V Leeladhar: The evolution of banking regulation in India – a retrospect on some aspects

Special address by Mr V Leeladhar, Deputy Governor of the Reserve Bank of India, at the Bankers' Conference (BANCON) 2007, Mumbai, 26 November 2007.

* * *

It is my pleasure to be here with you this afternoon on the occasion of the Bankers' Conference, which has become a landmark annual event in the Indian banking industry. I am indeed grateful to the organisers for their kind invitation, which provided me an opportunity to share my thoughts on the evolutionary path of the banking regulation in India over the past several decades. The topic, to my mind, appears particularly relevant today when India has completed 60 years of its Independence this year. While during the last six decades, the Indian banking system has indeed come a long way traversing an arduous and tortuous path, it would perhaps be appropriate to assess in retrospect and take stock of how far we have come from where we started and what more remains to be achieved. I would, therefore, like to briefly present a bird's eye view of the salient milestones crossed in the long journey of our banking system and to take stock of the current status of the industry. I would also like to take this opportunity to briefly touch upon certain doubts, which somehow seem to have crept in, about certain aspects of the current regulatory dispensation for the Indian banking sector.

Institutional evolution of the Indian banking

As most of you would, no doubt, be aware, the indigenous system of banking had existed in India for many centuries, and catered to the credit needs of the economy of that time. The famous *Kautilya Arthashastra*, which is ascribed to be dating back to the 4th century BC, contains references to creditors and lending. For instance, it says "*If anyone became bankrupt, debts owed to the state had priority over other creditors*". Similarly, there is also a reference to "*Interest on commodities loaned*" *(PRAYOG PRATYADANAM)* to be accounted as revenue of the state. Thus, it appears that lending activities were not entirely unknown in the medieval India and the concepts such as "priority of claims of creditors" and "commodity lending" were established business practices.

During the period of modern history, however, the roots of commercial banking in India can be traced back to the early eighteenth century when the Bank of Calcutta was established in June 1806 – which was renamed as Bank of Bengal in January 1809 – mainly to fund General Wellesley's wars. This was followed by the establishment of the Bank of Madras in July 1843, as a joint stock company, through the reorganisation and amalgamation of four banks viz., Madras Bank, Carnatic Bank, Bank of Madras and the Asiatic Bank. This bank brought about major innovations in banking such as use of joint stock system, conferring of limited liability on shareholders, acceptance of deposits from the general public, etc. The Bank of Bombay, the last bank to be set up under the British Raj pursuant to the Charter of the then British East India Company, was established in 1868, about a decade after the India's first war of independence. The three Presidency Banks, as these were then known, were amalgamated in January 1921 to form the Imperial Bank of India, which acquired the three-fold role: of a commercial bank, of a banker's bank and of a banker to the government. It is interesting to note here that merger of banks and consolidation in the banking system in India, is not as recent a phenomenon as is often thought to be, and dates back to at least 1843 – and the process, of course, still continues. With the formation of the Reserve Bank of India in 1935, some of the central banking functions of the Imperial Bank were taken over by the RBI and subsequently, the State Bank of India, set up in July 1955, assumed the other functions of the Imperial Bank and became the successor to the Imperial Bank of India.

Evolution of legislative regulation of banking in India

In the very early phase of commercial banking in India, the regulatory framework was somewhat diffused and the Presidency Banks were regulated and governed by their Royal Charter, the East India Company and the Government of India of that time. Though the Company law was introduced in India way back in 1850, it did not apply to the banking companies. The banking crisis of 1913, however, had revealed several weaknesses in the Indian banking system, such as the low proportion of liquid assets of the banks and connected lending practices, resulting in large-scale bank failures. The recommendations of the Indian Central Banking Enquiry Committee (1929-31), which looked into the issue of bank failures, paved the way for a legislation for banking regulation in the country.

