Swaminathan J: Transforming financial landscapes - building resilience for economic stability

Keynote address by Mr Swaminathan J, Deputy Governor of the Reserve Bank of India, at the "Banking Transformation Summit - Season 2", organised by CNBC TV 18, Mumbai, 30 August 2024.

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Shri V Anantha Nageswaran, Chief Economic Advisor, Ms. Shereen Bhan, Managing Editor, CNBC TV 18, Ms. Latha Venkatesh, Executive Editor CNBC TV 18, Managing Directors & Chief Executive Officers of Banks and Non-Banking Financial Companies, leaders from the Fintech industry, distinguished guests, ladies, and gentlemen. A very good evening to all of you.

I am indeed delighted to be present here amongst you today to speak to you about the evolving banking landscape and the imperative need to build and sustain financial sector resilience if India is to achieve her aspirations of becoming a developed economy by 2047.

Importance of Financial Stability for Economic Growth

In a developing economy like India where private capital sources are limited, it is the banking system led financing model that comes to drive capital expenditure. The financial institutions, therefore, must maintain a sound financial position and strong balance sheet to support significant investments in infrastructure, industry, and innovation to fuel India's economic growth.

Thankfully, the financial health of both corporates and financial institutions is at its strongest level in decades. However, for sustaining this financial stability, the sector must prioritise financial and operational resilience alongside strong corporate governance. Further, banks and financial institutions need to strengthen their internal defence mechanisms, namely their assurance functions, cultivating a culture of compliance and fair play to ensure they retain the regulators', and more importantly, their customers' trust, at all times.

The Regulator is an enabler

Towards ensuring as well as preserving financial system stability, the Reserve Bank has been taking many definitive steps. Today, I would like to walk you all through a few of those enabling steps by the Reserve Bank.

Consultative approach to regulations

Globally, and especially in India, regulatory approaches have evolved to become more consultative, incorporating stakeholder feedback to develop balanced and effective regulations. The establishment of the Regulation Review Authority 2.0[1] in 2021 is a testament to RBI's commitment to streamline regulatory instructions, reduce compliance burden, and eliminate obsolete requirements, thus fostering a more efficient regulatory environment.

Having served as the Chair of the Advisory Group representing the industry at that time, I can personally attest to the regulator's responsiveness and sensitivity of the industry's concerns.

The implementation of various recommendations of RRA 2.0, coupled with the tireless efforts of the many Inter Departmental groups within Reserve Bank, has already led to the issuance of several harmonised, consolidated and updated Master Directions as well as withdrawal of over 1,000 circulars, apart from doing away with many regulatory and supervisory returns that have become redundant. These measures have significantly reduced the compliance burden on the regulated entities.

Towards ensuring good governance

History is replete with examples, both in India and abroad, as to how apparently successful business ventures quickly folded up due to poor governance and excessive greed. Therefore, the Reserve Bank has taken up this as one its focus areas to create awareness as well as to ensure adherence to good corporate governance practices. We are having more frequent and direct engagements with boards and top management of regulated entities as well as self-regulatory organisations. Through these dialogues, we share our concerns and priorities, and also strive to understand the challenges faced by the industry so that appropriate regulatory measures can be taken up.

Instilling a culture of compliance

An essential element for sustaining longevity of financial institutions is that a culture of compliance should prevail across the institution. The recent direct engagement with the Heads of Assurance functions as well as CFOs and Auditors is testimony to Reserve Bank's efforts to strengthen the internal defence mechanisms within our financial institutions. The independence and professional conduct of assurance functionaries, strongly backed by the Board and Top Management is essential to preserve this culture. I am glad to share with you that these initiatives have been very well received and I would like to thank the heads of our financial institutions for prioritising these initiatives in their organisations.

