Reserve Bank of India

Discussion Paper

Large Exposures Framework and Enhancing Credit Supply through Market Mechanism

March 27, 2015

Background

A bank's exposure to its counterparties may result in concentration of its assets to a single counterparty or a group of connected counterparties. Internationally, concentration risk has been addressed by prescribing regulatory and statutory limits on exposures towards counterparties and various sectors of the economy. The Basel Committee on Banking Supervision (BCBS) too recognised the need for banks to measure and limit the size of large exposures in relation to their capital. In particular, in January 1991, the BCBS issued supervisory guidance on large exposures, viz., *Measuring and controlling large credit exposures*, in an attempt to increase convergence in the supervision of large exposures while recognising the scope for variation according to local conditions.

2. In a similar vein, the *Core Principles for Effective Banking Supervision* (Core Principle 19), published by BCBS in October 2006 (since revised in September 2012) prescribed that local laws and bank regulations set prudent limits on large exposures to a single borrower or a closely related group of borrowers. But neither the 1991 guidance nor the Core Principles have set out how banks should measure and aggregate their exposures to a single counterparty, nor explained which factors should be taken into account when considering whether separate legal entities form a group of connected counterparties. This resulted in considerable variation of practices across the globe including material differences in important aspects such as: scope of application; the value of large exposure limits; the definition of capital on which limits were based; methods for calculating exposure values; treatment of credit risk mitigation techniques; and whether certain types of exposures were subject to more lenient treatments.

3. Against this backdrop and in order to bring regulatory convergence in the area of large exposures, the BCBS has issued the Standards on '*Supervisory framework for measuring and controlling large exposures*' in April 2014. As per these BCBS standards, the sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties

must, at all times, not be higher than 25 percent of the bank's available eligible capital base, i.e., the effective amount of Tier 1 capital fulfilling the criteria defined in the Basel III Capital framework. The **Large Exposures (LE)** framework will be fully applicable from January 1, 2019.

4. The limits defined under the extant exposure norms in India, especially the exposure ceilings for a group of connected counterparties, are relatively liberal compared to the existing and revised BCBS guidelines in the matter. This has been pointed out previously in the IMF report "India: Financial Sector Assessment Program (FSAP)" of August 2013, as appended below:

The prudential framework in India is characterized by concentration limits that are significantly higher than international best practice and a too-general definition of connected counterparties. The default of a borrower or a group of connected borrowers can cause a serious loss to a banking group. The current large exposure limit is a maximum of 55 percent of a banking groups' capital.

5. In view of the above, it has been decided to gradually converge the current prudential norms prescribed by the Reserve Bank of India (RBI) on "banks' exposures" with the BCBS standards on '*Supervisory framework for measuring and controlling large exposures'* by January 2019. As no separate limits are envisaged for single and group borrowers under the Basel Standards and as the definition of regulatory capital against which exposure limits will be calculated is based only on Tier 1 capital as against the total capital funds (Tier 1 plus Tier 2 capital) as in vogue currently, the regulatory ceiling, as a percentage of capital, on banks' exposures to groups of connected counterparties will be reduced as per the proposals given in this **Discussion Paper (DP)**.

6. Incidentally, in the BCBS standards, counterparties connected through specific relationships or dependencies are referred to as a group of connected counterparties and must be treated as a single counterparty. These relationships and dependencies arise from two criteria, viz., (i) Control relationship and (ii) Economic Interdependence. While the control relationship criterion of the BCBS Standard is similar to the RBI's current norms on identification of 'Group' borrowers, the criterion of 'Economic Interdependence' is an additional requirement. Practical difficulties are envisaged in implementing this criterion in India in terms of information availability and also in view of the current stage of development

of financial markets and economy. Accordingly, the adoption of the **proposal to include 'Economic Interdependence' as a criterion merits wider discussion with all stakeholders.**

Similarly, the adoption of the "Look Through Approach" (LTA) contemplated by the Basel standards may pose practical difficulties which will need to be thoroughly discussed before implementation.

7. The detailed proposals on the new Large Exposures Framework are given in **Part A** of this DP.

8. In India, the corporates continue to predominantly depend on banks for their financial needs, instead of accessing the market. Notwithstanding the various steps taken by the government, Reserve Bank of India, and, various other regulators to augment alternative sources of credit flow to the economy, the desired results have not been visible. It is important to have alternate sources of funding for the corporate sector, both to finance growth, de-risk the balance sheets of banks as also to strengthen balance sheets of investors as well as issuers. The Reserve Bank considers it desirable that such large corporate groups should gradually start tapping the corporate bonds and commercial paper markets for meeting at least a part of their financing needs. RBI proposes to encourage large borrowers to raise a certain portion of their financing needs through the market mechanism. Proposals in this regard are given in **Part B** of this DP.

Part- A
Large Exposures Framework

1. Introduction

1.1 The existing risk-based capital framework may not be sufficient to fully mitigate the microprudential risk from exposures that are large compared to a bank's capital resources, and, therefore, needs to be supplemented with a simple 'Large Exposures (LE) Framework' that protects banks from traumatic losses caused by the sudden default of an individual counterparty or group of connected counterparties. Further, the LE Framework should also be designed to serve as a backstop to risk-based capital requirements, so that the maximum possible loss to a bank from a sudden failure of a single counterparty or group of connected counterparties does not endanger the bank's survival as a going concern. Another consideration while designing the LE Framework is that the prudential treatment of banks' large exposures should also contribute to the stability of the financial system in certain ways other than merely limiting the risk from large exposures. In this direction, another benefit envisaged from the LE Framework would be limiting the concentration risk arising from banks' indirect exposures to the shadow banking as well as various other financial market modules where direct exposure to a counterparty may not be normally visible but becomes apparent when a Look Through Approach (LTA) is applied.

2. Scope of application

2.1 Since the LE Framework is constructed to serve as a backstop to and complement the risk-based capital standards, it must apply at the same level as the risk-based capital requirements are to be applied, that is, a bank shall comply with the LE norms at two levels:

(a) the consolidated ("Group") level, after consolidating the assets and liabilities of its subsidiaries / joint ventures / associates (including overseas operations through bank's branches) etc., except those engaged in insurance and any non-financial activities; and

(b) the standalone ("Solo") level (including overseas operations through branches), which should measure the exposures to a counterparty based on its standalone capital strength and risk profile.

2.2 The application of the LE framework at the consolidated level implies that a bank must consider exposures, of all the banking group entities (including overseas operations through branches and subsidiaries) under regulatory scope of consolidation, to counterparties and

compare the aggregate of those exposures with the banking group's eligible consolidated capital base.

2.3 This Framework is applicable only for exposure to a bank's counterparties and does not address other types of concentration risks such as sectoral exposures. As such, the extant instructions contained in the RBI Master Circular on Exposure Norms will continue to be applicable, except to the extent superseded by the provisions of this Framework.

3. Scope of counterparties and exemptions

3.1 The **current exposure norms** prescribed by RBI do not apply to the following types of borrowers/entities:

(a) Rehabilitation of Sick/Weak Industrial Units

The ceilings on single/group exposure limits are not applicable to existing/additional credit facilities (including funding of interest and irregularities) granted to weak/sick industrial units under rehabilitation packages.

(b) Food credit

Borrowers, to whom limits are allocated directly by the Reserve Bank for food credit, are exempt from the ceiling.

(c) Guarantee by the Government of India

The ceilings on single /group exposure limit are not applicable where principal and interest are fully guaranteed by the Government of India.

(d) Loans against Own Term Deposits

Loans and advances (both funded and non-funded facilities) granted against the security of a bank's own term deposits may not be reckoned for computing the exposure to the extent that the bank has a specific lien on such deposits.

