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Building State Capacity in Regulation Through Performance Evaluation of Regulators

Background

India's history with specialized regulatory agencies is at least three decades long. The Reserve Bank of India, the country's Central Bank and the regulator of the banking system, has been in existence since 1934. With the advent of economic liberalization in the 1990s, several new regulators were created. India's first modern-era regulator - Securities and Exchange Board of India - was set up by a parliamentary statute in the year 1992 to regulate capital markets. Soon after, similar agencies were established to regulate sectors such as telecommunications (1997), insurance (1999), competition (2002), electricity (2003), food safety and standards (2006), pensions (2013), insolvency and bankruptcy (2016). At present, there are over thirteen specialized regulatory agencies at the Union level and the State Governments have also created a few.

Governance using the specialized agency-form is a widely accepted institutional arrangement around the world. Regulatory agencies that have some measure of separation from executive departments carry on the task of arms-length regulation. In India, such agencies have some common features: first, they are constructs of law; second, they are statutorily vested with quasi-legislative powers, executive powers, and often also have quasi-judicial powers; and third, they have operational autonomy along with certain accountability mechanisms. The creation of such agencies offers benefits like specialization, ability to undertake swift interventions in markets, and credible and depoliticized decision-making; however, they continue to face questions regarding their independence, accountability, and excessive concentration of power.

Challenges in regulatory independence

The boundary between the political executive and the regulatory agency can never be absolute. Agencies require a degree of autonomy in their resourcing arrangements, both financial and staff-related. Yet, agencies must also ensure coordination and consistency with the executive department in policy matters. Striking the right balance between these two objectives is the key institutional challenge of statutory regulatory agencies.

Regulatory capture (by regulated entities) is also a challenge. It leads to regulatory agencies serving the interests of established entities and prioritizing them over the protection of consumers. The independence of the regulator is a value that requires constant attention, improvement, and optimization given the ever-evolving nature of the market as well as the capabilities of the market participants.

Accountability deficit

The law that creates a regulator typically mandates that the regulations framed by the agency be placed before Parliament—which may rescind, modify, or annul them. Hence, in terms of design, parliamentary scrutiny of the legislative power exercised by such agencies is built-in. In reality, there is very little parliamentary discussion on these regulations and no known instance of their modification or annulment by either House of Parliament. Hence, while the requirement to place regulations before Parliament is formally fulfilled, the underlying objective of this accountability mechanism, i.e., parliamentary scrutiny, has remained on paper.

Over a twenty-three-period between 1999-2022, the Rajya Sabha Committee on Subordinate Legislation has reviewed 4 regulations, and the Lok Sabha Committee on Subordinate Legislation has reviewed 13 regulations passed by specialized regulatory agencies.¹ For context, just one regulator in India, the Securities and Exchange Board of India, has issued over 600 regulations since it was established in 1992.

Recommendation

The governing laws of agencies provide for financial audits by the Comptroller and Auditor General of India (CAG). However, there is no statutory requirement for performance audits like is done for executive bodies. Financial audits are insufficient to examine whether the regulator is able to fulfil its statutory objectives and whether it upholds good governance standards in doing so.

Institute third-party regulatory performance evaluations

To address this accountability gap, it is suggested that every specialized regulatory agency should be required to commission and publish an independent evaluation of its performance on three parameters: the regulator's internal governance; the processes it follows to fulfil statutory functions; and outcomes observed in the market it regulates.

Regulatory governance

The formal protection of a regulator's independence (by enshrining it in law) is an important mechanism to promote independent decision-making. Yet, the culture of independence in behaviour and operations must be induced by the top leadership of the

¹ Krishnan, K.P., Amrita Pillai, and Karan Gulati. "Statutory Regulatory Authorities and the Federal System in India." State Capacity Initiative Working Paper No. 2023-1. Centre for Policy Research, February 2023.

regulatory agency, namely, its Governing Board including the Chairperson.

The internal governance arrangements of the regulator as laid down by the Governing Board should be evaluated. This includes the Governing Board's intent and ability to ensure separation of powers within the organization, introduction of accountability and transparency measures, and its overall oversight on the agency's functions, responsiveness, and quality of output.

Regulatory actions

Each regulator is typically vested with powers to fulfill three sets of functions: executive, quasi-legislative, and quasi-judicial. A performance evaluation should not only assess whether these functions have been fulfilled but also the quality of processes used to fulfill regulatory functions. For instance, the function of licensing and registration should be undertaken in a specified, time-bound manner. Further, while the regulator can use its power to cancel or reject registrations, entities should be provided with a right of representation, and the regulator's final decision must be explained.

Another example is the requirement that every order passed by a regulator must contain (i) a statement of facts, (ii) issues/questions to be determined, (iii) submissions of parties, (iv) the regulator's findings on facts and contraventions (decision), and (v) the factors taken into account to determine the action (reasons). Regulatory actions should be examined to determine whether the regulator has acted as a fair 'referee' - consistently, impartially, and without conflict of interest.

Regulatory outcomes

Regulators generally do not produce direct outcomes; their services are inputs to the

activities of regulated entities and markets. Market outcomes are also influenced by several factors, some of which are beyond the

control of the regulator. In certain cases, the effects of the regulator's inputs may take many years to be apparent as outcomes. Despite such complexities, a comprehensive regulatory performance evaluation should consider parameters such as the growth of regulated entities, competition dynamics within the market, and court decisions on appeals made by entities against orders issued by the regulator.

The Parliament and the executive have recently begun responding to this gap in regulatory governance. The International Financial Services Centres Authority (IFSCA) Act, 2019, requires the regulatory agency it sets up (IFSCA) to constitute a Performance Review Committee to evaluate its performance annually.² Similarly, the rules made under the insolvency law, the Insolvency and Bankruptcy Code, 2016, require the Insolvency and Bankruptcy Board of India (IBBI) to publish a performance assessment of its Governing Board in the regulator's Annual Reports.³ IBBI has gone the extra mile to become the sole Indian statutory regulatory agency to commission an independent evaluation of its performance and publish it on its website.⁴

Regulatory performance evaluation is a strategic tool to build state capacity in regulation in India. Through such evaluations, regulators can improve their institutional capabilities, showcase their efforts in building professional competence, and create a conducive regulatory environment.

^{^2} Section 17, The International Financial Services Centres Authority Act, 2019.

^{^3} Rule 3 [Form of Annual Report], The Insolvency and Bankruptcy Board of India (Annual Report) Rules, 2018.

^{^4} Evaluation of the Regulatory Performance of the Insolvency and Bankruptcy Board of India, Reports, Insolvency and Bankruptcy Board of India, 2021.

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