# V FINANCIAL REGULATION AND SUPERVISION

5.1 The health of the financial sector is a matter of public policy concern in view of its critical contribution to economic performance. Financial regulation and supervision assumes importance in ensuring that the financial system operates along sound lines. As discussed in chapter III, there has been a long tradition of regulating financial systems by central banks in several countries.

5.2 The regulation and supervision of banks are key elements of a financial safety net as banks are often found at the centre of systemic financial crises (Diamond and Rajan, 2005). The primary justification for financial regulation by authorities is to prevent systemic risk, avoid financial crises and protect depositors' interest and reduce asymmetry of information between depositors and banks. As the costs of financial crises were perceived to be very high, the authorities realised that they should be avoided at all costs. As a result, banks came to be regulated everywhere. Besides, financial regulation attempts to enhance the efficiency of the financial system and to achieve a broad range of social objectives. Going by the experience in several countries, effective regulation is in the interests of all concerned, though it cannot be based on a 'one-size-fits-all' approach (Mistry, 2003). However, it is important to bear in mind that while financial institutions do benefit from an appropriate regulatory regime, there is not much evidence that the existence of a regulatory jurisdiction makes institutions stronger and less prone to shocks (Fiebig, 2001). There is neither a unique theoretical model, nor just one practical approach to the regulation and supervision of a financial system. The existence of different types of regulatory models of the financial system makes the ideal choice a difficult exercise.

5.3 The Indian financial system consists of commercial banks, cooperative banks, financial institutions (FIs) and non-banking financial companies (NBFCs). The commercial banks can be divided into certain categories depending on the ownership pattern, *viz*., public sector banks, private sector banks and foreign banks. While the State Bank of India and its associates, nationalised banks and Regional Rural Banks (RRBs) are constituted under respective enactments of the Parliament, the private sector banks and foreign banks are considered as banking companies as defined in the Banking Regulation Act, 1949. The cooperative credit institutions in the country are broadly classified into urban credit cooperatives and rural credit cooperatives. The rural credit cooperatives are generally divided into short-term and long-term cooperatives. However, in some states, cooperative banks have unitary structure with a state level cooperatives operating through their own branches.

5.4 The regulation and supervision of the financial system in India is carried out by different regulatory authorities. The Reserve Bank regulates and supervises the major part of the financial system. The supervisory role of the Reserve Bank covers commercial banks, Urban Cooperative Banks (UCBs), some FIs and NBFCs. Some of the FIs, in turn, regulate and/or supervise other institutions in the financial sector, *viz*., RRBs, and central and state cooperative banks are supervised by National Bank for Agriculture and Rural Development (NABARD); and housing finance companies by National Housing Bank (NHB). Department of Company Affairs (DCA), Government of India regulates deposit taking activities of companies, other than NBFCs, registered under the companies Act, but not those which are under separate statutes. The Registrar of Cooperatives (ROC) of different states in case of single state cooperatives and the Central Government in the case of multi-state cooperatives are a joint regulator with the Reserve Bank for UCBs and with the NABARD for rural cooperatives. While RBI/NABARD is concerned with the banking function of the cooperatives, the management control rests with the State/Central Governments. This dual control impacts the supervision and regulation of the cooperative banks. The Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector and the capital market, credit rating agencies, *etc*., are regulated by Securities and Exchange Board of India (SEBI).

5.5 In the past five decades, the Indian banking system has traversed through a difficult path endeavouring to balance several competing and conflicting demands on it from large, medium, small and tiny borrowers in both organised and unorganised

sectors. The banking system's activities were initially tightly regulated and their freedom was restricted. It also confronted several domestic stresses and external shocks. However, the regulations have changed over time to ensure that the banking system steps out of the restrictive operational environment and functions in an atmosphere that bestowed them freedom to innovate and operate in a competitive environment.

5.6 In recent years, the blurring of the distinction among financial intermediaries under the combined impact of domestic and cross-border integration, innovations in instruments and processes, advances in technology and the increasing volumes of capital intermediated by the financial system have necessitated a proactive strengthening of the regulatory and supervisory framework. Emergence of several players with diversified and significant presence in the financial sector makes it imperative for supervision and regulation to be spread across various segments of the financial system.

5.7 The basic issues relating to the form of organisation, extent of ownership, nature of control over management by major stakeholder and the system of corporate governance are still subject to considerable debate (Reddy, 2000). In recent years, there has been a shift in emphasis from micro-regulation to macro-management, supported by a tightening of prudential norms and improvements in the functioning of the financial system.

5.8 This chapter traces the broad transformation that has taken place in the role of the Reserve Bank as the regulator and supervisor of the Indian financial system with a specific focus on the banking system. The chapter is divided into six Sections. Section I traces the genesis and evolution of the financial regulation and supervision in India. Section II highlights the conceptual history of the regulatory and supervisory policies, and strategies in bank regulation and supervision in India. Section III briefly examines the conduct of monetary policy function and its compatibility with regulatory and supervisory role from the Indian perspective. Section IV then discusses some of the emerging issues such as ensuring financial stability, and Indian banking system's transition to Basel II and its implications. Section V makes an assessment of the role played by the Reserve Bank in the financial regulation and supervision, and sketches the future role expected of it. Finally, Section VI offers concluding observations.

## I. GENESIS AND EVOLUTION OF FINANCIAL REGULATION AND SUPERVISION

5.9 There is no consistent theory that stipulates, anticipates and assists in controlling regulatory changes. An ideal structure of financial regulation in an economy depends upon the structure and degree of development of the financial system. The need for financial regulation rests on assumptions regarding the role of financial institutions in an economy (Box V.1).

5.10 Central banks' involvement with regulation and supervision of financial system in various countries has evolved gradually as the incidence of banking crises started increasing. Initially, the statutory regulation of banks was considered necessary for the protection of depositors, reduction of asymmetry of information and for ensuring sound development of banking. Subsequently, when the bank crises became widespread, financial regulation by authorities was considered critical to prevent systemic risk and avoid financial crises.

5.11 The need to entrust the regulation and supervision function to central banks is well recognised in view of the critical implications of bank failures. The owners or shareholders of the banks have only a minor stake and considering the leveraging capacity of banks (more than ten to one) it puts them in control of large volume of public funds, of which their own stake is miniscule. In a sense, therefore, they act as trustees and as such must be 'fit and proper' for the deployment of funds entrusted to them. The sustained, stable and continuing operations depend on the public confidence in individual banks and the banking system. The speed with which a bank under a run can collapse is incomparable with any other organisation. In a developing economy, tolerance for downside risk is much less among depositors, many of whom place their life savings in the banks. Hence from a moral, social, political and human angle, there is a more onerous responsibility on the regulator. Millions of depositors whose funds are entrusted with the bank are not in control of the management (Mohan, 2004a).

### *Core Central Banking Functions vis-à-vis the Function of Banking Regulation and Supervision*

5.12 It was recognised in many countries that the ability of a central bank to effectively discharge the core functions would be constrained unless the financial system is efficiently regulated. The traditional central bank functions, *viz.*, formulating monetary

**Box V.1**
**Evolution of Thinking on Regulation**

It is recognised that there are no well developed theories of regulation. 'Theory of innovation' postulates that regulatory changes can be measured by their effect on the quantitative and qualitative measures of the regulatory function (Kane, 1981). Theory of contestability (Baumol, *et al,* 1983) maintains that market structure adapts through the process of entry and exit to serve the needs of the customers at minimum cost. Frenkel, *et al,* (1991) distinguish between these two models according to their use of protective measures, bankruptcy procedures and contractual relationships between banks and customers. Sinkey (1992) attempted to develop a 'general theory of regulation' by combining 'agency theory' focusing on problems of hidden actions (moral hazard) and hidden information (adverse selection) with a 'theory of production of regulatory and financial services'.

Models conceived by Llewellyn (1996) and Goodhart, *et al* (1998) distinguish between 'institutional and functional regulation'. The institution based regulation focuses on the 'type of institution or firm', while the functional regulation is 'regulation according to activity'. Differences in regulatory models governing financial systems can largely be due to differences in the 'prudential supervisory methods' and 'protective rules'. 'Prudential or preventive methods' are those aimed at controlling the levels of risk assumed by banks in order to reduce the probability of bank failures. 'Protective measures', on the other hand, offer protection to customers of financial institutions in the case of actual or impending bank failures and can be applied at a firm or industry level (Currie, 2003).

The banking sector regulation, broadly, takes two basic forms *viz.*, preventive regulation and protective regulation. 'Preventive regulation' prescribes entry requirements in the form of minimum capital requirements, ownership requirements and branch licensing. It also imposes ongoing requirements like capital to asset ratios, loan documentation, credit risk management, provisioning and write-off policies, internal control, *etc.* 'Protective regulation' consists of deposit insurance and lender-of-last-resort functions that are exercised by a central bank.

policy, note issue, providing clearing facilities have complex linkages with the function of financial regulation and supervision. An important reason for vesting a financial regulation function in a central bank is that both monetary and financial stability policies are intertwined. The transmission mechanism for monetary policy may be gravely impaired if credit flows are distorted by a defective or unstable financial system. To ensure a stable environment for controlling the money supply, central banks provided liquidity to the banking system on an *ad hoc* basis. By the early 1900s, the 'lender-of-last-resort' function developed into one of their core responsibilities. In consideration of these interrelationships among various functions, many central banks have willingly accepted the formal responsibility for supervising and regulating the banking sector.

*Global History*

5.13 In the nineteenth century, central banks had started focusing their attention on ensuring financial stability and their role had increasingly come to eliminate financial crises. The Bank of England (BoE) used to adjust the discount rate to avoid the effects of crises and this technique was used by other European central banks as well. In the United States, a series of banking crises between 1836 and 1914 had led to the establishment of the Federal Reserve System. The experience of the Great Depression had a profound effect on banking regulation in several countries and commercial banks were progressively brought under the regulation of central banks (Box V.2). In more recent years, financial liberalisation and the emphasis on competition and market forces in many countries have led to the return of systemic risk and financial crises. Between 1980 and 1995, three quarters of IMF member countries had confronted at least one crisis. The above cited factors demonstrate that systemic risk manifested by crises became the basic reason for central bank's involvement with financial regulation and supervision. Central banks have also increasingly associated the tools of banking regulation and supervision to protect depositors' interest, enhancing the efficiency of the financial system and achieving certain social objectives. The financial history of several countries is replete with such instances.

5.14 Broadly, it is observed that initially central banks were not vested with the responsibility of financial regulation due to their preoccupation with other core central banking functions. Subsequently, owing to the need to address the issue of banking crises, many countries considered it appropriate to entrust the financial regulation and supervision function to their respective central banks. In more recent years, some countries are considering a reassignment of regulatory and supervisory function from the central banks to other newly created bodies due to various country-specific reasons (Table 5.1).

**Box V.2**

**Genesis of Central Banks' Role as Financial Regulator and Supervisor - Global History**

In the early twentieth century, bank failures in various countries became too frequent and the ramifications were felt both by depositors and economies as a whole, the issue of identifying a suitable regulator and supervisor of the banking system and vesting the responsibility of regulation assumed importance. When the Bank of England (BoE) was established in 1694, its primary purpose was to raise money to finance the Government. In the UK, there was no formal system of banking regulation and no agency was empowered by law to deal with banking regulation until the 1970s, except the provisions of the Companies Act. Many banks collapsed during the early nineteenth century. The ramifications of spiralling bank failures forced the government to permit from 1826 the formation of joint stock banks allowing the risk to be spread amongst many proprietors. In 1866, the spectacular collapse of bill brokers - Overend Gurney and Company and in 1878 the collapse of the City of Glasgow Bank, sent shockwaves in the financial community. In 1890, BoE had to help the banking system recover from the devastating crisis in which Baring Brothers, a leading merchant banking house in London was involved. The BoE organised a rescue operation in the form of a guarantee fund and more than £17 million were promised, much of it from the powerful joint-stock banks. The crisis was averted but the leading role played by the BoE demonstrated the responsibility it had come to feel for the stability of the banking system as a whole. The banks were drawn into funding the government's war loans and advances, and note issue increased rapidly. Once again, BoE had to intervene, the strong growth and diversification of the larger banks in the 1970s was marred by troubles in the industry. High interest rates caused the collapse of many of these banks from late 1973 and as the crisis deepened, the BoE launched a rescue operation supported by the clearing banks. Public confidence was restored as the failing banks were either reconstructed or liquidated, but the result was the Banking Act, 1976, which increased the formal role of BoE in supervision and regulation of the banking system.

The experience of the United States was different. Before 1863, only State Governments had the power to regulate banks, and this consisted merely in issuing bank charters. In 1863, however, the Federal Government began to take active interest in bank regulation. The National Bank Act of 1864 provided that a Federal Agency, the Office of the Comptroller of the Currency, would have the power to license banks. The Federal Government's bank chartering powers expanded rapidly. In 1864, the Federal Government passed the National Bank Act, which stipulated that newly chartered banks had to buy federal debt and issue notes provided by the treasury. From 1836 until 1914, the U.S. did not have a central bank, but it had many financial crises. These crises were usually followed by recessions. During 1913, through the Federal Reserve Act or Owen-Glass Act, the Federal Reserve System was created to function primarily as a reserves holding institute, a money-creator of last resort to prevent the downward spiral of withdrawal of funds.

The economic depression in the early 1930s had a disastrous impact on the banking system in America. Private banks, which had invested in stocks and shares found that the Wall Street Crash had eroded their funds severely. In December 1930, the Bank of the United States was forced to close. Many banks found it difficult to continue and within a few years a fifth of all banks in America were forced to close. By the beginning of 1933 the American people were starting to lose faith in their banking system. When Franklin D. Roosevelt was elected as president, he made it clear that his first concern would be to solve this banking crisis. The day after his inauguration, he called the Congress into a special session and declared a four day bank holiday. On March 9, 1933, the Congress passed the Emergency Banking Relief Act, which provided for the reopening of the banks as soon as examiners had found them to be financially secure. Later that year, Congress passed the Banking Act, 1933. The Federal Reserve Board was given tighter control of the investment practices of banks and the Federal Deposit Insurance Corporation was set up to insure all deposits in banks up to US $ 5,000 (Franklin and Herring, 2001).

The experience of some other countries in delegating the responsibility of bank regulation was totally different. Despite the occurrence of banking crises and the need for central bank's intervention in resolving the crises, some countries established a separate regulatory authority outside the central bank to supervise the banking system, often several years before or after the creation of the central bank. The Canadian Government established the Office of the Inspector General of Banks in 1925 after the collapse of the Home Bank. The Bank of Canada was created nine years later (Georges, 2003). Canada's experience was not unique. A number of other countries, including Chile, Mexico, Peru, and the Scandinavian countries, developed central banks and bank regulators completely separately. More recently, countries such as the U.K. and Australia have modified the institutional mandates of their central banks by transferring their regulatory responsibilities to a separate agency. Therefore, the experiences of countries in creating an appropriate structure and entrusting the responsibility of bank regulation and supervision vary considerably, although the basic motive has been to maintain systemic stability. Thus, there is a considerable cross-national variation in the institutional structure of financial regulation and supervision, and the legislation related to it.

**Table 5.1: Countries with a Single Supervisor, Semi-integrated Supervisory Agencies and Multiple Supervisors in 2002***

| Single Supervisor for the Financial System | | Agency Supervising 2 Types of Financial Intermediaries | | | Multiple Supervisors (at least one for banks, one for securities firms and one for insurance) | |
|---|---|---|---|---|---|---|
| | | Banks and securities firms | Banks and insurers | Securities firms and insurers | | |
| 1. Austria | 12. Japan Republic | 23. Dominican | 29. Australia | 40. Bolivia | 47. Argentina | 62. Italy |
| 2. Bahrain | 13. Latvia | 24. Finland | 30. Belgium | 41. Chile | 48. Bahamas | 63. Jordan |
| 3. Bermuda | 14. Maldives | 25. Luxembourg | 31. Canada | 42. Egypt | 49. Barbados | 64. Lithuania |
| 4. Cayman Islands | 15. Malta | 26. Mexico | 32. Colombia | 43. Mauritius | 50. Botswana | 65. Netherlands |
| 5. Denmark | 16. Nicaragua | 27. Switzerland | 33. Ecuador | 44. Slovakia | 51. Brazil | 66. New Zealand |
| 6. Estonia | 17. Norway | 28. Uruguay | 34 .El Salvador | 45. South Africa | 52. Bulgaria | 67. Panama |
| 7. Germany | 18. Singapore | | 35. Guatemala | 46. Ukraine | 53. China | 68. Philippines |
| 8. Gibraltar | 19. South Korea | | 36. Kazakhstan | | 54. Cyprus | 69. Poland |
| 9. Hungary | 20. Sweden | | 37. Malaysia | | 55. Egypt | 70. Portugal |
| 10. Iceland | 21. UAE | | 38. Peru | | 56. France | 71. Russia |
| 11. Ireland | 22. UK | | 39. Venezuela | | 57. Greece | 72. Slovenia |
| | | | | | 58. Hong Kong | 73. Sri Lanka |
| | | | | | 59. India | 74. Spain |
| | | | | | 60. Indonesia | 75. Thailand |
| | | | | | 61. Israel | 76. Turkey |
| | | | | | | 77. USA |
| **As percent of all countries in the sample** | | | | | | |
| **29%** | | **8%** | **13%** | **9%** | **38%** | |

* Sample includes only countries that supervise all the three types of intermediaries (banks, securities firms and insurers).
**Source :** Martinez Jose de Luna and Rose Thomas A. 2003.

## Genesis of Bank Regulation and Supervision in India

5.15 Indigenous system of banking existed in India for centuries, which met the requirements of an ancient economy (Rau, 1960). The roots of commercial banking in India dates back to early eighteenth century (Box V.3).

### *Efforts towards a Comprehensive Banking Regulation Legislation in India*

5.16 The initial phases of commercial banking development in India bring out that during the formative stage of banking development, the banks were regulated and governed by the East India Company's Government, the Royal Charter and the Government of India. Before the enactment of the Banking Regulation Act, 1949, the provisions of law relating to banking companies were contained in the Indian Companies Act. Company law was introduced in India with the Companies Act 43 of 1850, which was based on the English Companies Act, 1844. In 1857, an Act for the incorporation and regulation of joint stock companies and other associations either with or without limited liability of the members thereof was passed. But under this Act, the privilege of limited liability was not extended to a company formed for the purpose of banking or insurance. This disability was removed by the Act of 1860, based on the English Companies Act, 1857. The law relating to companies was re-enacted in a comprehensive form in the Companies Act, 1913, which was made applicable to banking companies as well.

5.17 A banking crisis that occurred during 1913 revealed weaknesses of the banking system such as the maintenance of an unduly low proportion of cash and other liquid assets, the grant of large unsecured advances to the directors of banks and to the companies in which the directors were interested. Some of the banks seem to have resorted to certain undesirable activities and practices. After hectic and uncontrolled expansion there followed the inevitable crash. In West Bengal, the position was especially grave. Four scheduled banks and a large number of non-scheduled banks failed. The amount of money lost, mostly the savings of the middle class, was over Rs.26 crore. The issue of failures of banks was

**Box V.3**
**Evolution of Commercial Banking in India**

The East India Company set up Bank of Bombay in 1720 with the objective of increasing trade and thereby the revenue of the Company. In 1773, Warren Hastings floated the General Bank of Bengal and Bihar, which was a private establishment but under the patronage of East India Company's government. The General Bank was closed in 1775 due to opposition in the Governor-General's council. In 1786, the General Bank of India was floated, which claimed limited liability on the shareholders. But neither British nor the Indian law existed at that time to confer the right of limited liability on the shareholders except by the Royal Charter. Subsequently, other banks, *viz.*, the Carnatic Bank (1788), the Madras Bank (1795), the British Bank (1795) and the Asiatic Bank (1804) were established as private institutions.

On February 1, 1806, the Government Bank started functioning in Madras by the passing of the resolution by Bentinck in his Council. The Government Bank was empowered to issue notes subject to some conditions. Apart from Bank of Hindustan, two other European banks operated for various periods in eighteenth century Bengal. The Commercial Bank (1819) and the Bank of Calcutta (1824) were floated mainly by the agency houses. The Union Bank was born by the merger of the Calcutta Bank and the Commercial Bank. These private banks were owned by few individuals and managed by a few men and were legally termed as partnership firms with limited liability.

The Bank of Calcutta was established in 1806 as a joint stock bank with limited liability, which was brought under the Royal Charter in 1809 and renamed as Bank of Bengal. Subsequently, the Bank of Bombay (1840) and the Bank of Madras (1843) were established by Act III of 1840 and Act IX of 1843 by the East India Company. The Government Bank founded by Bentinck was replaced and closed simultaneously with the opening of the Bank of Madras in June 1843. The business of these Presidency banks were initially confined to discounting of bills or other negotiable private securities, keeping cash accounts, receiving deposits, and issuing and circulating cash notes. The major innovations in banking method and organisation came with the establishment of Bank of Bengal, which included (a) use of joint stock system for raising capital; (b) conferring of limited liability on shareholders by means of a charter; (c) provision for the note issue which could be accepted for public revenue payments; (d) general provision for acceptance of deposits from the general public; (e) imposition of explicit limit on credit and the kind of securities it could accept; and (f) provision for regulatory changes in the board of directors. The Royal Charter governed the three Presidency banks, which was revised from time to time. There were no legally recognised commercial banks with special right within India other than the Presidency banks. The East India Company's government reserved the right to regulate the monetary and credit system to itself.

With the passing of the Paper Currency Act, 1861, the right to issue currency notes by the Presidency banks was abolished and the same function was entrusted to the Government. With the collapse of the Bank of Bombay, the New Bank of Bombay was established in January 1868. In 1876, the Presidency Bank Act came into existence, which brought the three Presidency banks under the common statute and restriction on business. In terms of Act XI of 1876, the Government of India decided on strict enforcement of the charter and the periodic inspection of the books of these banks. In 1921, the three Presidency banks and their branches were merged to form the Imperial Bank of India, which acquired the triple role of a commercial bank, a banker's bank and a banker to the government. In 1951, when the first Five Year Plan was launched, the development of rural India was accorded the highest priority. The All India Rural Credit Survey Committee recommended the creation of a State-partnered and State-sponsored bank by taking over the Imperial Bank of India and integrating with it, the former State-owned or State-associated banks. Accordingly, an Act was passed in the Parliament in May 1955 and the State Bank of India was constituted on July 1, 1955. Later, the State Bank of India (Subsidiary Banks) Act was passed in 1959 enabling the State Bank of India to take over eight former State-associated banks as its subsidiaries.

**Source :** Evolution of the State Bank of India, (Part I and II).

investigated in detail by the Indian Central Banking Enquiry Committee (1929-31), the terms of reference of which included "the regulation of banking with a view to protecting the interest of the public". The Report of the Indian Central Banking Enquiry Committee emphasised the need for enacting a special Bank Act, covering the organisation, management, audit and liquidation of banks. The authoritative recommendations of the Committee have been an important landmark in the history of banking reforms in India.

5.18 When the Reserve Bank of India Act, 1934 came into effect, an important function of the Reserve Bank was to hold the custody of the cash reserves of banks, granting them accommodation in a discretionary way and regulating their operations in accordance with the needs of the economy through instruments of credit control. With regard to the banking system of the country, the primary role of the Reserve Bank was conceived as that of the lender-of-last-resort for the purpose of ensuring the liquidity of the short-term assets of banks.

5.19 The first attempt at banking legislation in India was the passing of the Indian Companies (Amendment) Act, 1936, incorporating a separate chapter on provisions relating to banking companies. There were two important features of the new legislation, which embodied some of the recommendations of the Indian Central Banking Enquiry Committee. For the first time, a determined effort was made to evolve a working definition of 'banking' and to segregate banking from other commercial operations. The special status of scheduled banks was recognised though certain provisions of the amended Act, such as building up of reserves, were made applicable only to non-scheduled banks, on the ground that the scheduled banks could be left to the general supervision and control of the Reserve Bank. These provisions, however, touched only the fringe of the problem of banking regulation.

5.20 The failure of the Travancore National and Quilon Bank (TNQ Bank) in the middle of 1938 created a public scare. The role of the Reserve Bank in this episode came under public and media gaze. The banking crisis of 1938 was largely a localised affair confined to South India. However, it was observed that majority of the non-scheduled banks continued to be without any control as they were not willing to submit their operations to the Reserve Bank's regulation. Between 1939 and 1949, as many as 588 banks had failed in various States.

5.21 The Reserve Bank submitted to the Central Board, in October 1939, a Report on the non-scheduled banks, with special reference to the distribution of their assets and liabilities. The Report mentioned that several of these banks had poor cash reserves, low investment ratio, over extension of the advances portfolio and a large proportion of bad and doubtful debts. There had been a mushroom growth of banks whose financial position was suspect and all this information was given only on the basis of dressed-up balance sheets, which did not disclose many of the more unsatisfactory features. The Reserve Bank's proposal for a Bank Act was sent to the Government of India in November 1939, and circulated to the public by the Government in January 1940 among banks, banking and commercial associations, prominent members of the public and the press, with the request that the replies be sent to the Reserve Bank within a period of six months. The replies received indicated that generally the business community and their associations welcomed the draft Bill. However, based on the comments received from various local Boards of the Bank, the Reserve Bank wrote to the Government that the opinion in the country was not ripe for undertaking elaborate bank legislation at that point of time.

5.22 The efforts were revived again in September-October 1943 for a more comprehensive Bank Act. On April 6, 1945, the Finance Member moved in the Legislative Assembly a motion for reference of the Bill to a Select Committee. The motion was adopted by the House in April 1946, but the Committee could not meet until November 1946. The amendments and suggestions made by the Committee formed the basis for the Banking Companies Act, 1949. The regulatory measures taken on an *interim* basis include the Banking Companies (Inspection) Ordinance, 1946 and the Banking Companies (Restriction of Branches) Act, 1946. The Bill as amended by the Select Committee was introduced in the Legislative Assembly on February 8, 1949 and was passed on February 17, 1949 as the Banking Regulation (BR) Act. Thus, the banking regulation and supervision function is governed by the provisions of the Act, which comprehensively deals with several aspects of the banks ranging from setting up of a bank to amalgamation besides several operational issues. The Department of Banking Operations, which was entrusted with the administration of the Act, was originally organised in August 1945 to provide the requisite administrative machinery to discharge the several duties and responsibilities, which were expected to devolve upon the Reserve Bank after the passing of the Banking Companies Bill.

5.23 In sum, the decades of 1930s and 1940s had witnessed proliferation of banks, which were not regulated and supervised statutorily in a comprehensive manner. As a sequel, several banks failed. In order to protect the interests of the depositors and develop the banking system on sound lines, the regulation and supervision of the banking system was entrusted to the Reserve Bank by enacting the Banking Regulation Act, 1949. The Banking Regulation Act has been modified continuously in response to financial developments and there have been 33 amendments to the original Act so far.

## II. DEVELOPMENT OF BANK REGULATION AND SUPERVISION POLICIES IN INDIA

5.24 As the functions of the Reserve Bank evolved over years, the regulatory and supervisory approaches were modified as and when deemed necessary. The focus of the Reserve Bank's role as a

regulator and supervisor has shifted gradually from micro regulation of banks' day to day activities to macro supervision with a view to ensuring that the regulations are adhered to in an environment where banks' management are given freedom to take all commercial decisions based on their own judgment. Some major developments tracing the evolution of the Reserve Bank's role as a financial regulator and supervisor of commercial banks, cooperative banks, non-banking financial companies and financial institutions are presented in this section.

### A. Regulation and Supervision of Commercial Banks

5.25 Before 1950, there were a number of bank failures and the banking sector had not then developed to meet the requirements of the economy. The supervisory powers conferred initially in 1940 vested the Reserve Bank with the right to inspect banking companies on a restricted scale in consultation with the Government of India. The purpose of these inspections was limited to satisfy the Reserve Bank regarding the eligibility for a license, opening of branches, amalgamation, and compliance with the directives issued by it. With the prior consent of banking companies concerned, the Reserve Bank undertook to inspect their books and accounts with a view to determining the real or exchangeable value of their paid-up capital and reserves for the purpose of considering their eligibility for inclusion in the Second Schedule to the Reserve Bank of India Act. Specific powers to inspect banking companies were granted to the Reserve Bank by the Banking Companies (Inspection) Ordinance, 1946. The Ordinance made the prior consent of a banking company unnecessary for its inspection and also widened the objective of the inspection. The Reserve Bank, under the Banking Regulation Act, 1949 is required to satisfy itself, by inspecting the books of accounts and methods of operation of the banking company, before granting a license. This provision helps to ensure that the banking company is in a position to pay its depositors in full as their claims accrue and that its affairs are not conducted to the detriment of its creditors.

5.26 The purpose underlying the inspections gradually shifted from a quantitative assessment of the real or exchangeable value of the paid-up capital and reserves of a banking company to a qualitative appraisal of its financial position, management and methods of operation. In July 1949, the policy of instituting systematic periodical inspections of all banking companies was announced. In February 1950, it was decided that all banking companies would be inspected in turn, irrespective of their size and standing and that such inspections would be a regular feature of the Reserve Bank's supervisory activities.

*The Foundation Phase (1950-1968)*

5.27 The focus of regulation and supervision during the 1950s was to facilitate the creation of a structure of banking system to cater to the requirements of the nascent economy, which had embarked on a path of planned economic growth. The Reserve Bank commenced systematic periodical inspections of all banks in March 1950. These inspections brought out certain undesirable features in the operation of some banks such as defective advances and investments; deficiencies in management and control; inadequate branch supervision; low level of reserves; low level of investments in Government securities; and inadequate provision for investment depreciation. Many of these deficiencies occurred more frequently in the case of non-scheduled banks. The Reserve Bank had, in those cases where such shortcomings were noticed in an inspection designed to assess eligibility of banks for licences, postponed taking any decision so as to give the respective banks a fair chance to qualify for the license, and in a number of cases licences were granted after improvement had been recorded. In 1953, the Reserve Bank tentatively agreed for amalgamation of some banks, if they were deemed to be in the interest of the depositors.

5.28 The administration of the Banking Regulation Act, 1949 brought forth certain loopholes in the law in dealing with managerial irregularities of banking companies, in particular, the powers of the Reserve Bank in respect of the terms of appointment of directors, managing directors and chief executive officers. The issue of directives to banking companies in relation to matters of policy was found to be inadequate. It was with a view to obviating these shortcomings that the Act was amended in January 1957. Other developments such as provision of refinance facilities to banks and enactment of the SBI Act to ensure that flexibility was provided to the banking system so as to make it more responsive to the requirements of a developing economy.

5.29 The collapse of the Palai Central Bank and Laxmi Commercial Bank, both in 1960, affected several aspects of the Reserve Bank's policy towards commercial banks. The failure of these two banks alerted the Reserve Bank to the need to improve the inspection machinery so that it could undertake

surprise inspections of banks or even some of their branches and thereby detect frauds. Following the closure of the Palai Central Bank, the Reserve Bank acquired new powers to enforce amalgamations and the speedier 'de-licensing' of banks. In 1961, the Reserve Bank reorganised and strengthened its inspection arrangements to cover many more branches than in the past and they were widened to include elements of selective audit. The Reserve Bank evinced keen interest in evolving capital adequacy norms for Indian banks as well as introducing a deposit insurance scheme, considering capital standards of commercial banks. These measures helped to strengthen the role of Reserve Bank's inspections.

5.30 Between 1960 and 1968, the thrust of the regulatory and supervisory function of the Reserve Bank continued to be on ensuring soundness of operations of banks, and consolidation and protection of the interests of the small depositors through various measures, including compulsory amalgamations and liquidations. The deposit insurance scheme was also introduced during this period. Through the branch licensing policy, the Reserve Bank started correcting the lopsided branch distribution of Indian banking with its concentration in towns. The growth of banking in some under-developed areas was encouraged through a programme of branch expansion and enlargement of facilities for remittance of funds. During this period, the control exercised by a particular group of persons over the affairs of respective banks in which they have ownership interest was diluted. The need to give the banking system a sense of direction was recognised in 1967 and the 'social control' concept was introduced over issues related to deployment of credit (Malhotra, 1990).

### *The Phase of Strengthening and Consolidation (1969-1991)*

5.31 The nationalisation of 14 major commercial banks on July 19, 1969 was a turning point in the Indian banking system with the entry of the public sector. The focus of regulation was reoriented to meet the objectives of the nationalisation of banks. In the context of the wider role assigned to banks following the nationalisation, a re-orientation of the system of bank inspections was called for. The objectives as per the re-orientation of bank inspections were the evaluation of the overall performance of each bank in different aspects. The Reserve Bank initially advised the newly nationalised banks to consult it before sanctioning any proposal that required their Board's approval under normal circumstances. The Reserve Bank had also assured the nationalised banks unqualified support in the unlikely event of a transfer or withdrawal of business. The Reserve Bank held discussions with these nationalised banks regarding the steps necessary to implement objectives of nationalisation and issues related to rationalisation of branch expansion.

5.32 The Central Government in consultation with the Reserve Bank constituted the first Board of Directors for each of the nationalised banks on July 18, 1970. Thus, as a regulator, the Reserve Bank ensured that the newly nationalised banks would continue to operate smoothly and the depositors and customers would not be inconvenienced.

5.33 The Government had also started exercising control over matters such as banks' branch expansion policy leading thereby to a situation under which duality of jurisdiction over banking system's regulation arose. The Reserve Bank made concerted efforts to ensure that banking facilities are expanded in a balanced manner through its licensing policy. The setting up of the National Credit Council (NCC), arising out of the policy of 'social control', also had a bearing on the branch licensing policy and procedures. The NCC suggested certain revisions in the branch licensing policy. Accordingly, the policy was modified in May 1968. The Lead Bank Scheme introduced in December 1969, had its genesis in this endeavour and it provides an example as to how banking became an instrument of social policy.

5.34 After nationalisation, the branch licensing policy underwent a major transformation. The Reserve Bank had proposed that applications for new offices would be considered after assessing the business potential of the particular locality and whether the area was adequately banked. However, the Department of Banking, Ministry of Finance was of the view that branch expansion was still largely urban-oriented in terms of the policy specified in May 1968 and that the norms of 1:1 for urban and rural areas and 10 per cent of branches in centres with a population of less than one lakh in the seven under-banked States were probably not relevant any longer. The Department of Banking also felt that the opening of branches by a nationalised bank in a State or Union Territory where it did not have a large presence already should be discouraged because of the difficulties arising from language barriers and the unfamiliarity of senior officers with local problems. The Reserve Bank, however, was of the opinion that the responsibility for branch licensing must continue to be that of the Reserve Bank.

5.35 Subsequently, the Reserve Bank had conceived a perspective plan calling for a branch expansion programme covering three years, 1972 to 1974. This was to be prepared by each bank, giving priority to underdeveloped/under-banked districts. But, the Ministry of Finance had a different perception. They felt that the proportion of rural offices opened by banks had shown a declining trend and that the modified formula had a built-in tendency to reduce the ratio of rural and semi-urban branches to total offices. However, a study conducted by the Reserve Bank concluded that the revised formula of the Reserve Bank had not adversely affected the opening of bank offices in rural and semi-urban areas and had no built-in tendency to reduce the proportion of such offices to the total. Subsequently, the newly created Department of Revenue and Banking in the Ministry of Finance had also insisted on a faster pace of branch expansion in rural and semi-urban areas. The Reserve Bank accommodated this view by issuing guidelines to all the commercial banks. The Reserve Bank pointed out that the stage had been reached wherein banks have to give adequate and due consideration to the need for reducing the inter-State and inter-district disparities in branch development and also to pay attention to the process of consolidation.

5.36 To strengthen the supervisory mechanism further, it was decided to institute a new type of inspection during 1977-78, *viz.,* Annual Appraisal of banks in addition to the Financial Appraisal. While the main emphasis in Financial Inspection was on appraising assets and liabilities and methods of operations of banks, in the Annual Appraisal system of inspection more stress was laid on an objective assessment of systems and developmental aspects. The system of inspection of banks has been subjected to continuous scrutiny to ensure that the exercise yields the desired objectives.

5.37 During the 1970s, the Reserve Bank also dealt with various issues related to strengthening of the management of private sector banks through reconstitution of their boards. Attention was also given to supervision and control of foreign branches of Indian nationalised banks. Issues related to accounting in the banking sector, provision of refinance, and introduction of systems and procedures inspection in the banking system were also addressed.

5.38 During the 1980s, the Reserve Bank's regulatory and supervisory function focused on a variety of issues. In 1980, it was decided that public sector banks would aim at raising the proportion of their advances to priority sectors to 40 per cent by 1985 and a significant proportion would be allocated to the beneficiaries of the Twenty-Point Programme. The Reserve Bank endeavoured to ensure that small and marginal sectors would be provided with resources and induced banks to channel more credit to sectors starved of credit. The focus was on the issues that arose subsequent to nationalisation of six more banks in 1980.

5.39 The massive expansion of the banking system had resulted in certain stresses and strains. With wider geographical coverage, lines of supervision and control weakened. The Reserve Bank appointed a Working Group on inspection of banks in December 1981 to review the system of inspection of commercial banks in the public and the private sectors and to suggest improvements/modifications. Following the recommendations of the Working Group, the Annual Appraisal of inspection of public sector banks was dispensed with. With effect from January 1985, a system of Annual Financial Review was introduced to be conducted subsequent to the annual audit of the banks. Issues such as review of internal control systems at bank branches, reconstitution of boards of nationalised banks and increasing the capital base of banks in the context of growing international exposure of Indian banks were given importance. A review of existing system of inspection of banks was also undertaken. Rehabilitation of troubled central cooperative banks and land development banks was attempted. Local Advisory Boards of foreign banks were constituted. Consequently, in the middle of the 1980s the system entered its phase of consolidation, diversification and liberalisation (Malhotra, 1990). By this period, branch expansion had slowed down considerably.

*The Phase of Deregulation and Liberalisation (1991 onwards)*

5.40 The decade of the 1990s was a watershed in the history of the Indian financial system in general and the banking system in particular. Notwithstanding the remarkable progress made by the Indian banking system in achieving social goals during the 1980s, it experienced certain problems that led to decline in efficiency and productivity, and erosion of profitability. Factors such as directed investment and directed credit programmes affected the operational efficiency of the banking system. The quality of loan portfolio also deteriorated. The functional efficiency was affected due to over-staffing, inadequate progress in inducting technology and weaknesses in internal organisational structure of the banks. These factors necessitated urgent reforms in the financial system.

Accordingly, a Committee on the Financial System (Chairman: M. Narasimham, 1991) was constituted to look into various issues related to banking with a view to initiating wide ranging financial sector reforms. Following the Report of the Narasimham Committee I, the Reserve Bank adopted a comprehensive approach on the reforms of the financial sector.

5.41 The Department of Supervision (DoS), now called Department of Banking Supervision (DBS) was set up within the Reserve Bank in 1993 to strengthen the institutional framework. A high powered Board for Financial Supervision (BFS), comprising the Governor of Reserve Bank as Chairman, one of the Deputy Governors as Vice-Chairman and four Directors of the Central Board of the Reserve Bank as members was constituted in November 1994.

5.42 Measures such as deregulation of interest rates, reduction of statutory preemptions such as CRR and SLR, and provision of operational autonomy to the banks were taken to strengthen the banks. Further, various prudential measures that conformed to the global best practices were also implemented. One of the major objectives of banking sector reforms has been to enhance efficiency and productivity through enhanced competition (Mohan, 2005). Following the Narasimham Committee's recommendations guidelines to facilitate entry of the private sector banks were issued in 1993 to foster greater competition with a view to achieve higher productivity and efficiency of the banking system.

5.43 Over the years, the regulatory and supervisory polices in India have transformed significantly in tandem with the global developments and the changing pace of the Indian financial system. Apart from on-site inspections, the Reserve Bank has adopted three other supervisory approaches, *viz.*, off-site monitoring, internal control system in banks and use of external auditors. A review of the Reserve Bank's inspection system was undertaken by a Working Group to Review the System of On-site Supervision over Banks (Chairman: S. Padmanabhan), set up in February 1995. The Group, while re-emphasising the primacy of on-site inspections, recommended switching over to a system of ongoing supervision. It recommended a strategy of periodical full-scope 'on-site examinations' supplemented by an in-house 'off-site monitoring system' and linked exercises in between two statutory examinations.

5.44 The Working Group recommended orienting supervision for enforcement of correction of deviations. It was decided that the periodic and full-scope statutory examinations should concentrate on core areas of assessment, *viz.*, (a) financial condition and performance, (b) management and operating condition, (c) compliance, and (d) summary assessment in line with the internationally adopted capital adequacy, asset quality, management, earnings, liquidity and system (CAMELS) rating model with systems and controls added to it for Indian banks and for foreign banks on CACS model (capital adequacy, asset quality, compliance, systems and controls). Subsequently, examination of 'liquidity' was added to make the model as CALCS. The periodic statutory examinations were to be supplemented by four types of regular and cyclical on-site assessments, *viz.*, targeted appraisals, targeted appraisals at control sites, commissioned audits and monitoring visits.

5.45 The Off-site Monitoring and Surveillance (OSMOS) system was operationalised in 1995 as a part of crisis management framework for early warning system and as a trigger for on-site inspections of vulnerable institutions. The banks were required to increase the level of utilisation of the INFINET for regulatory-cum-supervisory reporting. To identify areas requiring urgent supervisory action and initiate timely action, the time limit has been reduced for submitting returns across all categories of banks since June 2005.

5.46 The recommendations of the Working Group on Internal Control and Inspection/Audit System in Banks (Chairman: R. Jilani) were implemented during 1997-98. The Bank had set up a Regulations Review Authority in April 1999. With a view to capturing the financial position of a bank having subsidiaries/joint ventures at a consolidated level, consolidated accounting and supervision has been introduced since March 2003. A Consolidated Prudential Reporting (CPR) system was introduced in 2003.

5.47 A Working Group was set up to examine the extant norms and practices followed for appointment of statutory auditors in the public sector banks keeping in view the vast changes that have taken place in size and complexities of operations. The role of external auditors in bank supervision has been strengthened.

5.48 Considering the complexities of banking business and emerging product innovations with complex risk profiles, the Reserve Bank initiated measures to implement Risk Based Supervision (RBS) approach to the supervision. The RBS process has been recently revisited by revising the risk profiling templates and introducing a new rating framework. This revision is likely to make the RBS process more risk-sensitive, objective and user-friendly (Box V.4).

**Box V.4**
**Risk Based Supervision – Country Practices**

The Risk Based Supervision (RBS) is based on the principle of differentiated supervision. A number of countries, both from advanced and emerging market economies group have adopted this risk-based supervisory approach. The Bank of England moved to risk-based supervisory approach following the publishing of two consultative papers in 1997 covering two approaches such as Risk Assessment, Tools of Supervision, Evaluation (RATE) and Schedule 3 Compliance Assessment, Liaison, Evaluation (SCALE). The Bank of England (the supervision now assigned to the Financial Services Authority) has adopted a flexible and differentiated risk-based approach in setting standards of supervision. Under this approach, the regulator prepares a risk map of an institution taking into account various external threats. The regulator also develops Risk Mitigation Programmes (RMP) including diagnostic, monitoring, preventive and remedial tools, which are designed to be outcome-oriented (Bank of England, 1998).

The Office of the Superintendent of Financial Institutions (OSFI), Canada introduced risk-based supervisory framework in August 1999 for supervising domestic and foreign operations, and activities of subsidiaries and affiliated companies of the bank. OSFI's risk-based approach to supervisory activities includes the evaluation of all significant activities of the bank, whether banking related or non-banking related. The approach of supervision includes assessing the inherent risks and control in various business risk areas (such as credit, market, operational, liquidity, *etc.*) and arriving at the 'net risk' of the bank.

In Australia, in the late 1990s, it was found that about 86 per cent of banks representing 95 per cent of total bank assets were rated in the bottom of the risk exposures by the Australian Prudential Regulatory Authority (APRA) in the category of 'low' risk. Thus, it was found that the ratings provided insufficient basis for prioritising supervisory activities for entities within the banking sector. In this background and in line with the convergence with international best practices, in July 2000, the APRA adopted a risk-based supervisory methodology for sophisticated financial institutions, including most banks. APRA's supervision framework seeks to promote consistent, robust, effective and targeted risk-based supervision. In addition, these countries have taken the necessary steps in enhancing the effectiveness of 'risk-based approach' to supervision by refining the tools involved to meet the emerging needs.

In India, the idea to move towards risk-based supervision of banks was first mooted in 2000. The RBS framework of the Reserve Bank evaluates the risk profile of the banks through an analysis of various risks faced by a bank. There were two rounds of pilot run of RBS covering 23 banks. Based on the experience gained, the RBS process was revisited in October 2005 to make the risk profiling exercise more risk-sensitive, objective and user-friendly. A new rating framework has been designed for proper risk assessment and risk aggregation.

Smooth implementation of RBS framework for banks could be considered as a precursor to the New Capital Accord (Basel II) which would enable Indian banks to comply with the Basel II norms in an improved way. This would strengthen the risk management practices of Indian banks and shield them against any possible crisis (Leeladhar, 2005).

5.49 With the complex growth of the financial sector and also the growth of the cross-border financial conglomerates (FCs), the supervisory process requires special attention to address the country responses in dealing with country-specific systemic crises and potential risks associated with financial conglomerates. The Reserve Bank has initiated to hold half-yearly discussion meeting with the Chief Executive Officer of the FCs in association with other principal regulators to address outstanding issues/ supervisory concerns, which would further strengthen the system of monitoring the FCs.

5.50 As a step towards building a safe and sound banking system backed by a strong supervisory regime, a system of Prompt Corrective Action (PCA) has been envisaged. Prevention of money laundering activities has assumed importance in international financial relationships in recent years. In November 2004, the Reserve Bank revised the guidelines on 'Know Your Customer' (KYC) principles in line with the recommendations made by the Financial Action Task Force (FATF) on standards for Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT).

5.51 In recent years, comprehensive credit information, which provides details pertaining to credit facilities already availed of by a borrower as well as his payment track record, has become critical. Accordingly, a scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions was introduced. In order to facilitate sharing of information related to credit matters, a Credit Information Bureau (India) Limited (CIBIL) was set up in 2000.

5.52 To tackle the issue of high level of non-performing assets (NPAs), Debt Recovery Tribunals were established consequent to the passing of Recovery of Debts Due to Banks and Financial Institutions Act, 1993. With a view to putting in place a mechanism for timely and transparent restructuring of corporate debts of viable entities facing problems, in 2001, a Scheme of Corporate Debt Restructuring (CDR) was started outside the purview of BIFR, DRT and other legal proceedings. To provide a significant impetus to banks to ensure sustained recovery, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was passed in 2002. With a view to increasing the options available to banks for dealing with NPAs, guidelines were also issued on sale/purchase of NPAs on July 13, 2005.

*Progress in Implementing Basel Norms*

5.53 In order to strengthen the banking system, it was considered necessary to introduce capital adequacy norms to ensure uniform standards of capital structure and progress towards Basel Committee norms (Basel I). The adoption of Basel Core Principles for Effective Banking Supervision requires adherence to the principles of 'consolidated accounting and supervision' of the affairs of the bank's subsidiaries.

5.54 The Basel II framework has been designed to provide operations to banking system for determining the capital requirements for credit risk, market risk and operational risk and enable banks/supervisors to select approaches that are most appropriate for their operations and financial markets. Under Basel II, banks' capital requirements will be more closely aligned with the underlying risks in banks' balance sheets. With a view to ensuring migration to Basel II in a non-disruptive manner, given the complexities involved, a consultative approach is envisaged. Indian banks are preparing to adopt the Basel II norms from March 2007, as directed by the Reserve Bank. The pace and sequence of approaching various levels of sophistication under the Basel II standards would be decided by the Reserve Bank in due course.

*Modernisation of Banking Regulation and Supervision*

5.55 Considering the significance of the banking system from the systemic point of view, the issues related to corporate governance were given high importance. The Reserve Bank has been focusing on encouraging market discipline and ensuring good governance with an emphasis on "fit and proper" management and diversified ownership in more recent times. Banks were encouraged to diversify and offer more varieties of products and services in addition to the conventional products. A policy regarding the approach to 'universal banking' was announced.

5.56 A Standing Technical Advisory Committee on Financial Regulation was constituted in November 2003 to strengthen the consultative process among banks, market participants and regulators of financial markets in the context of carrying forward India's prudential regulatory system. The Reserve Bank had also constituted a Working Group on Conflict of Interest in the Indian Financial Services Sector to identify the sources and nature of potential conflicts, and suggest possible measures/actions to be taken for mitigating them.

5.57 An independent Banking Codes and Standards Board of India has since been set up on the model of the UK in order to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to. With a view to achieving greater financial inclusion, since November 2005, all banks need to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. Banks are urged to review their existing practices to align them with the objective of 'financial inclusion'.

5.58 Computerisation of banking has received high importance in recent years due to technological advancement that are taking place in the financial systems world over. The direction towards 100 per cent computerisation has resulted in renewed vigour in the banks towards fulfillment of this requirement, which could provide better customer service, internal control and effective management. The financial sector technology vision document released by the Reserve Bank in May 2005 elucidates its thrust areas by providing generic information on various standards and approaches, IS audit and requisite focus on business continuity plans.

**B. Regulation and Supervision of Cooperative Banks**

5.59 The cooperative banking system is an important constituent of the Indian financial system. The cooperative banks in India play an important role in catering to the banking needs of the rural population and of certain sections of the urban population as

well. The inadequacy of rural credit engaged the attention of the Reserve Bank and the Government throughout the 1950s and the 1960s. The agricultural credit system as it has emerged has been a product of both evolution and intervention, and symbolises the system's response to the stimuli from continuing dissatisfaction with credit delivery (Mohan, 2004a).

5.60 The Reserve Bank of India Act, 1934 has specific provisions relating to agricultural credit. Section 54 of the RBI Act specifically authorised the creation of an Agricultural Credit Department within the Reserve Bank to deal not only with the rural credit but also with the long-term finance including refinance. Section 17 of the Act empowered it to provide agricultural credit through state cooperative banks or any other banks engaged in the business of agricultural credit. The foundation for building a broader credit infrastructure for rural credit was laid down by the All India Rural Credit Survey (1954). The Committee of Direction that conducted the survey recommended the creation of National Agricultural Credit Fund, which was subsequently created by the Reserve Bank. The Agricultural Refinance Corporation (ARC) set up by the Reserve Bank in 1963 provided funds by way of refinance, but credit cooperatives still did not function too well. Decentralised credit planning through the Lead Bank Scheme was also introduced to spearhead the credit allocation for, *inter alia*, agricultural lending. In order to emphasise the developmental and promotional role assigned to the ARC in addition to refinancing, the ARC was renamed as the Agricultural Refinance and Development Corporation (ARDC) in 1975. Despite all these efforts, the flow of credit to the agricultural sector failed to exhibit any appreciable improvement as the cooperatives lacked resources to meet the expected demand. To solve these problems, the Regional Rural Banks (RRBs) were set up in 1975. In order to strengthen the institutional credit for agriculture and rural development, NABARD was set up on July 12, 1982. On its establishment, NABARD took over the entire functions of the ARDC, the refinancing functions of the Reserve Bank in relation to cooperatives and Regional Rural Banks (RRBs).

5.61 The State Government and the Registrar of Cooperative Societies appointed by the State are the main regulatory authorities for the cooperative societies that are operating only within a State. The regulation and supervision of the urban cooperative banks (UCBs) have been brought within the ambit of the Reserve Bank's statutory control under the Banking Laws (as Applicable to Cooperative Societies) Act, which came into force from March 1, 1966. The regulatory powers conferred on the Reserve Bank with regard to cooperative banks are limited. While the principles of supervision with regard to cooperative banks have been formulated and implemented by the Reserve Bank in respect of UCBs under the Banking Regulation Act, 1949, the Act does not apply to primary agricultural credit societies and land development banks, thus leaving them under the regulatory purview of the State.

5.62 One important feature of providing agricultural credit in India has been the existence of a widespread network of rural financial institutions. The present structure of the rural financial institutions consists of a three-tier rural cooperative credit institutions (Primary agricultural credit societies, District central cooperative banks, State cooperative banks), RRBs, Local area banks, urban cooperative banks and branches of commercial banks. Some important issues related to regulation and supervision of cooperative banks are discussed in this section.

5.63 The rural credit structure consists of many types of financial institutions as large scale branch expansion was undertaken to create a strong institutional base in rural areas. The number of various cooperative institutions at present is over 1,10,000. This has led to an expansion in rural credit. However, the share of cooperative institutions' credit to agriculture has been declining with the share of commercial banks and RRBs increasing during the 1980s and 1990s (Mohan, 2004a). This calls for a wider reach of the cooperative credit institutions.

*Duality of Control*

5.64 The 'duality of control' over the cooperative institutions is a contentious issue. The Task Force on Cooperative Credit System (Chairman: Jagdish Capoor, 1999) addressed the issue of duality of control over cooperative credit institutions and suggested to remove the overlap of controls and endowing functional autonomy and operational freedom to cooperatives. The Task Force suggested to draw an Action Plan to redefine the roles and responsibilities and areas of regulation through delegation of powers in respect of all the players in the field, *viz*. the State Government, Reserve Bank, NABARD and apex bank and cooperative institutions. In view of the weaknesses persisting in the cooperative banks, a system of preparation of institution specific development action plans and execution of Memorandum of Understanding have been initiated since 2003-04. Further, a Task Force (Chairman: A. Vaidyanathan)

was appointed in August 2004 to examine, *inter alia*, the issues relating to an appropriate regulatory framework for rural cooperative banking institutions. The recommendations of the Task Force have been accepted in principle by the Government.

*Strengthening of the Financial Position of the UCBs*

5.65 Keeping in view the weak financial position of many UCBs, the Reserve Bank has undertaken a series of measures directed towards strengthening of the UCBs. Since March 31, 1993, the UCBs have been advised to adhere to the prudential norms, which include applying capital adequacy standards, prescribing an asset-liability management framework, enhancing the proportion of holding of Government and other approved securities for the purpose of SLR stipulation, restriction on bank finance against the security of corporate shares and debentures, and limiting the exposure to capital market investment. In view of the challenges arising from the functioning of the UCBs for the financial system, the Reserve Bank appointed a High Power Committee (Chairman: K. Madhava Rao, 1999) to review the performance of UCBs and to suggest necessary measures to strengthen this sector. Based on the recommendations of this High Power Committee, measures have been initiated to strengthen the existing urban banking structure.

*Strengthening of the Supervisory System Related to UCBs*

5.66 Instances such as the Madhavapura Mercantile Cooperative Bank's failiure brought to the fore the need to have stringent regulatory control over the cooperative banking system. In order to strengthen the supervisory mechanism, the Reserve Bank extended the Off-site Surveillance System (OSS) to all non-scheduled UCBs having deposit size of Rs.100 crore and above. A supervisory reporting system was introduced for the scheduled UCBs since March 2001 as a first step towards setting up of OSS for all UCBs. The capital adequacy norms have been introduced in a phased manner since March 2002. Better risk management through avoidance of concentration of credit risk, off-site surveillance for non-schedule UCBs and following up of KYC guidelines have also been introduced to strengthen the UCBs.

5.67 A total ban has been imposed since October 2003 on grant of loans and advances to directors of UCBs, their relatives and concerns in which they have interest with a view to preventing certain irregularities. The Reserve Bank has also directed that UCBs should undertake usual due diligence in respect of investments in non-SLR securities. The Reserve Bank introduced a new system of grading of UCBs in April 2003, which is based on their CRAR, level of net NPAs, record of losses and compliance with regulatory environment. Similarly, a system of supervisory rating for UCBs under the CAMELS model has also been introduced. Initially, it was implemented for scheduled UCBs but, subsequently its simplified version was extended to non-scheduled UCBs in March 2004.

5.68 Notwithstanding the structural and cultural differences between UCBs and commercial banks, the above measures suggest that the Reserve Bank has been exercising its regulatory and supervisory powers to ensure that the cooperative credit structure is strengthened on the lines similar to the regulation and supervision of commercial banks.

5.69 In sum, the Reserve Bank has been bestowing greater attention in recent years towards strengthening of the regulation and supervision of the cooperative banking structure in the country. As a prudent step towards aligning the UCBs with the financial system, a Draft Vision Document (2005) of the Reserve Bank seeks to rationalise the existing regulatory and supervisory system; facilitate a focused system of supervision through enhancement of technology; and to evolve mechanism to address the dual control. The future course of action envisaged by the Reserve Bank is to remove operational irritants and to strengthen the UCBs and align them with the commercial banks.

## C. Regulation and Supervision of NBFCs

5.70 In India, four types of non-banking financial companies (NBFCs), *viz.*, equipment leasing companies, hire-purchase companies, loan companies and investment companies are under the regulatory purview of the Reserve Bank. With the increasing services sector activity in India, the NBFCs have been playing a critical role in providing credit. NBFCs have extensive networks. The insertion of chapter III B in the Reserve Bank of India Act, 1934 enabled the Reserve Bank to regulate the NBFCs statutorily since February 1964. Since then, the Reserve Bank has initiated a series of measures to appropriately regulate and supervise the NBFCs according to the need from time to time. In 1966, new directives were issued to increase the regulatory powers of the Reserve Bank with regard to NBFCs.

*Regulation of Deposit Acceptance Activities*

5.71 In 1966, two new directives, *viz.,* the Non-Banking Financial Companies (Reserve Bank) Directions, 1966 and Non-Banking Non-Financial Companies (Reserve Bank) Directions, 1966 were issued. To remove the hardship faced by industrial undertakings in complying with the provisions of the directives on time, the Reserve Bank made certain modifications in the Directives in 1967.

5.72 During 1973-74, the Reserve Bank issued Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973 to regulate the acceptance of deposits by the companies conducting prize chits, lucky draws, savings scheme, *etc*. In May 1987, the Reserve Bank issued Residuary Non-Banking Companies (Reserve Bank) Directions, 1987 to regulate such companies. The Reserve Bank of India (Amendment) Act, 1974 empowered the Reserve Bank to inspect NBFCs, whenever the Reserve Bank considers such inspection is necessary or expedient.

5.73 In pursuance of the recommendations of the Working Group on NBFCs in 1992 (Chairman: A.C. Shah), the Reserve Bank initiated a series of measures including redefining the deposit acceptance scheme of registration of NBFCs based on the net owned fund of Rs.50 lakh and above. The Reserve Bank also started regulating the asset side of the NBFCs. In 1994, NBFCs were subjected to prudential norms relating to income recognition, asset classification, provisioning and capital adequacy. Accordingly, registered NBFCs were required to achieve a minimum capital adequacy norm of 6 per cent in March 31, 1995. The CRAR norms for NBFCs have been progressively increased and the norm prescribed at present is 12 per cent.

5.74 In order to strengthen further the regulatory framework of these entities, the Reserve Bank of India (Amendment) Act was enacted in 1997. The legislative focus was primarily aimed at moderating their deposit mobilisation activity by linking the quantum of deposit acceptance to their net owned funds. It also prescribed the revised entry point norms, compulsory registration with the Reserve Bank, maintenance of certain percentage of liquid assets in the form of unencumbered approved securities, formulating a reserve policy and transferring certain proportion of profits every year.

5.75 In order to ensure that the depositors are served appropriately and systemic risks are avoided, the current focus of the Reserve Bank is on improving their functioning, including transparency of operations, corporate governance, 'Know Your Customer' rules, *etc.* The NBFCs registered with the Reserve Bank that have net owned funds of Rs.5 crore have been permitted to undertake insurance business as agent of insurance companies on a fee basis, without any risk participation. A minimum 12 per cent capital adequacy for NBFCs, which want to enter into insurance joint ventures has been prescribed. If the company holds public deposits, the minimum capital adequacy has been proposed at 15 per cent. Further, minimum net worth requirement of Rs.500 crore, three years of continuous net profit, and maximum non-performing assets of 5 per cent of the total outstanding leased/ hire purchase assets and advances have been prescribed for NBFCs.

*Strengthening of the Supervision of NBFCs*

5.76 In the wake of failure of some NBFCs and loss of depositors' money, the supervision of NBFCs assumed critical importance. In the backdrop of the recommendations of the Khanna Committee (1999), a comprehensive supervisory model has been devised for effective supervision of the NBFCs depending upon the size, type of activity and acceptance or otherwise of public deposits. For this purpose, a four-pronged mechanism comprising on-site inspection on the CAMELS pattern, off-site monitoring through periodic control returns using state-of-the-art information technology; an effective market intelligence network; and a system of submission of exception reports by statutory auditors of NBFCs were instituted in order to buttress the regulatory and supervisory framework for NBFCs. The system of on-site examination is structured on the basis of CAMELS approach and the same is akin to the supervisory model adopted for the banking system. The inspection policy of the NBFCs has recently been revised to regulate them effectively. In order to bring the functioning of the NBFCs in line with international best practices, the Reserve Bank initiated a consultative process with the NBFCs with regard to their plan of action for voluntarily phasing out of their acceptance of public deposits. Recently, the Reserve Bank has laid down a road map for Residuary Non-Banking Companies (RNBCs) with a view to ensure that the transition process of these institutions complies with the Reserve Bank's directions.

## D. Regulation and Supervision of Financial Institutions

5.77 Over the years, the Reserve Bank has been involved in setting up of financial institutions such as the erstwhile Industrial Development Bank of India, Unit Trust of India, National Bank for Agriculture and Rural Development, National Housing Bank and Infrastructure Development Finance Company Ltd. Interestingly, although the Reserve Bank has helped to create and foster these institutions, it did not regulate them until the early 1990s. However, the Reserve Bank had the statutory powers to call for information and give directions to them under the RBI Act. Development Finance Institutions (DFIs) expanded rapidly, especially in the 1980s. Therefore, in the early 1990s, DFIs were brought under the monitoring arrangement of the Reserve Bank as an adjunct to monetary and credit policy. In 1994, major term lending institutions [IDBI, ICICI, IFCI, Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IIBI) and Exim Bank] were subjected to prudential guidelines relating to income recognition, asset classification, provisioning and capital adequacy. These norms were subsequently extended to Tourism Finance Corporation of India (TFCI) and IDFC. In 1996, refinancing institutions such as SIDBI, NABARD and NHB were also brought under the purview of the prudential regulations. Credit exposure norms relating to single borrower/group of borrowers have also been prescribed for all-India term-lending and refinancing institutions.

*Strengthening of Supervision of FIs*

5.78 In April 1995, select all-India financial institutions were brought under the supervisory purview of the BFS. Subsequently, the regulatory and supervisory framework of financial institutions has undergone a significant change along with the accelerated pace of commercial development of banks in the globalised environment.

5.79 Measures have been initiated to strengthen the supervision of FIs to make them stronger. All India financial institutions are being covered by an on-site supervisory process (CAMELS standards) since 1995 on the lines similar to that for commercial banks. Taking into account the developmental functions and supervisory functions exercised by some of the financial institutions such as NABARD, SIDBI and NHB, a modified approach for supervisory assessment of these institutions has been introduced. In view of the dichotomy among the FIs that gave rise to large variations in the interest rates offered and maturity pattern, *etc.*, which could eventually result in disorderliness of the market, the resource mobilisation by DFIs was brought under the purview of regulations in 1998. After reviews on an on going basis, the regulations have been liberalised and made flexible in line with developments in the debt market. Faced with rising resource cost, increased competition and decline in asset quality, DFIs have diversified their operations into para-banking activities. This necessitated a review of the regulatory mechanism for the DFIs. Based on the recommendations of the Working Group on Development Financial Institutions, the Reserve Bank would continue to supervise NABARD, SIDBI, NHB and EXIM Bank through on-site inspection and also supervise DFIs. On-site and off-site surveillance system has been instituted for DFIs more or less on the lines of commercial banks. A major restructuring in the financial sector is evident in the recent conversion of ICICI and IDBI into banks. It is recognised by the Reserve bank that the recent trends towards transformation of select FIs into banks warrant continued and appropriate regulatory and supervisory hold over them.

### Broad Transformation in Reserve Bank's Regulatory and Supervisory Role

5.80 The regulatory and supervisory policies and strategies pursued by the Reserve Bank in the past few decades were largely need driven and in response to both domestic and global developments. In tune with the developments that have taken place from time to time in the Indian economy in general and the banking system in particular, the objectives and approaches of regulation and supervision have also been changed in the past five decades, while retaining the basic purpose of maintaining the soundness and stability of the banking system. Consequent to the changes in objectives and approaches to regulation and supervision in India, the role of the Reserve Bank as regulator and supervisor has also transformed significantly over the years.