(e) Exposure on NABARD

The ceiling on single/group borrower exposure limit is not applicable to exposure assumed by banks on NABARD. The individual banks are free to determine the size of the exposure to NABARD as per the policy framed by their respective Board of Directors. However, there is no exemption from the prohibitions relating to investments in unrated non-SLR securities

prescribed in terms of the Master Circular on Prudential Norms for Classification, Valuation and Operations of Investment Portfolio by Banks, as amended from time to time.

3.2 Under the **proposed LE Framework**, a bank's exposure to all its counterparties and groups of connected counterparties will be considered for exposure limits except certain exemptions. The **exposures that are proposed to be exempted** from the Framework are listed below:

a. Central Government;
b. Reserve Bank of India;
c. Exposures guaranteed by, or secured by financial instruments issued by Central Government, to the extent that the eligibility criteria for recognition of the credit risk mitigation (CRM) are met in terms of paragraph 8.7 of this DP.
d. Intra-day interbank exposures;
e. Intra-group exposures, which will continue to be governed by the RBI circular DBOD.No.BP.BC.96/21.06.102/2013-14 dated February 11, 2014 'Guidelines on Management of Intra-Group Transactions and Exposures';
f. Banks' clearing activities related exposures to Qualifying Central Counterparties (QCCPs), till further notification as detailed in paragraphs 11.I of this DP.

3.3 Thus, the exemptions currently available to exposures arising on account of Rehabilitation of Sick/Weak Industrial Units and Food Credit as well as exposures to NABARD will not be available under the LE Framework. Further, all exempted exposures must be reported by a bank as specified in paragraph 4.2 below, if these exposures meet the criteria for definition of a 'Large exposure' as per para 4.1 below.

3.4 In addition, if a bank has an exposure to an exempted entity which is hedged by a credit derivative, the bank will have to recognise an exposure to the counterparty providing the credit protection as prescribed in paragraphs 8.14- 8.15, notwithstanding the fact that the original exposure is exempted.

3.5 **Exposures to RNBCs and NBFCs:** Banks' exposures towards RNBCs and NBFC counterparties will be governed by exposure limits prescribed in paragraphs 11.II of this DP.

3.6 **Exposures of G-SIBs and D-SIBs to other G-SIBs and D-SIBs:** Mutual exposures among G-SIBs and D-SIBs will be governed by exposure limits prescribed in paragraphs 11.III of this DP.

4. Definition of a large exposure and regulatory reporting

4.1. Under the LE Framework, a large exposure is defined as the sum of all exposure values of a bank to a counterparty or a group of connected counterparties (as defined in paragraph 7 below), if it is equal to or above 10 percent of the bank's eligible capital base, i.e., Tier 1 capital (as defined in paragraph 5.2 below). For this purpose, the exposure values must be measured as specified in paragraphs 8, 9 and 10 of this DP.

4.2. Banks will be required to report to the Reserve Bank of India, Department of Banking Supervision, Central Office, (DBS, CO) the exposure values before and after application of the credit risk mitigation techniques, as per the reporting template given in **Appendix I** to this DP. For the treatment of the Credit Risk Mitigation techniques, a reference may be made to paragraphs 8.7 – 8.15 of this DP. The reporting, inter-alia, will include the following :

(i) all exposures with values equal to or above 10 percent of the bank's eligible capital (i.e., meeting the definition of a large exposure as per para 4.1 above);

(ii) all other exposures with values measured without the effect of credit risk mitigation equal to or above 10 percent of the bank's eligible capital;

(iii) all the exempted exposures (except intraday inter-bank exposures) with values equal to or above 10 percent of the bank's eligible capital;

(iv) their 20 largest exposures included in the scope of application, irrespective of the values of these exposures relative to the bank's eligible capital base.

5. The Large Exposure limits

5.1 Under the **current exposure norms**[1], there are separate regulatory ceilings on single and group exposures of a bank, as given below:

> *(a)The exposure ceiling limits are fixed at 15 percent of capital funds in case of a single borrower and 40 percent of capital funds in the case of a borrower group. The capital funds for the purpose comprise of Tier I and Tier II capital as defined under capital adequacy standards. Credit exposure to a single borrower is allowed to*

[1] Master Circular on 'Exposure Norms' dated July 1, 2014 as updated from time to time.

exceed the exposure norm of 15 percent of the bank's capital funds by an additional 5 percent (i.e. up to 20 percent) provided the additional credit exposure is on account of extension of credit to infrastructure projects. Similarly, credit exposure to borrowers belonging to a group can exceed the exposure norm of 40 percent of the bank's capital funds by an additional 10 percent (i.e., up to 50 percent), provided the additional credit exposure is on account of extension of credit to infrastructure projects.

(b) In addition to the exposure permitted as above, banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower (single as well as group) up to a further 5 percent of capital funds subject to the borrower consenting to the banks making appropriate disclosures in their Annual Reports.

(c) With effect from May 29, 2008, the exposure limit in respect of single borrower has been raised to twenty five percent of the capital funds, only in respect of Oil Companies which were issued Oil Bonds (which do not have SLR status) by Government of India. In addition to this, banks may in exceptional circumstances, consider enhancement of the exposure to the Oil Companies up to a further 5 percent of capital funds.

5.2 **Under the proposed LE Framework**, the sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties (as defined in paragraph 7 of this DP) must not be higher than 25 percent of the bank's available eligible capital base at all times. The eligible capital base for this purpose is the effective amount of Tier 1 capital fulfilling the criteria defined in paragraph 4 along with relevant Annexes of the Master Circular on 'Basel III Capital Regulations' dated July 1, 2014 as updated from time to time. Further, the exposures must be measured as specified in paragraphs 8 -10 of this DP.

5.3 A snapshot of the extant and proposed LE limits is given below:

A. Current Exposure Limit for a Single Counterparty		
(i)	General Exposure Limit	15 % of Capital Funds (Tier 1 + Tier 2 capital)
(ii)	Additional exposure on account of extension of	5% of Capital Funds (Tier 1

	credit to Infrastructure projects	+ Tier 2 capital)
(iii)	Additional exposure on Board discretion	5% of Capital Funds (Tier 1 + Tier 2 capital)
(iv)	Maximum exposure permissible to a single borrower	25% of Capital Funds (Tier 1 + Tier 2 capital)
B. Current Exposure Limit for a Group of Connected Counterparties		
(i)	General Exposure Limit	40 % of Capital Funds (Tier 1 + Tier 2 capital)
(ii)	Additional exposure on account of extension of credit to Infrastructure projects	10% of Capital Funds (Tier 1 + Tier 2 capital)
(iii)	Additional exposure on Board discretion	5% of Capital Funds (Tier 1 + Tier 2 capital)
(iv)	Maximum exposure permissible to a Group of Connected Counterparties	55% of Capital Funds (Tier 1 + Tier 2 capital)
C. Proposed LE Limit for a Single Counterparty		
	LE limit to a single counterparty	25% of Tier 1 Capital
D. Proposed LE Limit for a Group of Connected Counterparties		
	LE limit to group of connected counterparties	25% of Tier 1 Capital

5.4 However, the above LE limit will not be applicable in cases of counterparties mentioned in paragraph 11 of this DP. In such cases, limits prescribed in the respective sub-paras of paragraph 11 will apply.

5.5. Any breach of the above LE limits should be under exceptional conditions only. The same should be reported to RBI (DBS, CO) immediately and rectified at the earliest but not later than a period of 30 days from the date of the breach.

