

Whither independent regulatory authorities

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The recent decision of the UK government to bonsai the Financial Services Authority (FSA) is critical to the future of independent regulatory authorities (IRAs) everywhere. This event is significant in several ways: in designing and structuring regulation of financial markets; autonomy and accountability of regulators; contracting to solve the agency problem and finally, the institutional mechanism of governance in general.


In order to understand the full implications of this event, we need to analyse the architecture of IRAs. They have been considered the most important governance reforms in the past few decades. Though some of the central banks had been performing certain oversight functions and are independent and autonomous with respect to their monetary policy responsibilities, IRAs as institutional innovations are of recent vintage. Interestingly, the FSA is one of the youngest.

The logic behind setting up of IRAs was simple. States need agents, i.e., specialised institutions with powers to address dynamic issues that require a speedy response. The traditional mechanism of state action through its conventional branches of executive and legislature was considered a long drawn process. The ideal candidate for such speedy mechanism of governance is the financial markets. Modern financial markets work at lightening speed with the help of hi-tech tools. Money is fungible and transferable across the globe, though subject to varying national restrictions.


The architects of governance institutions, however, were aware of the potential agency problem in delegating responsibility. The agency problem arises both on account of information asymmetry as well as moral hazard emanating from adverse selection. The remedy is to draw up a contract, very often a statutory one. But given the high information asymmetry haunting financial markets, such contracting would be imperfect and a legal centric approach alone is expected to produce only a limited result. Given this, the agency problem is perennial, almost embedded in the scheme of delegation to the IRAs. This would inevitably result in difficulties for the principal as its objectives would not be fully met.

The issue of autonomy and accountability has been another area of conflict between the principal and the agent. Although contracting through a legislative framework tries to address this problem, its limitations kept some of the windows of potential disputes open. IRAs across the world are accountable to the legislature but their accountability to the executive often creates ripples. In order to resolve this conflict, in many countries, particularly with advanced institutional structures, IRAs were given almost complete autonomy from the


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executive and made accountable only to the legislature. This has, however, widened the scope for simmering conflict between the executive and the IRAs because the executives head is accountable to the legislature for the actions and inactions of the IRAs.

IRAs are extremely powerful creations with legislative, judicial and executive powers, while in statecraft these functions have been assigned to separate agencies to facilitate mutual checks and balances. Given that even the sovereign has not vested all powers in a single entity, IRAs became a centre of jealousy with their curious mixture of unbridled powers. Along with the autonomy they have in their design and with super-organisational powers, IRAs became empires-within-empires in no time.

There were sceptics of IRAs from early on. Particularly relevant was the powerful argument advanced by George Stigler in the early 1970s about regulatory capture. In its simplest form, it was argued that the regulatory agencies would come to espouse the cause of the industry, which they are supposed to regulate rather than the cause of the consumers for whose benefits regulations were to be made. Regulatory capture and regulatory bargaining in a multi-regulatory environment provided a strong concoction for their lethargy, which was magnified into regulatory collapse in the run-up to the recent financial crisis. Some of the observers termed this as self-tying up to the mast to listen to the Sirens song, culpable homicide, when they became parties to the building of the global financial crisis. This crisis also brought out the incapability of the regulators to take advance action, although they were expected to be closer to the ground reality.

Within a short period of mushrooming growth, the wind had started blowing against IRAs. Even before the crisis, questions about their unlimited powers (and to a certain extent unnatural in comparison even with the state), relative lack of accountability (democratic deficit to some of observers) were asked. Their unwillingness to cooperate among themselves and take concerted action in multi-regulatory contexts was a major embarrassment to the governments in several jurisdictions. Their failure in preventing and resolving the crisis resulting in the state having to fire-fight ensured that the IRAs enjoying the Sirens song were in fact their hearing their swansong.

It is said that regulatory changes are rarely made, except in response to crisis, but this time around many became sceptical about the speed of action as for about two years, there were only discussions and draft papers. Still, finally the speed with which the axe fell on the FSA was rather surprising. Particularly because the FSA was considered the new model of regulatory architecture, a powerful super regulator. The irony is that failure occurred irrespective of the regulatory structure; whether it was single or multiple regulators ruling the space. The epicentre of the crisis had many regulators and that too at different layers. If regulatory failure was not unique to any structure why did FSA become the victim Further the UK is not replacing the IRA, it is only substituting it. Effectively the Bank of England takes over as the super regulator. If in the next crisis (not unexpected in a bubbled global economy) the Bank of England fails, will it be closed down

Our initial fears on moral hazard and agency problems of delegated governance are haunting us with greater force. In an increasingly integrated but asymmetric world, what is the ideal institutional structure for market regulation and governance If a failed agency is substituted by another agency does it solve the problem Will the growing disenchantment with the

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delegated regulatory model post-crisis lead to the State recalling the powers of the IRAs, making them perhaps the shortest experiment in institution building. So far it seems the fear was only for the market players on the possibility of stiffer regulation. These existential questions, however, have created fear in the psyche of the regulators as well. The recent financial crisis has resulted in one more uncertainty, uncertainty about the shape and fate of independent regulatory authorities. This will throw the reluctant institutional innovations in emerging markets into further flux.

CKG Nair is with the finance ministry and MS Sahoo is with Sebi. Views are personal

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