Ruled Based Regulation vs Prudential Regulation

Group B

STRUCTURE

- Introduction
- Rules-based approach & its pros and cons
- Macro Prudential approach & its pros and cons
- International Practices
- Member's Country Practices
- Conclusion

Introduction

Rules based regulations are based on a set of detailed rules that govern individual regulated entities. Such rules enable firms to "tick-the-box" to ensure compliance. As opposed to it, **Macro Prudential regulations refer to a broad set of standards that are designed to mitigate the risk of the financial system as a whole.**

EXAMPLE:

An example for the difference between these approaches:

Inspection of Financial Institutions based on CAMELS / CAMELSC and the newly introduced concept of Risk Based Supervision.

Merits

1. Rule Based regulations:
- Clarity and certainty
- Transparency
- More operational than principles.

2. Macro Prudential regulation
- Forward looking
- Focuses on Systemic risks and issues.
- Flexibility and greater freedom & ability to respond to changing scenarios.
- Scalability
- Robustness

De-Merits

1. Rule Based..

- Backward looking
- High compliance costs
- Concentrates on Institution specific risks.
- Generally Pro-cyclic.
- Prone to Moral Hazard.

2. Macro Prudential Based..

- Politically, more challenging to implement.
- Supervision and enforcement more challenging
- Requires a greater degree of inter regulator and Government coordination both Domestic as well as International.
- Definitions of indicators of systemic risk/triggers/thresholds.

International Practices

- In some of the EMEs Macro Prudential instruments have been in use even before the crisis struck.
- Internationally, particularly in the developed economies, there is a visible shift towards Macro Prudential Regulation. In fact, international bodies like BIS, FSB, IMF all are emphasising on a shift to Macro Prudential regulation as a strong tool for reducing the probability of a similar occurrence in future. Some of the examples of initiatives in this area are:

Cont….International Practices

Country	Measures
United States	Dodd Frank Legislation.
European Union	Establishment of Macro prudential Authority of EU (2011)
South Africa	Adoption of Twin Peaks and formation of Financial Stability Oversight Committee
UK	Formation of FPC within BOE
India	Formation of FSDC having all the regulators and GOI as members. SEBI and RBI have separate systemic stability units.
Kenya	Formation of Financial Sector Forum, which brings together all the regulators and Government.

Member's Country Practices - UAE

- Kingdom of Saudi Arabia:

1. SAMA is regulator of the entire financial sector including markets
2. Introduction of Risk Based Supervision & issuing of related communications.

Member's Country Practices - Kenya

- Establishment of Domestic Financial Sector Regulators Forum.
- Establishment of Supervisory Colleges for banking groups with cross border operations.
- Adoption of Non – Holding operating company structure for Banking Groups to facilitate consolidated supervision.
- Established FSU within Research Department.
- Adoption of RBS framework.
- Signed MoU with other Central Banks in the East African Community to facilitate information sharing.
- Publication of Annual Financial Stability Reports.

Member's Country Practices – Sri Lanka

- Establishment of Financial System Stability Study Division within the Central Bank.
- Introduction of RBS in an advanced stage.
- Establishment of IRIC – Inter Regulatory Institution Council.

Member's Country Practices - India

- Macro Prudential measures have been a part of our regulatory and supervisory instruments along with the rule based measures.
- For Financial Conglomerates, RBS approach is now being used.
- FSDC under the chairmanship of Finance Minister has been established.
- Signing of MOU with foreign regulators.

Conclusion

- The cost to economy in dealing with such crisis is very large and even an enhanced level of capital may not provide a cover against a systemic crisis. Therefore, the only option is to minimise chances of their occurrence.
- Therefore, the way forward is to move towards Macro - Prudential supervision.