5.81 As the Indian banking system has started acquiring gradually global character in recent years, the regulation and supervision have focused on preventing systemic instability, fostering competition, improving market practices, reducing information asymmetries and preventing money-laundering activities. Over years, in tune with the changing financial environment, certain regulations lost their relevance fully or partially like administration of interest rates and imposition of restrictions on activity,

location and investment activities of banks. The broad objectives of regulation and supervision of banks in India and the corresponding regulatory measures and controls during the past five decades have been portrayed in Tables 5.2, 5.3 and 5.4.

5.82 In sum, with constant changes in the domestic and external financial environment, the Reserve Bank has responded appropriately from time to time and in a proactive manner by changing the focus of its regulation and supervision function as the situation evolved. From the role of a facilitator of the process of creation of the financial structure in the 1950s, the Reserve Bank had extended its focus not only to expanding the structure but also to improving the innate strength of the banking sector through enhancing operational efficiency, quality of assets and financial strength of banks, and ensuring the safety and soundness of the structure and depositors' interest during the subsequent decades. While the fundamental objective of regulation and supervision continued to be "maintaining the soundness and stability of the financial system" all along, regulation and supervision has simultaneously focused on other objectives such as transparency of balance sheet, protection of depositor interest, meeting social needs, improving the efficiency, fostering competition, improving market practices and reduction of asymmetries of information. The current and future focus of the regulatory and supervisory function of

**Table 5.2: Financial Regulation Approaches, Measures and Objectives in India - 1950s to 1980s**

| Regulatory Approaches, Measures and Controls | Objectives | | | |
|---|---|---|---|---|
| | Increasing system's stability | Improving efficiency | Depositor protection and customer service | Meeting Social needs |
| MACROECONOMIC CONTROLS : | | | | |
| Reserve Requirements | * | | | |
| Credit/Deposit Ceilings | * | | | |
| Interest Rate Controls | * | | | * |
| Restrictions on Foreign Transactions | * | | | * |
| CREDIT ALLOCATION | | | | |
| Directed Selective Credit Programmes | | | | * |
| Preferential Interest Rates | | | | * |
| Compulsory Lending requirements | | | | * |
| STRUCTURAL CONTROLS | | | | |
| *Entry, Exit and Merger Requirements* | * | * | * | * |
| Geographic Restrictions | * | | | * |
| Activity Restrictions | * | | | * |
| PRUDENTIAL CONTROLS | | | | |
| Capital Adequacy Requirements | * | * | * | |
| Portfolio Risk Concentration/Diversification | * | * | | |
| Non-Performing Asset Classification | * | * | | |
| Reporting Requirements | * | * | | |
| ORGANISATIONAL CONTROLS | | | | |
| Market Making rules | * | * | * | |
| Participation Rules | * | * | * | |
| Market Information | * | * | * | |
| Disclosure Requirements | * | | * | |
| Minimum Technical Standards | * | * | * | |
| PROTECTIVE CONTROLS | | | | |
| *Consumer Information Disclosure Requirements* | | | * | * |
| Consumer Confidentiality Protection | | | * | * |
| Consumer Compensation Rules in event of default | | | * | * |
| Dispute arbitration and settlement rules | | | * | * |

Format Source : *Mistry Percy, 2003, "Trends in International Financial System Regulation & Supervision", Commonwealth Secretariat's Meeting, London, June.*

**Table 5.3: Financial Regulation Approaches, Measures and Objectives in India - 1990s**

| Regulatory Measures | Objectives | | | | |
|---|---|---|---|---|---|
| | To prevent Systemic Risk | Prevent Crises | Depositor Protection | Efficiency Enhancement | Bank Restructuring |
| Competition Policy | | | * | * | * |
| Disclosure Standards | * | * | * | * | |
| Conduct of Business Rules | | | * | * | * |
| Capital Adequacy Standards | * | * | * | | * |
| Entry Tests (fit and proper persons) | * | * | * | * | * |
| Liquidity Requirements | * | * | * | | * |
| Reporting Requirements | * | * | * | | * |
| Restrictions on Services | * | | | | * |
| Asset Restrictions | * | | | | * |
| Deposit Insurance | * | * | * | | * |
| Reserve Requirements | * | * | * | | * |
| Customer Suitability Requirements | | | * | | |
| Interest Rate Controls on Deposits | * | | * | | |
| Interest Rate Controls on Loans | | * | * | | |
| Investment Requirements | | | | | * |
| Geographic Restrictions | | | | | * |

Format Source : *Mistry Percy, 2003, "Trends in International Financial System Regulation & Supervision", Commonwealth Secretariat's Meeting, London, June.*

the Reserve Bank would be on transforming the Indian financial system on the lines of global standards in efficiency and robustness so as to withstand shocks and maintain stability, while protecting the depositors' interests. The role of regulation and supervision would continue to evolve, as has been the case worldwide.

**Table 5.4: Financial Regulation Approaches, Measures and Objectives in India - 2000 and Beyond**

| Regulatory Approaches and Measures | Objectives | | | | |
|---|---|---|---|---|---|
| | To enhance competition | To improve Market practices | To reduce Information Asymmetries | To prevent Systemic Instability | To prevent Money-Laundering |
| **Competition** | | | | | |
| Market Structure Policy | * | | | | |
| **Market Conduct** | | | | | |
| Disclosure Standards | | * | | | |
| Conduct of Business Rules | | * | | | |
| Market Governance | | * | | | |
| **Prudential Regulation** | | | | | |
| Entry Rules | | * | * | | |
| Risk Capital Requirements | | * | * | * | |
| Balance Sheet Disclosures | | | * | * | |
| Off-Balance Sheet Restrictions | | | * | * | |
| Associated Institutions | | | * | * | |
| Liquidity Requirements | | | * | * | |
| Reserve Requirements | | | * | * | |
| Accountability Requirements | | | * | * | |
| **Systemic Stability Rules** | | | | | |
| Lender of last resort | | | | * | |
| Oversight of Payments System | | | | * | |
| **AML-CFT Measures** | | | | | * |

Format Source : *Mistry Percy, 2003, "Trends in International Financial System Regulation & Supervision", Commonwealth Secretariat's Meeting, London, June.*

## Regulatory Model in India

5.83 There is no unique theoretical model or just one practical approach to the regulation and supervision of a financial system. Four broad approaches for financial market supervision and regulation can be identified as 'institutional supervision', 'supervision by objectives', 'functional supervision' and 'single-regulator supervision' (Giorgioi, 2001). In the more traditional 'institutional approach', supervision is performed over each single category of financial operator or over each single segment of the financial market and is assigned to a distinct agency for the entire spectrum of activities. The supervision by objectives model postulates that all intermediaries and markets may be subjected to the control of more than one authority, each single authority being responsible for one objective of regulation regardless of both the legal form of the intermediaries and of the functions or activities they perform. The functional supervision considers as 'given' the economic functions performed in the financial system. The single-regulator supervisory model is based on just one control authority and with responsibility over all markets and intermediaries regardless of whether, it is in the banking, financial or insurance sector. Barth *et al* (2001) documented a large body of literature that purported to explain the superiority of one model over the other. However, opinion continues to vary about the efficacy of various models of regulation and supervision.

5.84 It is indeed a difficult task to choose an ideal model of regulation, as there exist different types of models. Thus far, the operational experience, not only in the Euro area but also in the United States, indicates that central banks are carrying out supervisory tasks in an effective way. At the same time, little experience has been gained so far with the performance of the FSA-type single agency model in place in the U.K.

5.85 India has traditionally followed an institution-based system of regulation. The Reserve Bank acts as a supervisory body in respect of banks, NBFCs and all-India financial institutions (AIFIs). The ROC of different States are a joint regulator for the banks in the cooperative sector, both urban and rural. SEBI regulates the capital markets and several institutions such as the stock exchanges, mutual funds and other asset management companies, securities dealers and brokers, merchant bankers and credit rating agencies. The insurance sector is regulated by Insurance Regulatory and Development Authority (IRDA).

5.86 The issue about whether the current regulatory model and structures are appropriate or if there is a need to change them has been debated in recent years in India. The debate on the issue of regulatory overlaps and gaps was discussed by several committees and working groups. The views expressed by these Committees and the outcomes of the technical discussions are varied in nature. Some important views, in this context are that the duality of control over the banking system between the Reserve Bank and the Banking Division, Ministry of Finance should end and the Reserve Bank should be the primary agency for the regulation of the banking system. The Khan Working Group felt that it is desirable to establish a 'Super Regulator' to supervise and coordinate the activities of the multiple regulators in order to ensure uniformity in regulatory treatment. The Deepak Parekh Group felt that there is a need for greater coordination in regulation through the High Level Group on Capital Markets by conferring a legal status to it.

5.87 Considering all relevant factors, it has been argued that the existing regulatory gaps and overlaps should be identified without disrupting the existing regulatory structures and it is necessary to explore the feasibility of an umbrella regulatory legislation, which creates an apex regulatory authority without disturbing the existing jurisdiction. It was proposed that the BFS of the Reserve Bank can continue to supervise banks and non-banks but with a Deputy Governor as the Chairman, the insurance regulating authority should supervise insurance companies and SEBI should continue its regulatory jurisdiction over capital market. The apex financial regulatory authority may be constituted by statute with the Governor of the Reserve Bank as Chairman and the members could be Chairmen of the three regulatory agencies. The apex body should also include some outside experts on a part time basis. Finance Secretary could be a permanent special invitee or a regular member without voting rights as in the case of the Reserve Bank Board. The apex authority could have by law, jurisdiction to assign regulatory gaps to one of the agencies; arbitrate on regulatory overlaps and ensure regulatory coordination. The apex authority could be serviced by a part-time secretariat from the Reserve Bank. The spirit of this proposal is to improve and formalise the present informal arrangement into a legislative based authority. The justification for Governor of the Reserve Bank to be the Chairman of such an authority has also been debated and it was argued on the ground that every transaction, irrespective of the market in which it takes place, has

one leg in the cash/inter-bank market in terms of ultimate payment/settlement. Any problem in the market in which the transaction takes place has to impact the cash market. The Reserve Bank as the ultimate provider of liquidity (though may not be as regulator) has, therefore, to concern itself with the stability in the functioning of all financial markets (Reddy, 2001b).

5.88 In order to improve regulatory effectiveness, achieve regulatory harmony, plug the regulatory gaps and minimise the regulatory overlaps, the Reserve Bank has been taking various initiatives in recent years. There are certain mechanisms through which broad coordination is ensured among various regulators in the financial system. A system of regular exchange of information among various regulators has been put in place. Functioning of a High Level Committee on Capital and Financial Markets headed by the Governor of the Reserve Bank, with Finance Secretary, Chairman SEBI and Chairman IRDA as members has been looking into policy issues where there is a regulatory overlap. The Committee has set up three Technical Standing Committees with cross representation to provide an inter-agency forum to review the developments in the banking sector, the insurance sector and the capital market.

5.89 A detailed scrutiny of the structure of the Indian financial system, current regulatory structures and regulatory arrangements reveals that the regulatory overlaps, regulatory conflicts on ‘turf grounds’ and ‘regulatory arbitrage’ are negligible. It is also clear that the current regulatory practices are not creating an ‘uneven field to perform’, while regulating different types of financial institutions that are undertaking similar activities (Raj, 2005). In this context, the relevant point is not whether the choice should be either a single regulator or multiple regulators, but what works effectively and suits the economy keeping in view the circumstances in the Indian financial system and institutional background. “The choice should not be made as a measure of ‘doing something’ to meet pressing demands. The choice need not be made in extremes of single and multiple regulators since there are possibilities of hybrids and supplementing arrangements. Under any system, issues of information exchange and coordination are inevitable. In the final analysis, the regulatory objectives, coverage, skills, operational effectiveness and credibility are important, and structures remain one element of financial regulation” (Reddy, 2001b).

5.90 It is recognised that regulatory and supervisory approaches, systems and structures need to keep adapting to cope with the progressive evolution and integration of economies, financial product/service markets, technology, and the transformation of financial institutions in response to competition in meeting the changing market demands. In India, the current model of regulation with the Reserve Bank exchanging relevant information with other regulators in a synchronised manner is functioning effectively.

## III. CONDUCT OF MONETARY POLICY AND COMPATIBILITY WITH REGULATORY AND SUPERVISORY ROLE

5.91 As discussed in chapter III, an important debate in the context of a central bank is whether there is any inherent conflict in discharging both the monetary policy and supervisory functions simultaneously by the central bank. An important argument for preserving a financial stability function in a central bank, even when regulation of financial entities is passed to another institution, is that monetary and financial stability policies are intertwined (Sinclair, 2000). Monetary policy can have important implications for financial stability and financial stability decisions, in turn, have implications for monetary policy.

5.92 Financial sector stability is best achieved in the context of a stable macroeconomic environment. An approach to macroeconomic policy management, which aims at keeping prices stable and facilitates flexible adjustment of the economy is fully consistent with prudential goals. International experience shows that financial and banking distress has been inextricably linked to currency and macroeconomic crises. Therefore, prudential policies need to aim at promoting financial system’s stability, which is a pre-condition for macroeconomic stability. While the relationship between a supervisory role and monetary policy role is complementary from the central banker’s perspective, in reality there might be occasions when there could be a potential conflict between these two functions (Box V.5).

5.93 There is a clear two way intimate inter-relationship between monetary policy and banking soundness (Reddy, 1998). The special links between monetary policy and banking soundness warrant that both functions need to be combined. The banking system continues to be the main vehicle for monetary policy signals in India. Bank soundness is, therefore, a legitimate concern of the Reserve Bank.

**Box V.5**
**Conflict of Interest between Supervisory Role and Monetary Policy**

A practicing central banker can envisage situations of conflict between monetary policy objectives and prudential goals, which might arise particularly in conditions of serious economic or financial system stress. Such a situation arises when inflationary pressures require interest rates to be raised sharply and banks are potentially exposed to possible write-downs of their asset valuations. Conflict could arise if it were thought that the value of some assets underpinning bank loans might fall below the amount of the loans as a result of interest rate increases. This could become a prudential concern if borrowers were highly geared, as the fall in asset values would be substantial. Another issue could arise if the central bank became deeply involved in managing some kind of a banking crisis. This has the potential to significantly divert the central bank's attention from its monetary policy activities.

While the importance of central bank independence for the conduct of monetary policy has been the subject matter of numerous empirical studies, relatively little research has been focused on the significance of other aspects of the structure of the central bank, particularly its role in bank supervision. Recently, however, this role has received increased attention from policymakers. Although roughly three-quarters of OECD nations assign their central banks either total or shared responsibility for bank supervision, many of these countries are reviewing those responsibilities. For example, in mid-1997 the Bank of England was given greater independence, but was relieved of its bank supervisory responsibilities. In this context, the former Governor of the Bank of England said, "monetary and financial stability are inter-related. It is inconceivable that the monetary authorities could quietly pursue their stability-oriented monetary policy objectives if the financial system through which policy is carried on—and which provides the link with the real economy - were collapsing around their ears…This inter-relationship means that, whatever the precise institutional arrangements for financial regulation and supervision, central banks necessarily have a vital interest in the soundness of the financial system" (George, 1994).

One key element of the debate about whether the central bank should retain bank supervisory duty is whether these responsibilities contribute to the performance of monetary policy. The Federal Reserve has effectively incorporated bank supervisory information into monetary policy deliberations. Expressing his views on the subject and pleading that the Federal Reserve should not be divested of the supervisory functions in his testimony to the Committee on Banking and Financial Services, U.S. House of Representatives on March 19, 1997, Chairman Alan Greenspan stated that "the Federal Reserve Board believes that financial modernisation should not undermine the ability and authority of the central bank of the United States to manage crises, assure an efficient and safe payment system, and conduct monetary policy. We believe all of these require that the Federal Reserve retain a significant and important role as a bank supervisor. In today's structure, we have adequate authority and coverage to meet our responsibilities". Although the U.S Congress attempted to divest the regulation and supervision function from Federal Reserve many times, as the Federal Reserve has convincingly argued against such separation and retained the function with it. Recently, the new Fed Chairman Ben Bernanke (2005) also said "modernisation of the banking system and the improvement of bank regulation and supervision are essential for promoting stable monetary policy and low inflation".

