UNIT 10: REGULATION OF FINANCIAL MARKETS IN INDIA

UNIT STRUCTURE

10.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- define the concept of regulation of financial markets
- know the objectives of financial regulation
- identify the importance of Indian financial markets
- describe the various regulators of financial system

- outline the regulatory role of various regulatory bodies in the financial System
- describe the various initiatives for Regulation of financial market.

10.2 INTRODUCTION

A significant development of the 20th century, particularly in its later part, is expansion of financial market world over which mostly was driven by globalization, technology, innovations and increasing trade volume. India has not been an exception with probably largest number of listed companies with a very large investor population and ever increasing volumes of trades. Since the economic development of an economy is directly linked with the development of financial market, the effectiveness of monetary policies largely depend on the performance of financial market. A well-regulated financial market increases the level of confidence among the investors and insures them against the potential risk.

The regulation and supervision of the financial markets in India is carried out by different regulatory authorities. The Reserve Bank of India (RBI) regulates and supervises the major part of the financial system. The supervisory role of the RBI covers commercial banks, urban cooperative banks (UCBs), and nonbanking finance companies (NBFCs). Some of the financial institutions, in turn, regulate or supervise other institutions in the financial sector, for instance, Regional Rural Banks and the Co-operative banks are supervised by National Bank for Agriculture and Rural Development (NABARD); and housing finance companies by National Housing Bank (NHB). Department of Company Affairs (DCA), Government of India regulates deposit taking activities of corporate, other than NBFCS registered under companies Act, but not those which are under separate statutes. The Registrar of Cooperatives of different states in the case of single state cooperatives and the Central Government in the case of multi-state cooperatives are joint regulators, the RBI for UCBs, and NABARD for rural cooperatives. Whereas RBI and NABARD are concerned with the banking functions of the cooperatives, management control rests with the State/ Central Government. This “dual control” impacts the supervision and regulation of the cooperative banks. The capital market, mutual funds, and other capital market intermediaries are regulated by Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector; and the Pension Funds Regulatory and Development Authority (PFRDA) regulates the pension funds.

India has a legacy financial regulatory architecture. The present work allocation between RBI, SEBI, IRDA and PFRDA – was not designed; it has evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time. Each regulator has their own rules on registration, code of conduct, commissions and fees to monitor the product providers and distributors. RBI, SEBI and IRDA have grievance redress procedures through sector financial Ombudsmen services. The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act, 1992, in order to protect the interests of the investors in securities as well as promote the development of the capital market. It involves regulating the business in stock exchanges; supervising the working of stock brokers, share transfer agents, merchant bankers, underwriters, etc; as well as prohibiting unfair trade practices in the securities market.

10.3 CONCEPT OF REGULATION OF FINANCIAL MARKET

The functioning of financial markets is regulated by several legislations that include Acts, Rules, Regulations, Guidelines, Circulars, etc. Understanding the legislations governing the financial markets in India will give the reader a fair idea of how the financial markets in India are regulated. The regulators of the financial market lay down specific rules of behaviour for participants in the financial system and provide for the monitoring of the observance of the rules and regulation. Such regulations became more important in the situations of far reaching technological progress, liberalization and greater integration in the financial system.

10.4 OBJECTIVES OF FINANCIAL MARKET REGULATION

Following are the objectives of financial market regulation :-

(A) To protect the interest of the investor and consumer of the financial services.

(B) To maintain stability in the financial system.

(C) To reduce the fraudulent activities in the financial system.

(D) To provide confidence to the small investors to invest in the financial market

(E) To provide easy and flexible financial transaction.

10.5 REGULATORS OF INDIAN FINANCIAL MARKET

In Indian financial system each financial services is regulated by the individual regulators.The following table will give us an idia about who regulate what.

