The touchstones of effective regulation

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We are familiar with Maslow's hammer: "If all you have is a hammer, everything looks like a nail." This cognitive bias leads to over-reliance on a familiar tool. A person with only a hammer is likely to fix everything using the hammer, often without considering other options.

In the age of 'regulatory state', there is a regulation to fix any market issue — real, illusory, or hypothetical. This has created a thriving industry of regulations. Deregulation Commissions/Task Forces have come up in matured jurisdictions to arrest the growth and reduce the burden of regulations. Not surprisingly, regulations have supporters and opponents alike, raising a doubt whether regulation is as much a disease as the cure.

While all-pervasive, regulation remains an art and science of the elite few. This is an attempt to understand the basics of regulations — what, why, when, and how. Though reforms replaced control with regulations, they are not opposites of each other.

The former prescribes what is permissible and what is not, while the latter permits almost every activity subject to meeting certain pre-specified norms.

For example, while the Capital Issues (Control) Act, 1947 prohibited raising capital from market except with the approval of the government, the SEBI Act, 1992 allows raising capital for any business, subject to true and complete disclosures. Regulations are legal prescriptions that incentivise market participants to carry out transactions (example: making a public issue) in accordance with the rules of the game and disincentivise them from digressions.

Economists believe there is only one reason for having regulations, that is, to address market failure; without regulations, market is most likely to fail (to yield optimum allocation of resources). The market fails only when it has any of the three infirmities — information asymmetry, externalities, and market power. Literature provides several other motives for regulation such as safety, security, health, and ecological concerns, consumer protection, prevention of market manipulation and anti-competitive conduct, and protection of freedom at the marketplace.

Most of these are subsumed in the three infirmities. For example, a polluting industry may keep the cost of production low by dumping pollutants into the nearby river. The producer and, consequently, consumers do not bear the full cost of the product, which is an example of an externality. This attracts more resources to the industry, which amounts to market failure.

Regulations may require the producer to bear the full cost, by appropriate ecological interventions, to address the market failure. The ecological concern is thus a sub-set of the externality infirmity. Regulations may have non-market motivations such as fairness and equity, like reservation in public issues for retail individual investors or main-streaming all sections of the society like minimum rural underwriting by insurance companies.

Regulation may be necessary in case of missing markets. For example, market for derivatives did not take off in India even after the ban on options was lifted in 1995. It found favour with investors only when a regulatory framework was put in place in 2000. Regulation is necessary to develop the market and once the market develops, it needs to be regulated.

Derivatives market

This, however, does not hold good when derivatives emerged for the first time in the world. The market for derivatives emerged as a few enterprising participants felt a need and designed a new product to meet the need. As people found the product useful, the market developed. With development of market, the participants understood the nuances of the market and developed light-touch regulations to deal with the nuisances. As the market developed further, a variety of derivatives emerged to meet the demand of each niche segment and instances of market abuse were also noticed. This led to a robust regulatory framework to deal with the possible abuses.

Thus, development and regulation feed on each other in a virtuous circle for an orderly growth of the market. This should guide provision of regulatory framework, subject to socio-ethical considerations, in case of emerging areas such as artificial intelligence, internet content, social media, big tech, digital platforms, and most recently, cryptocurrency.

There has been an unending debate as to whether regulations should be ex-ante or ex-post. This essentially presumes regulations prior or in response to an episode. There could be many episodes that have been prevented by proactive regulations. One does not notice such regulations as the episode never happened. One only notices regulations that follow an episode.

A responsive regulator, however, designs and modifies regulations proactively with changing needs of the market. Recent provision of pre-pack insolvency resolution is an example. This enables the law to evolve continuously in tandem with the market to address any emerging gaps, accommodate new structures, deal with innovative transactions, and improve the efficiency of operations in the market.

While it is not possible to have standard regulations to address a market failure, it is essential to have a standard process for making regulations to ensure that the regulations are effective as well as responsive, yet not excessive. One example is the regulations made by the Insolvency and Bankruptcy Board of India that govern the manner of making regulations.

These regulations mandate the regulator to involve the public in regulation-making through a consultation process. To make the consultation effective, the regulator must demonstrate that the benefits from the proposed regulation exceed costs and, of the available regulatory options, the proposed one is the most cost effective. Such consultation refines regulations and brings in ownership, making implementation easier.

Thus, the regulator needs to ask a few sequential questions before introducing any regulations. Is there evidence or a strong likelihood of any market failure? Can regulations address the market failure? Is regulation better than non-regulatory options? Is the choice of regulations better than other regulatory options? Do benefits from regulations exceed the associated costs? Can the regulation be implemented and not subverted? Does regulation have any unintended consequences?

At any point of time, these tests should be applied to find out which regulation needs to be introduced, modified, or repealed. This exercise, in common parlance, is known as ‘Regulatory Impact Assessment’. The assessment may result in ambiguous findings as these depend substantially on subjective assessment of people carrying out the tests. As far as possible, efforts should be made to make the tests objective and be supported by credible research. Regulation should be made only after it has cleared all the tests to the satisfaction of an external, independent agency. This will unfurl an era of better regulations.

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