Enhancing Quality Of Regulations To Prevent Financial Frauds

V.K.Wadhwa, A.K.Saini, S. Sanjay Kumar

Abstract: Despite vast research on existing oversight mechanism of financial market regulators in India it remains unclear as to why these regulators time and again are failing in one way or the other. It is not known that whether it is natural to fail or something is lacking which is preventing these financial market regulators to operate at less than desirable level. This paper investigates despite noticeable primary law and also subordinate regulatory mechanism in place episodes of financial frauds are never ending. Adequate research evidence is available demonstrating poor quality of regulatory governance framework and also shoddy compliance. Visible legal conformances differ from behavioural performance. We examine suboptimal performance of regulators and explore elements of the best governance practices required for effective system of regulation. At the end recommendations covering potential tools and techniques for improving regulatory mechanism are examined.

Index Terms: Financial Frauds, Regulatory Performance, Governance setup, Quality of Regulations.

1 INTRODUCTION

FINANCIAL sector regulation has always been a challenge because of the very nature of activities. In India financial services sector is regulated by a mixture of institutions. Prominent among these institutions are as per Table No 1. The list shows a collection of varied type of institutions with vast array of objectives. It is well known that despite a lot of efforts to establish an effective institutional setup to implement regulatory process, episodes of financial frauds are unabated. Financial frauds damage our society in multiple ways. It is not just generation of monetary loss at a point of time but financial frauds have a long term adverse impact on trust worthiness thereby jeopardising productivity of economic system.

Table No. 1

S.No.	Abbreviation of Institution	Name of the Financial Sector Institutions/ Regulators
1.	RBI	Reserve Bank of India
2.	SEBI	Securities and Exchange Board of India
3.	SAT	Securities Appellate Tribunal
3.	SFIO	Serious Fraud Investigation Office
4.	MCA	Ministry of Corporate Affairs
5.	IRDA	Insurance and Development Authority
6.	ICRA	ICRA Limited
7.	CARE	Credit Analysis and Research Limited
8.	CRISIL	Credit rating Information Services of India
9.	BWR	Brickwork Rating
10.	NSE	National Stock Exchange
11.	BSE	BSE Limited (Erstwhile Bombay Stock Exchange)
12.	ICAI	The Institute of Chartered Accountants of India
13.	ICAI	The Institute of Cost Accountants of India
14.	ICSI	The Institute of Company Secretaries of India
15	NFRA	National Financial Reporting Authority
16	NCLT	National Company Law Tribunal
17	NCALT	National Company Law Appellate Tribunal
18	SIDBI	Small Industries Development Bank of India
19	NHB	National Housing Bank
20	EXIM Bank	Export-Import Bank of India
21	IIFCL	India Infrastructure Finance Company Ltd.
22	IFCI	Industrial Finance Corporation of India
23	NABARD	National Bank for Agriculture and Rural Development

Prime objective of an economic and social system is to maintain orderly operations for the benefit for everyone. Maintaining law and order is the first priority of any government. Besides prevention of offences other noteworthy activities of government gaining importance is to develop conditions conducive to economic growth. Role of government is increasingly becoming important to establish appropriate economic and social system helpful for sustainable economic growth. Adequate economic growth is crucial for all pervasive welfare of our society. Vibrant economic activity is essentially dependent on sound regulatory environment. First objective of this study is to discover weaknesses which reduce effectiveness of regulations particularly in financial services sector. It is imperative to find out what specific aspects of regulation support the objectives and what particular aspects of regulations are not conducive for stimulating conditions for economic development. Evidence based identification of a part of regulations which encourage economic system to function effectively as against parts of regulations which damage efficiency of economic structure can help to design appropriate regulatory policy. Following Table No. 2 gives a set of parameters relating to quality of regulatory policy.

Table No. 2

S.No.	Core parameter	Idea explicated
1.	Balancing of accountability and independence	Independent regulators are not directly accountable but the concerned ministry continues to be liable for exact performance. Therefore the principle that 'authority and responsibility go hand in hand' continues to hold thereby so called independent regulatory are generally subject to a lot of interference from line Ministry.
2.	Ex-Ante Ex-post evaluation	Any piece of regulation should be evaluated with respect to a study as to whether the regulations have been effective not. A comparative study should be conducted, once prior to implementation of the regulation and another after implementation of the regulation and the difference of the two should confirm or reject the effectiveness of the regulation.
3.	Data based evaluation	It is generally difficult to capture whether a particular segment of regulation is effective in