Though the RBI, as part of its monetary management mandate, had, from the very beginning, been vested with the powers, under the RBI Act, 1934, to regulate the volume and cost of bank credit in the economy through the instruments of general credit control, it was not until 1949 that a comprehensive enactment, applicable only to the banking sector, came into existence. Prior to 1949, the banking companies, in common with other companies, were governed by the Indian Companies Act, 1913, which itself was a comprehensive re-enactment of the earlier company law of 1850. This Act, however, contained a few provisions specially applicable to banks. There were also a few *ad hoc* enactments, such as the Banking Companies (Inspection) Ordinance, 1946, and the Banking Companies (Restriction of Branches) Act, 1946, covering specific regulatory aspects. In this backdrop, in March 1949, a special legislation, called the Banking Companies Act, 1949, applicable exclusively to the banking companies, was passed; this Act was renamed as the Banking Regulation Act from March 1966. The Act vested in the Reserve Bank the responsibility relating to licensing of banks, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. Important changes in several provisions of the Act were made from time to time, designed to enlarge or amplify the responsibilities of the RBI or to impart flexibility to the relative provisions, commensurate with the imperatives of the banking sector developments.

It is interesting to note that till March 1966, the Reserve Bank had practically no role in relation to the functioning of the urban co-operative banks. However, by the enactment of the Banking Laws (Application to Co-operative Societies) Act, 1965, certain provisions of the Banking Regulation Act, regarding the matters *relating to banking business*, were extended to the urban co-operative banks also. Thus, for the first time in 1966, the urban co-operative banks too came within the regulatory purview of the RBI.

Prudential policy framework for banking regulation and supervision

The basic rationale for exercising fairly close regulation and supervision of banking institutions, all over the world, is premised on the fact that the banks are "special" – for several reasons. The banks accept uncollateralised public deposits, are part of the payment and settlement system, enjoy the safety net of deposit insurance funded by the public money, and are an important channel for monetary policy transmission. Thus, the banks become a keystone in the edifice of financial stability of the system – which is a “public good” that the public authorities are committed to provide. Preventing the spread of contagion through the banking system, therefore, becomes an obvious corollary of regulating the banks to pre-empt any systemic crisis, which can entail enormous costs for the economy as a whole. This is particularly so on account of the inevitable linkages that the banks have by virtue of the nature of their role in the financial system. Ensuring safety and soundness of the banking system, therefore, becomes a predominant objective of the financial regulators. While the modalities of exercising regulation and supervision over banks have evolved over the decades, in tandem with the market and technological developments, the fundamental objective underlying the exercise has hardly changed. Of course, a well-regulated and efficient banking sector also enhances the allocative efficiency of the financial system, thereby facilitating economic growth.

In this backdrop, as the functions of the RBI evolved over the years, the focus of its role as a regulator and supervisor of the banking system has shifted gradually from micro regulation to macro prudential supervision. A journey through the major landmarks in the evolution of the RBI's role vis-à-vis the commercial banks provide interesting insights. Allow me to very briefly dwell on the salient aspects of this evolutionary process.

As regard the prudential regulatory framework for the banking system, we have come a long way from the administered interest rate regime to deregulated interest rates, from the system of Health Codes for an eight-fold judgmental loan classification to the prudential asset classification based on objective criteria, from the concept of simple statutory minimum capital and capital-deposit ratio to the risk-sensitive capital adequacy norms – initially under Basel I framework and now under the Basel II regime. There is much greater focus now on improving the corporate governance set up through "fit and proper" criteria, on encouraging integrated risk management systems in the banks and on promoting market discipline through more transparent disclosure standards. The policy endeavor has all along been to benchmark our regulatory norms with the international best practices, of course, keeping in view the domestic imperatives and the country context. The consultative approach of the RBI in formulating the prudential regulations has been the hallmark of the current regulatory regime which enables taking account of a wide diversity of views on the issues at hand.