Regulator	Financial Services and Schemes
RBI (Reserve Bank of India)	Fixed deposits and other banking products and services
SEBI (Securities and Exchange Board of India)	Services in the capital market and capital market intermediaries
Insurance Regulatory and Development Authority (IRDA)	Insurance Sector
Pension Fund Regulatory and Development Authority	New Pension Scheme

10.6 RESERVE BANK OF INDIA (RBI)

The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over the entire banking system. In exercise of the powers under these Acts, the RBI regulates the entry into banking business by licensing, exercise controls over shareholding and voting powers of shareholders, exercises control over managerial persons, and regulates the business of the bank by permitting and prohibiting certain business. RBI also supervises the functioning of the banks operating in the country by inspecting and issuing directions from time to time in public interest and in the interest of the banking system as a whole. It also gives directions to the bank to adhere the norms laid down by it or by the Bank for International Settlement for maintaining an international standard in the operations of banks relating to capital adequacy, asset classification, income recognition, management quality, efficiency, liquidity and surveillance. The bank also regulates the functions of other banks by giving directions in respect of interest rates, lending limits, investment limit and other matter. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. Under the Reserve Bank of India (Board of Financial Supervision) Regulations 1994, a separate Board for Financial Supervision (BFS) was set up within the Bank. The objective of this Board is to strengthen supervision and surveillance over the financial system and to provide a sharper focus to supervisory policy and skills. This Board covers banks, non-banking financial institutions and other para-banking institutions.

10.6.1 Regulatory functions of RBI

The regulatory and supervisory functions of the RBI may be summed up as follows:

1. **Power to issue license:** The RBI grants license to banks for carrying out banking business. License is given to the new banks as well as to the existing banks for branch expansion and for opening extension counters, new branches, even to close down existing branches.
2. **Power of appointment and removal of banking board/ personnel:** An amendment Act passed in 1963, which became effective February 1, 1964, gave further powers to the Reserve Bank, particularly to restrain the control exercised by particular

groups of persons over the affairs of banks and to restrict loans and advances as well as guarantees given by banks. It also enlarged the Reserve Bank's powers of control in the appointment and removal of banks' executive personnel. Further, The RBI is empowered to supersede, after consultation with the central government, the Board of Directors of banking companies and to appoint an Administrator. On recommendation of RBI, the central government may supersede the Board of Directors of nationalized banks, SBI and subsidiary banks of SBI under certain circumstances and appoint Administrator.

3. **Powers to regulate the business of banking:** The Reserve Bank of India Act, 1934 (RBI Act) empowers the Reserve Bank of India (RBI) to issue rules, regulations, directions and guidelines on a wide range of issues relating to banking and the financial sector.

4. **Power to give directions to banks:** The RBI is empowered to give directions from time to time to other banks operating in India regarding various banking and other activities. Section 21 (3) of RBI act further lays down that every bank shall be "bound to comply with any direction given by Reserve Bank".

5. **Power to inspect and supervise banks:** The Reserve Bank at any time may, and on being directed so to do by the Central Government shall, cause an inspection to be made by one or more of its officers of any banking company and its books and accounts; and the Reserve Bank shall supply to the banking company a copy of its report on such inspection.

6. **Power to conduct audit of the banks:** Where the Reserve Bank is of opinion that it is necessary in the public interest or in the interest of the banking company or its depositors to do so, may at any time by order direct that a special audit of the banking company's accounts, for any such transaction or class of transactions or for such period or periods as may be

specified in the order, shall be conducted and may by the same or a different order either appoint a person duly qualified under any law for the time being in force to be an auditor of companies or direct the auditor of the banking company himself to conduct such special audit and the auditor shall comply with such directions and make a report of such audit to the Reserve Bank and forward a copy thereof to the company.

7. **Powers relating to moratorium, amalgamation and winding up:** The RBI can make an application to the High Court for the winding up of the banking company, in respect of which an Order of Moratorium has been issued by the High Court.
8. **Power to impose norms of practice and maintenance of accounts:** The RBI can impose norms of practice and maintenance of accounts to other banks operating in India from time to time in accordance to the changing scenario of accounting practices prevailing in India.
9. **Power to collect and furnish credit information:** The RBI may at any time direct any banking company to submit to it such statements relating to such credit information and in such form and within such time as may be specified by the Bank from time to time
10. **Power to impose penalty:** The RBI can impose penalty on any banking company if it violates norms and practices as defined under banking law prevailing in India.

Recently a provision was incorporated by the Information Technology Act, 2000 which enabled the RBI to make regulations for regulating payment systems of banks and financial institutions.

CHECK YOUR PROGRESS

Q 1: Mention two objectives of financial regulation.

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Q 2: Mention two regulatory functions of RBI.

