

# Compliance Risk

## *Impact on Indian Commercial Banks and NBFCs<sup>1</sup>*

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### 5.1. Introduction

Over the last few decades, the banking and financial sector has become increasingly complex and mired by episodes of individual misconduct and systemic crises. Since the global financial crisis in 2007-2008, regulators have been issuing an ever-growing set of rules, guidelines, and codes of conduct, expecting adherence both in letter and spirit. Supervisory scrutiny has intensified, and the frequency and size of penalties for regulatory breaches and ethical lapses have amplified. Compliance risk has thus emerged as one of the biggest overall enterprise-level risks for banks and financial institutions.

As early as 2005, the Basel Committee on Banking Supervision (BCBS) issued a high-level paper (BCBS 2005) that advocates the need for a compliance function in banks that can effectively manage compliance risk and enhance sound banking practices to support supervisory review processes. Compliance risk is defined as the “risk of legal or regulatory sanctions, material financial loss or loss of reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards and codes of conduct applicable to its banking activities. Ten principles of compliance management are delineated, including the responsibilities of the

Board and Senior Management, creation of a Board-approved Compliance Policy, and establishment of an independent, well-resourced, and accountable compliance function within the organizational structure.

The core principles for effective banking supervision (BCBS 2012), state that effective supervision requires a suitable legal framework that empowers supervisors to address compliance with laws, safety, and soundness. The principles further elaborate that supervisors should be empowered to remove individuals, impose sanctions, and revoke licenses to ensure compliance with regulations and prudential guidelines. Regulators have often used fines and sanctions as tools to discourage misconduct and improve compliance.

Over the past two decades, financial regulators worldwide have imposed staggering penalties on banks and financial institutions for non-compliance with regulatory rules and codes of conduct. Investigations post the global financial crisis led to several prominent financial institutions being heavily fined. Bank of America emerged as one of the largest penalized entities, followed by JP Morgan, for misdemeanours associated with the sub-prime mortgage crisis. Apart from these instances, a few other highly publicised cases of compliance failures include the LIBOR scandal, HSBC’s Anti Money Laundering lapses and BNP Paribas’s sentence for terrorist financing.

Flore et al. (2021) observe that globally the 25 largest financial institutions have paid more

1. The authors are grateful to K. Srinivasa Rao and Bazil Shaikh for their valuable comments and suggestions. The usual disclaimer applies.

than USD 255 billion in legal penalties between 2005 to 2015. Examining data on penalties from December 2009 to December 2014, the European Systemic Risk Board (2015) reports that the worldwide cumulative cost of misconduct was around EUR 200 billion. US banks accounted for the majority of the misconduct costs; European banks bore a cost of about EUR 50 billion, and the greater part of the penalties were concentrated amongst ten Global Systemically Important Banks.

The Indian banking regulator, Reserve Bank of India (RBI) issued a circular on the Compliance Function in Banks in 2007, which adopted the recommendations contained in the BCBS (2005) document. Subsequently two additional circulars have been issued in 2015 and 2020 which further strengthen the role of the compliance function in the Indian financial sector<sup>2</sup>. These circulars emphasize the significance of a robust compliance system integral to the corporate governance structure of institutions.

At a keynote speech<sup>3</sup> in 2014, the presiding Deputy Governor RBI at that time, SS Mundra raised a concern on issues of non-compliances observed in the Indian banking sector, which included instances of mis-selling of complex derivative products; lack of adherence to Anti Money Laundering (AML) and Know Your Customer (KYC) norms; and frauds caused by lapses in internal processes. He also emphasised the growing importance of compliance as part of the supervisory oversight by the RBI. Non-compliances in India have been met with timely penalties or sanctions. For instance, during the year 2024-25, RBI imposed a total penalty of INR 54.78 crores on 353 regulated entities. Regulated entities include commercial banks, non-banking finance companies, and cooperative banks.

Penalties on financial institutions can result in several outcomes. They may act as deterrents to the affected banks and others from engaging in non-compliant activities. They may prompt

banks to strengthen their internal processes. They may reduce risk-taking behaviour, causing shifts to safer and conservative business practices. The announcement of penalties can also potentially cause reputational damage and impact the profitability of institutions.

Several studies have examined the stock market reaction to penalty announcements through short-term event studies. These studies have primarily explored two events: the first is the public announcement of misconduct, and the second is the settlement of a case of misconduct, which signifies the end of the litigation and publishes the regulatory and legal costs. The initial announcement of misconduct by an entity is often met with a negative stock market reaction (Karpoff & Lott, 1993; Marciukaityte et al., 2006). However, the announcement of a settlement is met with positive reaction (Flore et al., 2021; Köster & Pelster, 2017). Köster & Pelster (2017) ascribe the favorable reaction to the investors being happy that the case is closed successfully and the issue resolved by the Bank.

