



REGULATION AND SUPERVISION OF BANKS IN INDIA: THE IMPERATIVE OF REORIENTATION

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Abstract:

The Commercial Banks in India, predominated with public sector's presence, have witnessed phenomenal growth. However, the explosion of transactions along with massive and fast growth has posed a serious operational problem and in terms of adhering to the systems and procedures. In this context, Banking regulation and supervision, audit and inspection assume topical significance. Procedures, rules, manuals, circulars by themselves do not and cannot establish control unless somebody in an organization watches and reports on the extent of compliance of prescribed norms, rules and regulations. There lies the role of the internal inspector or auditor. Ultimate objective of internal inspection is to forewarn the deficiencies in the organization and detect the irregularities of initiating timely and appropriate corrective action rather than pinpointing loopholes and lacunae.

Keywords: CAMELS, CALCS, Commercial Banks

Introduction

Regulation is defined in the American Heritage Dictionary as a principle, rule of Law designed to control or govern conduct whereas supervision means to have direction and oversight of the performance of other. Under regulation, banks were effectively subject to rules that governed their decision making virtually making the regulators bank managers. Since deregulation in the reform era, the Central Banks (RBI in India) are expected to provide the regulatory and supervisory guidelines necessary for sound management.

The Commercial Banks in India, predominated with public sector's presence, have witnessed phenomenal growth. However, the explosion of transactions along with massive and fast growth has posed a serious operational problem and in terms of adhering to the systems and procedures. In this context, Banking regulation and supervision, audit and inspection assume topical significance. Procedures, rules, manuals, circulars by themselves do not and cannot establish control unless somebody in an organization watches and reports on the extent of compliance of prescribed norms, rules and regulations. There lies



the role of the internal inspector or auditor. Ultimate objective of internal inspection is to forewarn the deficiencies in the organization and detect the irregularities of initiating timely and appropriate corrective action rather than pinpointing loopholes and lacunae. The objective of RBI regulation and supervision is mainly to ensure solvency of the banking system, quality of assets, adequate liquidity and reasonable profitability. It is also to check from time to time whether statutory, regulatory and prudential requirements are being complied with. The basic objective of the present unit is to explain you the need for Regulation and Supervision of Banks in India.

Regulation and Supervision of Banks – The Rationale

The efficiency of the banking system reflects on the performance of the economy. The efficiency of banks in attracting savings and transforming them into investment influences the economy. The mismanagement of the risks and misallocation of the resources will lead to failure of the banking system and consequently the economy. Therefore regulation and supervision assumes significance.

The banks failures were the root cause. An absolutely uncontrolled and indiscriminate growth of new banks and branches after 1940 led to the crash of the banks. Due to large unsecured advances, advances against speculative shares, advances against immovable property which could not be recovered easily in an emergency resulted in the

failure of 588 banks with a loss of Rs. 26 crores to the public savers between 1939 and 1949. Then commercial banks were governed by the companies act and the RBI had no adequate power of control and regulation. Analysing the causes of these failures the Central Banking Enquiry Committee in 1931 concluded that the provisions of the Indian Companies Act were quite inadequate to deal with banking malpractices and recommended for a comprehensive legislation to cover the organization, management, audit and liquidation of banks. The provisions relating to the banking companies introduced in the companies act 1913 were thereupon amended in 1936 and a separate chapter was added. These provisions, however, proved ineffective. Later the Banking Companies Act 1949 was passed based on the proposals of the central board of the RBI in 1939, and was renamed as Banking Regulation Act, 1949. The act empowers the RBI to control and supervise the activities of the commercial banks in India.