Whether a central bank is vested with the responsibility of supervision and regulation or not, good central banking requires a thorough understanding of financial institutions, financial markets, and financial system infrastructure. For monetary policy purposes, understanding the role of financial institutions and markets in the transmission process from central bank decision making to their ultimate economic effects, aids efficiency in policy implementation. It is also required for prudential purposes as, while it is institutions that fail, often financial markets and financial system infrastructures can be either the source of problems or transmit risk from one institution to another. Although the regulation and supervision was not a core central banking function initially, subsequently, most central banks have accepted the function of regulation and supervision. The debate is put to rest by Professor Goodhart: "after all, banking supervisors and those in the central bank concerned with systemic stability must continue to work closely together wherever the supervisors are physically located" (Goodhart, 2000).

5.94 The supervisory activities of the Reserve Bank have benefited from its price stability objective, and it is recognised that safety and soundness of banks must be evaluated jointly with its responsibility to ensuring stability and growth in the economy. To carry out its overall responsibilities, the Reserve Bank has had to develop extensive and detailed knowledge of the intricacies of both Indian and global financial systems. The Reserve Bank with joint responsibilities for monetary policy and supervision has both the

insight and the authority to use techniques that are less blunt and more precisely calibrated to the problem at hand. Such tools improve its ability to manage crises and, more importantly, to avoid them. The dynamic financial system is vulnerable to episodes of stress. It is conceded that the Reserve Bank's ability to respond expeditiously to any particular financial stress does not necessitate comprehensive information on each banking institution. But it does require that the Reserve Bank has in-depth knowledge of how different institutions are likely to behave and what resources are available to them in the event of a severe financial stress. Even for those events that might precipitate financial crises, the system turns first to the Reserve Bank, not only because it is the lender-of-last-resort, but also because it has the expertise and the experience.

5.95 The Reserve Bank's supervisory responsibilities give it important qualitative and quantitative information that not only helps it in the design of monetary policy, but provides important feedback on how policy stance is affecting bank actions. To illustrate, the rising shares of bank credit to housing, real estate and retail finances have warranted appropriate policy responses to ensure credit quality. Asset price changes can have a powerful effect on investment and/or consumption through a financial accelerator effect and in this context, large swings in asset prices can pose a challenge for monetary policy. From the regulatory and supervisory perspective, especially in view of non-linearities in asset price changes, such a high growth needs to be regulated through the prescription of appropriate risk weights. Keeping in view such temporary cyclical penetration of credit, the Reserve Bank increased the risk weight, in December 2004, from 50 per cent to 75 per cent in the case of housing loans and from 100 per cent to 125 per cent in the case of consumer credit including personal loans and credit cards. Subsequently, the risk weight for credit risk on capital market and commercial real estate exposures increased from 100 per cent to 125 per cent in July 2005.

5.96 Confidential supervisory information garnered through bank examinations can potentially improve the conduct of monetary policy (Joe *et al*, 1999). Therefore, it is advantageous to simultaneously pursue the monetary policy function along with banking regulation and supervision. In the Indian context, these two functions are more complementary than conflicting.

## IV. EMERGING ISSUES

5.97 In the emerging milieu, in order to ensure that the Reserve Bank's regulation and supervision function continues to be effective, certain issues need to be addressed. Prominent among these issues are ensuring financial stability, smooth transition to Basel II regime, and appropriate structures to regulate and supervise the emerging financial conglomerates and the electronic banking.

### (i) Ensuring Financial Stability

5.98 The notion that a central bank should have responsibility for financial stability is deep rooted in the history of central banking. Financial instability has been sufficiently prominent over the last couple of decades to rise to the top of the international policy agenda (Claudio, 2002). In the wake of several financial crises that occurred worldwide and the devastating implications of the crises to respective economies, 'financial stability' is being recognised as a critical function of central banks.

5.99 A broad transformation is discernible in the Reserve Bank's role in ensuring financial stability since its inception. Its role in preventing bank failures and maintaining financial stability has been strengthened and fine-tuned over the years. The approach adopted by the Reserve Bank to maintain financial stability is multi-pronged: maintenance of overall macroeconomic balance through monetary policy; improvement in the macro-prudential functioning of institutions and markets; and strengthening micro-prudential institutional soundness through regulation and supervision. In this regard, the Reserve Bank has been working in close coordination with other domestic regulators.

5.100 The maintenance of macroeconomic stability to prevent financial crises is a major concern of the Reserve Bank. Containing inflation and stabilising inflation expectations through its monetary policy, the Reserve Bank has also helped in fostering financial stability.

5.101 Strong and efficient financial markets provide stability to the financial system. The Reserve Bank has been encouraging efficient and smooth functioning of the financial markets by closely monitoring developments in key markets through its own operations in these markets for monetary policy purposes, and where necessary, by establishing an appropriate regulatory framework.

5.102 A strong capital base is imperative to enable the banks to acquire resilience to withstand shocks. By prescribing capital adequacy norms, the banks' ability to withstand shocks has been strengthened. After complying with the Basel I requirements, the Indian banks are now moving towards the New Capital Adequacy Framework (Basel II) regime. The Reserve Bank has accepted to adopt the Basel II in principle. Encouragement has been given to banks to formalise their capital adequacy assessment process (CAAP) in alignment with their business plan and performance budgeting system.

5.103 A troubled bank always needs adequate funds at right time to avoid defaults and runs. The measures for crisis resolution include the role of the central bank as the lender-of-last-resort. The Reserve Bank provides liquidity to banks as and when necessary for prudent liquidity management. It lends directly to an individual financial institution, which is fundamentally sound and solvent but in temporary liquidity distress.

5.104 The ownership and control of private sector banks when well diversified, helps to minimise the risk of misuse or imprudent use of leveraged funds. Towards the sound development of banks through healthy competition, the Reserve Bank issued detailed guidelines in February 2005 stipulating diversified ownership and restrictions on cross holdings by banks. On the issue of effective control over banks, the Reserve Bank has stipulated that aggregate foreign investment in private banks from all sources cannot exceed 74 per cent of the paid-up capital.

5.105 Considering the fact that weak payment system would endanger financial stability, the Reserve Bank has been nurturing and promoting safe and robust payment systems. A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has recently been constituted to prescribe sound policies relating to the regulation and supervision of all types of payment and settlement systems.

5.106 The Reserve Bank has been making a contribution to regulatory arrangements through its knowledge of day-to-day dealing with financial institutions. The surveillance and monitoring mechanism for the banking system has been strengthened through refinements in the existing practices. Stress was laid on on-site and off-site supervision, consolidated accounting and supervision and risk-based supervision. Risk-based supervision has been introduced on a pilot basis. An integrated view of all the segments of the financial system, *viz.,* banking, cooperative banking, NBFCs and FIs has been considered from the system's stability angle. In order to address weakness in a bank at an early stage, guidelines on 'prompt corrective action' have been issued. To ensure financial stability and to protect the banking system from untoward financial crisis, instructions on exposure norms, credit exposure on derivative products, 'Know Your Customer' and Anti-Money Laundering have been issued.

5.107 Keeping in view the weak financial position of some of the cooperative banks, the Reserve Bank has imposed strict prudential norms like pay order/ demand draft discounting norms, stock lending norms, capital market exposure limit, gold lending norms, *etc.*, to limit the damages and to avoid such recurrence in future. But at the same time, to maintain the financial stability, the Reserve Bank has taken action against the defaulting cooperative banks. The actions were directed towards safeguarding the interests of the depositors rather than shareholders. The Reserve Bank has been cautious so as to avoid any kind of moral hazard problems that may lead to setting a bad precedence for the banking system.

5.108 An important issue to consider in this context is that despite the regulatory rigours in place, bank failures and run on banks have occurred in the Indian financial system. The Reserve Bank's presence as a regulator and supervisor is not a guarantee to protect the banks from runs or failures due to their own violation and mismanagement. The incidents of bank failures in an era of effective regulation need to be viewed as failure of a financial institution due to its own mismanagement. Systemic concerns coupled with the necessity to safeguard the interest of small depositors have been paramount in the minds of the policy makers while dealing with insolvent banks in India (Mohan, 2005).

### (ii) Basel II Norms and its Implications

5.109 The banking systems worldwide are migrating to the Basel II regime. The Basel II framework is expected to promote adoption of stronger risk management practices by banks to address major risks. In the context of the Indian banking system's transformation to Basel II, some issues are likely to arise.

5.110 Though concurrent efforts are underway in India to refine and upgrade financial information monitoring, data dissemination and data warehousing in various banks, the magnitude of the task appears to be difficult as there are a large number of

commercial banks in India, which are at various levels of development. As the new accord is resource-intensive requiring large database, strong information technology architecture enabling building of risk profiles of banks on various scenarios, it places heavy demand on banks and the regulator to improve their information base through appropriate tools. Capacity building, both in banks and at the regulatory bodies, while working under the Basel II norms, especially in respect of adopting the advanced approaches is critical. Implementation of various simplified approaches require preparation on the part of the banks, banking regulator and the rating agencies. The rating agencies perhaps would need to develop a framework for assigning 'Issuer Rating'. Encouraging ratings of issuers as well as non-availability of reliable and qualitative historical data related to ratings is important. Inadequate historical data in conjunction with associated cost of developing and maintaining such data may also influence the speed of migration to advanced approaches of risk measurement under Basel II. As the implementation of Basel II gathers momentum, several banks in India may need additional capital to provide for capital charge for market risk and operational risk.

5.111 Despite these challenges, it appears that Indian banks would be able to migrate to Basel II norms as India has chosen to adopt simpler options for the transition initially. The Reserve Bank has adopted a consultative and participative approach for both designing and implementing the transition process. Many pubic sector banks and old private sector banks have already prepared a roadmap for migrating to Basel II by adopting Standardised Approach for credit risk and Basic Indicator Approach for operational risk.

### (iii) Consolidated Supervision and Financial Conglomerates – Regulatory Preparedness in India

5.112 Financial conglomerates have grown rapidly since the late 1980s with the deregulation of domestic financial markets. To align its regulatory and supervisory architecture to the international best practices, India has also adopted the framework of consolidated supervision (Box V.6).

**Box V.6**
**Consolidated Accounting and Supervision**

Consolidated supervision is an essential element of effective bank supervision and it complements the conventional technique of supervision of banks on individual basis. It is a group-wide approach to supervision where all the risks run by a banking group are taken into account in totality, independent of wherever they are booked. A major element of this approach is the preparation of financial statements on a consolidated basis - combining the assets and liabilities and off-balance sheet items of banks, and their related entities, treating them in effect as if they were a single entity. Such reports enable the supervisors to measure the financial risks faced by bank groups and apply supervisory standards such as large exposure and connected exposure limits and minimum capital adequacy ratios on a group basis. This approach helps in assessing the potential impact of other group companies on the bank. It incorporates both accounting consolidation and consolidated supervision, which form key aspects of the supervision of banking groups.

In terms of guidelines and other quantitative methods to facilitate Consolidated Accounting, banks have been advised, *inter alia,* that as a prudential measure aimed at better risk management and avoidance of concentration of credit risks, in addition to adherence to prudential limits on exposures assumed, banks should also adhere to prudential limits on single and group borrower exposures. As a part of the harmonisation of the prudential norms between banks and DFIs, guidelines on consolidated accounting and supervision, which were prescribed for banks, were also extended to DFIs as well from April 1, 2003. FIs have also commenced preparation/publishing Consolidated Annual Accounts as part of their Annual Report. The prudential norms relating to consolidated supervision (as on June 30, 2004) are applicable only to commercial banks *viz.* public sector, private sector and foreign banks. Commercial banks are required to prepare consolidated financial statements and adhere to certain prudential regulations on group basis. Foreign banks/other financial entities operating in India, whose parent is an overseas entity and groups whose parent is a non-banking entity (whether financial or non-financial) have been excluded from the framework of consolidated supervision. The UCBs and RRBs are not subject to consolidated supervision as they do not have subsidiaries. Also, the State Cooperative Banks (SCBs) and District Central Cooperative Banks (DCCBs) have not been issued any guidelines and therefore, they don't have to prepare consolidated accounts. As banks grow larger in size and enter and carry out intra-group complex operations, consolidated accounting and supervisory techniques would have to evolve further to meet the emerging needs and appropriate fire walls would have to be built to address the risks underlying such large organisations and banking conglomerates.

5.113 The emergence of financial conglomerates in India poses certain challenges to the existing regulatory and supervisory framework in the country. One challenge emanates from the moral hazard aspect, as some financial conglomerates have become too large. They pose the dilemma of 'too-big-to-fail' before the regulators. Another challenge relates to contagion or reputation effects on another subsidiary in a different segment arising from 'holding-out' phenomenon in a conglomerate, which warrants supervisory intervention. The complexity and non-transparency of intra-group transactions and exposures, non-arm's length dealings within a financial conglomerate give rise to concerns about regulatory arbitrage used by some of the financial conglomerates, which increases the risk of contagion.

5.114 The Reserve Bank had set up a multi-disciplinary Working Group in November 2000 (Chairman: Vipin Malik) to examine the feasibility of introducing consolidated accounting and other quantitative methods to facilitate consolidated supervision. On the basis of the recommendations of the Working Group, guidelines on consolidated supervision were issued to banks for implementation with effect from the year ended March 2003. The components of consolidated supervision in India include: preparation of Consolidated Financial Statements (CFSs) for public disclosure and Consolidated Prudential Reports (CPRs) for supervisory assessment of risks, which may be transmitted to banks or other supervised entities by other Group members. Besides, certain prudential regulations such as capital adequacy, large exposures/risk concentration on group basis are also applied. To supplement the consolidated supervision and as a proactive stance to address these issues and for further strengthening financial stability, the Reserve Bank had set up a Working Group of Financial Conglomerates. The Group, in its Report submitted in June 2004, suggested the creation of an Inter-Regulatory Forum with members drawn from the Reserve Bank, the SEBI and the IRDA. The Forum would exclusively monitor the activities of financial conglomerates. The new framework would be a complementary forum to the already existing regulatory structure - supervision of individual entities by respective regulators *viz*., the Reserve Bank, the SEBI, the IRDA and the system of Consolidated Prudential Reporting introduced in regard to banks. The Reserve Bank has already put in place a system of supervision of financial conglomerates in India. In June 2004, a Financial Conglomerate Cell was created in the Department of Banking Supervision of the Reserve Bank, which is the nodal unit and coordinates with the other two regulators (SEBI and IRDA) on matters of conglomerate supervision.

5.115 The operations of financial conglomerates require that the intricate and complex relationships among the group entities be understood in proper perspective. Also the danger of contagion as adverse developments in one part of the conglomerate could affect the operation of other parts also needs proper appreciation. The present inter-regulatory forum is an informal group without an effective coordination among the set of regulators in terms of sharing of information with each other. This necessitates that a formal regime be created which makes sharing of information among the supervisors mandatory. The regulation of financial conglomerates in India is still at an evolutionary phase, but measures have already been initiated to strengthen the regulatory framework to attune it to the emerging needs.

### (iv) Regulation and Supervision of Electronic Banking in India

5.116 Electronic banking is a process of delivery of banking services and products through electronic channels such as telephone, Internet, cell phone, *etc*., and it encompasses Internet banking, telephone banking, mobile banking, *etc*. The development of regulation and supervision of e-banking is still evolving in many of the emerging economies (Box V.7).

5.117 Several initiatives taken by the Government of India as well as the Reserve Bank have facilitated the development of e-banking in India. As a regulator and supervisor, the Reserve Bank has made considerable progress in consolidating the existing payment and settlement systems, and in upgrading technology with a view to establishing an efficient, integrated and secure system functioning in a real-time environment, which has further helped the development of e-banking in India. The Government of India enacted the IT Act, 2000 with effect from October 17, 2000, which provides legal recognition to electronic transactions and other means of electronic commerce.

*Upgradation of the Supervisory System*

5.118 The Reserve Bank has been gearing up to upgrading itself as a regulator and supervisor of the technologically dominated financial system. In 1998, it availed the technical assistance project of Department for International Development (DFID), UK for upgrading its supervisory system and adaptation

**Box V.7**
**E-Banking Regulation and Supervision – International Experience**

Finland was the first country in the world to have taken a lead in e-banking. The Scandinavian countries have the largest number of Internet users, with up to one-third of bank customers in Finland and Sweden taking advantage of e-banking. Internet banking is also widespread in Austria, Korea, Singapore, Spain, Switzerland, *etc*. E-banking facilitates an effective payment and accounting system thereby enhancing the speed of delivery of banking services considerably. While the e-banking has improved efficiency and convenience, it has also posed several challenges to the regulators and supervisors (BIS, 2000).