In light of the above discussion, our article focuses on an exploratory analysis of the impact of compliance penalty announcements by RBI in India. The nature of these announcements is unique, as the RBI publishes both the act of misconduct and the penalty amount to be paid by the organization simultaneously. Before the press release, the information about the misconduct may generally not be known to the market participants. Thus, unlike previous studies, which examine the impact of both the announcement and subsequent resolution of the misconduct as separate events, we consider only one event date, combining the notice of misconduct and the regulatory penalty applicable to the entity.

We create a unique and manually compiled database of regulatory penalties imposed on Scheduled Commercial Banks (SCBs), Payment Banks (PBs), and Non-Banking Finance Companies (NBFCs) from January 2010 to March 2025, which comprises 488 instances of penalties. Of these 368 cases pertain to SCBs and 120 cases are for NBFCs and PBs. We do not include co-operative banks in our study, as the average penalty amounts imposed on these banks is very small. For instance, during the period 2024-25, the average penalty amount

2. Compliance functions in banks and Role of Chief Compliance Officer (CCO); <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11962&Mode=0>

3. *Re-emphasizing the role of compliance function in banks* Centre for Advanced Financial Research and Learning, Conference of Chief Compliance Officers, August 2014.

imposed on cooperative banks was about Rs. 6 lakhs, while, the average penalty amounts for Public Sector Banks and Private Sector Banks were about Rs 1 crore; and for NBFCs about Rs 19 lakhs during the same period.<sup>4</sup>

The penalties are classified into 10 sub-categories for a better understanding of the underlying causes of contraventions, including an analysis of the shift in supervisory focus in response to the evolving business environment. We further analyse the stock market reaction to penalty announcements for listed SCBs using an event study method. Our results show that monetary fines have been effective deterrents of non-compliance by regulated entities in India. Furthermore, equity markets have reacted negatively to non-compliance instances in the short-run (4-day period) and in the subsequent week (8-day period), suggesting that the imposition of regulatory penalties does translate into a negative impact on the market reputation of banks.

The rest of the article is organized as follows. Section 5.2 discusses the regulatory provisions under which RBI penalizes banks. Section 5.3 describes the data and methodology used in the study. Section 5.4 summarises the stylized facts and results of the analyses and section 5.5 concludes.

## 5.2. Supervisory Approach and Regulatory Provisions for Imposing Penalties

The Reserve Bank of India's supervisory approach has progressed from one based on the CAMELS framework where capital adequacy, asset quality, management aspects, earnings, liquidity and systems and control were examined to the SPARC (Supervisory Programme for Assessment of Risk and Capital) approach under Risk Based Supervision (RBS). Under the CAMELS approach, onsite inspections played a primary role in ensuring compliance, supplemented with off-site monitoring. The SPARC framework involves supervision of financial institutions in accordance with their risk pro-

file and draws on comprehensive off-site monitoring and need-based, risk-focused on-site inspection. The revised supervisory strategy under RBS requires banks to take several steps including setting up of a comprehensive risk management architecture; adopting a risk-based approach to internal audit; strengthening management information systems; re-orienting staff to the risk-based approach and establishment of a compliance department.<sup>5</sup>

The RBI has issued several circulars that both emphasise the importance of, and strengthen the compliance function, an important pillar of the RBS approach. The first circular in 2007,<sup>6</sup> requires all banks to establish the compliance function; defines compliance risk and delineates the role of the board and senior management in establishing a culture of compliance, establishing a compliance policy and ensuring its adherence.

The 2015<sup>7</sup> circular highlights the need for a tighter compliance regime in banks through several measures. These include adherence to guidelines related to submission of data as per regulatory templates; the separation and independence of the audit and compliance function; need for review of compliance function by Board-level committees and the internal audit department; adequate staffing; coordination between reports submitted by the internal audit and compliance functions; ensuring compliance testing and promoting of a culture of compliance. The latest circular in 2020<sup>8</sup> focusses on the importance of the Chief Compliance Officer (CCO), and discusses criteria related to independence, stature, eligibility, selection process, tenure, duties and responsibilities, etc. of the CCO.

Under the Banking Regulation Act (1949), the RBI is vested with powers to issue directions where necessary in the interest of banking

5. Move towards Risk Based Supervision (RBS) of Banks. <https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=439>

6. Compliance function in banks; <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=3433&Mode=0>

7. <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9598&Mode=0>

8. <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11962&Mode=0>

4. <https://rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/0ANUALREPORT202425DA4AE08189C848C8846718B080F2A0A9.PDF>

policy, in public interest or where the affairs of the bank are being conducted in a manner detrimental to the interest of the depositors. The Act also empowers the RBI to levy penalties, impose restrictions, cancel licenses or even close banks. Section 46 of the Act specifies the quantum of penalty for various acts of non-compliance by banks. For instance, if any return, balance sheet or other document is deliberately falsified, or material information is knowingly omitted, a fine of Rs. 1 crore may be imposed. If the bank fails to produce information or books of account, or provide information requested by the regulator, a fine of Rs. 20 lakhs and an additional fine of Rs. 50,000 per day of the offence can be levied. Deposits taken in contravention of the Act, invite a penalty up to twice the amount of the deposit received. Violation of any other provision of the Act or failure to abide by any rule or directions given or sanctions/restrictions imposed can invite a penalty of Rs. 1 crore or twice the amount involved in the contravention, cumulating to larger amounts for every day that the default continues. The Act does not link the quantum of the fine to the size or financial position of the bank

Penalties on NBFCs are governed by the RBI Act, 1934. Section 58 of the RBI Act lists fines that may be imposed on NBFCs. For example, the RBI Act specifies a fine of Rs. 25,000 for failure to provide information. In case of acceptance of deposits in contravention of authorization, a fine twice the amount of deposits or Rs. 10 lakhs, whichever is higher may be imposed.

Apart from the provisions of the Banking Regulation Act 1949 and RBI Act 1934; RBI is also empowered under other laws to impose penalties on regulated entities. For example, fines may be applied for non-adherence to the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act); Foreign Exchange Management Act (FEMA), Payment and Settlement Systems Act and others.

### 5.3. Data and Methodology

For the purpose of our analysis, we collate the data on penalties imposed on SCBs and NBFCs

from press releases that are published on the RBI website. The data includes the following fields: date of press release, name of entity, amount of fine, and the reason(s) for the penalty. In a few cases, the RBI announces a sanction without a penalty amount, which is also included in our event study.

**TABLE 5.1**  
**Themes or Categories of Violations**  
**Identified across SCBs**

Sr. No	Theme	Description of Violation
1	KYC&AML	Non-Compliance with Know Your Customer (KYC) and Anti Money Laundering (AML) norms
2	IRACP	Non-Compliance with Interest Recognition, Asset Classification and Provisioning (IRACP) norms
3	C&I Norms	Non-Compliance with Prudential Norms for Credit and Investments
4	IP&C	Deficiencies in Internal Processes and Controls
5	CR&T	Violation of Customer Rights and Transparency Norms
6	G&L	Deficiency in Governance and Breach of Licensing Conditions.
7	FEMA&Swift	FEMA and SWIFT Related Violations
8	Fraud	Contravention of Fraud Guidelines
9	CI&O	Violations of norms on Cybersecurity, IT Risk, and Outsourcing
10	RR	Lapses in Regulatory Reporting and Inadequate Response to Supervisory Concerns

Source: Author's construction.

The next part of our analysis is based on penalties on SCBs. For this subset of cases, we drill down into the reasons for the penalties by creating ten themes or categories of violations (Table 5.1). Cross-sectional and temporal dimensions of monetary penalties are presented across these categories to depict the major types of violations and the changing supervisory focus.

Finally, we conduct an event study to examine the stock market reaction to the penalty

or sanction announcement. Data on adjusted stock prices is collected from the Prowess IQ database. The event study methodology has been used to determine the cumulative abnormal returns for 3 days and 7 days after the penalty announcement. We use the event study methodology as described by (MacKinlay, 1997).

An estimation window of 100 days (-30 to -130) before the penalty announcement date is used to determine the expected return of the penalised bank in relation to the Nifty 50 index. We use the market model for the estimation.

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it} \quad [1]$$

where

$R_{it}$  is the return on the i-th bank's stock at time t

$R_{mt}$  is the return on the market portfolio (represented by the Nifty 50 Index)

$\alpha_i$  is the intercept term

$\beta_i$  is the sensitivity of the bank's stock returns to Nifty 50 returns

$\varepsilon_{it}$  is the zero mean disturbance term

The next step is to arrive at the abnormal returns. Since, the penalty announcement is not known to the market players, until the press release, we consider the abnormal returns from the date of announcement (day 0), unlike studies that compute abnormal returns from before the announcement.

We compute abnormal returns for two periods; the first is from the date of announcement of the press release until day 3 after announcement, and the second is from the date of announcement until day 7 after announcement. The coefficients from the market model are used to determine the expected returns.

$$\text{Abnormal Stock Return} = \text{Actual Return} - \text{Expected Return} \quad [2]$$

Finally, we compute the Cumulative abnormal returns (CAR) for the penalised bank stock over 3 days after announcement and over 7 days after penalty announcement.

$$\text{4-day CAR} = \sum \text{Abnormal Returns Day 0 to Day +3} \quad [3]$$

$$\text{8-day CAR} = \sum \text{Abnormal Returns Day 0 to Day +7} \quad [4]$$

## 5.4. Stylized Facts and Results

In this section, we provide the cross-sectional and temporal dimensions of the non-compliance penalties imposed by RBI on various Regulated Entities (REs) in India, captured from 2010 onwards.

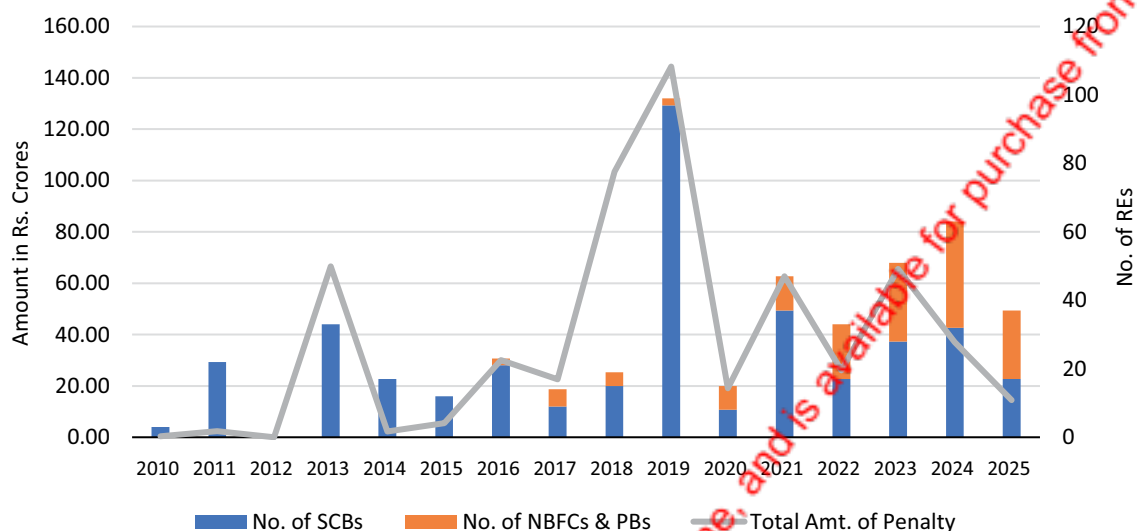
Table 5.2 below summarises the non-compliance instances and costs across types of regulatory entities. The SCB category includes public sector banks (PSB), private banks (PVB), Foreign Banks (FB) and small finance banks (SFB).

**TABLE 5.2**  
**Non-Compliance Penalties by Type of RE (2010 - March-2025)**

Category of RE	Type of RE	No. of REs	Share of Penalty Instances (%)	Amt. of Penalty (Rs. Crores)	Share of Penalty Amt. (%)	Avg. Penalty Per RE
PSB	SCB	167	34.22%	237.17	39.38%	1.42
PVB	SCB	135	27.66%	261.60	43.43%	1.94
FB	SCB	59	12.09%	50.56	8.39%	0.86
SFB	SCB	7	1.43%	3.09	0.51%	0.44
Sub-Total (SCBs)	SCB	368	75.41%	552.41	91.71%	1.50
HFC	NBFC&PB	15	3.07%	0.99	0.16%	0.07
NBFC	NBFC&PB	98	20.08%	33.21	5.51%	0.34
PB	NBFC&PB	7	1.43%	15.72	2.61%	2.25
Sub-Total (NBFC&PB)	NBFC&PB	120	24.59%	49.92	8.29%	0.42
	Grand Total	488	100.00%	602.33	100.00%	1.23

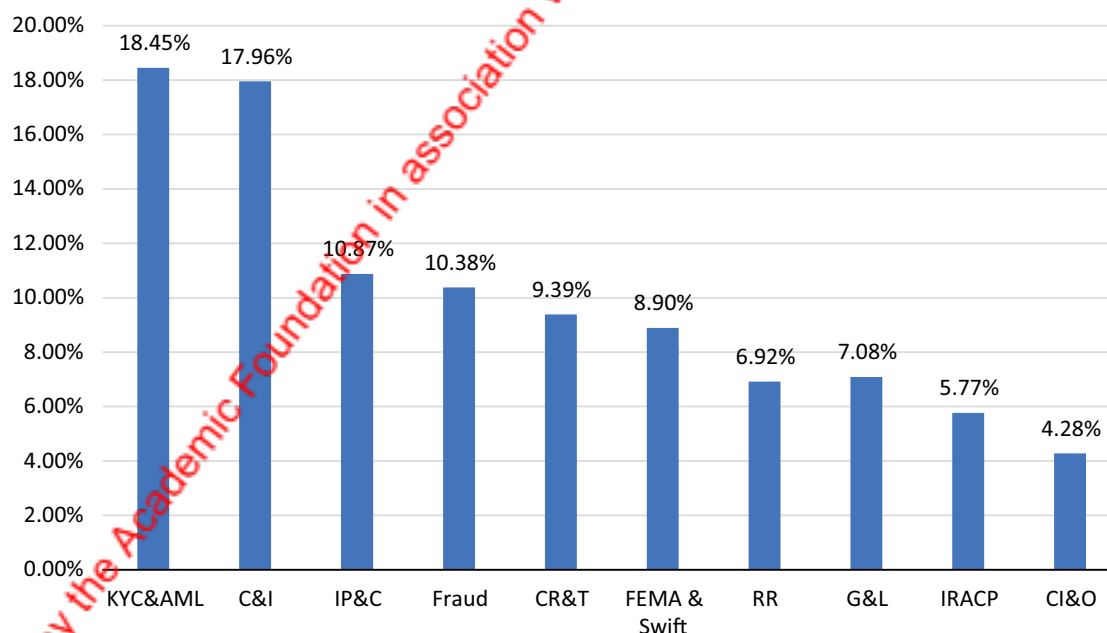
Source: Authors' Compilation.

**FIGURE 5.1**  
**Trend of Compliance Penalties on Regulated Entities**



Source: Authors' Construction.

**FIGURE 5.2**  
**Share of Penalty Instances on SCBs (%) (2010 - 2025)**



Source: Authors' Construction.

Non-bank finance companies (NBFC), housing finance companies (HFC) and payment banks (PB) have been grouped together as NBFC&PB, as these are recent entrants to the regulatory landscape. The highest share of the total 488

penalties has been of SCBs in general (75.41%) and PSBs in particular (34.22%). The penalty amount has also been largest for SCBs in aggregate (91.71% share) vis-à-vis NBFC&PBs. PBs have faced the highest average fines per

instance of violation (Rs. 2.25 crores), followed by private banks at Rs. 1.94 crores.

As seen in Figure 5.1, the scope of coverage of REs and the associated regulatory costs of non-compliance have, on average, increased over the years. The number of NBFCs and PBs that have been penalized for violations has been growing since 2020, vis-à-vis SCBs, indicating increased intensity of regulatory oversight on non-bank entities. The aggregate amount of penalty, while strongly correlated to the number of violating entities, has been volatile. The highest costs were imposed in 2019, adding up to Rs. 144. Crores, primarily on SCBs. In the year 2012, regulatory scrutiny was focused entirely on co-operative banks in India and as such, there were no penalties announced for SCBs.

For SCBs in particular, we identify 10 broad themes of violation as shown in Table 5.1. For the 368 SCBs that were penalized over the sample period, there are a total of 607 violations reported. This is because, under aggregate pen-

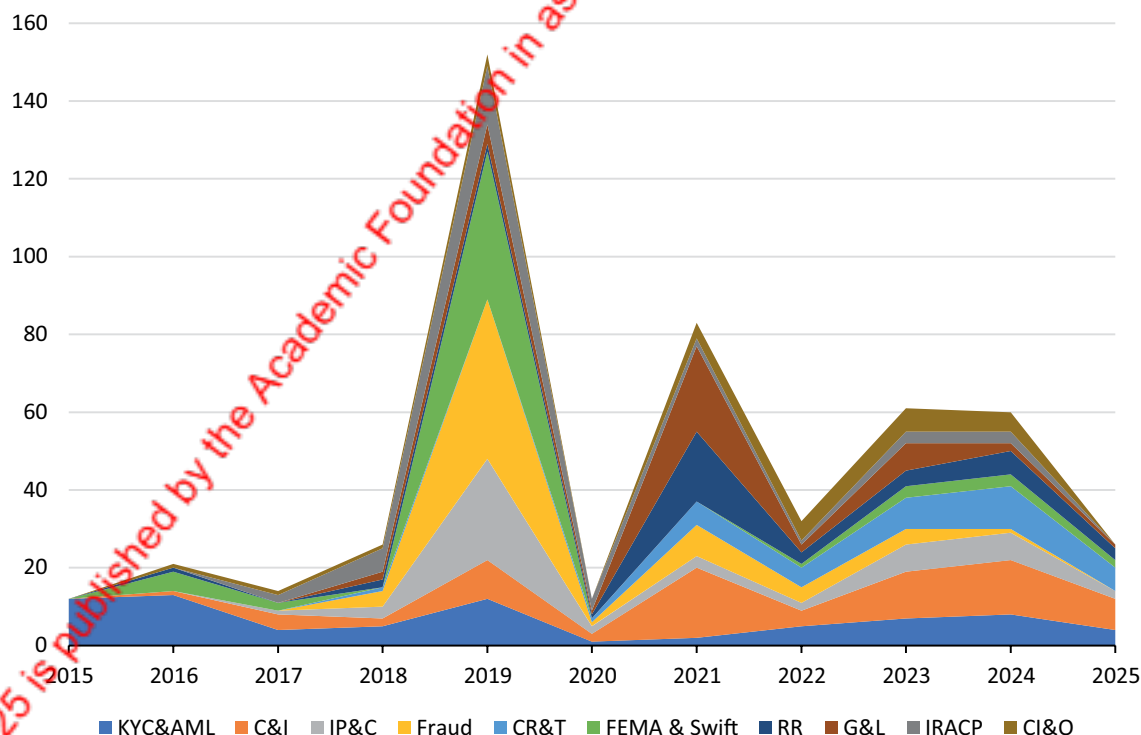
alty per bank, RBI may have identified several types of violations. Figure 5.2 depicts the share of each category of violation across all SCBs. Non-compliance with KYC/AML (18.45%) and breach of credit and investment norms (17.96%) have been most frequently penalized by RBI.

Over the last decade, the trend in SCB penalties shows that the composition of violation types has changed (Figure 5.3). This shift in regulatory focus is often the consequence of identification of major breaches in individual banks and also follows the evolving regulatory guidelines applicable to specific banking activities.

The RBI's scrutiny on contraventions of KYC and AML directions was more intense during 2015-16, given that the Master Directions – Know Your Customer (KYC) Direction had been issued in February 2016.

The spike in the number and amount of penalties imposed in 2019 related primarily to non-adherence with various RBI directions on

**FIGURE 5.3**  
**Trend in No. of Penalties by Violation Type**



Source: Authors' Construction.

time-bound implementation and strengthening of SWIFT-related operational controls, weaknesses in internal audit process and lapses in fraud risk management. This came about immediately after the Nirav Modi scam of Rs. 11,000 crores faced by a large public sector bank in 2018.

Lapses in regulatory reporting, particularly under CRILC caught the regulator's eye in 2021, after the Prudential Framework for Resolution of Stressed Assets was issued in June 2019. Once the Master Directions of RBI on "Fit and Proper Criteria" for Elected Directors on the Boards of PSBs, were issued in 2019, various governance failures, relating to divergence from permissible business activities, extent of shareholding in other companies and insider lending also came to the fore in 2021.

As the financial system became increasingly digitalised, from 2011 onwards, the RBI issued a series of guidelines, regulations and mandates to strengthen IT systems and cyber resilience in banks. These included guidelines on IT governance and risk management for financial institutions (2011), followed by guidelines on establishing a cybersecurity framework by banks (2016), a circular on strengthening security in card transactions (2020), direction on digital payment security controls (2021), Master Directions on Outsourcing of IT Services (April 2023) and Master Directions on IT Governance, Risk, Controls and Assurance Practices in November, 2023. The regulatory scrutiny of banks' adherence to these guidelines and imposition of penalties on violations of these guidelines increased from 2022 onwards.

In 2014, RBI had released a Charter of Customer Rights, which enshrines broad, overarching principles for protection of bank customers, enunciating (i) Right to Fair Treatment; (ii) Right to Transparency; Fair and Honest Dealing; (iii) Right to Suitability; (iv) Right to Privacy; and (v) Right to Grievance Redress and Compensation. Scrutiny of bank violations of the charter intensified after the COVID-19 pandemic, leading to a larger number of penalties on this account.

It is expected that markets will react adversely when banks face non-compliance fines from

the regulator. We present below the analysis of cumulative abnormal returns (CAR) associated with regulatory penalties for a sub-sample of regulated entities, which includes PSBs, PVBs and SFBs over the period of 2010 to 2025. We consider the 4-day CAR to capture the immediate market impact and the 8-day CAR to measure the effect over a slightly longer horizon.

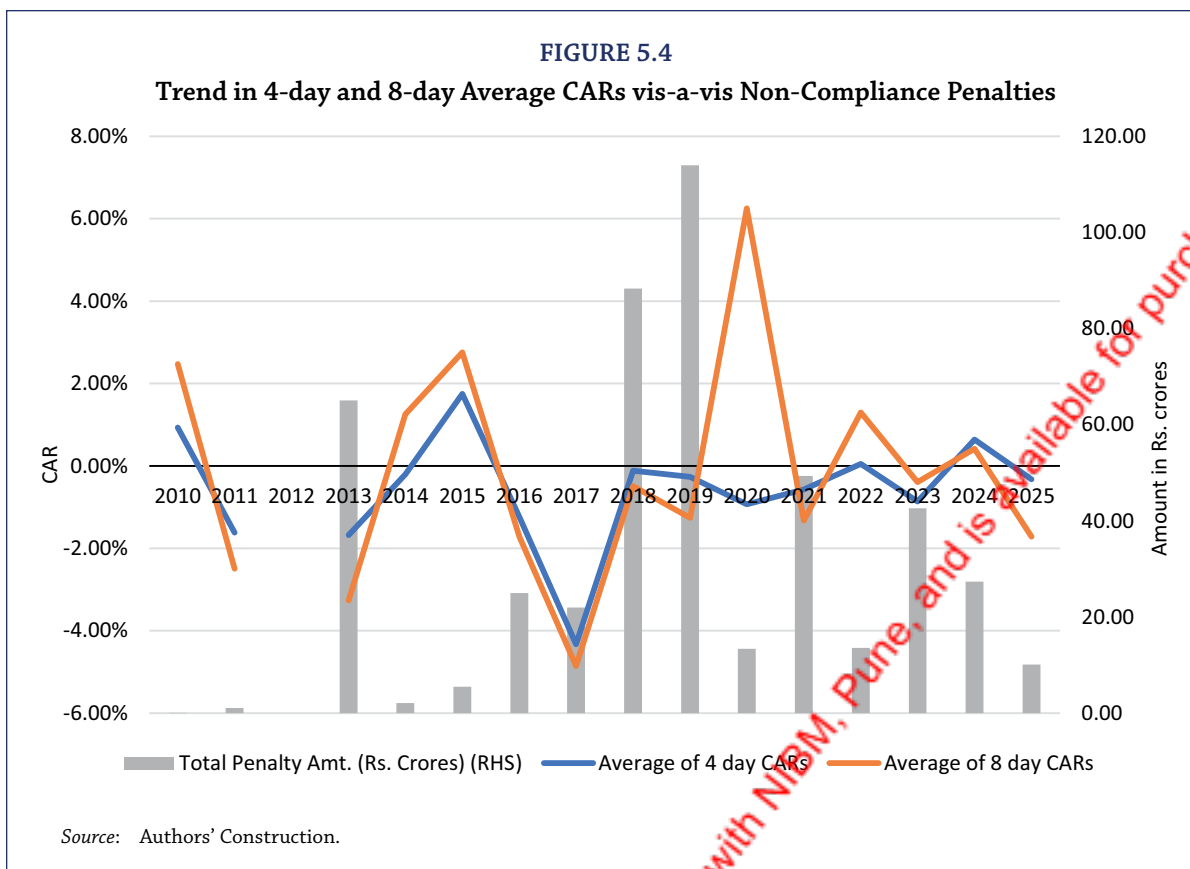
Table 5.3 summarises the descriptive statistics of the penalty-linked CARs. On average, the market impact of non-compliance by banks has been adverse, with the severity representing -0.52% abnormal negative returns over 4 days and -0.82% over 8 days. The CARs have been highly volatile across the sample, as seen by the high values of standard deviation.