6. Implementation date and transitional arrangements

6.1 All aspects of the LE Framework must be implemented in full by January 1, 2019. Banks must gradually adjust their exposures to abide by the LE limit with respect to the eligible capital base (effective amount of Tier 1 capital) prescribed in this circular by that date. Banks should avoid taking any additional exposure in cases where their exposure is at or above the exposure limit prescribed under this Framework.

6.2 Under the **proposed LE framework**, banks will get additional headroom for taking exposures towards single name counterparties. However, the exposure ceilings towards groups of borrowers will be significantly reduced vis-à-vis the present exposure ceilings. In order to examine the issues arising from such changes, a study was carried out taking into account the capital funds available with all banks in India and exposure headroom available with them under the current and proposed exposure norms. Another study was conducted by taking into account, the 20 largest exposures of 10 largest banks towards their groups of connected counterparties. A brief description of the outcome of the study is given in **Appendix II** to this DP.

6.3 Although banks in India have currently been allowed a maximum group exposure limit of 55 percent of their capital funds, it is observed from the study of 20 largest group exposures of 10 largest banks that the actual average group exposure of banks is only 10.60 percent of the capital funds. Moreover, out of 200 cases, the exposure exceeds the primary group exposure limit of 40 percent of Capital Funds only in one case and that too by only 3 percent of the Capital Funds. Further, when these exposures are measured against the proposed LE limit of 25 percent of Tier I Capital, only 10 percent of the exposures (20 out of 200 cases) exceed the proposed ceiling, while the average exposure remains at 14.75 percent of the banks' Tier I capital. It is also observed that the said 20 exposures which exceed the proposed LE limit pertain to seven industrial houses and four oil PSUs which have adequate funding capabilities from retained earnings or corporate bonds market. In view of the foregoing and also on account of the higher Tier I requirements under the Basel III Capital regulations which will significantly enhance the Tier 1 Capital base of the banks by April 2019, the banks in India are not likely to face any material difficulty in complying with the proposed LE Framework while maintaining their current level of exposures to the groups of borrowers/connected counterparties.

6.4 In view of the foregoing, the Boards of the respective banks may devise a smooth, non-disruptive transition plan in respect of the existing exposures to their single as well as the groups of borrowers which are currently in excess of the proposed LE limit in order to bring those exposures in compliance with the LE Framework by January 1, 2019 and, in exceptional cases, latest by April 1, 2019. Such transition may be by way of either reducing the exposure or by increasing the eligible capital base or both.

6.5 Banks should start reporting their large exposures as per paragraphs 4.2 and 5.5 of the DP from April 1, 2015.

7. Definition of connected counterparties

7.1. In terms of the **extant RBI Master Circular** on "Exposure Norms", a group of connected counterparties is defined as below:

> *a) The concept of 'Group' and the task of identification of the borrowers belonging to specific industrial groups is left to the perception of the banks/financial institutions. Banks/financial institutions are generally aware of the basic constitution of their clientele for the purpose of regulating their exposure to risk assets. The group to which a particular borrowing unit belongs, may, therefore, be decided by them on the basis of the relevant information available with them, the guiding principle being commonality of management and effective control. In so far as public sector undertakings are concerned, only single borrower exposure limit is applicable.*
>
> *b) In the case of a split in the group, if the split is formalised the splinter groups are to be regarded as separate groups. If banks and financial institutions have doubts about the bona fides of the split, a reference can be made to RBI for its final view in the matter to preclude the possibility of a split being engineered in order to prevent coverage under the Group Approach.*

7.2 Under the **proposed LE Framework**, a group of counterparties must be treated as a single counterparty, if their specific relationships or dependencies are such that, were one of the counterparties to fail, all of the counterparties would very likely fail. In this case, the sum of the bank's exposures to all the individual entities included within such a group of connected counterparties will be subject to the LE limit and to the regulatory reporting requirements as specified above.

7.3 Two or more natural or legal persons shall deemed to be a group of connected counterparties, if at least one of the following criteria is satisfied:

(a) **Control relationship**: one of the counterparties, directly or indirectly, has control over the other(s).

(b) **Economic interdependence**: if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties.

7.4 Banks must assess the relationship amongst counterparties with reference to 7.3 (a) and (b) above in order to establish the existence of a group of connected counterparties. In assessing whether there is a control relationship between counterparties, banks must automatically consider that criterion 7.3 (a) is satisfied if one entity owns more than 50 percent of the voting rights of the other entity. In addition, banks must assess connectedness between counterparties based on control using the following criteria:

a. Voting agreements (e.g., control of a majority of voting rights pursuant to an agreement with other shareholders);
b. Significant influence on the appointment or dismissal of an entity’s administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity’s voting rights;
c. Significant influence on senior management, e.g., an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g., through consent rights over key decisions).

7.5 Banks are also expected to refer to criteria specified in the extant accounting standards for further qualitative guidance when determining control.

7.6 Where control has been established based on any of the above criteria, a bank may still demonstrate to the Reserve Bank, in exceptional cases, that such control does not necessarily result in the entities concerned constituting a group of connected counterparties e.g., existence of control between counterparties due to specific circumstances and corporate governance safeguards.

7.7 **Criteria for Economic Interdependence:** Presence of one or more of the following qualitative criteria will qualify two or more counterparties for having economic interdependence. These are the minimum criteria which a bank must examine while establishing connectedness based on economic interdependence between its counterparties:

a. A substantial (50 percent or more) portion of one counterparty's gross receipts or gross expenditures (on an annual basis) deriving from transactions with the other counterparty (eg the owner of a residential/commercial property and the tenant who pays a significant part of the rent);

b. Full or partial guarantee of exposure of one counterparty by another counterparty, a counterparty having obligation to assume liability of exposure of another counterparty by any other means, and where the exposure is so significant that the guarantor is likely to default if a claim occurs;
c. A significant part of sales of one counterparty's production/output to another counterparty, which cannot easily be replaced by other customers;
d. In cases of loans extended by one counterparty to another, the expected source of funds to repay each loan being the same and the debtor counterparty not having another source of income from which the loan can be fully repaid;
e. Financial problems of one counterparty are likely to cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;
f. The insolvency or default of one counterparty likely to be associated with the insolvency or default of the other(s);
g. The funding problems of one counterparty is likely to spread to another due to a one-way or two-way dependence by them on the same main funding source and non-availability of alternative source of fund in the event of the common provider's default.

7.8 There may, however, be circumstances where some of the above criteria do not automatically imply an economic dependence that results in two or more counterparties being connected. In such cases, if a bank can demonstrate to the RBI that a counterparty, which is economically closely related to another counterparty, may overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time period, the bank need not combine these counterparties to form a group of connected counterparties.

7.9 There may be cases where a thorough investigation of economic interdependencies will not be proportionate to the size of the exposures. Therefore, banks will be expected to necessarily identify possible connected counterparties on the basis of economic interdependence only in cases where the sum of all exposures to one individual counterparty exceeds 5 percent of the eligible capital base.

7.10 Where two (or more) entities not exempted in terms of paragraphs 3.2 (a), (b) and (c), and not otherwise connected, but controlled by or/and economically dependent on an entity

exempted in terms of paragraphs ibid, they need not be deemed to constitute a group of connected counterparties. For example, two unconnected Government owned PSUs will not form a group of connected counterparties.

7.11 As stated in the paragraph 6 of the introductory 'Background' of this DP, it is the intent of the Reserve Bank that proposals on 'Economic interdependence' criteria (paragraphs 7.7 – 7.9 above) for establishing relationship or dependencies among a group of counterparties for the purpose of treating them as a single counterparty, will be considered for adoption or otherwise, only after wider discussion with all stakeholders and may not be made mandatory at the outset.

8. **Values of exposures**

8.I. General measurement principles

8.1 In terms of the **extant RBI Master Circular** on Exposure Norms, *an exposure shall include credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). The sanctioned limits or outstandings, whichever are higher, shall be reckoned for arriving at the exposure limit. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure.*

8.2 Under the **proposed L E Framework**, an exposure to a counterparty will constitute both on and off-balance sheet exposures included in either the banking or trading book and instruments with counterparty credit risk.

8.II. Definitions of exposure values under the LE Framework

8.3 **Banking book on-balance sheet non-derivative assets:** The exposure value should be defined as the accounting value of the exposure and gross of specific provisions.

8.4 **Banking book and trading book OTC derivatives (and any other instrument with counterparty credit risk)**: The exposure value for instruments which give rise to counterparty credit risk and are not securities financing transactions, should be the exposure at default according to the 'Standardised Approach – Counterparty Credit Risk (SA-CCR)'[2], which are being developed by the RBI. . Till the time the guidelines in the matter are

[2] See BCBS, March 2014, The Standardised Approach for measuring counterparty credit risk exposures at http://www.bis.org/publ/bcbs279.htm

finalised, theextant instructions as prescribed by the Reserve Bank for the counterparty credit risk in the Master Circular – Basel III Capital Regulation dated July 1, 2014, should be adhered to for this purpose.

8.5 Securities financing transactions (SFTs): Banks should use the method they currently use for calculating their risk-based capital requirements against SFTs.

8.6 **Banking book "traditional" off-balance sheet commitments**: For the purpose of the LE framework, off-balance sheet items will be converted into credit exposure equivalents through the use of credit conversion factors (CCFs) by applying the CCFs set out for the standardised approach for credit risk for risk-based capital requirements, with a floor of 10 percent.

8.III. Eligible credit risk mitigation (CRM) techniques

8.7 Eligible credit risk mitigation techniques for LE Framework purposes are those that meet the minimum requirements and eligibility criteria for the recognition of unfunded credit protection[3] and financial collateral that qualify as eligible financial collateral under the standardised approach for risk-based capital requirement purposes.

8.8 Other forms of collateral that are only eligible under the Internal-ratings based (IRB) approach (receivables, commercial and residential real estate and other collateral) are not eligible to reduce exposure values for LE Framework purposes.

8.9 A bank must recognise an eligible CRM technique in the calculation of an exposure whenever it has used this technique to calculate the risk-based capital requirements, provided it meets the conditions for recognition under the LE framework.

8.10 **Treatment of maturity mismatches in CRM :** In accordance with provisions set out in the paragraphs 5.17 and 7 of 'Master Circular – Basel III Capital Regulations', hedges with maturity mismatches will be recognised only when their original maturities are equal to or greater than one year and the residual maturity of a hedge is not less than three months.

8.11 If there is a maturity mismatch in respect of credit risk mitigants (collateral, on-balance sheet netting, guarantees and credit derivatives) recognised in the risk-based capital requirement, the adjustment of the credit protection for the purpose of calculating large

[3] Unfunded credit protection refers collectively to guarantees and credit derivatives the treatment of which is described in paragraphs 5.17 & 7.5 respectively (The standardised approach – credit risk mitigation) of the Master Circular - Basel III Capital Regulations dated July 1, 2014.

exposures will be determined using the same approach as in the risk-based capital requirement[4].

8.12 **On-balance sheet netting:** Where a bank has in place legally enforceable netting arrangements for loans and deposits, it may calculate the exposure values for LE purposes according to the calculation it uses for capital requirements purposes – i.e., on the basis of net credit exposures subject to the conditions set out in the approach to on-balance sheet netting in the risk-based capital requirement[5].

8.IV. Recognition of CRM techniques in reduction of original exposure

8.13 Under **the extant exposure norms of RBI**, no credit risk mitigation technique, except the bank's own fixed deposits are allowed for reducing a bank's exposures to counterparty. Under the LE Framework, a bank may reduce the value of the exposure to the original counterparty by the amount of the eligible CRM technique (except for cases mentioned in paragraph 8.15 below) recognised for risk-based capital requirements purposes. This recognised amount is:

a. the value of the protected portion in the case of unfunded credit protection;
b. the value of the collateral adjusted after applying the required haircuts, in the case of financial collateral when the bank applies the comprehensive approach[6]. The haircuts used to reduce the collateral amount are the supervisory haircuts under the comprehensive approach. Internally modelled haircuts must not be used.

8.V. Recognition of exposures to CRM providers

8.14 A bank may reduce its exposure to the original counterparty on account of an eligible CRM instrument provided by another counterparty (CRM provider) with respect to that exposure. However, in all such cases, it must also recognise an exposure to the CRM provider. The amount assigned to the CRM provider will be the amount by which the exposure to the original counterparty is reduced (except in the cases defined in paragraph 8.15 below).

8.15 When the credit protection takes the form of a credit default swap (CDS) and either the CDS provider or the referenced entity is not a financial entity, the amount to be assigned to

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[4] Refer to the Master Circular on Basel III Capital Regulations.
[5] Paragraph 7.4 of the Master Circular on Basel III Capital Regulation.
[6] Paragraph 7.3.4 of Master Circular on Basel III Capital Regulations.

the credit protection provider is not the amount by which the exposure to the original counterparty is reduced but will be equal to the counterparty credit risk exposure value calculated according to the Standardised Approach – Counterparty Credit Risk (SA-CCR)[7], once the guidelines in the matter are finalised by the Reserve Bank. Till such time, the banks may follow the extant method as prescribed by Reserve Bank for the counterparty credit risk in the Master Circular – Basel III Capital Regulation dated July 1, 2014.

For the purpose of this paragraph, financial entities comprise:

i. regulated financial institutions, defined as a parent and its subsidiaries where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international norms. These include, but are not limited to, prudentially regulated insurance companies, broker/dealers, banks, thrifts and futures commission merchants; and

ii. unregulated financial institutions, defined as legal entities whose main business includes: the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitisation, investments, financial custody, central counterparty services, proprietary trading and other financial services activities identified by supervisors.

8.VI. Calculation of exposure value for Trading Book positions

8.16 A bank must add any exposures to a counterparty arising in the trading book to any other exposures to that counterparty that lie in the banking book to calculate its total exposure to that counterparty. The exposures considered here correspond to concentration risk associated with the default of a single counterparty for exposures included in the trading book. Therefore, a bank's exposures to financial instruments issued by counterparties not exempted under this Framework will be governed by the LE limit, but concentrations in a particular commodity or currency will not be.

8.17 The exposure value of straight debt instruments and equities will be equal to the accounting value of the exposure in terms of our 'Master Circular - Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks'.

[7] See BCBS, March 2014, The Standardised Approach for measuring counterparty credit risk exposures at http://www.bis.org/publ/bcbs279.htm

8.18 Instruments such as swaps, futures, forwards and credit derivatives[8] must be converted into positions following the risk-based capital requirements[9]. These instruments should be decomposed into their individual legs. Only transaction legs representing a bank's exposures to the counterparty within the scope of the large exposures framework should be considered[10] for calculating a bank's total exposure to that counterparty.

8.19 In the case of credit derivatives that represent sold protection, the exposure will be to the referenced name, and it will be the amount due in case the respective referenced name triggers the instrument, minus the absolute value of the credit protection[11]. For credit-linked notes (CLNs)[12], the protection seller bank will be required to consider its positions both in the bond of the note issuer and in the underlying referenced by the note. For positions hedged by credit derivatives, see paragraphs 8.22 to 8.25.

