The Effectiveness of Prudential Regulations for Banks: Global Perspective and Indian Context

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Banking regulations intend to protect the interest of depositors, reduce the risk of bank failures, minimize the moral hazard, and strengthen the financial stability by controlling the behaviour of financial system participants and by building financial buffers. In countries like India, where banks dominate the financial sector, banking regulations assume added significance. This paper provides a global perspective on the prudential regulations and examines the extent to which the regulations could mitigate the risk of financial crises. It also analyses the role of macro-prudential regulations in achieving financial stability and its interaction with micro-prudential regulations. It further delves into the role of regulations in catalyzing financial innovations and hence, indirectly contributing to irrational exuberance and excessive risk-taking in the financial system. Certain other issues deliberated upon in this paper include a need to closely look at the nature and design of prudential regulations with a view to reducing complexities in regulatory and supervisory processes, and evaluation of the role of regulations in growth, governance, and performance of banks in India. The paper looks at the movement of credit to GDP ratio, the GDP growth trajectory, and a periodic emergence of credit gap in the Indian context, and discusses the utility of credit gap as an indicator for macro-prudential policy in India. This paper also analyses the pattern and movement of gross and net NPAs of the Indian banks and its relations with regulatory forbearance and supervisory processes. It suggests a continual need for strengthening institutional credibility for improving the effectiveness of regulatory and supervisory processes so as to achieve stability, transparency, and robustness in financial institutions and financial markets.

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A strong and resilient banking and financial system support economic growth and financial stability. Regulations minimize the risk of bank failures and strengthen financial stability. Regulations could take the form of macro-prudential or micro-prudential regulations and could be implemented by pricing or structural mechanisms. It is generally understood that the aim of macro-prudential regulations should be to restrict emergence, incidence, and impact of systemic risk, which is defined as the risk of disruptions to financial services that is caused by an impairment of all or parts of the financial system with serious negative consequences for the real economy (Sinha, 2011). Macro-prudential policies aim to protect financial stability, which is generally understood as a troika of efficient allocation of economic resources, forward-looking risk pricing, and smooth absorption of financial and real shocks (Schiansi, 2006). As a matter of fact, the factors enshrined in the above troika encapsulate both endogenous as well as exogenous elements. It is generally believed that threats to financial stability could arise not only from external shocks but also from the endogenous imbalances. During periods of imbalances, the return expectations are normally found to be unduly elevated and risks are generally mispriced. To explain the financial stability in terms of risk pricing, it is understood as a condition in which an economy's mechanisms for pricing, allocating, mitigating, and managing financial risks are well stabilized. Mitchener (2007) analysed the impact of prudential regulation and supervision on financial stability using the period of the great depression of 1929-30, and showed that the differences in state-specific bank regulations and supervisory structures help explain why the banking crisis during the depression was worse in some regions of the United States. Acharya (2009) discussed the systemic implications of the negative externalities of the bank's failures and showed that the regulatory mechanisms based on a bank's own risk can, in fact, accentuate systemic risk. The author has established that the prudential regulations operate at a collective level, regulating each bank as a function of both its correlated risk with other banks as well as its individual risk. It is now commonly agreed that notwithstanding perfectly rational policies adopted by individual financial system participants, their individual actions could give rise to certain collective negative externalities that can threaten the stability of the financial system as a whole, even if individual institutions appear sound and stable, and hence, a need to understand the building-block of regulatory framework.

Building-Blocks and Challenges of Macro-Prudential Framework

The success of a macro-prudential framework depends primarily upon three core areas, namely, strong financial system infrastructure (including regulatory structures), contained pro-cyclicality, and sound resolution/restoration structure. Different jurisdictions across the globe have adopted different
structures with regard to macro-prudential regulations (Figure 1). While central banks play a key role in regulatory architecture, globally they do not have exclusive control over the macro-prudential regulations. Central banks operate as the designated macro-prudential regulator in about 50 per cent jurisdictions and have such role in about 30 per cent Basel Committee on Banking Supervision (BCBS) countries. Other prevalent structures include committee(s) outside the central banks, or other supervisory authority, or a combination of them. A major obstacle in the implementation of macro-prudential policies relates to the risk in such decision-making and the dangers of being proved wrong in the future. Macro-prudential policy-makers make decisions in real-time based on their assessment of the prevailing situations and they cannot enjoy the benefit of hindsight available to the financial commentators, or analysts. Therefore, in some cases, in the hindsight, the decisions might not yield desired results or could be found wanting in terms of certain dimensions of the problem. In addition, analytical gaps, institutional limitations, along with the risk of going against the wind in a political economy remain some of the key constraints. Therefore, the inevitability of policy mistakes on the part of the macro-prudential regulator cannot be ruled out in any financial system. Further, in a booming economy possibly due to overheating or irrational...
exuberance, a countercyclical policy measure is most likely seen as a spoiler or anti-growth, and hence, may not be preferred by a majority. This reinforces the need for the financial system participants and the public at large to understand the rationale, approach, and limitations of the macro-prudential policy. Effective communications and a need for formally defined regulatory architecture also play a critical role in the effectiveness of the macro-prudential regulations. Globally, and more so in the BCBS countries, well-defined powers assigned to the macro-prudential authority has been the most preferred regulatory architecture (Figure 1). Another dimension of implementation of macro-prudential policy stems from globalization and increasing interconnectedness amongst economies, and financial market participants, and hence, the need for harmonization of policies. Therefore, in addition to the regulatory effectiveness at the national levels, a supra-national regulatory paradigm overseeing global governance is also equally important.

Section II

Financial Crises and the Role of Global Governance

The following chart (Figure 2) presents the incidence of financial crises over the last 200 years. The only exception to the almost regular occurrence of financial crises had been the period of 1950-1970 during which the post-World War II Bretton Woods system operated (Taylor, 2013).

![Figure 2](image_url)

Source: IMF (Taylor, 2013)

The above chart shows that the existence of a well-structured macroeconomic system of global coordination and governance helped in minimizing the vulnerabilities of the global financial system, even though during this period, the banking regulations were at a nascent stage and no comprehensive global
regulatory architecture, similar to Basel norms, were in operation (Srivastava, 2018).

After the collapse of the Bretton Woods, a significant event during the ’70s was the closure of a German bank named Bankhaus Herstatt on June 26, 1974, which exposed its counterparty banks to the full value of the Deutsche Mark deliveries made against expected delivery of USD. In the post-Bretton Woods era, this further exposed the vulnerability of the financial institutions to liberalised cross-border transactions and arguably highlighted the fact that the prudential financial regulation lagged the liberalisation of the financial markets. Since then, global efforts have been focussed on developing and putting in place an effective mechanism of a regulatory and supervisory system for financial system participants based on sound principles and clearly delineated objectives.

Section III
Principles and Objectives of the Financial Regulations

Excessive risk-taking, incorrect risk pricing, liquidity mismanagement, and lack of regulations to keep pace with the market innovations, as well as failure to correctly understand the systemic implications of transactions, and events, had been the major reasons behind the repeated financial sector conundrum. Goyal (2010) deliberated on the regulatory structure for financial stability and development. The author argued that a combination of micro- and macro-prudential regulations can moderate pro-cyclicality, information asymmetry, and market anomalies. Plantin (2015) however, showed that tightening capital requirements may lead to a surge in shadow banking activities causing an uptick in the riskiness of the financial system and the regulatory arbitrage has been a key reason for the growth in shadow banking. Judge (2017) argued that information gaps emanating from the expansion of shadow banking could be a source of systemic risk and showed that information gaps impede market and regulatory responses intended to dampen the impact of the financial crisis.

It is being increasingly recognized that long periods of macroeconomic and price stability does not necessarily result in financial stability, which largely depends on the financial sector participants and their market behaviour. A lack of adequate understanding of the relationship between microeconomic risk-taking and macroeconomic propagation of the financial distress has been a fundamental reason for frequent recurrences of the financial crises (Alexander, 2007). Broadly, a consensus has emerged in favour of regulations in accordance with the public interest theory of regulation, which believes that the regulations serve the public interest; control externalities, limit systemic risk and the regulators are driven by their concern for safeguarding the interests of the public through effective regulatory oversight. From an implementation point of view, regulations could be price-based or structural in nature depending
upon the circumstances, and accordingly suitable regulatory instruments need to be developed as discussed below.

