Regulatory Insights into 2024[1]

(Special Address - delivered by Shri M. Rajeshwar Rao, Deputy Governor, Reserve Bank of India on March 30, 2024, at the India Investment Summit & Awards organised by Mint in Mumbai)

Good Evening,

It is indeed a pleasure to be here amidst this distinguished gathering. The theme of the summit, *'Rise of the Indian Spring',* is both contextual and inspiring, reflecting not just the rising trajectory and profile of the Indian economy, but also the sentiments prevailing within the country and across the world.

As a Regulator, our endeavour always is to promote a robust and resilient financial intermediation system with an appropriate regulatory and supervisory framework. During my address today, I therefore intend to share some perspectives on how are we building the enabling regulatory frameworks to prepare Indian financial system and entities to support the nation's growth aspirations as well as building guardrails for ensuring financial stability.

The technological developments and innovations, which we are currently witnessing hold great promise for the financial sector. They have immense potential to increase the reach of financial firms, enhance the range of product offerings and conveniences for customers, expand the ambit of finance to hitherto excluded segments with the added benefit of lower costs for delivering them. At the same time, we need to be alert to the possibilities that the new entrants into the financial services space, including FinTech firms, could significantly alter the universe of financial services providers. This could affect the degree of market concentration and competition and may give rise to new challenges.

[1] The inputs provided by Pradeep Kumar, Peshimam Khabeer Ahmed and Pramanshu Rajput are gratefully acknowledged.

Regulatory Principles

Regulations can be thought of as cornerstones for building trust, enabling integrity and ensuring stability in the financial sector. Regulations define the boundaries of industry conduct, while ensuring a fine balance between fostering innovation and safeguarding public interest.

Before I touch upon the specific areas of our potential focus going forward, I would like to outline a few guiding principles that usually guides us in deciding our regulatory approach. While each policy formulation focusses on addressing a specific set of requirements, having its own schema and flavour, policy makers should be guided by three broad guiding principles namely – Prudence, Proportionality and Proactiveness. Given the dynamics of the Indian financial landscape and the institutional set-up, one more principle relevant for us at the Reserve Bank is a "harmonised approach to regulations".

Prudence in Regulations

Prudence in financial regulations refers to being cautious and sensible in managing risks within the financial system. It involves ensuring that financial institutions maintain adequate capital, hold sufficient provisions and make sound financial decisions to prevent excessive risk-taking that could lead to instability or systemic failures in the financial system.

Time and again, episodes of crisis have demonstrated that lack of prudent behaviour by one or a few entities can impact not just the entity concerned but can potentially snowball into a systemic crises. Therefore, when risk management and prudence takes a back seat *vis-à-vis* growth ambitions, there is an onus on the regulator to ensure effective functioning of safety nets in the form of prudential regulations to preserve financial stability and protect larger interests.

A key aspect of the RBI's prudential approach to regulation is having strong processes for supervision and monitoring of banks and other regulated entities. Through this, RBI endeavours to have a thorough assessment of the entities' financial health, risk management practices, as well as compliance with regulatory requirements. This proactive approach is intended to help the RBI to identify potential vulnerabilities and address them promptly, thereby enhance the resilience of the financial system.

Proportionality in Regulations

The principle of proportionality is a concept we have flagged previously and implemented in some of our recent regulations. It has to be recognized that overregulation in any sector could lead to increased compliance costs affecting efficiency and innovation among the market players. Accordingly, the focus is on achieving a delicate equilibrium that addresses the critical concerns without imposing undue burden on the regulated entities.

The principle of proportionality is synonymous with a nuanced strategy to ensure that the intensity of regulations correspond with identified risks. Our policy measures such as the scale-based regulations for NBFCs, tiered regulations for UCBs and tailored regulations for differentiated banks, i.e., small finance banks and payments banks are reflective of this approach.

Proactiveness in Regulations

Adopting a pro-active approach to regulations is a necessity in current times. A forward-looking approach in regulation entails identifying and analysing emerging trends so as to proactively pre-empt any build-up of risks. Additionally, it facilitates the recognition of the evolving landscape and provides valuable inputs for regulators to accommodate new developments amid evolving challenges and uncertainties.

Being proactive also means remaining attuned to market innovations and global trends. Reserve Bank has always supported and encouraged responsible innovations. However, there is always the possibility of a trade-off between regulation and innovation. As regulators of an evolving financial landscape, we need to remain alert to the spawning of new ideas/ trends in the markets, try and understand their scale, assess their potential to disrupt the market and consider interventions where and if necessary. For example, Regulatory Sandbox is one such initiative where pilot programs can be tested in a controlled environment without any fallouts. This ensures that regulations evolve concomitantly with new products/ services rather than being pre-emptive or reactive to innovations.