8.20 The measures of exposure values of options under this framework differ from the exposure value used for risk-based capital requirements. The exposure value of option under this framework will be based on the change(s) in option prices that would result from a default of the respective underlying instrument. The exposure value for a simple long call option would therefore be its market value and for a short put option would be equal to the strike price of the option minus its market value. In the case of short call or long put options, a default of the underlying would lead to a profit (i.e., a negative exposure) instead of a loss, resulting in an exposure of the option's market value in the former case and equal the strike price of the option minus its market value in the latter case. The resulting positions in all cases should be aggregated with those from other exposures. After aggregation, negative net exposures shall be treated as zero.

8.21 Exposure values of banks' investments in transactions (i.e., index positions, securitisations, hedge funds or investment funds) must be calculated applying the same rules as for similar instruments in the banking book (see paragraphs under 9.II).

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[8] CDS is the only credit derivative allowed under our extant guidelines.

[9] Annex 7 and Annex 9 of Master Circular on Basel III Capital Regulations.

[10] A future on stock X, for example, is decomposed into a long position in stock X and a short position in a risk-free interest rate exposure in the respective funding currency, or a typical interest rate swap is represented by a long position in a fixed and a short position in a floating interest rate exposure or vice versa.

[11] In the case that the market value of the credit derivative is positive from the perspective of the protection seller, such a positive market value would also have to be added to the exposure of the protection seller to the protection buyer (counterparty credit risk; see paragraph 8.4 of this discussion paper). Such a situation could typically occur if the present value of already agreed but not yet paid periodic premiums exceeds the absolute market value of the credit protection.

[12] CLNs are not permitted to be issued by banks in India under the extant RBI guidelines.

8.VII. Offsetting long and short positions in the trading book

8.22 **Offsetting between long and short positions in the same issue:** Banks may offset long and short positions in the same issue (two issues are defined as the same if the issuer, coupon, currency and maturity are identical). Consequently, banks may consider a net position in a specific issue for the purpose of calculating a bank's exposure to a particular counterparty.

8.23 **Offsetting between long and short positions in different issues:** Positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of the same seniority.

8.24 Similarly, for positions hedged by credit derivatives, the hedge may be recognised provided the underlying of the hedge and the position hedged fulfil the provision of paragraph 8.22 above (the short position is junior or of equivalent security to the long position).

8.25 In order to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, "Equity", "Subordinated Debt" and "Senior Debt").

8.26 For those banks that find it excessively burdensome to allocate securities to different buckets based on relative seniority, they should not recognise offsetting of long and short positions in different issues relating to the same counterparty in calculating exposures.

8.27 In addition, in the case of positions hedged by credit derivatives, any reduction in exposure to the original counterparty will correspond to a new exposure to the credit protection provider, following the principles underlying the substitution approach stated in paragraphs 8.13 & 8.14..

8.28 **Offsetting short positions in the trading book against long positions in the banking book:** Netting across the banking and trading books is not permitted.

8.29 **Net short positions after offsetting**: When the result of the offsetting is a net short position with a single counterparty, this net exposure need not be considered as an exposure for the purpose of LE Framework.

9. Treatment of specific exposure types

9.1 This section covers exposures for which a specific treatment is deemed necessary.

9.I. Interbank Exposures

9.2 In addition to the single and group borrower limits, RBI has also prescribed specific instructions on banks' exposures towards Call Money market and Inter-bank liabilities.

9.2.1 The **extant borrowing and lending limits in Call Money market** for Scheduled Commercial Banks (SCBs) are given below

Borrowing Limit	*Lending Limit*
On a fortnightly average basis, borrowing outstanding should not exceed 100 per cent of capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 per cent of their capital funds on any day, during a fortnight.	*On a fortnightly average basis, lending outstanding should not exceed 25 per cent of their capital funds. However, banks are allowed to lend a maximum of 50 per cent of their capital funds on any day, during a fortnight.*

9.2.2 The **current Prudential Limits for Inter-Bank Liabilities (IBL)** are given below:

(a) The IBL of a bank should not exceed 200% of its networth as on 31st March of the previous year. However, individual banks may, with the approval of their Boards of Directors, fix a lower limit for their inter-bank liabilities, keeping in view their business model.

(b) The banks whose CRAR is at least 25% more than the minimum CRAR (9%) i.e. 11.25% as on March 31, of the previous year, are allowed to have a higher limit up to 300% of the net worth for IBL.

(c) The limit prescribed above will include only fund based IBL within India (including inter-bank liabilities in foreign currency to banks operating within India). In other words, the IBL outside India are excluded.

(d) The above limits will not include collateralized borrowings under CBLO and refinance from NABARD, SIDBI etc.

(e) The existing limit on the call money borrowings prescribed by RBI will operate as a sub-limit within the above limits.

9.2.3 Under the LE Framework, the **interbank exposures, except intra-day interbank exposures, will be subject to the large exposure limit of 25% of a bank's Tier 1 capital** till a further review by the BCBS. However, the existing market specific limits on 'Call Money and Notice Money Borrowing and Lending'[13] and 'Interbank Liabilities'[14] as given above will continue to be applicable simultaneously till a further review.

9.II. Collective Investment Undertakings (CIUs), securitisation vehicles and other structures - adoption of "Look Through Approach" (LTA)

9.3 There are cases when a structure lies between the bank and its exposures, that is, the bank invests in structures through an entity which itself has exposures to assets underlying the structures (hereafter referred to as the "underlying assets"). In all such cases, banks must assign the exposure amount, i.e., the amount invested in a particular structure, to specific counterparties following the approach described below in paragraphs 9.4 through 9.10. Such structures include funds, securitisations and other structures with underlying assets.

Determination of the relevant counterparties to be considered

9.4 In cases where a bank has exposure to a structure and it can be demonstrated that the portion of the bank's exposure amount assigned to each underlying asset of the structure is smaller than 0.25 percent of its eligible capital base, it may assign the total exposure amount to the structure itself, defined as a distinct counterparty. For this purpose, only the exposures to the underlying assets that result from the investment in the structure itself should be considered, and the exposure value should be calculated according to paragraphs 9.9 and 9.10[15]. In such cases, a bank is not required to look through the structure to identify the underlying assets.

9.5 A bank must look through the structure to identify those underlying assets for which the underlying exposure value is equal to or above 0.25 percent of its eligible capital base. In this case, the counterparty corresponding to each of the underlying assets must be identified so that these underlying exposures can be added to any other direct or indirect exposure to the same counterparty. The bank's exposure amount to the underlying assets that are below 0.25

[13] Master Circular IDMD.PCD.03/14.01.01/2014-15 dated July 1, 2014 on Call / Notice Money Market Operations
[14] Circular DBOD.No.BP.BC.66/21.01.002/2006-2007 dated March 6, 2007 on Prudential Limits for Inter-Bank Liabilities (IBL) read with Mail Box clarification dated January 16, 2008
[15] By definition, this required test will be passed if the bank's whole investment in a structure is below 0.25% of its eligible capital base.

percent of the bank's eligible capital base may be assigned to the structure itself (ie partial look-through is permitted).

9.6 If a bank is unable to identify the underlying assets of a structure:

- where the total amount of its exposure does not exceed 0.25 percent of its eligible capital base, the bank must assign the total exposure amount of its investment to the structure;
- otherwise, it must assign this total exposure amount to the unknown client.

The bank must aggregate all unknown exposures as if they related to a single counterparty (the unknown client), to which the LE limit would apply.

9.7 When the look-through approach (LTA) is not required in terms of paragraph 9.4 above, a bank must, nevertheless, be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not e.g. the bank has not circumvented the LE limit by investing in several individually immaterial transactions with identical underlying assets.