Regulatory role of the RBI is highly significant and essential to control the overall credit and the price levels in the economy. It ensures a sound and healthy banking system, effective coordination and control over the credit through appropriate monetary and credit policies. The powers of the RBI, in pursuing the maintenance of cash reserves by the cash reserves by the commercial banks, collecting and furnishing of credit information from the commercial banks, determining policy and issue directions, collect information



regarding deposits, prohibit acceptance of deposits, filing winding up petitions etc., are vested under the RBI Act, 1934. Apart from the RBI Act, 1934, The Banking Regulation Act, 1949 was also enacted to regulate The Indian Banking Sector. The rationale for such regulation of banks can be gauged through the facts that:-

- (a) Banks hold a major portion of the public savings, (public interest).
- (b) Banks effectively channelize funds to investment avenues and thus ensure efficient and productive use of funds for economic development. (A macro-economic development interest).
- (c) Banks influence the monetary position of the economy and play a significant role in implementing monetary policy. (monetary policy interest).
- (d) Banks administer the national payments and settlement system.

As stated the RBI Act, 1934 and the Banking Regulation Act, 1949 provide the legal framework for the regulation and supervision of banks. A number of development took place in the sphere of regulation and supervision of banks consequent upon the Bank Scams, liberalization, banking sector reforms etc. In the past reform scenario supervision of banks has assumed considerable importance in the context of maintaining the stability and the soundness of the Banking System. Major development in the supervisory functions of the RBI took place based on the recommendations of the Narasimham Committee. The

committee recommended the setting up of a separate agency, which could be quasi-autonomous banking supervisory board under the aegis of the RBI.

Approaches of Regulation and Supervision of Banks - The Need For Reorientation

The regulatory and supervisory roles of the RBI began with the setting up of the department of supervision (DOS) by the RBI in 1993. This was followed by the setting up of a separate board for supervision in November 1994. The BSF aims at dedicated and integrated supervision of all credit institutions including banks, DFI's and other finance companies. The supervisory function of the BF's would include the verification of the capital adequacy and liquidity, the management practices, the presence of adequate systems and controls and compliance with laws and regulations. The on-site verification involves examination of the book of accounts by the BF's officials or by external auditors. The off-site monitoring and surveillance, introduced in March 1996, is based on the prudential reporting system and banks are required to furnish various reports on quarterly basis to the Reserve Bank of India. The system provides an opportunity to the regulator to monitor banks performance based On CAMELS\CALCS. CAMELS are an acronym of capital adequacy, asset quality, management, earning, liquidity, systems and controls-applicable to all domestic banks. CALCS: Stands for capital adequacy, asset quality, liquidity, compliance and system-applicable to



Indian operations of banks incorporated outside India.

The RBI have decided to switch over to RBS for the reasons of Autonomy to banks, increased competition, growing complexities and diversities of banking business due to globalization averting or minimizing the contagion effects of crisis in system, need for disclosure and transparency and to comply with the second pillar (Supervisory Review Process) requirements under new Basel Accord which will be effective in due course. The Basel Committee, inter alia, identified the following four key concepts of supervisory review.

- (a) Banks should have a process for assessing their overall capital in relation to their risk profile and a strategy for maintaining their capital.
- (b) Supervisors should review and evaluate banks internal capital adequacy assessments and strategies as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the results of this process.
- (c) Supervisors should expect banks to operate above the minimum regulatory capital ratios.
- (d) Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a bank. It should also call for a rapid remedial action if capital is not maintained or restored.

The periodic reviewing of the techniques and methodologies of regulation and supervision became necessary to align them with the international standards and also to keep pace with the challenges of liberalization, competition, deregulation etc. India needs to shift from prescriptive rules based regulation to a principles based one to establish predictive supervision.

The Imperative of Regulation and Supervision of Banks

The Indian Banking Sector has witnessed a series of upheavals since 1991. The tasks before most banks are to tackle. Their urgent problems of priority installing Risk Management Systems and implementing them, conforming to new disclosure standards, keeping pace with the requirements of market related, credit related, competitive related challenges etc. The major policy thrust, as emphasized by the Narasimham Committee, is to improve the operational and allocate efficiency of the financial system as a whole by correcting many of the exogenous and structural factors affecting the performance of financial institutions and banks. Therefore, entry deregulation, deregulation of interest rates, introduction of capital adequacy and prudential norms, greater autonomy to public sector banks, curbing excessive regulation etc., which have been on the Agenda of reforms are implemented. This is with the primary objective of improving the operational and financial efficiency of banks. The banking sector entered the era of deregulation.