On the supervisory side, we have traversed vast territory in progressively refining our supervisory focus to ensure a safe and sound banking system, comparable with the best in the world. Thus, we have continually graduated from the system of on-site Annual Appraisal of the banks by the RBI followed in the 1970s to the system of Annual Financial Review during the 1980s, then on to the Annual Financial Inspection of stand-alone banks during the 1990s and further on to the consolidated supervision of financial conglomerates so as to address the supervisory concerns on a group-wide basis. The off-site monitoring of the banking system was also introduced in 1995 as a part of the supervisory strategy of ongoing supervision of the banks, so as to supplement the periodical full-scope on-site bank examinations. The supervisory rating models (CAMELS and CACS), based on crucial prudential parameters, were also developed by the RBI to provide a summary view of the overall health of the banks. The Prompt Corrective Action (PCA) Framework was put in place to enable timely intervention in case of any incipient stress in a bank. The latest supervisory initiative has been the introduction of risk-based supervision of the banks so as to move away from transaction audit and to enable the modulation of the supervisory efforts in tune with the risk profile of the banks and to achieve optimal deployment of the scarce supervisory resources. Last but not the least, the Board for Financial Supervision, constituted in 1994 under the Chairmanship of the Governor, RBI has been the guiding force in securing the transformation in the regulatory and supervisory apparatus of the banking system.

While the multi-dimensional regulatory and supervisory measures are justifiably reflected in the significantly improved prudential parameters of the Indian banking system, be it the level of NPAs or the capital adequacy ratios, there is hardly any room for complacence. In the era of ever-increasing financial globalisation and in the face of rapid financial innovations, all of us will continually need to remain on a steep learning curve and upgrade our skills and knowledge to be able to meet the emerging challenges in the financial world.

Some elucidation regarding the regulatory environment

Let me now digress a little to address a somewhat different aspect of our regulatory environment. The Reserve Bank of India has earned, in the service of our country, a proven track record of professionalism, which has lent it considerable credibility – both domestically and globally. This credibility enables the RBI to confidently carry on with the reform process to be able to maintain price and financial stability, while enabling a self-accelerating equitable growth at elevated levels. However, as I mentioned earlier, in certain quarters, there seem to be some misunderstandings, regarding certain dimensions of the extant prudential regulatory framework of the RBI. I would like to briefly address some of the salient ones and explain as to how the perceptions and the reality may not often converge.

Branch authorisation policy

As you are aware, the RBI announced a new Branch Authorisation Policy in September 2005 under which certain changes were brought about in the authorisation process adopted by the RBI for the bank branches in the country. As against the earlier system, where the banks approached the RBI, piece meal, through out the year for branch authorisation, the revised system provides for a holistic and streamlined approach for the purpose, by granting a bank-wise, annual aggregated authorisation, in consultation and interaction with each applicant bank. The objective is to ensure that the banks take an integrated view of their branch-network needs, including branch relocations, mergers, conversions and closures as well as setting up of the ATMs, over a one-year time horizon, in tune with their own business strategy, and then approach the RBI for consolidated annual authorisations accordingly.

There seems to be some misunderstanding in some quarters that, under the new policy, the **banks have to wait for the annual authorisation exercise** and are constrained in approaching the RBI for any emergent authorisation in between. Since the branch expansion planning of the banks is expected to be a well thought out, Board-approved annual process, normally, there should be no need for any emergent or urgent authorisation being required by the banks, in the interim. However, I would like to emphasise that the new policy does not preclude the possibility of any urgent proposals for opening bank branches being considered by the RBI even outside the annual plan, specially in the rural / under-banked areas, anytime during the year. This flexibility has been clearly articulated in our policy guidelines as contained in the Master Circular of July 2007 but somehow, it seems to have got overlooked.

There also seems to be a feeling among some banks that under the new authorisation policy, the process adopted is more cumbersome and, as a result, there have been delays in issuing authorisations. Since the banks are required to approach the RBI only after obtaining the approval of their respective Boards for their annual branch expansion plan, it is possible that the preparatory time required for filing their annual plan with the RBI might be a little longer. The processing time at the end of the RBI, however, has been generally in the range of one to two months – which I consider to be reasonable, given the element of consultation with the banks built into the process. However, the actual number of authorisations issued by the RBI under the new policy has been much higher than before. For instance, as against the a total of 881, 1125 and 1259 authorisations given by the RBI under the old policy regime during 2003-04, 2004-05 and 2005-06, respectively, the number of authorisations issued under the new policy during 2006-07 was 2028. Thus, as against the general perception that the new policy has been more restrictive in granting authorisations, the fact is that there has been a sharp increase of about 61 per cent in the total number of authorisations granted last year.