**Price-based Regulations, Structural Regulations, Market Innovations, and Regulatory Instruments**

Globally, regulations could be broadly clustered around two groups, namely, price-based regulations and structural regulations. The price-based regulations intend to guide and control the market behaviour through a system of incentives and disincentives in the form of regulatory pricing of capital and requirement of provisions. On the other hand, the structural regulations intend to curb certain undesired behaviour through an explicit system of prohibitions and prudential exposure limits on risky assets, and sector-specific concentrations. Usually, price-based regulations work better in a market economy with more informed participants. However, at times, regulators also use the structural regulations, such as exposure limits, to quickly achieve the desired outcome. Most of the prudential regulators use both methods depending upon the circumstances. Although the price based regulations are believed to be less market-distorting than the structural regulations, the history shows that both are prone to be circumvented, and hence the need for caution. Further, a latent manifestation of the regulations is that these may modulate the behaviour of market participants around risky innovations in financial instruments with a view to neutralizing the impact of regulations. In fact, many financial innovations emanated with a view to circumventing some of the regulatory prescriptions. For instance, securitization as a means for off-loading credit exposure from the balance sheet quickly gained ground after the introduction of the capital charge for credit risk under Basel I. It is important, therefore, to understand the relationship between regulations and risky innovations as also the interaction between macro-prudential and micro-prudential policies.

**The Interaction Between Macro-Prudential and Micro-Prudential Policies**

Based upon the requirements, micro-prudential tools such as fixed prudential exposure limits can be imposed to curb the risk associated with specific activities, such as Loan-to-Value (LTV), or debt service ratios, currency mismatches, or sector-specific credit concentrations. Suitable calibration of capital and liquidity requirements could also be used. The Basel III capital framework includes countercyclical capital requirement as a macro-prudential instrument. Countercyclical capital buffer, higher loss absorbency for systemically important banks, and leverage ratio act as core tools for a macro-prudential regulatory framework. In order to serve the cause of growth and stability, it is desired that the micro-prudential tools (such as capital, and liquidity requirements, exposure limits, loan-to-value ratios etc.) should be precisely calibrated with the macro-prudential policy stance (such as countercyclical buffers, leverage, etc.). For instance, in case of an economic downturn, countercyclical macro-prudential measures would warrant the utilization of capital buffers created during good times, and in such a situation,
the micro-prudential policies should not be aimed at tightening. Both, the macro-prudential regulations and micro-prudential stipulations must work in close coordination to achieve the desired outcome. There must be synergy between macro and micro-prudential policies and the institutional arrangements should support such coordination, and ensure operational independence of regulatory and supervisory processes.

Adequacy of Regulatory Reforms and Operational Independence of Supervision

The regulatory reforms put in place in the form of Basel III have attempted to improve the resilience of the global financial system. In addition, other measures such as improving the resolution framework, Central Counterparty Clearing (CCP) settlement of OTC derivative contracts, reporting requirements, ongoing consultations regarding a regulatory capital floor in respect of advanced approaches, etc. are meant to strengthen the stability. Interconnectedness among the financial markets namely, banking, securities, and insurance have invited the attention of regulators. However, it is a little difficult to claim with confidence that the newer and improved regulations have made the financial world safer. The history shows that even the best-intentioned regulations, at times, resulted in market distortions and gave rise to complex financial innovations, which proved fatal in due course. Further, the regulatory and supervisory architecture can achieve its objectives effectively only in a system with well-functioning institutions with a sound system of checks and balances. Moreover, the regulations, which minimize informational asymmetry and strengthen the ability and incentives of the market to supervise the banks and financial institutions tend to promote a sound financial system.