Regulatory reform took place in Indian Banking Sector expecting changes that improve regulatory quality. Deregulation refers to a subset of regulatory reform and refers to a complete or partial elimination of regulation. The need for Regulation and Supervision Banks in India can be articulated through the following points.

1. To maintain capital standards to overcome risks: A strong banking sector with a strong capital base is better able to supply credit to business, fund investment opportunities, create employment and contribute to a stronger economy. But banks are exposed to complex and diverse credit risks which may have grave socio-economic impact. Therefore, regulation and supervision help to develop and maintain capital standard.

2. To assure transparency in banking operations: Transparency in banking operations is very essential. Information about financial performance, risk management strategies and practices, risk exposures, accounting policies and basic business management together with corporate governance is crucial to assure transparency. Banks have to ensure comprehensive, accurate, relevant, timely and comparable information. This is possible through systematic regulation and supervision.

3. To sustain the health of the banking system: For sustaining the health of the banking system and to maintain asset quality, accounting

standards and regulatory provisions need to be implemented.

4. To guard against moral Hazards: Proper regulation and supervision of banks is essential to save the banks from 'moral hazards'. Generally moral hazard is likely to be encountered by banks in a liberalized and deregulated environment. The deposits collected from the public may be invested by banks in risk or business due to pressure on profits. This may lead to moral hazard and loss of public confidence if the banks fail to achieve the expected from its investments. Banks can be guarded against such hazards and failures only if the regulatory and supervisory framework exists.

5. To maintain stability and soundness of Banking system: Traditionally, the RBI has employed periodic inspections as the prime and exclusive instrument of prudential supervision over banks. These inspections, however, may not be sufficient to ensure continuously a stable banking system. Ever since the financial sector reforms have commenced, bank supervision has assumed considerable importance in the context of maintaining the stability and soundness of the Indian Banking System.

6. To Guard Against Speculative Activities and market destabilization: The financial and banks markets are different from product markets and therefore, greater liberalization needs to go along with depot supervision and higher degree of regulation. This is because the banks are more leveraged



and there is more scope for speculative activities in assets with inherent volatility. Moreover, there are negative externalities that can destabilize financial markets and it can adversely affect the real economy.

7. To ensure price stability: The operations and operational environment of the banking sector need to be regulated and supervised to exercise control over the volume of credit created by the commercial banks to ensure price stability.

8. To lead economic growth: Various factors influence economic growth of a nation. The main factors are money supply, interest rates and exchange rates. Monetary expansion stimulates economic activity thereby leading to economic growth. Sometimes rapid expansion may become the cause for rise in inflation which may restrain economic expansion and cause slowdown in the economic growth. Hence regulation and supervision of banks through monetary policy is highly need to lead the economy towards growth.

9. To pave way for market discipline: Regulatory\supervisory intervention is very pertinent to pave way for market discipline and to arrest cascading sequence of defaults that can culminate in financial implosion.

10. To ensure safety of Depositors Funds: The regulatory and supervisory framework consists of various key regulatory tools, rigorous bank examination and regulation of various operating and balance sheet ratios. The

overriding concern of all the mechanism is for the safety of the depositors funds.

Conclusion

The commercial banks in India posed a serious operational problem in terms of adhering to the systems and procedures. In this context banking regulation and supervision assures significance. Even in the deregulated environment in the reform era. The RBI is expected to provide the regulatory and supervisory guidelines necessary for sound and stable banking system. The need for regulation and supervision of banks in India is to maintain capital standards to overcome risks, to assure transparency in banking operations, to sustain. The health of the banking system, to guard against moral hazards, to maintain stability and soundness of banking system, to guard against speculative activities and market destabilization, to ensure price stability, to lead economic growth, to pave way for market discipline and to ensure safety of depositors funds.

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