I am afraid, however, that similar improvements can not be said about the performance of the banks in utilising the authorisations received. Even though the banks were granted authorisations to the extent of 97 per cent and 62 per cent of the authorisations sought by them for the years 2004-05 (April-March) and 2005-06, respectively, as at end-March 2007, as much as 30 per cent and 38 per cent of the authorisations granted for those years had still not been utilised, even after more than a year or two of grant of the authorisations. As on that date, the extent of non-utilisation for the year 2006-07 was much higher at 61 per cent when only 69 per cent of the authorisations sought had been granted. Though I presume that many more licences would have been utilised since March 2007, I would, nonetheless, like to urge the banks present here to ensure expeditious and fullest utilisation of the authorisations granted.

You would recall that under the old authorisation policy, the banks were free to install off-site ATMs, at the places of their choice, without the prior approval of the RBI but only needed a licence from the concerned Regional Office of the RBI before operationalising the ATM, so as to ensure compliance with the provisions of Section 23 of the B R Act. Under the revised authorisation policy, however, the banks are required to obtain prior approval of the RBI even for the off-site ATMs. Some, therefore, expressed a view that the requirement of prior authorisation of the ATMs in the new policy is not quite justified, as an ATM is not a full-fledged place of business for the banks. Let me hasten to mention here the RBI has been liberal in authorising setting up of the ATMs and all the requests received by the RBI for establishing as many as 7443 ATMs were fully acceded to for the year 2006-07.

As we know, the ATMs, in the format they are used today in India, already provide for deposit and withdrawal of cash, balance enquiry, account statements, etc. However, as seen in some of the advanced countries, the technology permits and can be leveraged to deploy the ATMs for delivering a much wider variety of banking services to the banks' customers and thus, have the potential of becoming a much fuller place of banking business. In any case, since the ATMs constitute an important channel for delivery of banking services, it is only logical that the network planning of the banks also captures the plan for setting up their ATMs and reflects it in their annual plan furnished to the RBI for authorisation. Besides, in India's WTO commitments in regard to banking services, the Market Access limitations provide for specific licensing of the ATMs of the foreign banks, though the ATM licences are not counted within the ceiling of 12 licences per year, as committed by India. In the emerging global context, therefore, it is only appropriate that the ATMs continue to be kept within the purview of regulatory authorisation policy.

Operations of foreign banks in India

At present, there are 29 foreign banks operating in India with a network of 273 branches and 871 off-site ATMs. Among some circles, a doubt is sometimes expressed as to whether the regulatory environment in India is liberal in regard to the functioning of the foreign banks and whether the regulatory approach towards foreign participation in the Indian banking system is consistent with liberalized environment. Undoubtedly, the facts indicate that regulatory regime followed by the Reserve Bank in respect of foreign banks is non-discriminatory, and is, in fact, very liberal by global standards. Here are a few facts which bear out the contention;

- India issues a single class of banking licence to foreign banks and does not require them to graduate from a lower to a higher category of banking licence over a number of years, as is the practice followed in certain other jurisdictions.
- This single class of licence places them virtually on the same footing as an Indian bank and does not place any restrictions on the scope of their operations. Thus, a foreign bank can undertake, from the very first day of its operations, any or all of the activities permitted to an Indian bank and all foreign banks can carry on both retail as well as wholesale banking business. This is in contrast with practices in many other countries.
- No restrictions have been placed on establishment of non-banking financial subsidiaries in India by the foreign banks or of their group companies.
- Deposit insurance cover is uniformly available to all foreign banks at a non-discriminatory rate of premium. In many other countries there is a discriminatory regime.
- The prudential norms applicable to the foreign banks for capital adequacy, income recognition and asset classification, etc., are, by and large, the same as for the Indian banks. Other prudential norms such as those for the exposure limits, investment valuation, etc., are the same as those applicable to the Indian banks.