**TABLE 5.3**  
**Descriptive Statistics of CAR**

	4-day CAR	8-day CAR
Average	-0.52%	-0.82%
Standard Deviation	4.40%	5.92%
Skewness	2.25	0.21
Kurtosis	23.75	12.14
No. of Observations	287	288

Source: Authors' Analysis.

The average CARs have fluctuated annually (Figure 5.4), with values being negative for most years, where the aggregate penalty amounts are higher. In some years, however, there have been unexpected positive CARs. For example, in 2014, the RBI fined multiple banks based on contraventions pertaining to a single, common credit exposure to an individual company. While this led to a minor negative CAR at the time of penalty announcement, the effect was reversed over 8 days. In 2015, the average CARs were positive for both 4-day and 8-day periods. In this instance, 10 banks were simultaneously pulled up for KYC&AML violations in April 2015, but only 3 of the banks were subject to financial penalties, while the rest were only cautioned by the regulator. The penalty announcements coincided with the declaration of strong fourth-quarter performance results of most banks, which offset the adverse implications of non-compliance. In 2020, the 8-day CAR was positive on average primarily because



**TABLE 5.4A**  
**CAR Profiles by Bank Categories**

Bank Type	Average 4-day CARs	Average 8-day CARs	Total Penalty Amt. (Rs. Crores)	Average Penalty Amt. (Rs. Crores)	No. of Violations
PSB	-0.64%	-1.29%	233.07	1.51	279
PVTB	-0.36%	-0.35%	245.27	2.01	204
SFB	-1.19%	5.42%	1.29	0.43	3
Grand Total	-0.52%	-0.82%	479.64	1.72	486

Source: Authors' Analysis.

**TABLE 5.4B**  
**CAR Profiles for Non-monetary Sanctions**

Bank Type	Average 4-day CARs	Average 8-day CARs
PSB	-5.09%	-3.52%
PVTB	-11.23%	-10.85%

Source: Authors' Analysis.

of a large PSB, which was fined for divergence of its non-performing assets. This hurt the particular bank's 4-day CAR by 1.975%, which sharply rebounded to a positive 8-day CAR of 25%.

Across bank categories, some interesting trends emerge (Table 5.4a). The unfavourable market implication of non-compliance was least severe for private banks, as seen by the relatively less negative values for both the 4-day and 8-day CAR. Thus, even though the regulatory pen-

**TABLE 5.5**  
**Average CARs by Type of Violation**

Type of Violation	4-day CAR	8-day CAR	No. of Violations
Non-Compliance with IRACP & NPA norms	-2.59%	-1.51%	31
Violations of norms on Cybersecurity, IT Risk and Outsourcing	-2.08%	-1.97%	21
Deficiencies in Internal Processes and Controls	-1.74%	-2.43%	57
Contravention of Fraud Guidelines	-1.01%	-0.42%	60
Lapses in Regulatory Reporting and Inadequate Response to Supervisory Concerns	-0.95%	-2.22%	31
Violation of Customer Rights and Transparency Norms*	-0.67%	-0.64%	38
Deficiency in Governance	-0.47%	-0.65%	28
Non-Compliance with Prudential Norms for Credit and Investments	-0.33%	-0.63%	88
Breach of Licensing Conditions	-0.19%	-0.81%	4
Non-Compliance with KYC/AML	0.15%	-0.53%	98
FEMA and Swift Related Violations	1.10%	-0.33%	29
	-0.52%	-0.82%	485

Source: Authors' Analysis based on RBI data.

