

# Financial Sector Regulator: ‘Rule of Law’ Review

## Preface:

The role of the Reserve Bank of India (RBI) in protecting the financial sector in India cannot be understated. In the words of the Supreme Court, the RBI occupies a place of pre-eminence to ensure monetary discipline, and to regulate the economy or the credit system of the country as an expert body<sup>1</sup>. In the case of certain entities, such as Non-Banking Financial Companies (NBFCs), its power to regulate extends from “womb-to-tomb”<sup>2</sup>, and, for good reason. Because of urgent financial needs, financial illiteracy or otherwise, many borrowers remain vulnerable to what may be termed as usurious or excessive interest rates. There is, thus, a need for the regulator to exercise heightened vigilance. However, it is also important to ensure that any regulatory action abides by the “rule of law”, i.e. fundamental principles of justice, accountability, fairness and impartiality. Any unannounced action, and, lack of clear guidance for those regulated, by the regulator, may go against the rule of law.

In this article, we discuss the fundamental rules the regulatory processes should adhere to so that regulators may achieve their objectives while also creating a conducive environment for investment and consumer planning in the financial sector.

## I. Background

“Institution-building” is the talk of the hour. Nobel prize winners Daron Acemoglu, Simon Johnson, and James Robinson find that institutions with a strong rule of law add wealth, and make nations prosperous.<sup>3</sup> Institutions with a strong rule of law framework, strengthen the nation’s economy by attracting both domestic and foreign direct investment<sup>4</sup>, and increasing consumer confidence. Certain jurisdictions such as the EU have a dedicated rule of law conditionality report to assess the deteriorating rule of law in member states and to safeguard the financial interests of the EU<sup>5</sup>.

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<sup>1</sup> Peerless General Finance and Investment Co. Limited v Reserve Bank of India 7 (1992) 2 SCC 343.

<sup>2</sup> Nedumpilli Finance Company Limited vs. State of Kerala and Ors. (10.05.2022 - SC) : MANU/SC/0620/2022

<sup>3</sup> Press Release available at: <https://www.nobelprize.org/uploads/2024/10/press-economicsciencesprize2024.pdf> (last accessed in November 2024)

<sup>4</sup> Xiujie Zhang and Weihua Liu, ‘The Rule of Law and Foreign Direct Investment’ (ICEMCI

2021) <<https://www.atlantispress.com/proceedings/-icemci-21/125965842>> accessed November 2024

<sup>5</sup> Available at: [https://commission.europa.eu/strategy-and-policy/eu-budget/protection-eu-budget/rule-law-conditionality-regulation\\_en](https://commission.europa.eu/strategy-and-policy/eu-budget/protection-eu-budget/rule-law-conditionality-regulation_en) (last accessed in November 2024)

While the everyday usage of the phrase “rule of law” conveys hazy notions of fairness, the term more accurately denotes “procedural values that are inseparable from the law, and form its inner morality”.<sup>6</sup> The most significant of these specific procedural values are that: (i) laws should be prospective, open and clear; (ii) laws should be relatively stable; and (iii) the principles of natural justice should be followed.<sup>7</sup>

In recent news, certain Regulated Entities have been sanctioned/restricted by the Reserve Bank of India for allegedly indulging in unfair and usurious practices, and in some cases have been directed to desist from the sanction and disbursal of loans with immediate effect. The regulator has indicated that the restrictions may be lifted subject to course correction by the regulated entities. In this backdrop, it would be relevant to discuss how the rule of law applies to any regulatory processes<sup>8</sup>.