- Unlike some of the countries where overall exposure limits have been placed on the foreign-country related business, India has not placed any restriction on the kind of business that can be routed through the branches of foreign banks. This has been advantageous to the foreign bank branches as the entire home-country business is generally routed through these branches. Substantial FII business is also handled exclusively by the foreign banks.
- In fact, some Indian banks contend that certain amount of positive discrimination exists in favour of foreign banks by way of lower Priority Sector lending requirement at 32 per cent of the adjusted net bank credit as against a level of 40 per cent required for the Indian banks. Unlike in the case of Indian banks, the sub-ceiling in respect of agricultural advances is also not applicable to foreign banks whereas export credit granted by the foreign banks can be reckoned towards priority sector lending obligation, which is not permitted for the Indian banks.
- Notably, in terms of our WTO commitment, licences for new foreign banks may be denied when the share of foreign banks' assets in India, including both on- as well as off-balance-sheet items, in the total assets (including both on- and off-balance-sheet items) of the banking system exceeds 15 per cent. However, we have autonomously not invoked this limitation so far to deny licences to the new foreign banks even though the actual share of foreign banks in the total assets of the banking system, including both on- and off-balance-sheet items (on Notional Principal basis), has been far above the limit. This share of foreign banks stood at 49 per cent, as at end-January 2007, as mentioned in the India's Trade Policy Review, 2007.

It is thus very obvious that the Indian regulatory regime is essentially non-discriminatory as between branches of foreign banks and domestic banks, in regard to their authorisation or the scope of their operations, though some hold that there is some positive discrimination in favour of the foreign banks. As explained, Indian regulatory regime is in fact much more equitable and provides a far more level playing field to the foreign banks, than in many other jurisdictions both developed and emerging economies.

As regards the **market share** of the foreign banks in the Indian commercial banking system, the share, as at end-June 2007, in the deposits and advances stood at 6.11 and 6.83 per cent, respectively. However, the foreign banks were far more dominant in the off-balance sheet business with a market share of as high as 72.66 per cent. Besides the foreign banks, there are also two large Indian private sector banks in which the non-resident ownership is very close to 74 per cent permitted, which could, therefore, be considered as incorporated in India but predominantly foreign owned banks. These banks together with the foreign banks, have a combined market share in the country in the deposits, advances and off-balance-sheet business of 17.46, 18.65 and 76.63 per cent, respectively, which, by no means, are insignificant levels. Moreover, there are also about 10 large listed public sector banks in which the non-resident / FII shareholding was close to the permitted ceiling of 20 per cent, as at March-end 2007. In these public sector banks, resident private shareholding would thus be close to thirty per cent only.

Furthermore, the share of the foreign banks in the foreign exchange market in India was also significant and had registered a rising trend. For instance, as against their share of 41 per cent in the total foreign exchange turnover during 2005-06, their share during the first half of 2007-08 stood at 52 per cent.

Thus, viewed in totality, it would be extremely difficult to justify the notion that the foreign and non-resident participation in the Indian banking markets is insignificant or restricted and that the policy or regulatory environment is not conducive to it.

Another dimension of the foreign banks' functioning in India is the **returns generated** from their Indian operations. Let me mention a few interesting facts here. The net profit per branch for the foreign banks in India for the year 2005-06 was Rs. 11.99 crore as against the corresponding figure of Rs. 0.33 crore for the public sector banks (PSBs). Further, for the year 2006-07, the Return on Assets (ROA) of the foreign banks was 1.65 per cent while the Return on Equity (ROE) was 14.02 per cent, as against the corresponding figures of 0.82 per cent and 13.62 per cent for the PSBs. These returns need to be viewed in the context of the international benchmarks for these parameters, which are generally considerably lower. Thus, the Indian operations of the foreign banks are very remunerative and the returns are notably higher than that of their domestic counterparts as also the customary international levels. While this could be attributed, to an extent, to the level of domestic market development and lack of contestability in the Indian markets, this is also, in no small measure, on account their business mix and a dominant share in the off-balance business, which is more regulatory-capital efficient, and the pattern of their branch presence, which is so far largely confined to the major cities of the country.