9.8 Calculation of underlying exposures - bank's exposure amount to underlying assets: If the LTA is not required to be applied, a bank's exposure to the structure must be the nominal amount it invests in the structure.

9.9 Any structure where all investors rank pari passu (eg CIU): When the LTA is required according to the paragraphs above, the exposure value assigned to a counterparty is equal to the pro rata share that the bank holds in the structure multiplied by the value of the underlying asset in the structure. Thus, a bank holding a Re 1 investment in a structure, which invests in 20 assets each with a value of Rs.5, must assign an exposure of Re 0.05 to each of the counterparties. An exposure to counterparty must be added to any other direct or indirect exposures the bank has to that counterparty.

9.10 **Any structure with different seniority levels among investors (eg securitisation vehicles):** When the LTA (in terms of paragraphs above) is required for an investment in a structure with different levels of seniority, the exposure value to a counterparty should be measured for each tranche within the structure, assuming a pro rata distribution of losses

amongst investors in a single tranche. To compute the exposure value to the underlying asset, a bank must:

i. first, consider the lower of the value of the tranche in which the bank invests and the nominal value of each underlying asset included in the underlying portfolio of assets
ii. second, apply the pro rata share of the bank's investment in the tranche to the value determined in the first step above.

9.11 As stated in the paragraph 6 of the introductory 'Background' of this DP, the adoption of the "Look Through Approach" (LTA) as above may pose practical difficulties and thus will need to be thoroughly discussed before implementation.

10. Identification of additional risks

10.1 While taking exposures to structures, banks must identify such third parties which may constitute an additional risk factor and which are inherent in the structure itself rather than in the underlying assets. Such a third party could be a risk factor for more than one structure that a bank invests in. Examples of roles played by third parties include originator, fund manager, liquidity provider and credit protection provider.

10.2 The identification of an additional risk factor has two implications.

i. The first implication is that banks must connect their investments in those structures with a common risk factor to form a group of connected counterparties. In such cases, the manager would be regarded as a distinct counterparty so that the sum of a bank's investments in all of the funds managed by this manager would be subject to the LE limit, with the exposure value being the total value of the different investments. But in other cases, the identity of the manager may not comprise an additional risk factor, e.g., if the legal framework governing the regulation of particular funds requires separation between the legal entity that manages the fund and the legal entity that has custody of the fund's assets. In the case of structured finance products, the liquidity provider or sponsor of short-term programmes (asset-backed commercial paper – ABCP – conduits and structured investment vehicles – SIVs) may warrant consideration as an additional risk factor (with the exposure value being the amount invested). Similarly, in synthetic deals, the protection providers (sellers of protection by means of CDS/guarantees) may be an additional source of risk and a common

factor for interconnecting different structures (in this case, the exposure value would correspond to the percentage value of the underlying portfolio).

ii. The second implication is that banks may add their investments in a set of structures associated with a third party that constitutes a common risk factor to other exposures (such as a loan) it has to that third party. Whether the exposures to such structures must be added to any other exposures to the third party would again depend on a case-by-case consideration of the specific features of the structure and on the role of the third party. In the example of the fund manager, adding together the exposures may not be necessary because potentially fraudulent behaviour may not necessarily affect the repayment of a loan. The assessment may be different where the risk to the value of investments underlying the structures arises in the event of a third-party default. For example, in the case of a credit protection provider, the source of the additional risk for the bank investing in a structure is the default of the credit protection provider. The bank must add the investment in the structure to the direct exposures to the credit protection provider since both exposures might crystallise into losses in the event that the protection provider defaults (ignoring the covered part of the exposures may lead to the undesirable situation of a high concentration risk exposure to issuers of collateral or providers of credit protection).

10.3 It is conceivable that a bank may consider multiple third parties to be potential drivers of additional risk. In this case, the bank must assign the exposure resulting from the investment in the relevant structures to each of the third parties.

10.4 The requirement set out in paragraph 9.8 to recognise a structural risk inherent in the structure instead of the risk stemming from the underlying exposures is independent of whatever the general assessment of additional risks concludes.

11. Exposures to and among certain specific counterparties

11.I. Exposures to Central Counterparties

11.1 The appropriateness of setting out a LE limit for banks' exposures to qualifying central counterparties (QCCPs[16]) is subject to an observation period set by BCBS till 2016. In the meantime, banks' exposures to QCCPs related to clearing activities will be exempted from the LE framework.

[16] Please refer to circular DBOD.No.BP.BC.82/21.06.217/2013-14 dated January 7, 2014 on Banks' Exposure to Central Counterparties (CCPs) - Interim Arrangements'

11.2 The definition of QCCP for the purpose of this Framework is the same as that used for risk-based capital requirement purposes. A QCCP is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.

11.3 In the case of non-QCCPs, banks must measure their exposure as a sum of both the clearing exposures described in paragraph 11.5 and the non-clearing exposures described in paragraph 11.7, and the same will be subject to the general LE limit of 25 percent of the eligible capital base.

11.4 The concept of connected counterparties described in paragraph 7 does not apply in the context of exposures to CCPs that are specifically related to clearing activities.

11.5 **Calculation of exposures related to clearing activities:** Banks must identify exposures to a CCP related to clearing activities and sum together these exposures. Exposures related to clearing activities are listed in the table below together with the exposure value to be used:

Trade exposures	The exposure value of trade exposures must be calculated using the exposure measures prescribed in other parts of this framework for the respective type of exposures. .
Segregated initial margin	The exposure value is 0[17].
Non-segregated initial margin	The exposure value is the nominal amount of initial margin posted.
Pre-funded default fund contributions	Nominal amount of the funded contribution[18].
Unfunded default fund contributions	The exposure value is 0.

[17] When the initial margin (IM) posted is bankruptcy-remote from the CCP – in the sense that it is segregated from the CCP's own accounts, eg when the IM is held by a third-party custodian – this amount cannot be lost by the bank if the CCP defaults; therefore, the IM posted by the bank can be exempted from the large exposure limit.

[18] The exposure value for pre-funded default fund contributions may need to be revised if applied to QCCPs and not only to non QCCPs.

11.6 Regarding exposures subject to clearing services (the bank acting as a clearing member or being a client of a clearing member), the bank must determine the counterparty to which exposures must be assigned by applying the provisions of the risk-based capital requirements.

11.7 **Other exposures:** Other types of exposures that are not directly related to clearing services provided by the CCP, such as equity stake[19], funding facilities, credit facilities, guarantees etc, must be measured according to the rules set out in this framework, as for any other type of counterparty. These exposures will be added together and be subjected to the LE limit.

11.II. Exposures to NBFCs

11.8 Current Prudential ceilings for exposure of banks to NBFCs

(i) *The exposure (both lending and investment, including off balance sheet exposures) of a bank to a single NBFC / NBFC-AFC (Asset Financing Companies), which is not predominantly engaged in lending against collateral of gold jewellery, should not exceed 10 percent / 15 percent respectively, of the bank's capital funds as per its last audited balance sheet. Banks may, however, assume exposures on such a single NBFC / NBFC-AFC up to 15 percent / 20 percent respectively, of their capital funds provided the exposure in excess of 10 percent / 15 percent respectively, is on account of funds on-lent by the NBFC / NBFC-AFC to the infrastructure sector. Further, exposure of a bank to the NBFCs-IFCs (Infrastructure Finance Companies) should not exceed 15 per cent of its capital funds as per its last audited balance sheet, with a provision to increase it to 20 per cent if the same is on account of funds on-lent by the IFCs to the infrastructure sector.*

(ii) *The exposure (both lending and investment, including off balance sheet exposures) of a bank to a single NBFC which is predominantly engaged in lending against collateral of gold jewellery (i.e. such loans comprising 50 per cent or more of their financial assets), should not exceed 7.5 per cent of bank' capital funds. However, this exposure ceiling may go up by 5 per cent, i.e., up to 12.5 per cent of banks' capital funds if the additional exposure is on account of funds on-lent by such NBFCs to the infrastructure sector.*

(iii) *Bank Finance to Residuary Non-Banking Companies (RNBCs): Residuary Non-Banking Companies (RNBCs) are also required to be mandatorily registered with Reserve Bank of*

[19] If equity stakes in a CCP are deducted from the capital on which the large exposure limit is based, these must not be included as exposure to the CCP.