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10.7 SECURITIES AND EXCHANGE BOARD OF INDIA

The Securities and Exchange Board of India was established on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India Act, 1992.

The reason the SEBI was constituted was because before the SEBI law relating to the securities market in India was contained in different enactments like Companies Act, 1956, Securities Contract (Regulation) Act, 1956, and the Capital Issues (Control) Act, 1947. The capital market witnessed a tremendous growth during 1980's, characterised particularly by the increasing participation of the public. This ever expanding investor's population and market capitalisation led to a variety of malpractices on the part of companies, brokers, merchant bankers, investment consultants and others involved in the securities market. The glaring examples of these malpractices include existence of self –styled merchant bankers, unofficial private placements, rigging of prices, unofficial premium on new issues, non adherence of provisions of the Companies Act, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. These malpractices and unfair trading practices have eroded investor confidence and multiplied investor grievances. The Government and the stock exchanges were rather helpless in redressing the investor's problems because of lack of proper penal provisions in the existing legislation.

In view of the above, the Government of India decided to set-up a separate regulatory body known as Securities and Exchange Board of India.

10.7.1 Objectives of SEBI

The overall objective of SEBI is to protect the interests of investors and to promote the development of, and regulate the securities market. This may be elaborated as follows:

1. To regulate stock exchanges and the securities industry to promote their orderly functioning.
2. To protect the rights and interests of investors, particularly individual investors and to guide and educate them.
3. To prevent trading malpractices and achieve a balance between self regulation by the securities industry and its statutory regulation.
4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc., with a view to making them competitive and professional.

10.7.2 Functions of SEBI

Keeping in mind the emerging nature of the securities market in India, SEBI was entrusted with the twin task of both regulation and development of the securities market. It also has certain protective functions, Which are mention bellow :-

Regulatory Functions

1. Registration of brokers and sub brokers and other players in the market.
2. Registration of collective investment schemes and Mutual Funds.
3. Regulation of stock brokers, portfolio managers, underwriters and merchant bankers and the business in stock exchanges and any other securities market.
4. Regulation of takeover bids by companies.

5. Calling for information by undertaking inspection, conducting enquiries and audits of stock exchanges and intermediaries.
6. Levying fee or other charges for carrying out the purposes of the Act.
7. Performing and exercising such power under Securities Contracts (Regulation) Act 1956, as may be delegated by the Government of India.

Development Functions

1. Training of intermediaries of the securities market.
2. Conducting research and publishing information useful to all market participants.
3. Undertaking measures to develop the capital markets by adapting a flexible approach.

Protective Functions

1. Prohibition of fraudulent and unfair trade practices like making misleading statements, manipulations, price rigging etc.
2. Controlling insider trading and imposing penalties for such practices.
3. Undertaking steps for investor protection.
4. Promotion of fair practices and code of conduct in securities market.

10.7.3 Additional functions of SEBI under the Securities Contracts (Regulation) Act,1956

The Securities Contracts (Regulation) Act, 1956 (SCRA) which was enacted to prevent undesirable transactions in securities and to regulate the business of securities had given certain powers to the Central Government, under the provisions of that Act. The functions of the Central Government under that Act have been granted to SEBI. These Functions are:

(a) **Power to call for periodical returns or direct enquires to be made (Section 6):** SEBI will receive from every recognized

Stock Exchange such periodical returns relating to its affairs as may be prescribed by SCRA rules.

(b) **Power to approve the bye-laws of stock exchanges:** Section 9 of SCRA provides that any stock exchange may make bye-laws for the regulation ad control of contracts with the previous approval of SEBI.

(c) **Power of SEBI to make or amend bye-laws of recognized stock exchanges (Section 10, SCRA):** SEBI may either on a request in writing received by it in this behalf from the governing body of a recognized stock exchange or in its own motion make bye-laws on matters specified in Section 9 of SCRA or amend any bye laws made by stock exchange.

(d) **Licensing of dealers in securities in certain areas (Section 17 SCRA):** SEBI has been empowered to grant a license to any person for the business of dealing in securities in any State or area to which Section 13 of SCRA has not been declared to apply.

(e) **Power to delegate:** Section 29A of SCRA provides that the Central Government may, by order published in the Official Gazette, direct that the powers exercisable by it under any provision of the SCRA shall, in relation to such matters and subject to such conditions, if any as may be specified in the order, be exercisable also by SEBI or the Reserve Bank of India.