Yet another aspect of the foreign banks' operations is the **authorisation of their branches** in India. As you might be aware, as per India's existing WTO commitments, which came into effect from 1997-98, our obligation is to permit to foreign banks only 12 licences per year, including both – the new entrants and the existing banks. As per the commitment made by India, this obligation of 12 licences does not include the ATMs that might be permitted by the RBI. RBI has, however, consistently been granting authorisations at levels higher than our obligation, not counting the numbers of ATMs set up by the foreign banks. Thus, during the period 2003 to October 2007, RBI had authorised as many as 75 branches of the foreign banks in India, excluding the off-site ATMs set up by them. Thus, branch authorisation policy for the foreign banks in India may even be described as quite generous, and not merely liberal.

Notwithstanding the WTO obligations, permitting foreign banks' presence in a country is in some senses also guided by the **extent of reciprocity** amongst the nations – which simply means that there should be some defensible proportionality in the authorisations granted for the banks of each other's countries. In this context, an illustration would be revealing of the ground realities. During the period 2003 to October 2007, India had granted 19 authorisations to the USA-based banks, most of which also stand utilised. However, during the same period of five years, USA did not authorise any office of the Indian banks in the US territory, vis-à-vis the requests from the Indian banks for setting up three branches, two subsidiaries and nine representative offices. Some of the requests have been pending with the US authorities for more than five years.

Yet another aspect of the foreign participation in the Indian financial sector is the **foreign ownership of the non-banking finance companies** (NBFCs) operating in India, quite a few of which are the subsidiaries of the foreign banks. It is interesting to note that, as of August 2007, in the category non-deposit-taking systemically important (ND-SI) NBFCs, the NBFCs with some element of foreign ownership had an asset base of Rs. 87,542 crore and accounted for more than 26 per cent of the total assets of this class of NBFCs. Of these, the NBFCs with majority foreign ownership had an asset base of Rs.34,095 crore accounting for 9.2 per cent of the total assets of this class of companies – a level which could not be considered to be insignificant. The ND-SI NBFCs, which are not closely regulated by the RBI, therefore, provide, in certain ways, a means of expanding the reach of the foreign banks in India. Thus, the current policy environment enables a fair level of foreign participation even in the non-banking financial sector of the country.

Securitisation guidelines of the RBI

As you are well aware, the RBI had first issued the draft guidelines for securitisation of standard assets in April 2005, for public comments and after an extensive consultative process, the final guidelines were issued in February 2006, in order to facilitate an orderly development of this market. In certain quarters, however, a view has been expressed that these guidelines, tend to negate the benefits envisaged in the very concept of securitisation, and thus, are hindering the growth of securitisation market in the country. Let me attempt to briefly present today the international perspective vis-à-vis RBI guidelines and the thinking and rationale underlying our formulation.

RBI's guidelines are broadly in tune with the stipulations of several regulators in other jurisdictions. For instance, concept of "true sale" and the independence of the Special Purpose Vehicle (SPV) from the originator of the assets, prescribed in our guidelines is also embedded, in one form or the other, in the regulatory guidelines obtaining in Australia, Malaysia, Singapore, the UK and the USA. Similarly, the prudential treatment of the credit enhancement provided to the SPVs and the requirement of capital charge thereagainst, as prescribed in our guidelines, is also echoed in the regulatory framework in Australia, the United Kingdom and Singapore. Likewise, the provisions relating to the "Clean up Calls", or repurchase of the residual performing assets from the SPV by the originator, also figure in the regulations in Australia, the United Kingdom and Singapore. The restrictions placed by us on purchase of securities issued by the SPV by the originator are also found in other jurisdictions such as Australia, Singapore and the UK. Similarly, the restrictions in regard to the provision of liquidity facility to the SPV, underwriting of the securities issued by the SPV and the servicing of the securitised assets are also found in several other jurisdictions, with variations in details and in the degree of stringency. I am citing all this at some length to point out that RBI's guidelines on securitisation are broadly in line with the practices obtaining in several other jurisdictions, though they have some unique features.