In response to the challenges thrown by the Internet banking, regulators and supervisors from various countries have prepared their own mechanism of regulation. There is a matrix of legislation and regulations within the United States that specifically codifies the use of and rights associated with the internet and e-commerce, in general, and electronic banking and internet banking activities, in particular. The concerns of the Federal Reserve are limited to ensuring that Internet banking and other electronic banking services are implemented with proper attention to security, safety and soundness of the bank, and the protection of the banks' customers.

In the U.K, there is no specific legislation for regulating e-banking activities. The FSA is neutral on regulations of electronic banking. In Sweden, no formal guidance has been given to examiners by the Sveriges Bank on e-banking. General guidelines apply equally to Internet banking activities. The role of the Bank of Finland has been, as part of general oversight of financial markets in Finland, mainly to monitor the ongoing development of Internet banking without active participation. The Reserve Bank of New Zealand applies the same approach to the regulation of both Internet banking activities and traditional banking activities. There are however, banking regulations that apply only to Internet banking. Supervision is based on public disclosure of information rather than application of detailed prudential rules (Report on Internet Banking, 2001a).

The Monetary Authority of Singapore (MAS) subjects Internet banking to the same prudential standards as traditional banking. The MAS drafted an 'Internet Banking Technology Risk Management Guidelines' in September 2002, which calls upon all banks providing internet banking to establish a sound and robust risk management process. The Hong Kong regulatory approach towards e-banking is less specific in nature. The Hong Kong Monetary Authority (HKMA) expects their banks to undertake a rigorous analysis of the security aspects of their system by getting it reviewed by qualified independent experts (Report on Internet Banking, 2001a).

Like many of these countries, India does not have specific regulatory laws for e-banking. The existing regulatory framework over banks has been extended to Internet banking as well. However, certain guidelines have been issued to banks to recognise the risks arising from electronic modes and to devise control mechanisms that are needed to mitigate such risks. Banks offering the e-banking services in India need to comply with the guidelines.

of its supervisory functions to the computerised environment. It issued guidelines on 'risks and control in computer and telecommunication system' in February 1998 to all the banks advising them to evaluate the risks inherent in the systems and put in place adequate control mechanisms to address these risks, which can be broadly put under three heads, *viz.,* IT environment risks, IT operations risks and product risks.

*Promotion of Internet Banking*

5.119 The Reserve Bank had set up a Working Group to examine different aspects of Internet banking (I-banking). The Working Group had focused on three major areas of I-banking, *i.e.,* (i) technology and security issues, (ii) legal issues and (iii) regulatory and supervisory issues. The Group submitted its report in June 2001 and the Reserve Bank while accepting the recommendations of the Working Group, issued guidelines on 'Internet Banking in India' for implementation by banks. It also stated that the earlier guidelines issued by the Reserve Bank on 'Risks and Controls in Computers and Telecommunications' (1998) would equally apply to Internet banking as well.

*Strengthening Regulatory Framework Related to Technology*

5.120 The existing regulatory framework over banks has also been extended to Internet banking. These guidelines covered various issues that would fall within the framework of technology, security standards and legal and regulatory issues. Virtual banks, which have no offices and function only online are not permitted to offer e-banking services in India and that only banks licensed under the Banking Regulation Act and having a physical presence in India are allowed to offer such services. Further, banks are required to report to the Reserve Bank every breach or failure of security systems and procedures in Internet banking, while the Reserve Bank at its discretion may decide to commission special audit/inspection of such banks.

As per recent guidelines, banks no longer need any prior approval of the Reserve Bank for offering the Internet banking services. Nevertheless, banks must have their Internet policy and they need to ensure that it is in line with parameters as set by the 'Working Group on Internet Banking in India' in 2001.

*Issues Related to Electronic Money*

5.121 The Reserve Bank had constituted another Working Group on Electronic Money, which submitted its Report in July 2002. The Group identified certain areas of concern from the point of view of the central bank in the context of more widespread use of e-money so that the conduct of monetary policy is not impaired and at the same time, the integrity of the instrument is also preserved. Some of the suggestions made by the Group include multi-purpose e-money to be issued only by authorised banks on a credit basis, which should be strictly regulated and closely monitored; ensure redeemability in order to preserve the unit of account function of money as well as to control money supply in the economy; and reporting of monetary statistics for the purposes of monetary policy and protection against criminal abuse, such as money laundering.

*Ensuring e-security*

5.122 No innovation is without challenges and IT is no exception to this rule. The most prominent challenge arising from these innovations relates to the concept of security (Mohan, 2004c). Considering the scope for fraud in the e-banking area and the possibility of contagion, the Reserve Bank as a regulator and supervisor has been proactive in addressing the risks associated with e-banking that could have otherwise undermined the credibility of the Indian banking sector. The Reserve Bank has been promptly addressing issues related to fraud with the use of electronic banking facility. Even after issuing guidelines for a secured e-banking, the Reserve Bank from time to time advises the banks on control mechanisms to combat such frauds. In a recent case of attempt of fraud by a customer while using internet banking facility, the Reserve Bank advised the concerned bank to plug the loopholes and the same was also communicated to other banks so that they remained vigilant and control the misuse of internet banking system.

5.123 In India, the legal infrastructure for promoting e-banking has not yet been put in place in a comprehensive manner. India does not have a licensed certifying authority appointed by the Controller of Certifying Authorities to issue digital signature certificates. Also, India is not yet a signatory to the International Cyber Crime Treaty, which seeks to intensify co-operation among different signatory nations for exchanging information concerning crime and cyber criminals. Further, there are unresolved legislative issues related to cyber crimes laws, clarification relating to regulatory authority over e-money products, consumer protection and privacy laws. To make the e-banking operations in India more widespread, secure and efficient, these issues need to be addressed by relevant authorities.

5.124 As the banking practices and legislations concerning e-banking are still in the process of evolution in India and abroad because of technological innovations, there is a need for a constant review of various legislations and regulatory framework relating to banking and commerce. The Reserve Bank is monitoring and reviewing the legal and other requirements of e-banking on a continuous basis to ensure that the e-banking would develop on sound lines and the e-banking related challenges would not pose a threat to financial stability.

## V. REGULATION AND SUPERVISION IN INDIA – AN ASSESSMENT

5.125 The primary purpose of banking regulation in India by the Reserve Bank has been to ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. Barring some stray and isolated cases of individual bank stress, the regulation and supervision policies pursued by the Reserve Bank have been successful in ensuring that the broad objectives of regulation are met. The regulatory gaps have been continuously monitored and plugged through appropriate measures from time to time. The Indian public has trust in the soundness of the banking system going by the fact that they consider bank deposits absolutely safe. Consequent on two spells of bank nationalisation in 1969 and in 1980, public sector bank ownership has contributed to this strong sentiment. The sound financial position and strength of the banking system reflects the effectiveness of the Reserve Bank's regulatory and supervisory approaches. Over the years, India has started adopting international best practices and implementing standards and codes to ensure that the Indian financial system functions on sound lines.

5.126 An important feature of the move towards globalisation of the Indian financial system has been the intent of the authorities to move towards

international best practices (Mohan, 2005). India has always taken proactive initiatives in both conception and implementation of good practices in the financial sector administration. India is fully supportive of the need to observe certain minimum universally accepted standards in areas relevant to the maintenance of stability in the international monetary system, including increased transparency in formulation and implementation of monetary and financial policies and improvements in dissemination of relevant data. India advocates a voluntary approach, fair, equitable, and continuous process taking duly into account the institutional and legal structure and stage of development in different countries (Reddy, 2001a).

5.127 India has been closely associated with various standard setting bodies and has been taking active part in the work of several key international fora devoted to the task of developing and promoting implementation of financial standards and codes. In order to guide the process of implementation of international standards and codes, in India, the Reserve Bank in consultation with the Government, constituted in 1999, a ‘Standing Committee on International Financial Standards and Codes’ under the Chairmanship of a Deputy Governor, RBI and Secretary, Department of Economic Affairs, Ministry of Finance, Government of India as Alternate Chairman.

*International Benchmarks and Standards – A Cross-country Comparison*

5.128 International comparisons regarding the status of implementation and the impact of these standards on financial systems of various economies is a difficult exercise due to lack of uniform, authentic and latest information on relevant parameters. However, one can employ the information and data available in the World Bank Database (2003) on country practices on regulation and supervision to attempt cross-country comparisons with regard to financial regulation and supervision. Barth, *et al* (2003) have compared the regulation and supervision structures in different countries. There is also a private initiative known as ‘e-Standards Forum’ that provides comparable information on various countries with reference to implementation of financial standards and codes. In the absence of any official and authentic source of the relevant information, an attempt has been made here to make use of both the information made available by the e-Standards Forum in public domain and the World Bank database to benchmark the Indian banking system with other countries and make an objective assessment of India’s performance in conforming to standards, codes and best practices.

5.129 The e-Standards Forum computes indices for 13 international standards and codes for 83 countries for comparison purposes. The Standards Index measures a country’s level of compliance with these international standards and codes. It ranks countries from 1 (most compliant) to 83 (least compliant) and provides a score from 0 (worst performance) to 100 (best performance) (Table 5.5).

5.130 As per the scores compiled by the e-Standards Forum and updated periodically based on a common criteria, India has fared well in Data Dissemination, Monetary Transparency, Fiscal Transparency, Corporate Governance, Money Laundering and Banking Supervision with a score of 60 per cent. For the purpose of benchmarking the Indian financial system with others, a brief look at the scores of select other countries is in order. With reference to the Banking Supervision standards, India with a score of 60 is ahead of Argentina (40), China (40), and Mexico (40) and is at par with Japan, the Philippines, Russia, Singapore and South Korea.

5.131 A database was created by the World Bank, which documented important facts with respect to regulatory and supervisory practices of the banking sector in 107 countries. These indicators mainly provide information on capital standards, supervisory capacity, prompt corrective action abilities and restructuring powers. A set of indicators is presented in Table 5.6 on banking regulation in twelve countries including India.

5.132 There are no uniform country practices in regulation of the banking system in various countries considering the special features of each country and region. However, a broad pattern could emerge when a cross-country assessment is undertaken. In order to facilitate a broad comparison of important regulatory practices in various sample countries, a summary index has been constructed using the methodology of Stallings and Studart (2003). This Overall Regulation Index (ORI) has been constructed by dividing the values in each row in the Table 5.6 by the average of that row and then summing them up by country (Chart V.1).

5.133 Chart V.1 shows that among the select countries, Argentina is a tightly regulated country followed by Mexico. It is interesting to observe that the United States and Australia have lower level of regulatory restrictions than countries like Argentina and Mexico. India’s position in this respect is comparable to that of benchmark countries *i.e.*, the

**Table 5.5: Scores of Select Countries on Compliance with International Standards and Codes**

| | Data Dissemination | Monetary Transparency | Fiscal Transparency | Insolvency Framework | Accounting | Corporate Governance | Auditing | Money Laundering | Payment System: CB | Payment System | Banking Supervision | Securities Regulation | Insurance Supervision |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***India*** | **80** | **60** | **60** | **20** | **20** | **60** | **20** | **60** | **40** | **40** | **60** | **20** | **40** |
| Argentina | 80 | 60 | 60 | 60 | 20 | 40 | 60 | 60 | 0 | 0 | 40 | 60 | 60 |
| Australia | 80 | 100 | 80 | 80 | 60 | 60 | 60 | 80 | 80 | 100 | 80 | 80 | 80 |
| Brazil | 80 | 80 | 80 | 40 | 20 | 40 | 40 | 80 | 0 | 0 | 0 | 60 | 0 |
| Canada | 80 | 100 | 100 | 60 | 20 | 60 | 20 | 80 | 100 | 100 | 100 | 80 | 100 |
| China | 20 | 40 | 20 | 0 | 40 | 60 | 0 | 60 | 0 | 0 | 40 | 40 | 0 |
| France | 80 | 100 | 80 | 40 | 40 | 60 | 60 | 80 | 100 | 100 | 100 | 60 | 40 |
| Germany | 80 | 100 | 80 | 80 | 20 | 60 | 60 | 80 | 100 | 100 | 80 | 80 | 80 |
| Japan | 80 | 80 | 80 | 60 | 40 | 60 | 40 | 80 | 80 | 80 | 60 | 100 | 60 |
| Malaysia | 80 | 60 | 60 | 0 | 40 | 60 | 60 | 60 | 40 | 60 | 0 | 40 | 40 |
| Mexico | 80 | 80 | 80 | 60 | 0 | 60 | 60 | 80 | 60 | 40 | 40 | 40 | 60 |
| New Zealand | 40 | 100 | 80 | 40 | 60 | 60 | 60 | 100 | 80 | 80 | 80 | 80 | 20 |
| Philippines | 80 | 80 | 60 | 0 | 40 | 60 | 60 | 60 | 0 | 0 | 60 | 80 | 0 |
| Russia | 60 | 40 | 60 | 40 | 40 | 60 | 60 | 60 | 20 | 40 | 60 | 40 | 60 |
| Singapore | 80 | 60 | 60 | 80 | 40 | 60 | 60 | 80 | 0 | 80 | 60 | 60 | 80 |
| South Korea | 80 | 80 | 80 | 40 | 20 | 60 | 60 | 60 | 60 | 80 | 60 | 80 | 80 |
| Thailand | 100 | 80 | 60 | 40 | 40 | 40 | 0 | 40 | 60 | 80 | 0 | 60 | 0 |
| United Kingdom | 80 | 100 | 80 | 60 | 40 | 80 | 60 | 80 | 80 | 100 | 80 | 80 | 80 |
| USA | 80 | 100 | 100 | 80 | 40 | 80 | 20 | 80 | 100 | 100 | 100 | 100 | 80 |

**Note** : Full Compliance – 100, Compliance in Progress – 80, Enacted – 60, Intent Declared – 40, No Compliance – 20, Insufficient Information – 0.

**Source :** e-Standards Forum.

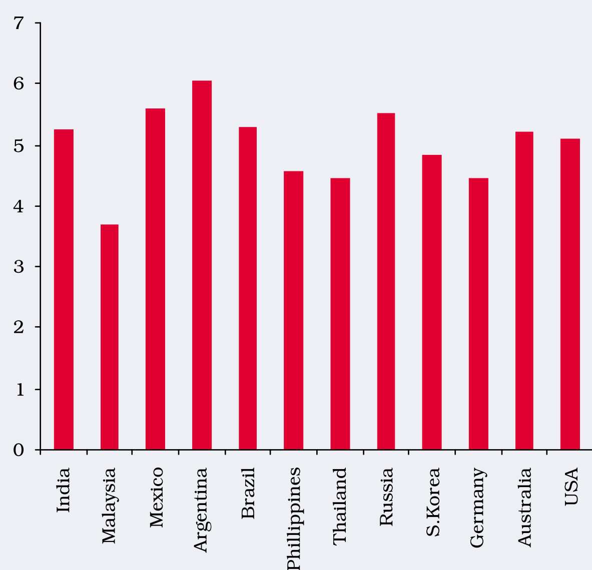
USA and Australia. Malaysia had the least ORI score among the select countries. However, in this context, it needs to be stressed that a lower ORI score need not necessarily be reflecting a lenient regulatory system in a country. It is possible that in some of the countries with a lower ORI score, the regulatory practices have been advanced to a point where the institutions are accorded more autonomy with regard

**Table 5.6: Bank Regulation - Select Indicators 1999-2000**

| | India | Malaysia | Mexico | Argentina | Brazil | Philippines | Thailand | Russia | S.Korea | Germany | Australia | USA |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Minimum Capital Asset Ratio Requirement (%) | 8.0 | 8.0 | 8.0 | 11.5 | 11.0 | 10.0 | 8.5 | 12.0 | 8.0 | 8.0 | 8.0 | 8.0 |
| Actual Risk-adjusted Capital Ratio (%) | 11.6 | 13.0 | 13.5 | 16.4 | 15.8 | 18.0 | 13.0 | 12.0 | 10.0 | 11.0 | 11.0 | 12.0 |
| Capital Stringency Index | 5 | 1 | 5 | 6 | 3 | 3 | 3 | 4 | 5 | 5 | 6 | 4 |
| Capital regulation Index | 7 | 3 | 7 | 8 | 6 | 4 | 5 | 5 | 6 | 6 | 7 | 6 |
| Overall bank Activities and Ownership Restrictiveness Index | 2.5 | 2.5 | 3.0 | 1.8 | 2.5 | 1.7 | 2.2 | 2.0 | 2.2 | 1.2 | 2.0 | 3.0 |

**Notes** :
1. Computed using the methodology in Stallings and Studart (2003).
2. The 'capital stringency index' includes adherence to the BIS guidelines, but also various measures of the degree to which leverage potential is limited.
3. The 'capital regulation index' combines the 'capital stringency index' with one measuring the type of assets that can count toward the capital asset ratio.
4. The 'Activities and Ownership Index' deals with types of activities that banks can engage in and restrictions on who can own a bank.