Harmonised approach to Regulations

Indian financial system is characterised by different types of financial institutions. Many of these entities are niche players with varying risk profiles. Therefore, they require differentiated regulatory treatment. While recognising the need to allow for differentiated regulatory treatment, we are increasingly looking to adopt the approach of "same activity", "same risk", and "same regulations".

This approach enhances our oversight capabilities by providing a holistic view of the activity across the financial system. It allows for identification of systemic risks, monitoring of cross-sectoral linkages, and initiation of pre-emptive measures to address potential vulnerabilities. However, let me reiterate a point I had made earlier[2] that harmonisation does not mean prescribing uniform set of regulations. In fact harmonisation entails a risk-based perspective, wherein regulatory requirements are tailored to the specific risks associated with each type of financial entity and activity. The idea is that regulatory arbitrage can not be an option exercisable by the regulated entity.

While we remain guided by these principles in framing regulations, it needs to be emphasized that in any maturing economy, the regulations must eventually graduate from a rule-based approach to a principle-based approach. The Reserve Bank too has been endeavouring to adopt principle-based regulations which means regulator would focus on setting broad principles, thereby allowing for a nuanced approach to risk management by the regulated entities. It helps in balancing flexibility with achieving regulatory objectives. However, an

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[2] RBI Speech: No More a Shadow (of a) Bank - available at https://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1416

essential pre-requisite for the success of such an approach is a financial landscape which values discipline and compliance in both - letter and spirit. Else, the flexibility available under a principle-based mechanism might be misused. Therefore, in their own interest, the market players should support such regulatory endeavours through suitably strengthening their compliance culture and governance frameworks.

Emerging areas of Regulatory Focus

Now, let me focus on the emerging areas which are engaging our attention at present. These are not just limited to the growth of FinTechs but traverse across the spectrum of the financial services sector.

A few areas of the focus going forward would include issues of how to go about harnessing the benefits of technology, ensuring good customer service and conduct, enabling a strong governance and compliance framework within the regulated entities, reinforcing and fine-tuning existing prudential regulations and contain the risks from procyclicality in lending.

Harnessing the benefits of technology

The key area where a lot of work is underway is evaluating the use of technology in financial services and assessing how RBI as a regulator can harness the benefits of technology for greater public good. The foundation of the digital revolution of today has been built on the digitalisation push of Government of India and enabling regulations by the Reserve Bank. To give an example, the Financial Stability and Development Council - Sub Committee (FSDC-SC) had set up a Working Group in April 2016 to look into the granular aspects of FinTech and its implications so as to review and reorient the regulatory framework. Sequel that on the framework for peer to peer (P2P) lending was issued in April 2016. Further, guidelines for Account Aggregators were also introduced in September 2016. Moreover, the RBI established its Regulatory Sandbox in August 2019. All of us here are well aware about the transformation of payments space in India where we can be proud of the country's progress and prowess.

Post covid, digital economy had got a push and adaptation rates have increased multi-fold. This has brought up newer challenges, especially in digital lending products such as issues pertaining to coercive practices, dark patterns and excessive interest and other financial charges. To address some of these issues RBI issued digital lending guidelines in 2022 to regulate such practices. Further, when industry innovated through structures like loss default guarantees, RBI supported such initiatives by issuing suitable regulations in June 2023. Reserve Bank has thus strived to remain ahead of many of its global peers in nurturing fintech innovations by way of regulations to support them from time to time.

As I have alluded to previously[3] that with newer players entering the financial services space and disrupting the rules of the game, banks may become but one amongst host of entities competing to win customer's business. Therefore, the focus of the banks as well as regulators has to pivot from intermediation paradigm to marketplace paradigm. As the consumer preferences change, banking and financial services industry would have to reorient their business models, processes and products. To cater to this change, the RBI has started its groundwork on enhanced use of technology in banking such as use cases of artificial intelligence, digital ledgers, and so on. Let me also add here that technology brings its own set of challenges in the form of data protection, cyber security, and technology-induced frauds. These are in fact areas which are increasingly engaging the attention of regulators not just in India, but also at a global level.

Strengthening Customer Service and Conduct

You all may have noticed that there has been a renewed focus on strengthening the conduct related aspects of our regulated entities. Over the last one year we have issued instructions on the responsibilities of regulated entities employing

[3] Changing Paradigms in the Financial Landscape - available at https://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1397

recovery agents, strengthening of conduct regulations relating to pricing for loan related products, return of loan related security documents, addressing customer grievances related to reporting of credit scoring, among others. The recent announcement for lenders to provide their borrowers a Key Fact Statement (KFS), which will be issued shortly, is also an endeavour in this direction. These regulatory initiatives are expected to foster more responsible lending conduct in lending by REs.