Industry is cyclical, this is the best time for prudent and decisive action

The financial industry, like any other sector, experiences cycles, and it is currently riding a high wave. Therefore, this is the right time to strengthen our institutions, enhancing their financial and operational resilience, and ensuring the long-term stability of our financial system. For those wondering why now, I emphasize that taking decisive action now, even if it means swallowing some bitter pills, is crucial to ensuring our financial institutions remain strong enough to support the national goal of becoming a developed economy by 2047.

It is not only important to simplify, harmonise and modernise but also to strengthen the regulatory and supervisory frameworks. Recent drafts on expected credit loss, project finance and liquidity coverage ratio exemplify this approach, aiming to reflect the needs of the industry while seeking to step up financial strength and stability.

Regulatory initiatives at promoting innovation

The RBI has undertaken several initiatives to support the development of digital public infrastructure and establish robust institutional frameworks, complemented by various policy measures aimed at enhancing the financial sector.

In 2019, the RBI introduced the 'Regulatory Sandbox' framework to provide a controlled environment for testing new financial products, services, or business models with real customers under regulatory oversight. This initiative facilitates collaboration among regulators, innovators, and financial service providers to assess the benefits and risks of emerging technologies. Since its inception, five cohorts of the sandbox have evaluated various ideas, with some proving to be feasible. To address situations where a product or service might fall under multiple financial sector regulators, an interoperable regulatory sandbox mechanism was introduced in 2022.

Complementing these efforts, the RBI has also organized global hackathons under the 'HaRBInger' initiative, which not only rewards winners generously but also provides stipends to shortlisted teams to support the prototyping of their solutions. The third edition, HaRBInger 2024, themed 'Innovation for Transformation,' invites solutions aimed at achieving 'Zero Financial Frauds' and creating 'Divyang Friendly' technologies.

In 2021, the RBI established the Reserve Bank Innovation Hub, which has been instrumental in advancing digital solutions, such as the fully digital and streamlined delivery of Kisan Credit Card (KCC) farm loans. Last year, it launched the pilot on Public Tech Platform, now renamed as ULI, designed to facilitate frictionless credit by enabling seamless flow of digital information to lenders. This platform features an open architecture and open Application Programming Interfaces (APIs), allowing financial sector participants to connect in a 'plug and play' model.

Regulator is a disruptor?

Having covered extensively on some of the initiatives that show cases the Reserve Bank as an enabler, I now would like to deal with some commentary of regulatory disruption that plays out in the market, thankfully only by a few, but it is still necessary for us to examine these.

One such narrative is that the regulator's actions may curb innovation or intrude excessively into business operations. There is also a feeling that Regulators must be more supportive of risk taking. What needs to be understood here is that while businesses can be adventurous and inclined to take on greater risks in pursuit of profits and investor returns, the regulators have the responsibility to protect depositor and customer interests and preserve financial stability. The role of the regulator is to establish guardrails or a balanced framework that encourages innovation while ensuring that risks are managed prudently.

For example, the Fintech platforms often provide customers with a seamless, efficient experience. By leveraging digital public infrastructure, these platforms can reach a wider customer base, including those who previously had limited access to financial services, thereby advancing financial inclusion and empowering underserved communities. They help reducing the cost of customer acquisition as well as transaction costs. Digitisation also allows banks and NBFCs to leverage data for greater insights into their customers requirements and behaviour which can be used for developing bespoke products apart from facilitating better risk management and compliance. Reserve Bank has been playing an encouraging role all through such initiatives.

However, this digital shift also introduces risks that must be properly identified, mitigated and managed to maintain a stable and secure financial ecosystem. The integration of disparate entities delivering a digital product, often results in complex structures with overlapping responsibilities. In many instances, the actual lender may not even be visible to the borrower, despite regulatory requirements for transparency. While fintech platforms drive innovation and revenues, credit, and operational risks along with consequent losses still primarily rest with the regulated lenders who collaborate with these platforms. This can create a disconnect between the service providers and those bearing the risks, leading to potential vulnerabilities for the individual lender as well as the financial system collectively.