Therefore, the supervision works best when it facilitates independent monitoring of institutions, besides promoting market discipline. Dissemination of high quality and trustworthy information about banks and creation of awareness amongst the public helps in improving the corporate governance of banks, improves supervision, and assists in the achievement of the objectives of the financial regulations. As a natural corollary, the operational independence of supervision assumes a significant role. Operational independence avoids capture of the supervisory process by self-interest agenda propagated by vested interests. In its 2010 report, the Financial Stability Board (FSB) had clearly underlined the need for operational independence of supervisory agencies to ensure their effectiveness. It underlined that the financial sector supervisors should have a clear mandate, adequate resources, and a strong governance structure. The BCBS introduced its core principles for effective banking supervision (BCP) in 1997 and came out with an updated version in September 2012. Podpiera (2006) found a significant positive impact of compliance with the BCP on the banking sector performance for 65 countries, as measured by non-performing loans and net interest margin, after controlling for the level of development of the financial system and certain macroeconomic and structural factors. In an assessment made by IMF staff (Figure 3), it has been observed
that more progress is needed in respect of many of the BCBS recommendations on effective banking supervision and the area requiring highest attention has been independence and resourcing. As shown in Figure 3, the IMF staff assessment observes that global adherence to supervisory norms varies from high compliance (green, e.g. supervisory reporting, internal control and audit) to low compliance (red, e.g. risk management process, independence and resourcing) for each of the 29 Core Principles. Besides, supervisory independence and resourcing, other areas of identified weaknesses included (i) related party transactions (ii) operational risk, including cyber risk (iii) money laundering or funding of criminal activities, (iv) forward-looking supervisory approach, including early intervention and resolution, and (v) risk identification, evaluation, mitigation, monitoring, and control. Obviously, efforts should be oriented towards streamlining the chinks in the regulatory and supervisory armoury and to make it broad-based, effective, and look beyond stability.
A Need to Look Beyond the Stability

A heightened focus on stability is a natural reaction to the financial crises. However, there is also a need to examine the impact of both macro-prudential, and micro-prudential bank regulation and supervision on a broader set of variables, such as financial sector development, the efficiency and effectiveness of financial intermediation, the integrity of the lending process, and the governance structure and strategic direction of banks. Banks should not only be concerned about the interests of the depositors but should also play a pivotal role in mobilization and allocation of national savings. Therefore, it is also important to understand as to how the regulatory policies could encourage banks to operate efficiently and to make sound capital-allocation decisions in a political economy.

Further, ensuring integrity in banking operations and reporting remains a critical requirement for bringing robustness in the growth story propelled by credit intermediation, especially in bank-led economies like India. Any deficiency in this regard not only proves costly in long-run but also impacts institutional credibility. Regulations play a key role in preserving the institutional credibility of the economy. The bank regulators, however, at times, may lack the resources, expertise, and conviction to initiate stringent actions partially due to the fragile nature of the banking sector and at times due to the external environmental factors. Hence, a comprehensive understanding of bank regulation and supervision and its future direction must consider the political, legal, and cultural context in which all of these forces operate and influence the conduct of financial system participants. In the following paragraphs, an analysis of banking regulations and its interaction with the real economy, primarily through the credit channel, has been explored with reference to India.

Section IV
Indian Scenario: GDP Growth, Bank Credit, Credit Gap and Regulations

Figure 4 presents a snapshot of the credit-deposit ratio, deposit to GDP ratio, and credit to GDP ratio relating to scheduled commercial banks in India during 1950-51 to 2017-18. It could be observed that the credit-deposit ratio has roughly hovered around 70 per cent (75.49 per cent during 2017-18) except for a dip during the 90s. This is quite understandable in view of the statutory reserve and liquidity requirements for banks in India and also due to the fact that the banks in India are primarily funded by deposits and are not very aggressive in tapping borrowed funds.

The above also suggests that the operating model of banks in India has almost remained the same throughout these years, though its base and volume has expanded significantly. This is evident from the fact that both the deposit to GDP and credit to GDP ratio have grown from less than 10 per cent during
1950-51 to around 68.12 per cent and 51.42 per cent, respectively during 2017-18. This also shows increasing penetration of banking and formalization of the Indian economy over the years. Regulations and government policy have played a key role in this transformation as evident in the growth phase (moderate to high) commencing during the 70s. This was the era when bank nationalization expanded the coverage and reach of banking in India. During the 90s, a major shift in the regulatory stance relating to bank licensing took place and several new-generation private sector commercial banks came up. This period also saw a significant push to technology-driven banking, and subsequently, a lot of regulatory thrusts was placed on financial inclusion. Quite evidently, banking regulations, with a focus on institutional and system development, contributed positively to the banking-led economic growth of the country. However, credit to GDP ratio in India, though somewhat in the range of countries like Russia, South Africa, Brazil, etc., is still much below its potential and also way below the range observed in developed economies (Figure 5). A further analysis about credit gap, which is defined as gap between the credit-to-GDP ratio and its long-term trend (Figure 4) shows that it operated with a negative gap during 1990-91 to 2005-06, whereas the credit gap subsequently turned positive as the credit-to-GDP ratio has been operating above its long-term trend during the subsequent current period.

