

## **A Theoretical Analysis of Depositor Discipline in Banking with reference to India**

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*In recent years, there is increasing emphasis on depositor discipline as a mechanism to augment Government oversight (discipline) of the financial sector, specifically depository institutions. Despite the abundance of empirical research on this score, limited theoretical analysis has been forthcoming on the issue. The paper develops a model that incorporates the twin features of depositor discipline and regulatory structure and examines the effects of several parameters on the optimal decision-making process of the bank. These findings are related to the on-going process of economic reforms in India.*

### **I Introduction**

Over the last two decades or so, both developed and developing countries alike have endured severe banking crises. The U.S. Savings and Loan (S & L) debacle in the early eighties, the Latin American banking crisis in the mid-eighties and more recently, the financial stress in Asian economies and subsequently in Argentina and Turkey are only a few examples. The costs of such crises have often been large, ranging from 3 per cent of GDP for the US S & L crisis to around 40-45 per cent of GDP for Thailand and Indonesia during the period 1997-1999 (World Bank 2001). At all times and, particularly, in order to avoid banking crises, authorities need to find ways to promote prudent behaviour by banks.

There are two primary ways of monitoring banks. The one traditionally employed in the banking industry is regulation and supervision of banks (Mishkin 2001). The other is corporate governance, which enables suppliers of finance to the bank assure themselves of getting a return on their investment. However, the fact that supervisory standards may be lax has been vividly illustrated in some of the crisis-

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