The accounting treatment prescribed in our guidelines provides for upfront recognition of any loss incurred on sale of assets to the SPV but the profit arising from such sale is required to be amortised over the life of the securities issued / to be issued by the SPV. Thus, we have not permitted the banks to recognise the profit upfront, on sale of assets to the SPVs. As you are aware, the main considerations for the originator in undertaking a securitisation transaction are obtaining the regulatory-capital relief and generating liquidity from an otherwise illiquid loan book, and not the profit, *per se*. In this background, RBI's guidelines have justifiably adopted such an approach in order to ensure that profit-booking does not become the primary motive for undertaking securitisation transactions – which could perhaps lead to profit smoothening, possibly through inappropriate valuations, and the consequent window dressing of the financial statements – none of which is prudentially desirable. In brief, the restrictions in our guidelines on upfront recognition of profit on sale of assets by the banks seek to create the right incentive framework for the banks so that the basic objective underlying the concept of securitisation does not get negated.

In the aftermath of the recent sub-prime episode in some of the developed countries, caused also by wide dispersal of credit risk throughout the system through complex structured transactions, I am sure, you would appreciate the merit of adopting an appropriate incentive-compatible prudential approach towards securitisation. We need to squarely recognise that securitisation, after all, is also a credit-risk-transfer instrument and has the potential of dispersing the risks from the originating banks to those parts of the system which might not necessarily be best equipped to manage that risk. Hence, RBI's stand in creating the right incentive framework through prudential restrictions would seem to be an approach which has much to commend itself.

Migration to Principles-Based Regulation (PBR)

A view has been expressed in certain quarters that the Indian regulatory framework should migrate to principles-based regulation from the current rules-based approach. The merits of a principles-based approach are that in a dynamic market context, where the product innovation is the order of the day, the principles-based approach to regulation provides a more enduring regulatory option since the underlying principles would not need to change with every new product whereas the detailed rules may have to be constantly modified to address the unique features of market and product developments. However, despite the stated superiority of the principles-based approach, so far very few countries have adopted this model in a big-bang or comprehensive manner. The FSA of the UK which is one of the forerunners in adoption of principles-based regulation has a rule book which has over 8000 pages. So, the PBR is not as simple to operationalise as it is to advocate.

Thus, in any regulatory regime, complete reliance on a principles-based approach would rarely be a feasible option since the high-level principles would need to be underpinned by the detailed rules at the operational level, to achieve the regulatory objectives. To illustrate, it might be easy to enunciate the principle that "Treat your customer fairly" but ensuring it at the ground level would invariably require specific rules and prescriptions to achieve the objective underlying the principle. Besides, a PBR approach also pre-supposes greater reliance on the discretion and judgment of the supervisors and regulators in interpreting the broad principles – an aspect with which the market players might not be very comfortable. On the other hand, the regulated entities too, in the absence of detailed regulatory prescriptions, would need to develop a certain level of maturity of outlook to correctly understand the spirit of the principles while implementing them at the operational level. This approach would, therefore, also require a good deal of skill up gradation on the part of the regulator as well as the regulated entities.

Moreover, in any jurisdiction, there could be certain areas of regulation which would be more amenable to a PBR approach while certain other areas might inevitably require detailed prescriptive rules. Thus, the rules-based and principles-based approaches to regulation are not mutually exclusive options but could very well co-exist and complement each other. To illustrate, the Pillar 1 of the Basel II framework is essentially rule-based prescription while the Pillar 2 is more oriented towards principles-based regime. Within the RBI, we too are in the process of exploring the feasibility of adopting a principles-based approach to banking regulation but it may be quite some time before we could be ready for adoption of the PBR approach on a significant scale in the Indian context.

Conclusion

To sum up, I would only say that the Indian regulatory regime for the banking sector has come a long way over the past six decades. The current regulatory dispensation is ownership neutral, non-discriminatory and provides a level playing field for the market participants. In my presentation today, I have also tried to present some facts, with a view to dispel certain ill informed apprehensions about the regulatory environment for the Indian banking system. Let me assure you that there is considerable scope for improvements in the regulatory systems in India and we have been pursuing a policy of constant improvements through a participative and consultative approach with market participants. The policy outcomes so far, in terms of contribution to growth, price stability, financial stability, efficiency and robustness of banking sector have been significant by all standards of measurements, but the search of excellence, in the RBI’s mission, is an unending journey. I would urge banking community to join us in this great adventure of serving a billion people, with passion as well as positive and broader set of values.

Thank you.