These efforts on regulatory front are being complemented by suitable supervisory examination of the conduct of regulated entities to ensure fair, sound, efficient and transparent delivery of banking products and services.

As we further strengthen our approach towards addressing the concerns in framing and enforcing conduct-based regulations, the guiding philosophy would be to set out minimum regulatory expectations, with the option for entities to adopt higher standards depending upon their size, proportionality and customer focus. The regulations should ensure that customers are not misled by false promises and /or do not fall prey to unfair practices.

Improving Governance and Compliance & Risk Management

Another area of focus is on improving governance in the regulated entities. If one were to choose a single expression that epitomizes banking business, it has to be 'risk management'. This arises from multiple factors including bank's fiduciary role in respect of depositors, their critical interaction with real economy and their role in ensuring financial stability. A strong governance framework and a robust risk management system coupled with effective oversight by the Board and the senior management provides a greater degree of complementarity to the objectives of the Regulator.

Recognising that governance is the bedrock of a sound banking system, guidelines have been issued to address several operative aspects with regard to the composition of the Board and certain committees of the Board; age, tenure and remuneration of directors, *etc.* The Reserve Bank has also issued guidelines on supervisory expectations and for providing sufficient authority, resources and independence to three critical assurance functions of risk management, compliance and internal audit. The Boards are expected to take an active role in identifying/ approving the head of control and assurance functions and to establish clear lines of communication between the Board and these assurance functions. Continuous assurance vetted by an independent process should give succour to the institutions managements and not just the Regulators.

Reinforcing prudential regulations

RBI will continue to rationalise and wherever required, reinforce prudential regulations to ensure that banks recognise risks in their balance sheets and proactively manage them. For example given that our financial system is largely bank driven, to make it more resilient, RBI is introducing the expected credit loss (ECL) based framework for loan loss provisioning in banks which is a forwarding looking measure and leading identifier of stress. When issued, it is expected to transform assessment of credit risk and ensure that banks build sufficient buffers through the business cycle to be able to withstand any impacts of the cyclical downturns.

Further, to facilitate the diversification of credit risk and ensure market-based credit products, enabling regulatory frameworks have been put in place. The Directions on 'Securitisation of Standard Assets' issued on September 24, 2021, focusing on traditional securitisation structures. Further, with a view to develop a robust secondary market in stressed loans segment, a framework for securitization of stressed assets is on the unveil.

These reforms combined with the planned rollout of revised Basel III guidelines would provide a fillip to individual institution's capacity to support the credit needs of a growing economy and aid stability of the financial system.

Containing risks from pro-cyclical lending

Unbridled credit growth and any laxity in credit discipline or underwriting standards can be deleterious to the health of the financial entity concerned and if widespread, could give rise to systemic concerns.

From this perspective, in recent times, credit-offtake towards the consumer credit segment, especially the unsecured portfolio was observed to be quite substantial. Also, increasing dependency of NBFCs on bank borrowings was leading to regulatory concerns. Although asset quality at broader portfolio level was not exhibiting any major signs of stress, the consistent high credit growth reported in the above segments warranted regulatory intervention. Accordingly, certain quantitative and qualitative measures were undertaken from a macro-prudential perspective.

As regulators, we would want to ensure continuous vigil to mitigate risks emerging from both within and the periphery of the financial eco-system. For example, the digital lending guidelines issued by the Reserve Bank envisage that regulated entity undertakes the due diligence required for lending decisions even when the loan is being sourced through a lending service provider (LSP). The increased reliance of banks/NBFCs to identify and onboard borrowers through fintech partners should not mean lowering of underwriting standards and improper pricing of risks.

As a regulator and supervisor, we are examining the prevailing models and practices to see how best they could be leveraged for effective credit delivery, without compromising on risk management and prudential credit underwriting standards.

Concluding thoughts

I would like to stress here that what has been shared so far is an illustration of some of the key areas of regulatory focus. At the same time, there are several other aspects which continue to be on the regulatory radar. I am sure, through a collective, consultative and collaborative approach, it would be possible to frame appropriate set of policy measures to address the current and emerging challenges. Through this process, we should be able to build a stable and resilient financial system which shall meet the emerging needs of our country in an effective manner.

To conclude, let me emphasize once again that even as the financial landscape evolves and transforms, the underlying principles of good governance, robust risk management, effective compliance, customer protection and responsible business conduct will be increasingly relevant. A robust culture within the organisation which delivers financial services while embracing these principles will stand the system and the Institutions in good stead in the long run.

Namaskaar!!