More Powers for SEBI: Certain additional powers with regard to certain provisions under the Companies Act, 2013, related to issue and transfer of securities and non-payment of dividend, in the case of listed public companies intending to get their securities listed on any recognized stock exchange, shall be administered by SEBI.

CHECK YOUR PROGRESS

Q 3: Mention two powers of SEBI.

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10.7.4 SEBI and Regulation of Securities Market

SEBI prescribes the conditions for issuer companies to raise capital from the public so as to protect the interest of the suppliers of capital (investors). The extensive disclosures prescribed for issuers facilitate informed investment decision making by investors while simultaneously ensuring quality of the issuer. Further, it has prescribed norms for such corporates on 'on going' basis and also during their restructuring (like substantial acquisition, buy back and delisting of shares) to safeguard the interest of investors. To ensure fair and high standards of service to investors, SEBI allows only fit and proper entities to operate in the capital markets as intermediaries. In this regard, it has prescribed detailed and uniform norms of their registration. Further, to ensure market integrity, it has prescribed norms for fair market practices including prohibiting fraudulent and unfair trade practices and insider trading. Detailed norms for safeguarding the interest of investors in secondary markets have also been prescribed. SEBI also prescribes conditions for operation of collective investor schemes, including Mutual Funds. SEBI tries to create favourable situation for the entry of investors with confidence in the market with a purpose to expand capital market particularly security market. SEBI's intervention has resulted into improvements in proper methods of transaction and to minimize defects and manipulations in them. But infrequently large improper transactions are taking place. For example, in 1992 Harshad Mehta used money from banks to make personal gains via investment in shares; in 1996 C R Bhansali raised public money through FDs, MFs and debentures via nonexistent firms and invested them in stocks for personal gains; in 2001 Ketan Parekh made Circular trading in selected stocks via borrowed money from banks to manipulate share prices; and in 2010 Sahara Chief Subrata Roy issued Sahara Housing Bonds to 29.6 million investors without following Sebi regulations and investor protection measures mentioned therein.

Activities of SEBI

The focus area of SEBI's activities are as follows:

- Increasing market transparency through further improvement of disclosure standards
- Improving the standards of corporate governance
- Improving market efficiency by speeding up the process of dematerialization and introducing rolling settlement in a phased manner.
- Reducing transaction costs by refining the margin system
- Enhancing the market safety through an efficient margin system and stepping up surveillance.

SEBI has identified the following areas for focusing its attention for the overall growth and the development of the stock market in India:

- Registration of the stock brokers
- Authorization of Merchant Banker
- Monitoring and controlling of the mutual funds business.
- Issue of portfolio managers regulations.
- Issue of guidelines for disclosure and investor protection.

10.8 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY(IRDA)

The government in order to provide better insurance cover to citizens and also to augment the flow of long term sources of financing infrastructure, initiated reforms in the insurance sector by setting up of committee under chairmanship of R. N. Malhotra, former Governor of RBI. The Committee on reforms of the insurance sector recommended for the creation of a more efficient and competitive financial system in tune with global trends. It recommended amendments to regulate the insurance sector to adjust with the economic policies of privatization. The government in pursuance of the recommendation of the committee, decided to establish a Provisional Insurance Regulatory and Development Authority in 1996, to replace the erstwhile authority called the Controller of Insurance constituted under the Insurance Act, 1938, which initially worked under the Ministry of Commerce and later transferred to the Ministry of Finance. Finally, the decision to establish the Insurance Regulatory and Development Authority was implemented by the passing of the Insurance Regulatory and Development Authority Act, 1999. In India, presently after the opening up of the insurance sector, the regulator for the monitoring of the operations of the insurance companies is the IRDA, having its head office in Hyderabad. The regulatory framework mainly aims to focus on three areas, viz.,

- The protection of the interest of the consumers
- To ensure the financial soundness of the insurance industry
- To pave the way to help a healthy growth of the insurance market where both the government and the private players play simultaneously.