For instance, while loan sanctioning and disbursement have become increasingly digital, effective collection and recovery still require a 'feet on the street' and empathetic approach. Many fintech platforms operate on a business model that involves extending small-value loans to customers often times with poor credit profiles. Unfortunately, this is often followed by aggressive recovery tactics, such as invading customers' privacy by accessing their contacts and personal data. These practices can seriously damage the reputation of the regulated lenders associated with these platforms. According to RBI regulations on outsourcing, even though a regulated entity may rely on third parties to perform certain activities, it remains ultimately accountable for the actions of its outsourced agents.

Another narrative I would like to address today is the perception that supervisors are overly eager to impose business restrictions, sometimes being portrayed as "trigger-happy." This misconception creates an impression that regulators are constantly looking for opportunities to clamp down on financial entities. We are sometimes asked by the media, "Who is next?"-implying that supervisory actions are routine in nature.

In reality, the decision to impose business restrictions is never taken easily. Strong supervisory actions are brought in only after careful onsite examinations, offsite data analysis, and extensive engagement with the regulated entities concerned for remediation, often times stretching into several months. Our primary goal is to ensure the stability and integrity of the financial system and not to hinder business operations. Out of the over 150 banks, over 9,000 non-banking financial companies as well as about 1,500 UCBs and other entities we supervise, stringent actions have been taken only in a handful of cases. That too, the most outlier in each category has been called out for such punitive actions so that it has a demonstrative effect on the rest of the industry. These measures are not about penalising but rather about protecting the interests of depositors, customers, and the broader financial system.

Despite these efforts, it is disheartening to see innovative misinterpretation of regulations. A recent case in point is that of Peer-to-Peer (P2P) lending regulations. The regulations as originally conceived, envisaged the platforms to function like online marketplaces connecting lenders with borrowers, with no credit risk borne by the platform and no co-mingling or retention of funds. However, the supervisory findings over the last one year revealed that some of these platforms adopted practices which were violative of both the letter and spirit of the regulations. Instructions issued earlier this month on P2P lending platforms are nothing new but are merely responding to the egregious violations observed in some cases. However, it is being presented in some quarters as if these 'new' regulations will 'kill' this industry. On the contrary, the differentiated licensing and light touch regulations that were granted to such entities are intended to help them set up a unique platform and not mimic banks or NBFCs that are more robustly capitalised and stringently regulated.

Conclusion

In conclusion, despite occasional brickbats, regulatory frameworks have been adopting a consultative approach which has helped shape a resilient financial sector. Over the past few decades, the Indian banking sector has navigated many challenges, including the Asian Financial Crisis, the Global Financial Crisis, and, most recently, the COVID-19 pandemic. Each time, the Indian financial sector has emerged stronger, thanks not only to the efforts and adaptability of the industry but also to the prudence and foresight of the regulatory framework.

All of us are partners in this journey towards realising the vision of Viksit Bharat 2047. However, dreams cannot be built on weak foundations, which is why it is the regulator's responsibility to set up both enablers and guardrails that will ensure we reach our destination safely and securely, and keep going.

Rather than viewing regulators as disruptors, I would urge industry to see the regulator as a partner towards a stable and prosperous financial ecosystem. It is therefore essential to appreciate the intent behind regulations, which are designed to protect customers, ensure fairness, and maintain stability. Let us channel our creativity into innovating products and services that not only comply with regulations but also enhance the overall health and inclusivity of the financial system. Let us focus on developing solutions that add genuine value, rather than seeking ways to bypass the rules or to do more of the same. By aligning innovations with regulatory objectives, we can build a stronger, more trustworthy financial sector that benefits everyone.

With this I thank the audience for their patient listening and CNBC TV 18 for inviting me to this summit and giving me an opportunity to address you today.

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[1] Previously, the Reserve Bank of India had set up a Regulations Review Authority (RRA) initially for a period of one year from April 1, 1999 for reviewing the regulations, circulars, reporting systems, based on the feedback from public, banks and financial institutions. RRA 2.0 was set up in May 1, 2021 and it submitted its report in June 2022.