**Source :** See Barth, Caprio and Ross (2001) for a description of the database, which was constructed from a survey of bank regulators and supervisors in 107 countries.




to regulation or market-based regulation might be playing a significant role. Similarly, a higher ORI score does not necessarily imply a greater resilience to shocks. The purpose of this analysis is limited to bringing out that the Indian regulatory practices are broadly conforming to the practices followed in advanced economies.

5.134 Using the same World Bank data source, the Table 5.7 portray the trends with respect to bank supervision also. To take a synoptic view of the supervision practices in the select countries, an Overall Supervision Index (OSI) has been constructed, following the same methodology used to construct the ORI. The Philippines, Brazil, South Korea, Argentina and Mexico have the highest ratings (the stringent supervisory standards), with Russia at the lower end along with India. The position of India with benchmark countries *i.e.*, the United States (8.5) and Australia (7.9) was marginally lower with a rating of 6.4 (Chart V.2).

**Table 5.7: Bank Supervision - Select Indicators 1999-2000**

| Country/Item | India | Malaysia | Mexico | Argentina | Brazil | Philippines | Thailand | Russia | S. Korea | Germany | Australia | USA |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Professional bank supervisors per institution | 5.5 | 4.7 | 11.5 | 2.4 | 4 | 7 | 10 | 2.4 | 5.7 | 1 | 2 | 0.1 |
| Official supervisory index | 9 | 11 | 10 | 12 | 15 | 12 | 11 | 8 | 10 | 11 | 12 | 14 |
| Prompt corrective action index | 0 | 2 | 3 | 0 | 6 | 6 | 0 | 2 | 4 | 0 | 0 | 5 |
| Restructuring power index | 2 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 2 | 3 | 3 |
| Declaring insolvent power index | 0 | 2 | 2 | 2 | 2 | 2 | 2 | 1 | 2 | 2 | 1 | 2 |
| Supervisory forbearance discretion index | 3 | 0 | 1 | 3 | 2 | 1 | 2 | 1 | 1 | 3 | 3 | 1 |
| Supervisor tenure index | 7 | .. | .. | 6.2 | 15 | 25 | 10 | .. | 17 | 10 | 2 | 7 |
| Likelihood supervisor moves into banking index | 1 | 2 | 1 | 3 | 2 | 3 | 2 | 3 | 1 | 2 | 3 | 1 |
| Percentage of top ten banks rated by international credit rating agencies | .. | 100 | .. | 100 | 100 | 60 | 90 | .. | 100 | 100 | 100 | 100 |
| Private monitoring index | 6 | 9 | 6 | 8 | 8 | 8 | 6 | 5 | 6 | 5 | 10 | 8 |

.. Not Available.

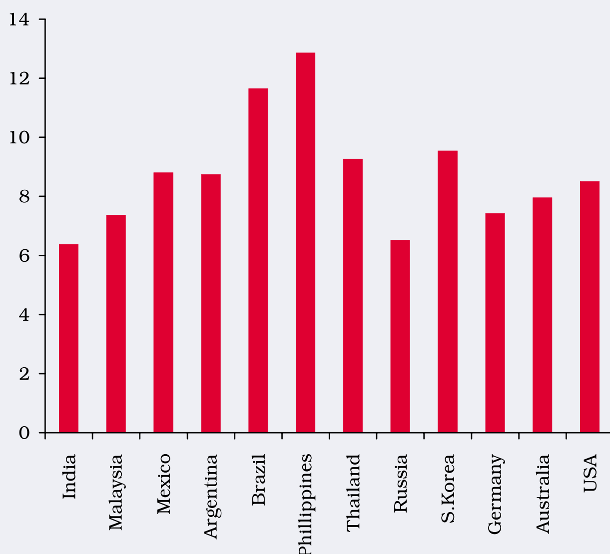
**Notes** :
1. Official Supervisory Power Index combines 16 measures of supervisory power to judge whether the supervisory authorities have the authority to take specific actions to prevent and correct problems.
2. Prompt Corrective Action Index signifies whether a law establishes pre-determined levels of bank solvency deterioration which forces automatic enforcement actions such as intervention.
3. Restructuring Power Index represents whether the supervisory authorities have the power to restructure and reorganise a troubled bank.
4. Declaring Insolvency Power: whether the supervisory authorities have the power to declare a deeply troubled bank insolvent.
5. Supervisory Forbearance Discretion Index: Even when authorised, supervisory authorities may engage in forbearance when confronted with violations of laws or regulations or with other imprudent behavior on the part of banks.
6. Likelihood Supervisor Moves into Banking: This variable is the fraction of supervisors employed by the banking industry subsequent to retirement.
7. Private Monitoring Variables: Though the banks behaviour is circumscribed by various regulations and supervisory actions, private market forces also affect them. It is, therefore, important to try to capture to some degree the extent to which market or private supervision exists in different countries.

**Source :** Barth, Caprio and Levine (2001) for a description of the database, which was constructed from a survey of bank regulators and supervisors in 107 countries.

5.135 It needs to be recognised that the ORI and OSI summarise large amount of data into a single number and represents the position at a particular point of time and, therefore, subject to the normal limitations. Nevertheless, as the methodology used to compiling this data pertaining to various countries is uniform, it broadly brings out the regulatory and supervisory situation in various countries thereby facilitating rough and ready inter-country comparisons. The broad picture that emerges from the above analysis is that the current regulatory and supervisory practices applicable to the Indian banking system are broadly in alignment with the best practices elsewhere. The Reserve Bank's regulatory and supervisory policies have put in place the best global procedures, tools and practices in the Indian banking system, which are comparable to advanced banking systems. As a regulator and supervisor of the financial system, the Reserve Bank has endeavoured to implement standards, codes and best practices in a manner that is consistent with domestic circumstances.

5.136 The effective regulatory and supervisory policies pursued along with a series of financial sector reforms implemented in the banking system have strengthened the Indian banking system considerably. In line with international developments, the regulatory and supervisory framework has been broadened with considerable reinforcement for stability through a set of micro and macro-prudential measures, which have imparted strength to the Indian banking system. The regulatory and supervisory policies have been made more liberal by giving ample operational flexibility to Indian banks in meeting the global competition. This has enabled Indian banks to consolidate and realign their business strategies to survive the emerging competition. The prudent regulatory and supervisory structure has provided the necessary base and ingredients for healthy growth of the financial sector. While enabling a substantial deepening of the Indian financial system, the policies have also strengthened the health of the financial intermediaries and enhanced the instruments available in the financial system. The paradigm shift in the regulatory framework for banks since the reforms has achieved the desired results, while depicting the growing strength and resilience of the Indian financial system.

**Chart V.2: Overall Supervision Index**




5.137 The regulatory and supervisory policies have been effective in fostering the growth of banking industry and increased its reach to a wider base of the population. The advent of new banks and the ensuing competition has led to a substantial expansion in branches of commercial banks. The banks in India have acquired strong balance sheets, while working in a milieu of adequate operational flexibility. In the post-reform period, banks have consistently maintained high rates of growth in their assets and liabilities. Deposits as a ratio of total liabilities of scheduled commercial banks have increased from 77.7 per cent in 1991-92 to 80.1 per cent in 2004-05. There has also been a marked improvement in the financial health of banks as reflected in capital adequacy and improved asset quality. As at end-March 2005, 86 out of 88 scheduled commercial banks operating in India maintained a CRAR at or above 9 per cent. There has also been a considerable improvement in the asset quality of Indian banks, while NPAs declined substantially and consistently since the mid-1990s to 2.0 per cent (net NPAs) at end-March 2005. There has been an increase in profitability levels of various banks in India. In terms of profitability, major Indian banks compare favourably with banks in other economies. The operating expenses per unit of asset have also declined in recent years. Increase in business per employee, decline in staff cost, *etc.*, has reflected in increased efficiency of the Indian banking system. The sequenced implementation of international best practices and gradual opening up of the financial sector in India has enabled the country to avoid major financial sector crisis as experienced by many other emerging economies since the 1990s (Mohan, 2005). These quantitative and qualitative indicators point to the fact that the performance of the Indian banks on various parameters has been gradually approaching international standards.

5.138 The regulatory and supervisory environment is, however, not without some concerns. The financial health of cooperative banks and regional rural banks is far from satisfactory. There is scope for improving the efficiency of banks in terms of their profits and profitability. Reduction in transaction costs is an area for focused attention (Mohan, 2005). Customer services need to be improved and further renewed focus is necessary on financial inclusion. The banking services accessibility to rural masses needs to improve further. Credit delivery mechanism to various needy sectors needs further improvement. Legal changes need to be effected in certain areas. Notwithstanding these concerns, an objective evaluation of the regulatory and supervisory functions of the Reserve Bank bring out that it has by and large, succeeded in protecting the interests of depositors and maintaining the soundness of the banking system though some stray incidents of bank failures occurred.

5.139 Indeed, the regulatory and supervisory process in India at the current juncture is at an exciting phase and is progressing towards further maturity aiming to impart greater strength and stability to the financial system. Therefore, the legitimate question to be posed at this juncture is 'from here to where'? It would be useful to identify the factors that may affect the functioning of the Indian banking system in the short, medium and long term. Accordingly, the regulatory focus and the supervisory processes would need to be altered in some areas and fine-tuned in some other areas in the light of the challenges identified.

5.140 Financial systems worldwide are still evolving and the Indian financial system is not an exception. Rapid growth of computer and telecommunications technology would continue to transform the Indian financial sector. Financial innovations have been the driving force behind the blurring of distinctions among what were, traditionally, very distinct forms of financial firms. In recognition of the new market realities and progression towards universal banking, appropriate legal and regulatory changes would need to follow. The deregulation and liberalisation process is likely to get further expedited. Regulatory response in India has already been focused on promoting a financial system, which is based on market principles. The economic rationale for banking sector consolidation in India is unquestionable at the present juncture. The character of the ownership is undergoing change away from a predominantly Government ownership. The regulatory response, against this backdrop, could be to play a role of facilitator while leaving the market forces to decide the extent and content of the consolidation process.

5.141 Consequent to the sweeping changes that are affecting the way in which banking business is conducted in tune with implementation of stringent capital standards, a key requirement to be fulfilled by the banks as well as the regulator is that of nurturing high quality human resources in the system to cope with and to adapt to the new environment. Owing to the existence of various segments within the Indian banking sector, the regulatory requirements still leave room for regulatory arbitrage and at times, circumvention. In this context, the need for doing away with multiple regulatory jurisdictions over the cooperative banking sector has been recognised and further sustained efforts are needed in that direction. While banks and NBFCs have differences in their structure, due to the similarities in the activities undertaken by them, there are areas of operational convergence. Therefore, an important issue is to bring clarity to the extent of 'regulatory convergence' between banks and NBFCs.

5.142 The Reserve Bank's responsibility in a rapidly changing technological era is more onerous as such changes bring in new and additional challenges in periodical upgradation of the technology and consequent changes in supervision strategies. Challenges to the Indian payment systems may come from key operational dependencies on various technology platforms and messaging services that are used in various settlement mechanisms. Non-implementation of basic internal controls can have appalling consequences. Adequate internal controls are a key prerequisite for the system of risk-based supervision, which has already been put in place. While it is ideal to leave the broad framework of the internal control to the individual banks, the Reserve Bank can possibly play a role of educator by throwing light on the best practices and frameworks adopted by the best-managed banks in a global context. Experience with some recent episodes of banks' stress indeed calls for continuous vigilance against causes of bank failures such as credit concentrations, mismanagement, frauds and undertaking unfamiliar and risky activities. Effective arrangements of market intelligence assume critical importance in this context.

5.143 Availability of a large volume of high quality financial information is important in the Indian context. In its duty to safeguard and reinforce financial stability, the Reserve Bank has a legitimate interest in the quality of accounting standards and their effective implementation. As India gets increasingly integrated with the rest of the world, the Indian banking system's interaction with foreign banks and *vice versa* would rapidly increase. Greater attention may be needed to overseas operations of Indian banks and cross-border

transactions to collaborate with foreign supervisors more intimately. In the context of money laundering activities, cooperation among various foreign supervisors assumes importance.

5.144 Whilst the majority of people in India today have access to financial services, there are still others who experience difficulties in availing the full range of services and products from the banking system. Promoting 'financial inclusion' should be a key element of Indian regulatory approach in future through sensitising the banking system with regard to their corporate responsibility. Substantial improvement of customer service is indeed a challenge that both banks and regulator need to be strengthened further. The Banking Ombudsman Scheme has been modified recently to address the concerns related to customer service.

5.145 As the Indian banking system responds to these multitude of challenges, the nature of supervision would also need to undergo significant change. As the industry makes efforts to keep pace with new practices and innovations, supervisors too need to re-orient their skills and practices. If Indian banks are to compete globally, the time is opportune for them to institute sound and robust risk management practices (Mohan, 2003). In order to reduce regulatory burden and improve the effectiveness of supervision, banks need to be encouraged to have sound internally developed models and practices in risk management. The future goal of the Reserve Bank as a regulator and supervisor would possibly be maintaining an appropriate balance between allowing the banks maximum possible freedom to innovate efficient business practices, while carefully protecting the safety of depositors' interest, ensuring the soundness of the banking system and maintaining financial stability. Considering the diversity in stature and size of banks in India, a clear distinction between the largest and complex banks, and the majority of small and medium sized banks may be necessary. While the rigorous risk appraisal is mandatory for the large banks and conglomerates, the overwhelming majority of small banks need a differential and institution-specific approach. 'Simplicity' versus 'complexity' and 'risk sensitivity of regulator' reminds that 'one-size-does-not-fit-all' and calls for a differential treatment.

## VI. CONCLUSIONS

5.146 While reckoning the emerging challenges and the changes to be effected in the regulatory and supervisory approaches, the long-term vision for Indian banking system is to transform itself from essentially a domestic one to the global level. Taking the banking industry to the heights of international excellence will require action on several fronts such as induction of new technology, improved credit risk appraisal, continuous financial innovation, better internal controls and appropriate legal framework. Ultimately, the credibility of both the banking system and the regulator lies squarely in the public confidence. The role of the Reserve Bank in this context boils down to promote safety and soundness, while allowing the banking system to compete and innovate. However, it is recognised that the banking regulation is designed to 'limit' but not to 'eliminate' the risk of failure (Greenspan, 2005). Further, while the banking system and the regulators adjust and adapt to the changes influencing their functioning, they cannot ignore the realities of the Indian economy. Governance and 'financial inclusion' would emerge as the key issues for a country like India, at this stage of socio-economic development' (Reddy, 2005). Therefore, the benefits of the improved efficiency of the banking system due to a reoriented regulatory and supervisory structure should ensure that the entire range of products and services from the new age banking system are made available to all sections of the society.

5.147 In sum, the changing role of financial regulation and supervision of the Reserve Bank is one of less accent on 'micro regulation' but more focus on 'prudential supervision'; less emphasis on 'regulatory intervention' but more thrust on creating an environment in which the banks think freely and innovate, less reliance on 'rules' but more importance to 'principles'; and less weightage to 'monitoring the banks' day to day activities' but more attention to 'risk assessment and risk containment'. In future, the regulatory and supervisory role would not only be 'friendly' and 'frank', but also 'prompt' and 'firm'. The Reserve Bank's new role recognises the differences among various segments of the Indian banking system and accommodates appropriate flexibility in the regulatory treatment. The changing face of regulation and supervision would accord importance to intensified use of technology in supervisory processes and substantially enhancing the skills and capacities of the supervisors. The regulatory and supervisory role of the Reserve Bank in future would guide and facilitate the metamorphosis of the domestic banks into strong and globally acknowledged players, while fully meeting the socio-economic objectives, and would continue to maintain stable and orderly conditions in the financial system.