Need of IRDA in Regulation of Insurance Businesses

Any industry wherein the stakes of the public are high would come within the purview of a Regulation – reason being that failure of such companies could result in serious implications on the economy of the country at large. Insurance business involves collection of money from various Policyholders, investing them properly, honouring the obligations of the Policyholders and providing an efficient service. It is important to ensure that the entities providing these services stick to their commitments. Failure to honour commitments by such entities could have major repercussions on the financial services industry. After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.

10.8.1 Powers/Functions of IRDA

Under Section 14 of the IRDA Act, IRDA has the following powers:

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

(c) Specification of requisite qualifications, practical training and code of conduct for insurance agents and intermediaries.

(d) Specification of code of conduct for surveyors and loss assessors.

(e) Promoting efficiency in the conduct of insurance business.

(f) Promoting and regulating professional organizations connected with insurance and reinsurance business.

(g) Levying fees and other charges for carrying out the purposes of the Act.

(h) Calling for information from or undertaking inspection of insurance companies, intermediaries and other oganisations connected with insurance business.

(i) Control and regulation of rates, terms and conditions that may be offered by general insurance companies.

(j) Specifying the form and manner in which books of account shall be maintained by insurance companies and intermediaries.

(k) Regulation of investments of funds by insurance companies.

(l) Regulation of maintenance of margin of solvency.

(m) Adjudication of disputes between insurers and insurance intermediaries.

(n) Supervising the functioning of Tariff Advisory Committee.

(o) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organizations.

(p) Specifying the percentage of insurance business to be undertaken by insurers in rural or social sectors.

(q) Such other powers as may be prescribed.

10.9 Pension Fund Regulatory Development Authority (PFRDA)

Pension Fund Regulatory and Development Authority (PFRDA) was established by the Government of India on 10th October 2003 to promote old age income security and to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental there to. The Central Government has introduced the National Pension System (NPS) with effect from 1st January 2004. The NPS covers, at present, new entrants to Central Government services (excluding Armed Forces), some State Government services and autonomous bodies at their discretion and all citizens of India on a voluntary basis with effect from 1st May 2009. PFRDA has since been constituted under the provisions of the PFRDA Act 2013 w.e.f. 1st February 2014. PFRDA is responsible for appointment of various intermediate agencies such as Central Record Keeping Agency (CRA), Pension Fund Managers, Custodian, NPS Trustee Bank, etc. Currently, PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.

10.9.1 Functions and Powers of PFRDA

- Regulate and ensure orderly growth of NPS and other pension schemes.
- Registering and regulating intermediaries.

- Protecting interest of subscribers by ensuring safety of contribution and by ensuring that intermediation and operational costs under NPS are economical and reasonable.
- Promoting professional organisations connected with pension system, research and projects.
- Adjudicating of disputes between intermediaries and between intermediaries and subscribers.
- Residuary powers like inspection, conducting inquiries, investigation, audit.
- Powers of Civil Court for the purpose of examining persons, inspection of books, register etc.
- Powers of restrain, impounding and retaining proceeds etc.

CHECK YOUR PROGRESS

Q 4: Mention two powers of IRDA.

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Q 5: Mention two powers of PFRDA.

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10.10 LET US SUM UP

The main aspects covered in this unit are -

- The major aim of financial regulation is to maintain integrity of the financial market.
- The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI

wide powers of supervision and control over the entire banking system.

- The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India Act, 1992.
- After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.
- PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.

10.11 FURTHER READINGS

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10.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Two Objectives of financial market regulation are:

(a) To protect the interest of the investor and consumer of the financial services.

(b) To maintain stability in the financial system.

Ans to Q No 2: Two powers of RBI are-Power to issue license and Powers to regulate the business of banking.

Ans to Q No 3: Following are the two powers of SEBI:

(a) To regulate stock exchanges and the securities industry to promote their orderly functioning.

(b) To protect the rights and interests of investors, particularly individual investors and to guide and educate them.

Ans to Q No 4: Following are the two powers of IRDA

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

Ans to Q No 5: Following are the two powers of PFRDA

(a) Regulate and ensure orderly growth of NPS and other pension schemes.

(b) Registering and regulating intermediaries.

10.13 MODEL QUESTIONS

Q 1: Discuss the functions of SEBI.

Q 2: Discuss the regulatory powers of RBI.

Q 3: Discuss the powers and functions of IRDA and PFRDA.

Q 4: Explain the regulatory environment of financial markets in India.

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