SUPERVISORY AND REGULATORY FUNCTION OF THE RBI

RBI is vested with a wide range of functions and responsibilities. Established in 1935 under the RBI Act 1934, the main object was to regulate the issue of bank notes and the keeping of reserves to secure monetary stability in India and to operate the currency and credit system of the country to its advantage\(^1\). Within these overall objectives, the bank also performs a wide range of promotional functions to accelerate the pace of economic development.

One of the major tasks the RBI has undertaken is the building up of sound and adequate banking and credit structure on modern lines. For this purpose extensive powers of supervision and control of banks were acquired by the RBI\(^2\). At present the supervisory function over banks is being exercised by a department of the RBI. The focus of the statutory regulation of the

\(^1\) *Supra* p.167.

\(^2\) S.35 B.R.Act, 1949 RBI is empowered the general authority to conduct inspection of books and accounts of banks other sections related to it are Sections 22(3), 37(2), 38(4), 44(1), 44A, 44B and 45Q of the B.R.Act, but these special inspections have rarely been undertaken in recent year.
commercial banks till 1990 was mainly on licencing of banks and branches, administration of minimum capital requirements, reserves and liquid assets requirements, control over management, methods of operations and amalgamation, reconstruction and liquidation. In addition RBI has been vested with powers of supervision through the mechanism of inspection of the financial strengths of the banks in India. RBI enjoys operational independence and adequate resources to meet these objectives. There is a two way relationship between a well functioning economy and a well functioning banking system. If the economy gets into trouble because of a cyclical downturn, the banks become the shock absorbers. As banks are important elements of the infrastructure of today's societies, so is bank supervision.

Meaning and Object of Supervision and Regulation

The words ‘supervision’ and ‘regulation’ are used more or less to mean the same thing. However in reality they are not the same. The word ‘supervise’ means to oversee—normally general charge of administration. The word ‘regulate’ has its origin in the Latin word ‘regulatus’ which means to

control, govern, direct according to a rule or a principle or a system. Regulation is defined in the American Heritage Dictionary as a principle, rule or law designed to control or govern conduct where as supervision means to have direction and oversight of the performance of the other.

‘Supervision’ is a favourite word of the RBI but usage of ‘Regulation’ is felt more appropriate. It makes it difficult for poor bankers to analyse the difference in ‘supervisory’ and ‘regulatory’ roles of the RBI. The supervision exercised can be termed as ‘inspection’ or ‘audit’. That is checking of adherence to rules, while ‘Regulation’ confines itself to making the rules themselves. Supervisory measures cannot be categorized as preventive and protective while regulations can be separated according to these two categories. The examples of preventive regulation include branch licensing, capital adequacy requirement, permissible business activities, limits on loan concentration etc. Protective regulations include deposit insurance, facility as lender of last resort and emergency measures for bailing out weak banks. The aforesaid comparison of supervision and regulation can lead to a belief that

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6 RBI circulars on the issue of Y2K can be one such example. CRR prescription is another example. Over the years the RBI has reduced CRR for commercial banks. It is difficult to understand whether this is a supervisory or regulatory task.

they are two different exercises although driven in the same direction for more or less the same purpose. In any case process of regulation is more consultative compared to supervision.\(^8\)

Supervision can be seen as having several broad aims. First to protect the small depositor from mis-management or fraud. Secondly to protect the public from what has been called systematic risk. This refers to the possibility that the failure of one bank could lead to the failure of several banks and a lack of confidence in the earlier system. Thirdly, some Countries have national deposit insurance systems or otherwise implicitly undertake to protect bank depositors. In these countries, supervision serves to protect the insurance fund or the Government’s own fund from loss. It has long been recognized that banks that are within a free market setting are prone to failure. Accordingly, most national banking systems have in place extensive protective mechanisms designed either to support troubled banks or to safeguard depositors in the event of failure. Worldwide, competitive position of banks has been deteriorating in response to several adverse developments.\(^10\)

\(^8\) Narasimhan Committee report (1998) on *Regulation and Supervision*, p.63.


\(^10\) Ibid.
The financial sector, the most important constituent of which is the banking system, has therefore, traditionally been an area of regulatory interest the world over. The case for regulation of the financial system rests on the obvious ground that its solvency, safety and soundness is of paramount importance for stability and orderly growth of the economy. Regulation is thus designed to ensure efficiency of the system, prevent concentration of business and protect depositors and investors from the vulnerability of financial institutions to market failure, mismanagement and fraud\textsuperscript{11}.

In U.S.A. there is a blend of functional regulation of non-banking activities by specialised regulators and an umbrella supervision of diversified financial services holding companies by the Federal Service. In major banking centers, organisational structure varies quite considerably\textsuperscript{12}. In U.K. this responsibility of supervisory banks lies with the Central Bank. In U.S.A. and Japan they have a mixed system, with the central bank sharing supervisory responsibilities with separate Government agencies. Each country has its own unique set of financial, institutional and legal frameworks. In this context what


\textsuperscript{12} \textit{Supra}, p.136.
perhaps is more important than where the supervisory authority lies is the extent of supervisory powers and its independence\textsuperscript{13}.

The core task is the supervision of operating banks by using specific techniques. Ideally a supervisory system should allow for both ‘on site’ and ‘off site’ supervision. These are vehicles or means used by the supervisor, not an end in themselves. Such reports and information on the banking system is of use not only to the supervisor but also to the economic policy makers within the Government.

The off-site surveillance gives a proper bank rating system. The on-site inspections relates to checking the banks internal control procedures. In many countries, the supervisory function is small and on-site inspections occur frequently. In U.S.A. they rely heavily on inspections for identifying potential problems and sufficient resources are made available to visit banks at least once a year. So regardless of the type of supervision one uses, an essential element in successful supervision is frequent contact with the bank at all levels. From the above it is clear that while there exists a convergence of views on the

\textsuperscript{13} Ibid. There are varying practices rooted in the history and traditions of different countries. U.K., Canada and Switzerland rely on a single regulator responsible for consolidated financial services while the Central Banks have no supervisory responsibilities.
goals of bank supervision, i.e., to promote a safe, stable and efficient financial system, supervisory structures vary across the world. Broadly there are 3 types:\footnote{D.G.Gupta, \textit{Tasks for RBI Supervisory Board}, The Hindu (Madras), Sept.9, 1993.}

a) Separation between regulatory and supervisory bodies, e.g. Germany;

b) Separate regulatory and supervisory functions under the same agency, e.g. U.S.A., U.K. and India

c) Separate regulatory and supervisory institutions working in close co-ordination, e.g. France

\textit{The U.S. experience – Causes of Regulation}

The experience of the 1930’s depression and the subsequent bank failures coloured and even now colour the approach of U.S. regulators and legislators. Regulation is in place because of concerns about the safety of financial institutions and security of people who purchase insurance, stocks and bonds and who make deposits in banks. The system in the U.S. is enmeshed in a peculiar web of regulatory measures. These measures are a veritable culture of different approaches blended with the hope that at least some will work.
In the U.S.A. deregulation is largely a cat and mouse game at circumventing the rules and partly an attempt at tiding over crises. The pressure on profits, the emergence of non-banking financial institutions and foreign banks overtaking American banks were some of the factors that led banks to circumvent the regulations. Inflationary pressures and higher nominal interest rates increased the opportunity value of depositors’ funds. Regulations prevented the traditional institutions from offering their services. The safety of the individual bank had to be ensured. Therefore competition was restricted.

**Deregulation in Japan**

Measures adopted in Japan to deregulate have stemmed largely from pressures external to the domestic banking sector. They have the hallmark of being governed by the logic of political struggle with the domestic and foreign pressure and players. Bankers clamored for greater freedom. A C.E.O. of one of the Japanese banks went to the extent of saying “Mr. Sakakibara, a Senior Deputy Director General of International Finance with the M.O.F. is stupid and that I would like to get rid of him”. But the M.O.F. views deregulation differently, “we do not want a big bang or shock therapy. We meant to have prudential controls, finances and somehow a public good and there must be sound surveillance”. A primary reason for the
rather slow pace of development is perhaps a lack of clarity at the policy level and no one is able to decide how reform of the financial system should proceed.