![Figure 4](image)

**Figure 4**

*Growth of Credit, Deposits, and GDP in India*

Source: Database on Indian Economy, RBI.

![Figure 5](image)

**Figure 5**

*Credit to GDP Ratio in Select Countries*

Source: BIS
As a macro-prudential policy, Basel III norms had introduced a Countercyclical Capital Buffer (CCB) to protect banks from the build-up of systemic vulnerabilities. This approach uses the Credit-to-GDP Gap as a key early warning indicator of ensuing banking crises. A number of jurisdictions use the credit gap along with other relevant economic indicators to putting in place a macro-prudential policy. For instance, the Bank of England has introduced a framework that is based on 18 core indicators, including the credit gap. Similarly, the Swiss National Bank, the Central Bank of Norway, and the Reserve Bank of India monitor a small number of indicators in addition to the credit gap in evaluating aggregate vulnerabilities and making decisions regarding the CCB (Drehmann and Tsatsaronis, 2014). However, opinion remains divided on the use of credit gap a sole incipient indicator of macroeconomic instability. Notwithstanding this aspect, the nominal rate of growth in bank credit also remains an important indicator for both prudential regulations and supervisory assessments. Figure 6 presents the nominal rate of growth of non-food bank credit along with its 2-year moving average and long-term trend line. Further, Figure 7 and Figure 8 provide useful analysis about the trend and composition of non-performing advances.

**Figure 6**
The Growth Rate of Non-Food Bank Credit (per cent)

![Credit Growth Rate (Non Food)](source: Database on Indian Economy, RBI)
It could be observed from figure 6 that the long-term trend-line nominal growth rate for bank credit (non-food) has been around 12 per cent to 15 per cent. Historically, credit growth has remained oscillating around this range. A significant fall in the credit growth and subsequent rebound was observed during the 90s' mostly on account of external vulnerabilities (BOP crisis) and economic sluggishness, and the subsequent course-correction by way of early...
1990s financial sector reforms. Reform measures included the adoption of international best practices through a consultative and gradual approach. The twin objectives of the financial sector reforms were enhancing efficiency and bringing stability in gradually introduced market-oriented processes. Specific financial sector reforms included a phased reduction in statutory reserve requirements, such as cash reserve ratio and statutory liquidity ratio and deregulation of interest rates. The RBI also attempted to put in place an effective regulatory environment duly supported by its supervisory processes.

However, an unusually very high credit growth rate was observed during the years 2004-05 to 2007-08 during which the credit growth rate more than doubled and touched up to 38.43 per cent (2005-06). This zooming rate of growth of non-food credit led to a debate on the evidence of signs of overheating in the economy. The Reserve Bank of India effectively contributed to the moderation in price situation through its monetary measures and also by way of prudential measures involving higher provisioning requirements and higher risk weights for certain bank-exposures, namely, consumer finance, real estate, housing and capital market exposures. These measures tackled the issues of rapid credit growth and the possible impact of volatile asset prices on banks’ balance sheets. Moreover, the regulatory norms relating to capital adequacy, income recognition, asset classification, and provisioning were progressively converged with international best practices in a non-disruptive and cost-effective manner.