India. In respect of such companies registered with RBI, bank finance is restricted to the extent of their Net Owned Fund (NOF).

11.9 Exposure Ceilings proposed under LE Framework

(i) **Exposures to Residuary Non-Banking Companies (RNBCs)**: Banks' exposures to RNBCs will be restricted to the extent of the RNBCs' Net Owned Fund (NOF) as defined in 'Master Circular on Bank finance to NBFCs' or 15 percent of the lending bank's eligible capital base (Tier 1 capital), whichever is lower.

(ii) **Exposures to all other NBFCs:** Banks' exposures to a single NBFC will be restricted to 15 percent of their eligible capital base (Tier 1 capital). **However, based on the risk perception, more stringent exposure limits in respect of certain categories of NBFCs may be considered.**

(iii)Banks' exposures to a group of connected NBFCs or groups of connected counterparties having NBFCs in the group will be restricted to 25 percent of their Tier I Capital.

11.10 The above exposure limits are subject to all other instructions as contained in Master Circular on Bank Finance to NBFCs.

11.III. Large exposures rules for global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs)

11.11 The LE limit applied to a G-SIB's exposure to another G-SIB is set at 15 percent of the eligible capital base (Tier 1). The limit applies to G-SIBs as identified by the Basel Committee and published annually by the FSB. At present, no Indian bank has been classified as G-SIB. When a bank becomes a G-SIB, it must apply the 15 percent exposure limit to another G-SIB within 12 months from the date of becoming G-SIB, which is the same time frame within which a bank that has become a G-SIB would need to satisfy its higher loss absorbency capital requirement.

11.12 The LE limit of a non-G-SIB bank in India (including the branch of a foreign bank) to a G-SIB and a non-bank G-SIFI will be 20 percent of the eligible capital base (Tier 1).

11.13 The Reserve Bank has issued the Framework for dealing with Domestic Systemically Important Banks (D-SIBs) on July 22, 2014, wherein it is indicated that the names of the banks classified as D-SIBs will be disclosed in the month of August every year starting from

2015. The LE limit for a D-SIB to another D-SIB and a non-D-SIB to a D-SIB will be capped at 20 percent of their eligible capital base (Tier 1).

Part B
Enhancing Credit Supply through Market Mechanism

12. In India, the corporates continue to predominantly depend on banks for their financial needs, instead of accessing the market. Notwithstanding the various steps taken by the government, Reserve Bank of India, and, various other regulators, to augment alternative sources of credit flow to the economy, the desired results have not been visible and the corporate sector's over-reliance on bank borrowing continues. It is seen from the statistics[20] of select 1628 Non-Government Non-Financial Companies for the three year period 2010-11 to 2012-13 that the average proportion of debentures (including privately placed debentures) in total borrowings of these companies was 6.70 percent, while average proportion of loans and advances from banks in India was 58.50 percent of the borrowing of these companies. Average short-term borrowings from banks form around 28.20 percent of average total borrowings of such companies.

13. In the recent past, the Reserve Bank has taken a number of steps to boost the corporate bond market such as allowing repo in corporate bonds, introduction of single name corporate default swaps (CDS) to hedge the credit risk. Another important step towards enhancing credit flow through market mechanism was to allow highly rated corporate borrowers to diversify their sources of short term borrowings (up to one year) by issue of commercial paper (CP) in December 1989. Subsequently, credit enhancement facility in case of commercial paper (CPs) was also allowed. The Reserve Bank in July 2014, incentivised banks by way of exemptions on the regulatory pre-emption such as CRR, SLR and priority sector lending obligations, if they raise long term bonds for the purpose of financing infrastructure and affordable housing loans.

Enabling Alternate Sources of Corporate Financing

14. It is important to have alternate sources of funding for the corporate sector, both to finance growth, de-risk the balance sheets of banks as also to strengthen balance sheets of investors as well as issuers. Well-functioning local corporate bond markets provide institutional investors with instruments that satisfy their demand for fixed-income assets, especially of long maturities and higher yields compared to government bonds. Corporate

[20] Statement No. 4 of "Finances of Non-Government Non-Financial Private Limited Companies, 2012-13" (RBI Publication – October 22, 2014)

bonds also offer asset diversification / risk diversification benefits. A deep and liquid corporate bond market might help prevent the build-up of asset price bubbles.

15. Currently, the Indian corporate bond market is characterized by predominance of privately placed issuances, issuer profile dominated by financial sector firms including banks, Non-Banking Financial Companies (NBFCs), financial institutions, housing finance companies (HFCs) and Primary Dealers (PDs). Similarly, majority of investment are made by banks and institutions including Foreign Institutional Investors (FIIs) with very little retail investor participation. A well-developed corporate bond market is critical for Indian economy as it enables efficient allocation of funds, facilitates long term infrastructure financing and safeguards financial stability. In order to achieve the objective, it is desirable to have diversified issuer and investor base and further develop the Indian corporate debt market.

16. In view of the foregoing, before taking a final view in the matter, the Reserve Bank elicits the views of stakeholders on the undernoted proposals, including suggestions on the quantifiable parameters:

- Large corporate borrowers enjoying working capital (fund-based) limits above a certain threshold from the banking system should necessarily meet a minimum prescribed percentage of their working capital requirements from the commercial paper market. This percentage should be progressively increased.
- As the core portion of the working capital requirement is needed continuously/over a long period, corporates may finance this core portion by issue of medium term corporate bonds [popularly known as Medium Term Notes (MTN)] of maturity of, say, 3 to 5 years. As working capital loans are generally secured by current assets of the borrowers, banks and corporates may mutually decide the issues of sharing securities/collaterals with the investors of such bonds.
- Large corporate borrowers enjoying term loan limits above a certain threshold from the banking system should necessarily meet a certain minimum extent of their term/project loan requirements from corporate bond market.

***

Appendix I

Return on Large Exposures

Name of the Bank	
Return for the Month	
Eligible Capital base (Tier I)	**(Rs. crore)**

A. Bank's 20 Largest Exposures to counterparties (single as well as group of connected counterparties) irrespective of their values relative to bank's eligible capital base

Sl No.	**Name of the Counterparty**	**Whether Single (S) or Group (G) of connected Counterparties**	**Exposure Amount**	**Exposure as % of Tier I Capital**
1				
2				
3				
--				
--				
18				
19				
20				

B. Bank's all exposures (measured with effect of CRM) with values equal to or above 10% of Tier I Capital

Sl No.	**Name of the Counterparty**	**Whether Single (S) or Group (G) of connected Counterparties**	**Exposure Amount**	**Exposure as % of Tier I Capital**
1				
2				
--				
n				

C. Bank's all exposures (measured without the effect of CRM) with values equal to or above 10% of Tier I Capital				
Sl No.	**Name of the Counterparty**	**Whether (S) or (G)**	**Exposure Amount**	**Exposure as % of Tier I Capital**
1				
2				
--				
n				

D. Bank's all exempted exposures with values equal to or above 10% of Tier I Capital				
Sl No.	**Name of the Counterparty**	**Whether (S) or (G)**	**Exposure Amount**	**Exposure as % of Tier I Capital**
1				
2				
--				
n				

Appendix II

Large Exposures Limits - Current Status of Banks in India

Banks in India are by and large placed comfortably with regard to their large exposures vis-à-vis limits prescribed under the LE Framework of the BCBS. While the current single exposure limit is 15 percent of the Capital Funds (Tier I + Tier II), the proposed LE Framework exposure limit is 25percent of Tier I Capital for single as well as groups of connected counterparties. Currently, the average Tier I and Tier II Capitals of banks in India are in the ratio of 70:30. Thus, even with their current levels of capital, banks in India will get additional buffer for their exposures to single counterparties under the LE Framework vis-à-vis the current exposure norms of RBI. However, their group exposure limits will be reduced to some extent. In order to understand the positions of the banks in this regard, the following two studies were carried out.