Should we adopt the British model of clearing and investment banks with no actual separation or the German Universal Banks protected by market practices or the bank holding companies operating in the U.S.A.? It takes time to decide the goal reform and M.O.F. is trying to avoid the situation of banks failing. Every country is groping for a system that is best for them. With hindsight and with all regulations in place, the N.P.A’s. of the Japanese banks totalled nearly 75 trillion Yen. This figure is an approximation. The recent failures of the Japanese and Korean banks and financial institutions make a mockery of regulations. No wonder the I.M.F. and the World Bank are chastising Japan and Korea for not heeding to their advice. The last 3 years have given a new edge to the whole question of deregulations. Under internal pressure and more particularly under American pressure in 1996, the then Japanese Prime Minister announced a package of measures described as the Big-Bang - It encompasses 5 areas namely, the bureaucracy, the National Budget, Economic Structure, Social Welfare and Educational Reforms.
In India, despite the recent events which exposed the existing supervisory system, there is no need to “re-invent the supervisory wheel” as the RBI Governor observed\textsuperscript{15}. What is needed is the strengthening of the system in terms of supervisory policies, i.e., while retaining the strength of the central monetary authority, the revamped system of supervision should be exclusively devoted to effective supervision.

As in other countries regulatory system in India also accords primacy to the protection of the depositors’ and investors’ interest. For this purpose, the RBI is statutorily vested with extensive powers of regulation and supervision of banks to ensure adherence to the various legal previsions and administrative directions or guidelines prescribed from time to time. With nationalisation, the PSBs have also been brought under the administrative and regulatory review of the government, in the process leading to a measure of duality of supervisory control over them.

According to the Narasimham Committee Report\textsuperscript{16} while regulation in terms of satisfying certain rules and norms of operation and supervision to

\textsuperscript{15} Kharak Singh Kaira, \textit{Need to give RBI more beeth – Rangarajan’}, The Business and Political Observer, Feb.11 (1994).

ensure compliance with such rules and norms is necessary and justified with
gards to the banks in India, this regulation and supervision has extended to
matters not directly connected with the depositors’ funds. Various aspects of
management of banks include matters of internal organisation, operational
procedures and administrative matters also have come within the purview of
regulation and supervisory control. There is hardly an aspect of operation and
management which is not covered. The system in consequence has become
over-regulated and over-administered and has placed an undue burden on the
supervisory authority. This degree of regulation and supervision has still not
been able to prevent a deterioration in the health of the banking system. The
reason for such deterioration is partly because of the administrative direction in
matters of assets deployment, lending and administered interest rates which has
led to banks receiving less than market related rates on their investments and
on a significant portion of their credit.\footnote{Ibid.}

The Committee believes that the task of supervision is to ensure
compliance with such prudential regulation – which is directly concerned with
the protection of depositor or investor’s interest. It is of the opinion that the
duality of control over the banking system between the RBI and the banking

\footnote{Ibid.}
division of the Ministry of Finance should end and that the RBI should be the primary agency for the regulation of the banking system.

Taking an overall view, the Committee recommended that while RBI would normally be the appropriate agency for regulation, its supervisory function should be separated from the more traditional central banking functions and that a separate agency which would be a quasi-autonomous banking supervisory board under the aegis of Reserve Bank should be set up.

In view of the widening and deepening of the financial sector and the emergence of many new types of financial institutions, the Committee proposed that the Board should have supervisory jurisdiction not merely over the banking system but also over the development of finance institutions, non-bank financial intermediaries and other para banking financial institutions. With the financial sector getting more diversified and more closely independent, there is great advantage in having a single integrated system of supervision so as to avoid segmentation of the market for supervisory purposes and the associated problem of inadequate co-ordination between different supervisory authorities covering the financial system.
The Government and RBI are understood to be working towards determining an optimal model for supervision of the Indian financial system\textsuperscript{18}. On the basis of this, the B.F.S. was constituted.

**Structure and function of Board for Financial Supervision**

In 1995 the B.F.S. was constituted under the aegis of RBI. The Board has been constituted for the effective supervision of the banks, financial institutions and non-banking financial companies. After the establishment of Board for financial supervision, the supervision of all India financial institutions was also taken up by the Board. The Board commenced on-site inspection of financial institutions from 1955 May on the basis of CAMEL\textsuperscript{19}. The Reserve Bank has started off-site surveillance system from 1999, under which the financial institutions are required to submit periodical returns to the RBI\textsuperscript{20}. The regulation and supervision of the financial institution is being done

\textsuperscript{18} *RBI supervisory board to be operational by year end*, Financial Express (Bombay) Oct.19, (1993). See Appendix VI.


by the financial institutions division of the Department of banking supervision of the RBI.