It could be observed from Figure 7 that between 2005-06 and 2013-14, the non-performing assets of the scheduled commercial banks were at a historically low level. It is also important to note that this period coincided with the global financial crisis as a result of which, the RBI allowed regulatory forbearance on certain kinds of stressed loan restructuring, to settle the temporary stress situations pending stronger growth (Rajan, 2016). However, in hindsight now it is pretty clear that strong credit growth before the global financial crisis and regulatory forbearance in the aftermath of the crisis were not used in a prudent manner by banks and it possibly resulted in under-reporting and non-recognition of credit weakness in their books. As a result, when the RBI ended its regulatory forbearance in April 2015 and started the Asset Quality Review (AQR) to ensure that banks were taking proactive steps to clean up their balance sheets, the volume of NPA suddenly jumped up by a significant proportion. As shown in Figure 8, a major contributor to the pile-up of non-performing advances have been the non-priority sector loans, and the proportion of the priority sector non-performing loans have been continuously declining. As such, there are reasonable concerns about the use the regulatory forbearance in a right earnest by the regulated entities, due to which the deterioration in the asset quality and its consequent negative impact on the performance of banks was not adequately measured and accounted for until the commencement of AQR in the year 2015, as discussed above. This brings out the discussions around supervisory effectiveness.
**Regulatory Complexities, Supervisory Effectiveness, Defaults and Recognition**

The above discussion brings out the need for avoiding forbearances, putting in place straightforward less complex regulations, and effective supervision because first, it is not possible to forecast and document every likely incidence of risk in the regulatory norms, and second, holding buffers against every possible eventuality could stifle the growth and could make the financial institutions inefficient. A forward-looking and vigilant supervisory mechanism could sense early signs of distress, distortions, and imbalances even during a period of regulatory forbearance, and raise a red flag for timely action. In fact, developing a larger eco-system of effective 360-degree supervision through information dissemination should be the ultimate goal of the supervisory process. Elaborating on the risks of implementation of best practices in prudential regulations in India during the 90s without clearly understanding the behavioural responses of banks towards prudential regulations, D’Souza (2000) argued in favour of creating incentives for safe and sound banking while emphasizing on structured supervision, and diversification. As a matter of fact, regulation/supervision works best when the need for compliance does not arise out of compulsion but as an economic necessity. Market oversight by the economic agents through a system of market-driven economic incentives/disincentives is an ideal situation. However, to believe that markets can take care of everything is also a fallacy and hence, the need for regulatory oversight. From the point of view of regulatory and supervisory oversight, it is also important that necessary safeguards and regulatory floors are put in place to guard against undue complexity and model dominance in regulatory computations. Certain advanced measurement approaches under Basel norms, expected credit loss computation, hedge accounting, and effective interest rate based accounting under IFRS (Ind-AS) involve significant complexities/model dominance, and accordingly could obscure the supervisory oversight and possibly weaken its effectiveness. It is being increasingly recognised that if there are too many complex models and computations that supervisors cannot easily understand and verify, given the time and resources at their disposal, the effectiveness of supervisory processes could be compromised. While the need for advanced measurements is well appreciated, conscious efforts such as prescribing a regulatory floor, independent vetting, etc. should be made to guard against such risks with a view to bring sharper focus into prudential regulations and to ensure supervisory effectiveness.

Another issue surrounds the so-called, benign and malignant nature of defaults and pressure on the supervisory authorities to treat such defaults differently based on the reasons for default. At times, it is argued that in cases where the borrowers are affected by factors beyond their control, their case should be treated as benign and genuine and some leniency in the recognition of stress and consequent provisions should be accorded. However, the fact remains that some defaults are an inevitable part of the credit decisions, and consideration of reasons for its recognition in books is nothing but a fallacy (Vishwanathan,
From a prudential regulation point of view, the recognition, and resolution of an expected credit loss should be seen as two separate aspects. The recognition of deterioration in the quality of asset and need for provisions against consequent expected credit loss should be completely independent of the reasons for such default or deterioration. Whereas, it is the resolution plan which should be a function of ability and willingness of the borrower to honour his obligations. Therefore, the question of benign or malignant default should come only while formulating an appropriate resolution and hand-holding plans and not at the time of the recognition of the non-performance. In order to be effective, the regulatory and supervisory processes should be oriented in this direction.