Note: \* This excludes the outlier data of one small private bank, for which the CAR had become abnormally positive.

alties were highest both in aggregate and per bank for the private banks, the equity market reaction was muted. There were only 3 instances of SFB CARs captured in our analysis, given the recency of SFB incorporations, and that many of them are unlisted. The markets were highly sensitive to regulatory violations by SFBs, during the immediate period following the regulatory announcements (average 4-day CAR was -1.19%), but also corrected sharply over 8-days, given that the penalty amounts were much smaller. PSBs faced a negative market impact of non-compliance at the level of -0.64% over 4 days, which became more acute over 8 days.

In Table 5.4b, we summarise the reaction to two events, one for a public sector bank and another for a private sector bank; where sanctions in terms of business restrictions were imposed, without any monetary penalty. We observe that the average 4-day CAR in both cases were much larger at -5.09% and -11.23% respectively, than for cases where only monetary penalties were applied. Over the 8-day period also, the significant negative effects of non-monetary sanctions continued with an average CAR of -3.52% and -10.85% respectively. This provides an interesting pattern as

compared with instances of monetary penalty, where we observe a trend reversal in the negative CARs for the 8-day period.

Table 5.5 depicts the CAR impact by type of violation disclosed by RBI. The worst market impact in the immediate period following the regulatory announcement was associated with deviations from the IRACP Norms, followed by non-compliance with norms on Cybersecurity, IT, and Outsourcing Risk, and deficiencies in internal processes and controls. FEMA and Swift-related violations were the only exception, for which the 4-day CAR became positive on average. It may be recollected that the Nirav Modi scam involving the failure of Swift processes of a large PSB came to light in January 2018. The scale of the fraud was then disclosed to the stock exchanges in February 2018. Subsequently, the RBI directed all banks to strengthen their SWIFT operations. In 2019, the RBI penalised a large number of banks that had not acted on its directions. By then, however, markets had already factored in the adverse implications of such deficiencies and did not react unfavorably to the regulatory penalties.

## 5.5. Conclusion

Addressing episodes of misconduct and instances of non-compliance by financial institutions has become a top priority for banking regulators in the recent past. The RBI, armed with legislative authority and guided by global best practices in supervision, has been imposing financial and non-financial penalties on regulated entities in India for contravention of various regulatory guidelines and transgressions of prudent business practices. Our article analyses the monetary and market implications of such penalties on Indian banks and financial institutions over the last one and a half decades (2010 to 2025).

Our data captures 488 instances of penalties imposed by the RBI on various regulated entities (excluding co-operative banks), adding up to approximately Rs. 600 crores, over the period under consideration. Commercial banks have been most impacted, both in terms of the number and amount of fines, with private banks collectively facing the highest forfeitures within this segment. Penalties on NBFCs have intensified after the introduction of Scale-Based Regulations to harmonize regulatory directions across banks and non-banks.

Violations of KYC and AML guidelines have been a recurrent and frequent cause of penalisation. The other significant areas of non-compliance have been prudential norms for credit and investments, followed by deficiencies in internal processes and controls. There have been surges in fines for other underlying causes of breaches or misconduct in specific years. These have been triggered either due to detected misconduct in individual cases or because of failures in compliance with incremental regulations. For instance, the year 2019 saw a large number of fines imposed for fraud and FEMA & Swift violations subsequent to the Nirav Modi scam. Another example is the higher penalties in recent years for failures in cybersecurity, IT, and outsourcing practices, for which the RBI has been issuing an expanding set of regulatory directions.

We observe that, except for violations of KYC & AML guidelines, regulated entities have typi-

cally not been repeat offenders for non-compliance with specific areas on which they were penalised in the past. There have been heavy and widespread fines associated with issues on fraud, FEMA and Swift processes, and IRACP norms in specific years, but these have tapered off subsequently. This suggests that regulatory scrutiny and penalties have been effective deterrents to non-compliant behavior.

Penalties have also led to some reputational damage, as seen from average negative CARs observed both in the immediate 3-day period following the announcement and over the longer-term eight-day window. Market reputation impact has been adverse overall, but often not very severe, and highly variable across entities and types of violation. In some cases, the market effect of non-compliance penalties may be offset by other factors like strong financial performance, smaller loss implications perceived by market participants, or the low magnitude of fines with respect to the size or capitalization of the entity.

Some important policy and business practice implications emerge from the above results. First, to enhance the effectiveness of non-compliance penalties, regulators may wish to review both the quantum of fines that are permitted under current law and consider the application of non-monetary business constraints, which would have a stronger impact on the future profitability of banks and consequently market discipline. As seen in our analysis, stock markets reacted more unfavorably to the instances where banks were subject to business sanctions instead of nominal fines. Second, penalties may be linked to the size of the regulated entity to reduce the adverse implications of non-compliance by systemically important financial institutions. Finally, with the increasing materiality of compliance risk, banks have to implement effective compliance programs, to manage and mitigate risks associated with regulatory requirements. In doing so, they can leverage AI tools for efficient and timely detection of violations, particularly for routine regulations. This will help to rationalize internal costs of the compliance function and minimize the adverse impact on market reputation.

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