A. From a study of the capital funds available with 90 banks in India as on March 2014, the following observations are made:

- At their current levels of capital, banks will gain an average additional exposure headroom of 7.29 percent of their Tier I Capital over their current exposure limit (15 percent of Capital Funds) for their single name counterparties under the proposed LE limit.
- The above additional buffer ranges from 2.06 percent to 10.00 percent of Tier I capitals of the 90 banks under study with a median of 7.83 percent.
- Further, foreign banks and private sector banks are more comfortably placed in this regard vis-à-vis the Public Sector Banks as the average headroom available with foreign banks and private sector banks respectively will be 8.86 percent and 7.40 percent of their current Tier I Capital vis-à-vis 4.62 percent in case of Public Sector Banks.
- Even if the present additional exposure limit of 5 percent of capital funds for exposures to infrastructure is taken into account, banks' will have average additional exposure capacity of 1.39 percent of their Tier I Capital under the proposed LE limit.
- Thus, the banks will be in an advantageous position on account of their single exposure limit under the LE Framework even with their current level of Tier I Capital. A tabular presentation of the study conducted on 90 banks in India is given below:

Comparative study of Exposure Limits under LR Framework vis-à-vis Current Exposure Norms

Table I - All Banks (90)

Excess of Tier I Capital over ⇓	Avg	Max	Min	Median	Std Dvn
15% of CF	7.29%	10.00%	2.06%	7.83%	2.50%
20% of CF	1.39%	5.00%	-5.59%	2.11%	3.33%
25% of CF	-4.51%	0.00%	-13.24%	-3.61%	4.17%
40% of CF	-22.22%	-15.00%	-36.19%	-20.78%	6.67%
50% of CF	-34.02%	-25.00%	-51.48%	-32.22%	8.33%
55% of CF	-39.92%	-30.00%	-59.13%	-37.94%	9.16%

Table II - PSBs (27)

Excess of Tier I Capital over ⇓	Avg	Max	Min	Median	Std Dvn
15% of CF	4.62%	6.48%	2.50%	5.06%	1.26%
20% of CF	-2.17%	0.31%	-5.00%	-1.58%	1.68%
25% of CF	-8.96%	-5.87%	-12.50%	-8.23%	2.10%
40% of CF	-29.34%	-24.39%	-35.00%	-28.16%	3.36%
50% of CF	-42.92%	-36.74%	-50.00%	-41.45%	4.20%
55% of CF	-49.72%	-42.91%	-57.50%	-48.10%	4.62%

Table III - Foreign Banks (44)

Excess of Tier I Capital over ⇓	Avg	Max	Min	Median	Std Dvn
15% of CF	8.86%	10.00%	2.06%	9.69%	1.80%
20% of CF	3.48%	5.00%	-5.59%	4.59%	2.40%
25% of CF	-1.90%	0.00%	-13.24%	-0.51%	3.01%
40% of CF	-18.05%	-15.00%	-36.19%	-15.82%	4.81%
50% of CF	-28.81%	-25.00%	-51.48%	-26.02%	6.01%
55% of CF	-34.19%	-30.00%	-59.13%	-31.13%	6.61%

Table IV - Private Sector Banks (20)

Excess of Tier I Capital over ⇓	Avg	Max	Min	Median	Std Dvn
15% of CF	7.40%	9.68%	3.01%	7.93%	2.05%
20% of CF	1.54%	4.57%	-4.32%	2.24%	2.73%
25% of CF	-4.33%	-0.54%	-11.66%	-3.45%	3.41%
40% of CF	-21.93%	-15.86%	-33.65%	-20.52%	5.46%
50% of CF	-33.66%	-26.07%	-48.31%	-31.90%	6.83%
55% of CF	-39.53%	-31.18%	-55.64%	-37.59%	7.51%

B. Further, a **study on the twenty largest group exposures of ten largest banks** (exposure taken as a percentage of their Capital Funds as on June 30, 2014) reveal the following results:

- Average exposure of banks under study to their groups of connected counterparties is 10.60 percent of their Capital Funds as against the permissible limit of 40 percent of Capital Funds.
- Average exposure of banks under study to their groups of connected counterparties is 14.75 percent of their current Tier I Capital as against the proposed LE limit of 25 percent of Tier I Capital.
- Group exposures exceed the proposed limit of 25 percent of Tier I Capital only in 10 percent of the cases, i.e.20 out of 200 cases. These 20 cases consist of exposures of 10 banks under study to 11 different corporate groups.
- The above Groups of companies where the exposure of the said 10 banks exceed the proposed LE limit of 25 percent of Tier 1 Capital are the largest corporate groups in India including the Oil PSUs.

Table – IV

Banks@	No. of Groups of Counter parties	Average Exposure to Groups of Counterparties as a % of Capital Funds (Tier I + Tier II)	Average Exposure to Groups of Counterparties as a % of Tier I Capital	Highest exposure to a Group as a % of Tier I Capital	Lowest exposure to a Group as a % of Tier I Capital	Median Value in the top 20 Group exposures as a % of Tier I Capital	Std Devn of exposures to top 20 Group of Counter parties	No. of Group exposures exceeding 25% of Tier I Capital
Bank 1	20	8.90 %	11.34%	26.98%	5.89%	10.09%	6.04%	1
Bank 2	20	6.89%	9.52%	22.84%	6.42%	8.43%	3.89%	0
Bank 3	20	10.22%	15.04%	45.75%	8.07%	12.78%	8.08%	1
Bank 4	20	9.56%	13.34%	36.07%	6.14%	9.95%	8.75%	2
Bank 5	20	10.55%	16.76%	42.06%	8.81%	13.12%	8.57%	2
Bank 6	20	8.63%	11.77%	47.51%	3.73%	8.97%	9.81%	1
Bank 7	20	12.37%	17.22%	41.90%	5.51%	14.37%	10.46%	4
Bank 8	20	9.32%	12.12%	24.41%	6.05%	11.87%	5.38%	0
Bank 9	20	18.31%	23.61%	56.71%	8.15%	21.58%	13.82%	8
Bank 10	20	11.22%	16.81%	49.92%	9.73%	14.14%	8.86%	2
	Average	10.60%	14.75%				Total	**20**

@Banks 1 to 10 above are not necessarily listed in order of their size.

Table – V

Sl No.	Group of Connected Counterparties (GCC)	Number of banks whose exposure exceed 25% of their Tier I Capital
1	GCC 1	2
2	GCC 2	6
3	GCC 3	3
4	GCC 4	2
5	GCC 5	1
6	GCC 6	1
7	GCC 7	1
8	GCC 8	1
9	GCC 9	1
10	GCC 10	1
11	GCC 11	1
	Total	20