time, various aspects of these policies would evolve. Currently, because of its infancy, there are several unsettled issues. The identification and measurement of systemic risk which has to be the starting point for designing macro-prudential policies needs a lot of work. Other important issues illustratively are: better understanding of the interaction of macro-prudential policies with other public policies, particularly with monetary policy; development of a tool kit to deal with systemic risk; designing of a robust early warning system regarding build up of systemic risks; evolving an optimal mix of rules and discretion while operating macro-prudential policies; extending the perimeter for macro-prudential instruments to cover the shadow banking system also which is going to be avery challenging task; defining the mandate and powers of the macro prudential authority and evolving a methodology to ensure accountability of such authority; and putting in place a framework for international cooperation, etc" (Sinha).

"In December 2010, the Financial Stability and Development Council (FSDC), under the chairmanship of the Finance Minister, has been set up to deal with issues related to, *inter alia,* financial stability, inter-regulatory coordination and macro-prudential supervision of the economy, including the functioning of large financial conglomerates. The Council has all the financial sector regulators as members. The Sub-Committee is expected to evolve as the operative body for financial stability in normal times while the FSDC would have a broad oversight and will assume a central role in crisis times. Now that the FSDC is in place, conventions and practices will develop over a period of time which will, while serving the goal of financial stability" (Sinha)

The economies of the world have moved away from commodisation to financialisation. In fact it is financialisation of commodities, whereby by the financial derivatives track the underlying derivatives. With further financialisation of the economies the challenges of regulation would be different. The State has to revisit the financial sector authorities role. The roles of monetary authority, macro prudential regulator and micro prudential regulator will soon have to segregated and defined. The economic and financial crises have enabled the State to appreciate the nuances in the different roles of the regulators. The roles, responsibilities and expectations of the three – monetary, macro and micro prudential authorities have to be redefined. In a globalised world the challenges faced by economies are different and economic crisis, systemic risk, financial instability contagion move seamlessly. One authority, as is being practiced in many economies, handling all the three would be handicapped to dampen the same. There could be adhoc arrangements in the form of FSDC which would be an over-arching body. But it could never substitute for a specialized regulator. Such bodies are not envisaged as super-regulators with responsibility. Their role is more advisory and coordnatory in nature as it is only an aggregate of all regulators. Sooner the State attempts to appreciate the nuances involved in the three different regulators and defines their respective roles and responsibilities than the economy/financial system/financial institutions would be ring fenced from the contagion of economic crisis, financial instability.

Conclusion: Financial Regulator and its role have evolved over a period of time. Usage of paper money gave a boost to trade and commerce. The need for a monetary authority was felt and ushered in a new era, which was also the starting point for financial regulation. Increased financialisation of commodities has lead to finance being recognized as a sector by itself. The financial sector was born. Increased globalization of finance has given rise to a number of challenges to the regulators. Regulators have to balance between growth and development on one side with risk taken by the financial sector. Financial engineering has made the role of regulators even more challenging. The financial sector regulator has a dual role regulation/supervision and also development of the financial sector. There are various models adopted by State in their development strategy. Market based Vs Institution based**,** Functional Perspective and Institutional Perspective, Wall Street Vs Main Street etc. Having chosen a model which would depend on the

stage of economic development and other factors there are certain principles that could be followed in regulation/supervision of the financial sector. These could be Rule based approach Vs Principle based approach, Regulation Vs Deregulation, Shareholder control Vs Stake holder control. With increased financialisation and innovation in finance and financial engineering taking centre stage a school of thought which is at a nascent stage and gaining prominence is financial regulation being a highly specilised segment needs separate authorities to ensure economic stability, financial stability and institutional stability. Central Banking which has three functions – monetary authority, macro prudential regulations and micro prudential regulations may have to be entrusted to three highly specilised agencies. Further, these regulators to be effective needs close co-ordination and inter-face of institutions. There could be an over-arching body like the FSDC in India which could be entrusted with advisory and co-ordination among regulators. Such a body should be institutionalized with sufficient powers under an appropriate legislative mandate.

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