Section V

**Improving the Effectiveness of Regulations**

A glance through the modern financial history shows that regulations and their increasing global convergence have helped in bringing stability, transparency, and robustness in financial institutions, and financial markets. However, regulations have often been criticised for being behind the curve, and reactive. The global financial crisis of 2008 followed the implementation of the then much awaited Basel II guidelines and as such, demonstrated that the prudential regulators could not get a sense of the inherent weaknesses of complex structured products, underestimated residual risks, and failed to gauge the systemic proportion of the incipient conundrum. In case of India as well, though there has been no major bank failures and the financial system has remained by and large stable, the prudential regulations could not contain a sharp deterioration in the bank’s asset quality, and the extant IRAC norms were not scrupulously adhered. The occurrence of several other incidents such as PNB's LOU fraud case, cyberheist at Cosmos Bank, an alleged conflict of interest issues at ICICI Bank, etc. are some of the recent examples of vulnerabilities, and governance failures in the regulated entities requiring concerted action. Though it is little unfair to expect that prudential regulations could work as a panacea for all the ills of the regulated entities, following steps can be taken to further strengthen the regulatory and supervisory architecture to make it much more effective.

**Maintaining Institutional Credibility, Deterrents and Enforcement**

The first and foremost requirement is to have institutional credibility about the policies, and actions initiated by the regulators. It is quite important for the regulated entities to believe in the policies, and regulatory stance put in place by the regulator. Secondly, the regulatory actions must be followed by clearly delineated deterrents in the form of disincentives, penal actions and a legally backed enforcement mechanism. In the context of India, suitable provisions are in place in the Banking Regulation Act, 1949. RBI has also set
up an Enforcement department in the year 2017 to monitor compliances and initiate action against erring banks.

Ensuring Regulatory Integrity – Shutting the Revolving Doors
Integrity in the regulatory processes and personnel is of paramount importance, and the issue of revolving doors between regulators and regulated entities and the consequent possibility of regulatory capture due to quid pro quo has been a matter of intense debate in the international arena. Though, there is an alternate school of thought which propounds that limiting mobility between regulators and regulated might exacerbate the former’s challenges in attracting and keeping the brightest minds (Lucca, et al, 2014). However, in order to ensure integrity, it makes sense to put reasonable restrictions on the movement of senior-level regulators to regulated institutions. In the context of India, such restrictions do exist.

Setting up a Forward-Looking and Operationally Independent Supervision
An efficient, forward-looking, and operationally independent supervisory process plays a key role in strengthening and improving the effectiveness of regulations. In comparison to bank regulators, bank-supervisors operate close to the regulated entities and get a better sense of ground realities. Supervision will be of real value with forward-looking risk assessments, instead of being strictly confined to the defined regulatory perimeter. A properly structured and coordinated feedback and response mechanism between regulation and supervision can go a long way in improving the effectiveness of regulations.

Section VI
The Way Forward

Inadequate regulations, or, failure of regulations to precisely respond to incipient structural/seasonal weaknesses, or adoption of undue regulatory forbearance could cause distress in the financial sector. However, equally critical factors for financial conundrum have been inadequate internal control, poor governance structure, false assumptions about market and liquidity, and lack of due diligence processes in regulated entities. Therefore, prudential regulations should aim at strengthening banks’ internal controls and risk management framework. It is a challenge to incentivise the banks and financial market participants to join the regulator(s) in pursuit of risk optimisation and strengthening of financial stability. While this should be a collaborative process, the market players should find value and incentive in such collaboration. Therefore, its success also depends upon the institutional credibility, deterrents, and enforcement mechanism of the regulatory processes. Moreover, prudential regulations should maintain pace with the time and changing dynamics of financial markets. Putting in place clear, uncomplicated regulations, and shunning complexity in the regulatory processes should be accorded top
Ensuring a forward-looking, and operationally independent supervision with close coordination between regulatory and supervisory architectures is of utmost importance. The key to success is to have a proper balance of macro-prudential and micro-prudential regulations, with effective supervision, adequately aligned with the nature and culture of financial market behaviour. In the context of India, certain initiatives such as resolution mechanism under the Insolvency and Bankruptcy Code (IBC), strengthening of the Banking Regulation Act, 1949, thrust towards digitalisation, and gradual consolidation in the banking sector are expected to further boost an orderly financial sector development and strengthen the regulatory resolve towards maintenance of financial stability.

References


