Indian Economy · GS - III

Why are systemically important financial institutions subjected to stricter prudential regulation? Analyse the role of additional capital requirements in reducing systemic risk.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 26/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

Answer Hint

Too-big-to-fail, systemic risk, capital adequacy, loss absorption, interconnectedness, Basel framework, financial stability, moral hazard

Model Answer

The Systemic Risk Problem

Systemically important financial institutions are banks whose failure can transmit financial distress across markets and economies. Their size, interconnectedness and complexity make their disruption potentially more damaging than the failure of ordinary institutions.

Rationale for Stricter Regulation

1. **Contagion prevention:** Interconnected banks are exposed to one another through lending, derivatives and payment systems. Failure of one institution can trigger liquidity shortages and losses elsewhere.

2. **Too-big-to-fail concerns:** Governments may feel compelled to rescue large banks to prevent wider financial collapse, creating moral hazard and encouraging excessive risk-taking.

3. **Cross-border exposure:** International operations can transmit financial instability across jurisdictions, requiring coordinated regulatory supervision.

Role of Additional Capital Buffers

1. **Loss absorption:** Additional Common Equity Tier 1 capital enables banks to absorb unexpected losses without immediately threatening depositors and creditors.

2. **Credit-cycle resilience:** Capital buffers help institutions withstand economic downturns and reduce the likelihood of sudden lending contraction.

3. **Market confidence:** Stronger capital positions can improve confidence among depositors, investors and counterparties.

4. **Regulatory discipline:** The Basel III framework and G-SIB requirements strengthen prudential standards for institutions with significant systemic footprints.

Limitations

Higher capital requirements may increase compliance costs and influence lending decisions. Moreover, capital buffers alone cannot address liquidity crises, poor governance or interconnected non-bank financial risks.

Conclusion

Additional capital requirements are an important defence against systemic banking crises, but they must operate alongside effective supervision, resolution mechanisms, liquidity regulation and international regulatory cooperation.