It may be point out in this context that reform of supervisory practices can be effective and successful, if supervision is viewed as a back-up support system for the banking industry. Banking supervision cannot be a substitute for prudent bank management. A strengthened supervisory system must be accompanied with an equally improved system of banks own internal control. The first line of defence against financial distress and banking crisis in the quality and character of management within the banks themselves. Strengthening supervision policies and a vigilant control system together can ensure protection of the safety and soundness of the banking system and reduce system risks.

*Basle Committee Recommendations*

Before anticipating the changes in the context of supervisory policies in a new liberalized environment, it is necessary to look at global developments. Increasingly there is a congruence of policies amongst various countries. The Basle recommendations were accepted by all Central Banks (1998):-
1. The watertight boundaries dividing the functional areas of financial institutions are breaking down and effective supervision in the future will need to demarcate clear responsibilities and objectives for each supervisory agency involved in the operational supervision of banks; equally important is the need for suitable legal framework.

2. Supervisors must be sure that banks have in place systems that accurately measure, monitor and control market risks.

3. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of business.

4. Banking supervisors must determine that banks have adequate policies that promote high ethical and professional standards in the financial sectors and prevent the banks from being used by criminal elements.

5. Supervisors would henceforth establish regular contact with bank managements and develop a thorough understanding of their operations.

6. Supervisors must be satisfied that each bank maintains an adequate record drawn up in accordance with consistent accounting
policies and practices that would enable the supervisors to obtain a true and fair practice of the financial condition of the banks and profitability of its business.

7. Supervisors must have adequate authority to take corrective measures when banks fail to meet prudential requirements or when there are regulatory violations.

8. Banking supervisors must require the local operation of foreign banks to be conducted with the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks to carry out consolidated supervision.

The RBI is in the process of remodeling itself and is fact moving in the direction of a supervisory note as defined above. There is a marked change in its perspective regarding banking developments. There is certainly a realization that banks are faced with problems associated with growing universalisation and the increasing internationalization of its operations\(^{21}\). The driving forces behind these changes are, continuing deregulation, heightened competition, and technological advances.

The regulators are keenly aware of the competitive pressures, and ever changing customer profile and the only way to reduce this pressure is to aggressively pursue growth with policy planning. The regulators are being forced to take note of the complexities of the banking business, innovations and the consequent need to improve risk management and controls. There is thus a growing awareness that a risk based supervision approach would be more efficient than a transaction based approach.

The RBI is fast moving towards the direction of risk based supervision. In fact, the RBI has appointed international consultants to develop an overall plan for moving towards risk based supervision, incorporating but international supervisory practices. There is a growing belief that supervisors can do much to promote sound risk management and provide banks with stronger incentives to manage and control risks. In course of time regulators will have to rely more on market discipline and ensure that customers and others have meaningful information about the level and nature of financial risks. All this provides continuing challenges for central bankers.

It is to be noted here that heavier supervision and regulation is no solution to


23 Ibid.
the problem. Relying less on governments and more on market forces is the logically determined answer to prepare banks for the new millennium.\(^{24}\)

A series of banking regulatory co-operation documents have been issued. The most noteworthy among these are the Bank Supervisors Concordat of 1975 and the revised version of 1982. These were followed by a supplement in 1990 and a normative version in 1992. The latest document in the series was brought out in 1996 and 29 recommendations made, with the sole aim of improving the bank’s supervision of international activities.\(^{25}\) Basically these relate to domestic and inter-country sharing information, as also problem areas and gaps in supervision. The timely communication of unusual findings and significant developments to the primary supervisors will permit their analysis and evaluation against other information. In particular, supervisors should share information on issues of risk management and internal control which would impact the control environment of entities in other jurisdictions.\(^{26}\)


\(^{26}\) Ibid.
In conclusion, banks must jealously guard their recently won freedom. The only way to ensure this is by avoiding deliberate mischief and more positively by proving themselves worthy of their new responsibilities. Greater the degree of supervision, lesser is the level of belief in the capacity of bankers to manage and take care of the institutions in their care\textsuperscript{27}.

Regulation and supervision are not a panacea, but they are necessary pillars to have a strong financial system and limit the damages caused by mismanagement and also to make macro-policies effective.

CHAPTER VII