## II. The RBI & Rule of Law Framework

The Supreme Court in 2022 has held that the power of the RBI over NBFCs is from the cradle to the grave. In the Court’s own words, “No NBFC may carry on business without being registered under the Act, and a NBFC which takes birth with the registration of the Act is liable to be wound up at the instance of the RBI”.<sup>9</sup> But this power is not without limits, at least, if well-established principles of substantive due process are to have any meaning.<sup>10</sup> Indeed, the Apex Court has very famously held that,

“Even executive authorities when taking administrative action which involves any deprivation of or restriction on inherent fundamental rights of citizens must take care to see that justice is not only done but manifestly appears to be done. They have a duty to proceed in a way which is free from even the appearance of arbitrariness, unreasonableness or unfairness. They have to act in a manner which is patently impartial and meets the requirements of natural justice”<sup>11</sup>

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<sup>6</sup>Joseph Raz, ‘The Rule of Law and its Virtue’ in Richard Bellamy (ed), *The Rule of Law and the Separation of Powers* (Routledge 2005).

<sup>7</sup> *Ibid.*

<sup>8</sup> The author’s discussion in this article is general, and no comment is intended to be made on the process followed by the regulator in the given cases.

<sup>9</sup> *Nedumpilli Finance Company Limited vs. State of Kerala and Ors.* (10.05.2022 - SC) : MANU/SC/0620/2022

<sup>10</sup> Technically, the rights under Article 19 are available to citizens (and not companies). However, the fundamental rights of the shareholder as citizens are not lost when they associate to form a company, when such fundamental rights are affected by state action. The rights of the shareholders under Article 19, are “projected, and manifested” by the corporate instrumentality. *See Bennett Coleman & Co. & Ors vs Union Of India* 1972 2 SCC 788.

<sup>11</sup> *Maneka Gandhi v. Union Of India* 1978 SCR (2) 621

For brevity, it may be stated that “administrative action”, refers to a broad area of governmental activities, in which the decision makers / delegated authority “may exercise every class of statutory function, of executive, quasi-legislative, and quasi-judicial in nature”.<sup>12 13</sup> It has also been held that all law-making, whether in the context of delegated legislation, or primary legislation, has to conform to fundamental tenets of transparency and openness.<sup>14</sup> The Reserve Bank of India is a statutory body, and by its admission is also a regulator.<sup>15</sup> Therefore, its actions would also need to be in accordance with the safeguards captured above. This assumes greater importance as no direct appeal lies against the decisions of RBI, unlike in the case of other sectoral regulators, such as the Securities and Exchange (SEBI) for instance, where the appeal lies before the Securities Appellate Tribunal (SAT) and then the Supreme Court.

In 2013, the Financial Sector Legislative Reforms Commission, headed by B.N Srikrishna, published a report capturing extensively the rule of law concerns surrounding financial sector regulators (Committee Report)<sup>16</sup> Two observations from the Committee Report may be commented upon here, i.e.,

- (1) Due process of regulation: The Committee Report states that “... the substance of financial regulation is too minute and dynamic to be legislated upon by Parliament, however, the process through which financial regulation is to be enacted should be clearly detailed in the law. Parliamentary legislation should therefore incorporate high standards of procedure that the regulator will be required to adhere to”. The Report recognized very crucially that regulation guides the internal functions and the decision-making processes of the regulated entities. And in this regard, it goes without saying, that regulation also guides the decision-making processes, and internal functions of persons investing in, or obtaining services from such regulated entities.

Here, the recommendations of the Committee Report may be cited, which state that “the process of regulation be rooted in the rule of law which would require the regulator to explain its actions to the

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<sup>12</sup> Where the administrative action is illegal, irrational, or suffers from procedural impropriety, it is liable to be struck down.

<sup>13</sup> Reliance Airport Developers Pvt. Ltd. vs. Airports Authority of India and Ors. (07.11.2006 - SC) : MANU/SC/4912/2006

<sup>14</sup> Global Energy Ltd. & Anr vs Central Electricity Regulatory Com 2009 (15) SCC 570

<sup>15</sup> Reserve Bank of India - Master Direction - Non-Banking Financial Company - Account Aggregator (Reserve Bank) Directions, 2016 available at: [https://www.rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=10598](https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10598).

<sup>16</sup> Government of India, ‘Report of the Financial Sector Legislative Reforms Commission’, Volume I, available at: [https://dea.gov.in/sites/default/files/fslrc\\_report\\_vol1\\_1.pdf](https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf) (last accessed in November 2024)

regulated entities, and the public at large; and that regulatory actions and changes should be imposed with adequate prior information to persons likely to be affected (unless inappropriate for a particular situation), and should be rarely carried out without hearing the concerned parties.”

- (2) Process of Investigation & Decision-Making: The Committee report recommends (specifically in the context of the Draft Financial Code it proposes), that, once the regulator conducts an investigation and concludes that a violation has occurred, “the principles of public administration suggest that the actual order should be written by a disinterested party.”, and that such orders should ultimately also be subject to judicial review at an appellate level.

The principle “*nemo iudex in causa*” requires that no one shall be a judge in their own case, and the decision maker should have no interest by way of gain or detriment in the outcome of a proceeding. The fact-finder must not at once also at once be the decision maker. It would not be appropriate to restrict the meaning of this phrase to a mere pecuniary interest, indeed, the Supreme Court has held that the interest may be direct, or indirect, and may arise from a relationship with the subject matter.<sup>17</sup> When regulators operate in the aforesaid manner, and become isolated power centres, firms may primarily concern themselves with their relationship with the regulator, rather than with running their business.<sup>18</sup> Instances where a regulator has a natural bias by virtue of being the fact-finder, or investigative authority are naturally subsumed under this. In the words of Montesquieu, “When the legislative and executive powers are united in the same person, or in the same body of magistrates, there can be no liberty; because apprehensions may arise, lest the same monarch or senate should enact tyrannical laws, to execute them in a tyrannical manner.”<sup>19</sup>

### **III. Solutions Proposed**

Therefore, under an ideal framework, regulatory action would meet the following requirements:

- (a) Principles of Natural Justice:

Before any penal measures are imposed by the regulator, the principles of natural justice would have to be followed. At a minimum, after the investigation process culminates, and before a decision is made, a

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<sup>17</sup>State Of Punjab v. Davinder Pal Singh Bhullar AIR 2012 SUPREME COURT 364

<sup>18</sup> Competition Law Review Committee, Working Group Report I: Regulatory Structure of Competition Law, available at: <https://ibbi.gov.in/uploads/resources/7757a9420c026ca6d537959631d4e3ee.pdf>

<sup>19</sup> Montesquieu, The Spirit Of Laws (1748)

show-cause notice must be furnished to the entities to enable a representation against the materials gathered. Under Section 58. G of the RBI Act, dealing with the power of RBI to impose a fine, there is a requirement that the regulator serve a show-cause notice, and give a reasonable opportunity of being heard to the concerned regulated entity. The very same principle should also extend to the issuance of cease and desist orders by the RBI, which arguably have a far greater impact on the entity, and its stakeholders than a penalty.

The Apex Court has in the past held<sup>20</sup> (and very recently upheld)<sup>21</sup> that “If there is power to decide and determine to the prejudice of a person, duty to act judicially is implicit in the exercise of such power. If the essentials of justice be ignored and an order to the prejudice of a person is made, the order is a nullity. That is a basic concept of the rule of law and importance thereof transcends the significance of a decision in any particular case.”

Additionally, the unit conducting the investigation and fact-finding exercise may be kept separate from the authority responsible for passing the order, such that no conflict, or prejudice arises in the performance of either function.

- (b) Clear and Transparent Rules: Rules need to be clear, and transparent. Where there are penal or any adverse consequences for the regulated entity, clear references to the black-letter of law must be had. For the regulated entity, what has to be done (i.e. the obligation) must be clear, and unambiguous, and alongside, the consequences of a breach must also be very clear, and unambiguous. This precludes penal action based on uncodified norms/expectations. In a system governed by the rule of law, actions cannot be judged by unknown or subjective standards. For instance, there have been numerous instances where lenders have been sanctioned for charging usurious interest rates, when there is no regulation which prescribes a ceiling rate upon the lenders. The text of the SBR Master Directions<sup>22</sup> even states, “Though interest rates are not regulated by the Reserve Bank, rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor be conforming to normal

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<sup>20</sup>State Of Orissa vs Dr. (Miss) Binapani Dei 1967 AIR 1269

<sup>21</sup> State Bank of India and Ors. vs. Rajesh Agarwal and Ors. (27.03.2023 - SC) : MANU/SC/0308/202.

<sup>22</sup>Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023, available at: [https://rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=12550](https://rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12550)

financial practice.” However, what constitutes “excessive interest rate”, “sustainable” or “conforming to normal financial practice” is unknown, completely subjective, and ultimately subject to the regulator’s discretion. A degree of ambiguity as such may not serve the principles underlying the rule of law.

Additionally, the prohibition is on NBFCs charging “excess” interest rate, but it is not clear whether the “excess” refers to the actual figure, or the interest spread over cost of funds. Further, sometimes rates seem high where the size of the lending and the tenure of the loan is small, so mostly, in financial mathematics, rates are not the sole parameter of profit. It is the net present value, and the relation between the net present value and the investment, which is also relevant. The application of this standard is also not consistent, entities charging a comparable band of interest are subjected to varying degrees of scrutiny (e.g. some are penalized/sanctioned, while others are not). It is also trite law that a person shall not be made to suffer a penalty, except for a clear breach of existing law, and the maxim *nulla poena sine lege* (no penalty without the law) can certainly not be confined only to criminal matters<sup>23</sup>. Former RBI Governor, and award-winning economist, Mr. Raghuram Rajan, had once remarked in jest about the institution that, “We are neither hawks, nor doves. We are actually owls”, and indeed that may be the case, but can everyone be expected to see in the dark?

- (c) Appellate Tribunal: More than a decade ago, (now Justice) Somasekhar Sundaresan had opined while writing for the Business Standard that, “The RBI does a number of things that SEBI does – it writes regulations on its own, issues circulars, issues show cause notices, initiates enforcement action, and even has powers to compound offences. Yet, there is no appellate oversight over such regulatory functions of the RBI. Therefore, the only recourse for anyone affected by a wrong decision of the RBI is to file a writ petition.<sup>24 25</sup>” However, the scope of the review will be limited to due process/procedural impropriety, etc, and will not include the merits / granular aspects of the regulator’s decision (which necessarily has

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<sup>23</sup> Vijay Singh v. State of U.P. & Ors Civil Appeal No. 3550 Of 2012.

<sup>24</sup> Somasekhar Sundaresan, ‘Merits of a Financial Services Appellate Tribunal’, available at: <https://indiacorplaw.in/2009/08/merits-of-financial-services-appellate.html> (last accessed in November 2024).

<sup>25</sup> In ‘Judicial review of central banks: An Indian perspective’ Pratik Datta, notes in footnote 41, “There are some statutory provisions which do provide for appeal before the central government from certain RBI actions such as refusal to issue certificate for creation of floating charge by a bank, cancellation of license for banking business, order for removal of any director or employee of a banking company etc. Such statutory appeals before the central government cannot be equated with judicial review by a superior court or a specialised tribunal. See, for eg, Banking Regulation Act 1949, ss 10B(7), 14A(3), 22(5), 36AA(3).” See Datta, Pratik, Judicial Review of Central Banks: An Indian Perspective (October 12, 2022). Indian Law Review (Forthcoming), Available at SSRN: <https://ssrn.com/abstract=4295988> or <http://dx.doi.org/10.2139/ssrn.4295988>

to be considered when challenging, say, a penalty imposed on pricing policy, in terms of the Weighted Average Lending Rate (WALR) and the Interest Spread charged over their cost of funds).

In this regard, “there also needs to be a mechanism to review the actions taken by regulators in exercise of their quasi-judicial functions. Given the specialised character of financial markets and the complicated nature of issues involved...there is a strong case for having a dedicated appellate tribunal.”<sup>26</sup>.

The appellate tribunal may have a mix of members with both technical expertise and a judicial background similar to that of the Securities Appellate Tribunal.

#### **IV. Present framework for different regulators**

Reference could also be made to the present framework under other financial sector regulators such as SEBI, and IRDAI. Under Chapter IV of the SEBI Act, 1992, SEBI has quasi-legislative, quasi-judicial, and quasi-executive functions. The SEBI investigation process has to be conducted through an investigation officer who upon completing the investigation submits a report to the Board (SEBI). The Board at this juncture, in compliance with the principles of natural justice, has to allow for representation by the concerned persons and passes an order/directions as deemed appropriate.

Similarly, the Insurance Regulatory and Development Authority of India (IRDAI) under Section 14 of the IRDA Act, has the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business. Here too, before any action is taken against the regulated entities by the IRDAI, a show cause notice has to be issued, and the opportunity to make a representation has to be allowed, and the inspection department (for conducting the investigation/fact-finding process) is separate from the enforcement department (responsible for imposing the action/penalties as the case may be). Further, appeals lie against the orders of both SEBI and IRDAI to the Securities Appellate Tribunal (SAT).

Consider for a more global perspective, the United States, where the Consumer Financial Protection Bureau (CFPB) is the body responsible for implementing and enforcing federal consumer financial law, and is established for the sake of protecting consumers from unfair, or deceptive practices. The life-cycle of

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<sup>26</sup>Government of India, ‘Report of the Financial Sector Legislative Reforms Commission’, Volume I, available at: [https://dea.gov.in/sites/default/files/fslrc\\_report\\_vol1\\_1.pdf](https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf) (last accessed in November 2024)

enforcement action by the CFPB is characterized by an investigation/fact-finding exercise, followed by a show-cause notice (a.k.a “The Notice and Opportunity to Respond and Advice), subject to its policies and procedures, and a personal hearing on a discretionary basis.<sup>27</sup> The matter is then escalated to a separate body for adjudication (either in state/federal courts, or to an administrative body)<sup>28</sup>. Similarly, in the United Kingdom, the Financial Conduct Authority (FCA), responsible for regulating the conduct and fair practices of financial sector entities, follows a comparable procedure, with its decisions being appealable to the Upper Tribunal<sup>29</sup>.

### **Concluding Notes**

Clear and transparent rules, due process, adherence to the principles of natural justice, and a forum for appeal, would have a markedly positive effect on the outcome of the regulatory action. The consumer interest would be protected, alongside the investor confidence. The regulator thus has to serve as an enabler, striking a balance between the very real need to safeguard the financial sector and the citizens who are to be its beneficiaries, and the need to maintain a business-friendly environment. One cannot lose sight of the fact that ultimately, the financial sector only exists so long as the institutions remain.

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<sup>27</sup> Consumer Financial Protection Bureau - Policies and Procedures Manual, available at: [https://files.consumerfinance.gov/f/documents/cfpb\\_enforcement-policies-and-procedures-memo\\_version-3.2\\_2022-02.pdf](https://files.consumerfinance.gov/f/documents/cfpb_enforcement-policies-and-procedures-memo_version-3.2_2022-02.pdf) (last accessed in October 2024).

<sup>28</sup> Available at: <https://www.consumerfinance.gov/enforcement/life-cycle-of-enforcement-action/> (last accessed in October 2024).

<sup>29</sup> The Tribunal Procedure (Upper Tribunal) Rules 2008, available at: <https://assets.publishing.service.gov.uk/media/666afaa7673d4d30f3372dc7/consolidated-ut-rules-2024-6-13.pdf> (last accessed in October 2024).