		meeting the originally planned objective of the regulation or not. With the advancement of information technology including big data it is desirable to capture suitable data to ensure accurate evaluation of the impact of the regulation. These days some of regulators are processing data on real time basis to trace anomalies.
4.	Multiple regulatory bodies	Almost in all the countries financial sector regulators are multiple. Silo style of functioning is quite harmful for the financial sector. In order to improve horizontal coordination some of the countries have started a super regulator whose job is ensuring coordinated operations among financial sector regulators.
5.	Capacity Building	Requirement of skill and knowledge for regulators is exceptionally high. In view of this there is a need to provide appropriate training to the regulators to build capacity of the level the regulators are in a position to perform reasonably well. In this case guidance role of OECD is commendable.
6.	Judicial oversight	Regulators cannot be given absolute authority. Judicial oversight is also to be planned for regulators separate from the regular judicial mechanism because the job of regulators is highly specialised.
7.	Transparency in operations	A large number of decisions taken by regulators are at the verge of being discretionary. Given the nature of operations in order to check arbitrariness it is essential that the basis of decision making is kept transparent.
8.	Reward whistle blowers Punish the guilty	A number of unethical and illegal activities will come to light but for the whistle blowers therefore it is imperative to develop right kind of policies for protection of whistle blower and also simultaneously speedy punishment of guilty.
9.	Corporate Governance norms for regulators	The regulators should also ensure to develop it own method of separation of executive function from adjudication. The regulators must also have well established administrative norms for conflict of interest.
10.	Behavioural Studies	Role of regulators should not be reduced to box ticking but the activities of regulators should be based on the core purpose for which the regulator is originally established.
11.	Innovative approaches	Regulators are moving towards more customer centric approaches realising that the purpose of regulations is to help and support right kind of operations and divergence is innocent in a large number of cases.
12.	Institutional structure	Establishment of appropriate form of institutional structure with provision of required resources, both monetary as well as quality human resources is the key to successful creation of effective regulatory effect.
13.	Stakeholders engagement	OECD has developed a standard method to measure best practices for Stakeholders engagement. These include adoption of consultations of stakeholder at the design stage and also at the review stage.
14.	Systematic adoption of subordinate regulations	Regulations create the situation of (i) over regulations causing unnecessary cost or (ii) missing regulation where there is a need to regulate and (iii) conflicting regulations resulting in poor results.
15.	Connecting regulatory policy to decision making	Government decision making to a large extent is political. Regulatory environment provides feedback to political decision making process. Regulators are becoming more responsive to the requirement of political system to develop feedback/evidence based approaches in decision making.

One of the core objectives of regulation of financial services sector is to ensure prevention of financial frauds. Our conjecture is that improved primary law along with subordinate regulations can set a momentum towards enhanced protection from abrupt financial frauds and will also derive economic welfare of everyone in the society. Most of the countries are guided by a set of broad general standard framework of regulatory policy. OECD (Organisation for Economic Co-operation and Development) has played a crucial role in development of these standards and development of tools to monitor quality of institutional setup and regulatory policy. Although, it is said that there cannot be any unique predetermined solution to the problem of improving quality of regulatory policy but the scope to enhance regulatory outcome is still achievable. Despite heterogeneity of oversight bodies the common goal of attaining inclusive growth in the economy is the focus of all the countries. Repetitive Failure of Regulatory Policy and Governance: It is true that failure of regulations have resulted in a number of instances of financial frauds in India. Examinations of some of these cases of financial frauds show that there are a number of checks which failed in a chain resulting in unfortunate outcome. Failure of Auditors, Failure of Rating Agencies, Failure of Internal Checks, Failure of Corporate Governance etc. are some the reasons of repetitive occurrence of financial frauds. The following table contains some of the major financial frauds and possible aspects which failed.

Table -III

S.No	Financial Fraud	Failed Aspect/s
1.	IL&FS	Auditors reporting not up to desired level Rating Agencies wrongful reporting Top Management oversight, Ever Greening of Loans
2.	DHFL	Short term borrowed funds deployed in long term loans by Management. Possible diversion of funds.
3.	PMC Bank	Fictitious accounts to divert fund to bypass RBI guidelines. Failure of internal checks/audit
4.	Punjab National Bank	Fraudulent use of International interbank SWIFT (Society for Worldwide Interbank Financial Telecommunication) system. Failure of internal check/audit
5.	Karvy Stock Broking	Misuse of Power of Attorney of general investors. Failure of Audit/ Failure of regulatory structure
6.	Satyam Computer Services Ltd.	Failure of auditors Top management indulgence
7.	Saradha Chit fund	Failure of governance and regulators

8.	Sahara India	Failure of regulator
9.	Frauds in Banking Sector	Banking sector frauds relate to wilful default on repayment of loan. The figures are very large. Primarily it is due to failure of credit appraisal officials.
10.	Harshad Mehta	Failure of banks to exercise internal controls

Conclusion: Improvement in effectiveness of regulators is a challenge in financial services sector. The regulation of financial services sector by its very nature has extremely high level of expectations of complete prevention of financial frauds. Any incidence of financial fraud in the financial services sector invokes a serious debate as to what and where things went wrong and what can be done to stop reoccurrence. As a consequence the role of regulators is subject to close scrutiny. Tools and techniques to enhance performance of regulatory policy is always a desired area of research. The research starts from primary laws and goes up to subordinate regulations. Primary laws are by and large not area under discussion but the subordinate regulations which is still and evolving matter is in focus. Political leadership of line ministry is always responsible for smooth functioning of financial services sector whereas subordinate independent regulators of the sector are assigned role to monitor the sector on day to day basis. Since line ministries continue to be responsible, the political leadership is compelled to interfere in the functioning of subordinate regulators. Ways and means to improve quality of regulatory policy has to rely on evidence based feedback system of specific piece of regulations. It is called 'Ex-Ante' and 'Ex-Post' analysis of norms of regulations. The problem of regulations can be classified into three segments. These are, firstly there is a situation when it is unnecessarily regulated causing preventable cost to the system, secondly is the situation of missing regulation where regulations are most desirable but are missing and also thirdly there may a situation when conflicting regulations are being imposed. Despite a lot of research efforts to identify most appropriate method to regulate the financial sector it is not yet been possible to discover the right strategy and financial frauds keep on happening. Finding the perfect strategy to prevent financial frauds required further research.

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