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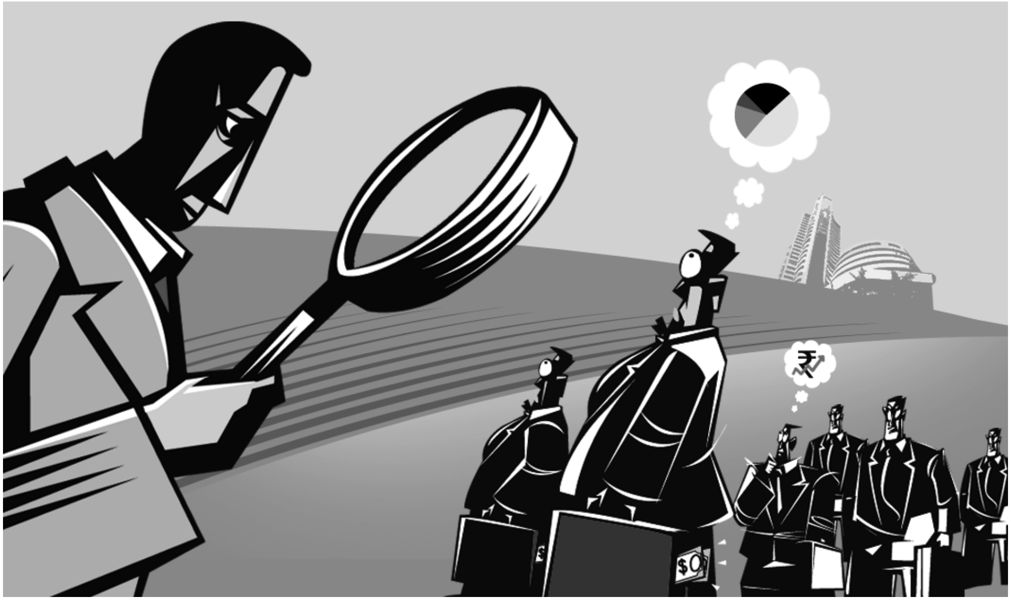

The road ahead at Sebi

Deep reforms necessary at the regulator to fulfil its core objectives

SNAKES & LADDERS

AJAY SHAH

Ajay Tyagi inherits one of the best regulators of India. As a black box, the Securities and Exchange Board of India (Sebi)'s main task is to deliver liquidity and market efficiency in India's financial markets. The report card at Sebi needs to also worry about the increasing importance of overseas trading of India's biggest financial products, Nifty and the rupee. The journey to these objectives runs through reforms of Sebi as an institution.

The most successful element of India's financial reforms is the equity market. The establishment of SEBI, NSE and NSDL gave a quantum jump in market design and regulatory mechanisms. Demutualisation minus listing, at NSE and BSE, made it possible for exchanges to be unconflicted frontline regulators. India was ahead of the world in the policy strategy in this field, and the key decisions have stood the test of time.

A nice thing about this field is that the key outcomes can be numerically measured. The liquidity of the market for the big companies is best measured using the 'impact cost' suffered when placing a basket trade on the market to buy ₹10 crore of all the Nifty stocks (in their correct proportions). India fares poorly by world standards on this. The next measure to look at is the impact cost suffered when doing a similar basket trade for Nifty junior. We should worry about how liquidity deteriorates as we go to smaller stocks. India does worse on this when compared with developed countries: A small Indian company is likely to fare worse on NSE/BSE when compared with its size peer on NASDAQ.

Key market efficiency measures can be computed using the derivatives markets. How big and persistent are the mispricings of the futures and options market? If India achieved a liquid and efficient market, mistakes in derivatives pricing would pop up only occasionally, and when they do, the market would rapidly undertake the trades that remove these mistakes. The size and persistence of mispricing can be quantified and monitored.

The looming threat to Indian finance is the departure of the Indian financial system. The two biggest financial products in India are Nifty and the rupee. We have difficulties of financial market policy, regulatory risk, mistakes in taxation and capital controls. In many respects, these problems have become worse in the last decade. As a consequence, Nifty and rupee trading has increasingly shifted to overseas venues such as Hong Kong, Singapore, and London.

Ten years ago, India had roughly 100 per cent market share in the trading of these products. This market share has declined to roughly 66 per cent today. If India regained prominence in Nifty and rupee trading, our financial markets would become more liquid. Indian finance is losing export revenues of roughly one per cent of GDP, or ₹1.5 lakh crore per year, as a consequence of this loss of market share.

The Ministry of Finance and Sebi should compute a group of these measures, going back into history, and updated every month. This will give a sense of the progress (or lack thereof) on Sebi's core objective, of delivering a liquid and efficient system of financial markets.

Sebi as a black box is accountable for the liquidity, efficiency and international competitiveness of India's financial markets. Why do we have difficulties in achieving these desirable things? The answers to this are found in public administration, in the working of Sebi. Why has Sebi not been able to achieve the institutionalised application of mind, through which problems are diagnosed and solved? The organisation design and processes followed at Sebi need reform.

Sebi is a regulator, and fuses the three branches of the state: The legislative, executive and judicial branches. This has created a tremendous concentration of power. It is all too easy for Sebi to make mistakes, and financial firms will be too timid to challenge the regulator. The issues of rule of law, and participatory governance, are particularly important in Sebi's context. Without these, Sebi can turn into the arbitrary exercise of power based on political and personal motivations. The Sebi board lacks a majority of independent directors, which could be a countervailing force.

The legislative process at Sebi works badly. Sebi repeatedly issues regulations that are not motivated by a problem in the market, that do not demonstrate the presence of a market failure, and are not backed by scientific evidence. Sebi sometimes undertakes public consultation on draft regulations, but I have not seen one episode in which one word of the draft regulation was modified in response to public comment.

Burman and Zaveri, 2016, compare Sebi, RBI, Trai and AERA on responsiveness in regulation-making. On a scale of 0 to 10, they emerge with scores of 1.1 for Sebi, 0.2 for RBI, 4.57 for Trai and 2.41 for AERA. A sound regulation-making procedure at Sebi would get the score up to 10.

On investigations and orders, Sebi procedures leave much to be desired. Punishments are often being imposed without the the basic process of an investigation and a hearing. The punishment of stopping financial markets activity imposes highly heterogeneous costs upon different firms, and is a lazy choice as it helps Sebi staff avoid the work of quantifying the harm caused. The arbitrary power wielded in the executive and quasi-judicial functions at Sebi is inconsistent with our aspiration of becoming a mature liberal democracy.

Sebi's faulty regulation-making process has given a series of mistakes in financial markets policy, and creates a risky environment where firms are afraid that something silly will come out next. Sebi's faulty executive and quasi-judicial functions has created regulatory risk for firms. This environment hampers the working of financial firms, and gives incentive to shift work to mature jurisdictions such as Hong Kong, Singapore or London.

Ajay Tyagi and Vikram Limaye, at Sebi and NSE respectively, are a great new leadership at the centre of India's financial reforms. They have a difficult journey ahead of them. We should all put our shoulders behind their task.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi