Supervision of the Indian Financial System
(Commercial banks, Non banking financial companies, and All India financial institutions)
1995 - 2000

Reserve Bank of India
Department of Banking Supervision
Central Office
Mumbai
December 2000

1. Introduction

Internationally, following the failure of some large banks and bank related entities, there has been a debate on the segregation of supervision from traditional central banking, citing the conflict between monetary policy objectives and bank supervision objectives. At the same time, there is also a considered view that bank supervision function can provide the central bank with far more information from and control over the institutions and markets and thus assist in maintaining financial stability. The financial markets have become more sophisticated and global in nature, adding to the challenges faced by central banks while at the same time rapid strides in telecommunication and electronic data processing coupled with new funding instruments, growth of securitisation, emergence of new institutions have increased the role and responsibilities of bank supervisors.

The legal and institutional framework for bank supervision in India is provided under the Banking Regulation Act, 1949. Until 1994, different departments in Reserve Bank of India were exercising supervision over banks, non-banking financial companies and financial institutions. To keep a close watch on financial markets and avoid recurrence of crisis in the financial system, the Board for Financial Supervision was set up under the aegis Reserve Bank under Reserve Bank of India (Board for Financial Supervision) Regulations, 1994 with the objective of paying undivided attention to the supervision of the institutions in the financial sector.

2. Organisation of the Supervision Function

Prior to 1993, the supervision and regulation of commercial banks was handled by the Department of Banking Operations & Development (DBOD). In December 1993 the Department of Supervision was carved out of the DBOD with the objective of segregating the supervisory role from the regulatory functions of RBI.

Globally, increasing financial dis-intermediation has led to an increase in the assets and reach of non-bank finance companies necessitating enhanced regulatory attention towards these non-bank and near-bank entities. The merger of Financial Institutions Cell with the Department of Supervision in June 1997 led to the formation of an exclusive Financial Institutions Division within the DoS which was entrusted with both supervision and regulation over all India development financial institutions. Later, the Department of Supervision was split into Department of Banking Supervision (DBS) and Department of Non-Banking Supervision (DNBS) on July 29, 1997 with the latter being entrusted with the task of focussed regulatory and supervisory attention towards the NBFC segment.

Department of Banking Supervision (DBS)

The Department of Banking Supervision at present exercises the supervisory role relating to commercial banks in the following forms:

a) Preparing of independent inspection programmes for different institutions.

b) Undertaking scheduled and special on-site inspections, off-site surveillance, ensuring follow-up and compliance.

c) Determining the criteria for the appointment of statutory auditors and special auditors and assessing audit performance and disclosure standards.

d) Dealing with financial sector frauds.

e) Exercising supervisory intervention in the implementation of regulations which includes – recommendation for removal of managerial and other persons, suspension of business, amalgamation, merger/winding up, issuance of directives and imposition of penalties.

Department of Non-Banking Supervision(DNBS)

Department of Non-Banking Supervision has following responsibilities:

a) Administration of Chapter IIIB of the RBI Act, formulating regulatory framework and issuing directions to the NBFCs (including residuary non-banking companies, mutual benefit companies, chit fund companies);

b) Administration of Chapter III-C of the RBI Act in respect of unincorporated bodies, Chit Funds Act in respect of chit fund companies, Prize Chits and Moneys Circulation Schemes (Banning) Act in respect of prize chits;

c) Identification and classification of NBFCs;

d) Registration of NBFCs under section 45-IA of the RBI Act;

e) On-site inspection and follow up;

f) Off-site surveillance and scrutiny of various returns;

g) Attending to complaints relating to NBFC sector; and

h) Initiating deterrent action against the errant companies.

Considering the manifold growth of NBFCs , a new regulatory framework was put in place in January 1998 to ensure that only financially sound and well run NBFCs are allowed to access public deposits. After interaction with the industry representatives and considering the recommendations of the Task Force on NBFCs set up by the Government, these regulations were modified in December 1998. The regulations and guidelines governing NBFCs are also made available periodically on the RBI websites as part of public domain information.

The experience of supervision in the intervening period has, however, led to the recognition of the fact that existing legislative framework requires further refinement because of the rising number of defaulting NBFCs and the absence of a quick redressal system for individual depositors. Government of India appointed a Task Force to go into the adequacy of the legislation, which has made wide ranging recommendations. Based on these, a draft 'Financial Companies Regulation' Bill has been prepared which will address the lacunae in procedures and statute.

3. Supervisory Process

The major instrument of supervision of the financial sector is inspection. The inspection process focuses mainly on aspects crucial to the bank’s financial soundness with a recent shift in focus towards risk management. Areas relating to internal control, credit management, overseas branch operations, profitability, compliance with prudential regulations, developmental aspects, proper valuation of asset/ liability portfolio investment portfolio, and the bank’s role in social lending are covered in the course of the inspection. The Department undertakes statutory inspections of banks on the basis of an annual programme, which is co-terminus with the financial year for public sector banks. After the inspection report is released to the bank, followed by a ‘supervisory letter’ based on the inspection findings to the bank, the concerns of the inspections are discussed with the CEO of the bank and a Monitorable Action Plan is given to the bank for rectification of those deficiencies. The Department submits a memorandum covering supervisory concerns brought out by the inspection to the Board for Financial Supervision (BFS). Specific corrective directions of the BFS are conveyed to the banks concerned for immediate compliance. The Memoranda submitted by the departments for supervisory scrutiny and consideration of BFS generally cover matters relating to supervisory strategy and operational supervision of individual banks, financial institutions and non-banking financial companies as also industry-wide issues and sectoral performance reviews.

Closer supervision on the asset quality and fixing responsibility on the board and accountability on top management of banks has had a perceptible impact on the Non Performing Assets (NPAs) of public sector banks. The banks have shown a declining trend in terms of percentage of NPAs to total advances during the last four years. The percentage of gross NPAs to gross advances of public sector banks declined from a high level of 19.45 at the end of March 1995 to 13.86 as on 31 March 2000. The net NPAs formed 8.07% of the net advances as on 31st March 2000.

The Capital to Risk-weighted Assets Ratio (CRAR) for banks initially fixed at 8% was increased to 9% from March 2000. The position of banks not achieving the prescribed CRAR level since 1995 has come down from 42 banks (14 public sector) as on 31 March 1995 to 4 banks (1 public sector) as on 31 March 2000 due to constant monitoring and directions for improvement in this area at quarterly intervals.

4. On-site inspection

(i) Banks

In terms of the new approach adopted for the on-site inspection of banks, the Inspecting Officers concentrate on core assessments based on the CAMELS model (**C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings appraisal, **L**iquidity and **S**ystems & controls). This approach eschews aspects which do not have a direct bearing on the evaluation of the bank as a whole or which should essentially concern the internal management of the bank. The new approach to Annual Financial Inspections was put in practice from the cycle of inspections commencing in July 1997.

A rating system for domestic and foreign banks based on the international CAMELS model combining financial management and systems and control elements was introduced for the inspection cycle commencing from July 1998. The review of the supervisory rating system has been completed so as to make it more consistent as a measure of evaluation of bank’s standing and performance as per on-site review. The improved rating framework is expected to come into effect from the on-site inspection cycle commencing from April 2001.

A model to rate the level of customer service in banks was developed and forwarded to Indian Banks’ Association for conducting appropriate surveys on customer satisfaction at periodical intervals. During the course of annual financial inspections ‘customer audit’ is carried out to evaluate quality of customer service at branches of commercial banks

A Quarterly Monitoring System through on-site visits to the newly licensed banks in their first year of operation has been put in place. Old and new private banks displaying systemic weaknesses are also subjected to quarterly monitoring.

In deference to the desire of the banks (as put forth during an informal feedback session with the Governor in October 1999) to have an opportunity to meet the supervisor at regular intervals for discussing compliance related issues and agreeing on regulatory and supervisory requirements in respect of new business initiatives, a quarterly informal meeting system for banks with the officials of Department of Banking Supervision has been designed and put in operation from January 2000.

Some of the public sector banks have also been placed under special monitoring, with a Senior Officer in the jurisdictional Regional Office of the Bank entrusted with the special monitoring efforts. The Deputy Governor / Executive Director in-charge of banking supervision call the CEOs of those banks, wherein serious deficiencies have been reported in the inspection reports, for a discussion on the specific steps the bank's top management would need to take to improve its financial strength and operational soundness.

A new Inspection Manual has been brought out in 1998 taking into account evolving supervisory needs and shift in approach towards risk based supervision. Another new manual for the use of inspectors looking at ALM and Treasury operations was prepared with the help of international consultants under the Technical Assistance Project funded by Department for International Development (DFID), UK and has been put to use by the RBI inspectors.

Detailed guidelines on risk control systems in computerised banks have been circulated amongst banks along with the details of electronic records to be maintained for supervisory access. Specialised training modules along with extensive guidelines for use of RBI Inspectors are in place for inspection of computerised bank systems. An international consultancy firm, funded by the DFID (UK), helped the Bank in its aforesaid project.

In order to address the issue of causes of divergence observed with regard to asset classification etc., provisioning required to be made between the banks/auditors and RBI Inspectors, a representative group of banks, a chartered accountant and RBI officials was constituted in March 2000 to review and arrive at uniform parameters of assessment of NPAs by banks/auditors and RBI Inspectors. Guidelines are being issued to the banks and the Inspecting Officers based on the recommendations of the Group.

(ii) Supervision of overseas branches of Indian banks

While inspection of the overseas operations of branches of Indian banks is left largely to the parent banks, a system of evaluation visits covering all branches functioning at different financial centres has been instituted as a part of the initiatives taken to strengthen cross border supervision. Besides periodical visits and meetings with overseas supervisors, formal MOUs for exchange of supervisory information are being worked out as part of the process of implementation of Basel Committee's core principles on cross border supervisory cooperation.

Portfolio appraisals of the International Divisions of Indian banks having foreign branches are also conducted by the Department of Banking Supervision annually. In these appraisal exercises conducted at the bank's corporate offices and controlling divisions of foreign operations, asset quality, operating results, etc. of the foreign branches and the host country regulators' perceptions are also assessed and periodically discussed with the banks' International Divisions for rectification of the functional gaps.

(iii) Financial Institutions

All India financial institutions are being covered by on-site supervisory process (CAMELS standards) on the lines in vogue for banks since 1995. Taking into account the developmental functions and supervisory function exercised by some of these institutions – NABARD supervises state/central cooperative banks and regional rural banks, National Housing Bank (NHB) regulates and inspects housing finance companies, and IDBI inspects state financial corporations – a modified approach for supervisory assessment of these institutions has been introduced. A Working Group under the chairmanship of Shri Y.H.Malegam, a Member of the BFS, has come out with guidelines that will become operative shortly.

(iv) Non-Banking Financial Companies

The system of on-site examination is structured on the basis of CAMELS approach and the same is akin to the supervisory model adopted for the banking system. A comprehensive Inspection Manual has been brought out for the use of Inspecting Officers. Appropriate supervisory framework, wherever necessary with the assistance of external chartered accountant firms, has been evolved for on-site inspection of all NBFCs holding public deposits.

5. Off-site Monitoring & Surveillance System

(i) Banks

As a part of the new supervisory strategy, an off-site monitoring system for surveillance over banks was put in place in RBI in March 1996. The first tranche of OSMOS returns require quarterly reporting on assets, liabilities and off balance-sheet exposures, CRAR, operating results for the quarter, asset quality and large credit exposures in respect of domestic operations by all banks in India. Data on connected and related lending and profile of ownership, control and management are also obtained in respect of Indian banks.

Bank profiles containing bank-wide database on all important aspects of bank functioning including global operations were obtained for the years commencing from 1994 and are being updated annually on an on-going basis. The database provides information on managerial and staff productivity areas besides furnishing important ratios on certain financial growth and supervisory aspects of the bank's functioning.

Analysis of financial and managerial aspects under the reporting system is done on quarterly basis in a computerised environment in respect of banks and reviews are placed before BFS for its perusal and further directions. The second tranche of returns covering liquidity and interest rate risk exposures were introduced in June 1999. To accommodate the increased data and analysis required by the second tranche of returns, a project to upgrade the OSMOS database has been completed and the new processing system has been put in place for the Returns commencing from the quarter ended September 2000.

Trend analysis reports based on certain important macro level growth/performance indicators are placed before BFS at periodical intervals. Some of the important reports generated by the Department include half-yearly review of the performance of banks, half-yearly key banking statistics, analysis of impaired credits, analysis of large credits, analysis of call money borrowings, analysis of non SLR investments, etc.

The Bank also provides details of peer group performance under various parameters of growth and operations for the banks of a comparative business size to motivate them to do self assessment and strive for excellence.

The Indian banks conducting overseas operations report the assets and liabilities, problem credits, maturity mismatches, large exposures, currency position on quarterly basis and country exposure, operating results etc. on an annual basis. The reporting system has been reviewed and rationalised in 1999 in consultation with the banks and the revised system put in place in June 2000. The revised off-site returns focus on information relating to quality and performance of overseas investment and credit portfolio, implementation of risk management processes, earning trends, and viability of the branches.

(ii) All India Development Financial Institutions

Quarterly returns have been designed based on data on the liabilities and assets as well as data on sources and deployment of funds.

(iii) Non-Banking Financial Companies

Off-site surveillance of NBFCs involves scrutiny of various statutory returns (quarterly/half yearly/annual), balance sheets, profit and loss account, auditors' reports, etc. A format for conducting the off-site surveillance of the companies with asset size of Rs.100 crore and above has also been devised.

6. Board for Financial Supervision: Constitution

The Committee on Financial System set up by the Government of India had suggested that the supervisory functions of RBI should be separated from the more traditional central banking functions and that a separate agency, which could pay undivided attention to supervision, should be set up under the aegis of RBI. A complete severance of supervision from central banking was not considered necessary or desirable in the Indian context. So, based on this recommendation**,** the first Board for Financial Supervision (BFS) was constituted on November 16, 1994 by the Governor as a committee of the Central Board of Directors of the Reserve Bank of India (RBI). It functions under the RBI (BFS) Regulations, 1994 exclusively framed for the purpose in consultation with the Government of India. The Board is chaired by the Governor and is constituted by co-opting four non-official Directors from the Central Board as Members for a term of two years. The Deputy Governors of the Bank are ex-officio Members. One of the Deputy Governors is nominated as Vice-Chairman. The Department of Banking Supervision serves as the Secretariat for the BFS.

Shri S P Talwar, Deputy Governor holding charge of the Bank's regulation and supervision function has been the Vice-Chairman of the BFS since its inception. Dr. Y. Venugopal Reddy and Shri Jagdish Capoor, Deputy Governors, are other ex-officio Members as on date. Shri Y H Malegam, Shri E A Reddy, Dr. S S Johl, and Dr. (Ms) Amrita Patel, who were members on the Central Board of Directors of the Reserve Bank, were the non-official members of the first Board. The Board has since been reconstituted for a term of two years in consultation with the Central Board in its meeting held on 21 December 2000, with Dr. Ashok S. Ganguly and Shri K. Madhava Rao nominated in the place of Dr. S. S. Johl and Shri E. A. Reddy, who ceased to be members of the reconstituted Central Board. Shri Y H Malegam and Dr. (Ms) Amrita Patel have been nominated to continue as Members of the reconstituted BFS. Executive Directors in-charge of Department of Banking Operations & Development, Department of Banking Supervision and Department of Non-Banking Supervision participate in the BFS meetings by invitation. In-charges of these departments are also to be in attendance for the meetings.

The Chairman, Vice-Chairman and Members of the Board jointly and severally exercise the powers of the Board. The Board is at present required to meet ordinarily at least once a month. Three Members, of whom one shall be Chairman or the Vice-Chairman, form the quorum for the meeting.

Advisory Council to BFS

For tendering advice to the BFS in its initial years on policy matters relating to the supervision of the financial system an Advisory Council was constituted on November 16, 1994 and was in place till March 27, 1998. The Council consisting of five members, eminent in the fields of law, accountancy, banking, finance and management met normally once a quarter during the period of its tenure.

Sub Committee (Audit) to BFS

The BFS also constituted an Audit Sub-Committee in January 1995 with the Vice Chairman of BFS as Chairman of the sub-Committee and two non-official members of BFS as other Members. Representatives of the Institute of Chartered Accountants are also invited to the meetings of the Sub Committee depending on the nature of the agenda. The Sub Committee’s main focus is on up-gradation of the quality of the statutory audit and concurrent audit / internal audit functions in banks, NBFCs and financial institutions, fixing of remuneration, approval of the panel of statutory auditors and branch auditors as also the accounting and disclosure standards.

Supervisory Jurisdiction

The supervision by BFS at present covers commercial banks, all India development financial institutions and non-banking finance companies.

In its very first meeting, the BFS approved a new strategy of supervision, the key elements of which include:

- Setting up an off-site surveillance function, the major components of which include establishing a system for in-house monitoring of banks and other credit institutions, based on a prudential supervisory reporting framework; building a "Memory" on all supervised institutions and setting up a market intelligence and surveillance unit (MISU)

- Restructuring the system of bank inspections in terms of focus, process, reporting & follow up.

- Strengthening the statutory audit of banks and enlarging the role of auditors in the supervisory process including using them as agents.

- Strengthening the internal defences within the supervised institutions such as corporate governance, internal control and audit functions, and management information and risk control systems, as an extension of the task of supervision.

7. Restructuring the System of Financial Supervision

To start with, expert working groups were constituted in 1994 to devise revised strategies of on-site supervision over banks and NBFCs for continuous supervision. Some of the important steps taken based on the recommendations of these working groups are as under:

a) Changes in frequency/periodicity of inspections, restructure reporting formats and introduce new off-site reporting system, introduction of three types of supplementary on-site assessments in between the statutory examinations, Rating system for banks based on the international CAMELS model as also more focused and enforcement-oriented follow-up based on the recommendations of Padmanabhan Working Group.

b) Toning up of the internal control/audit function in banks and more particularly the safeguards to be adopted in EDP environment.

c) Introduction of an effective prudential reporting system and registration process for NBFCs by switching over from the then prevailing compliance monitoring system with reference to RBI directions on deposit taking activities of such companies.

The reports of a few more Working Groups/ Committees are either under consideration or the reports are expected shortly.

Monitoring of overseas branches of Indian banks

A Working Group consisting of senior officials of banks and RBI reviewed the reporting/monitoring system covering overseas operations of Indian banks and recommended a series of measures for toning up the head office/RBI supervision in this area. The revised procedures, which were finalised in consultation with the banks, have come into force from the quarter ending June 2000.

Uniform guidelines on Write-off/ compromise settlements

A Working Group of professional bankers constituted in July 1998 examined the practices followed by public sector banks in arriving at compromise settlements and recommended certain guidelines that may be followed by banks. These guidelines have been circulated amongst banks for adoption.

Checklist for Inspecting Officers

A Working Group comprising internal auditors from banks and Chartered Accountant professionals constituted in July 1998 recommended guidelines for RBI Inspectors for objective evaluation of the internal audit system in banks. Based on these guidelines, a checklist has been designed for the use of the bank inspectors and also circulated amongst banks for use by their internal auditors.

Study of large value bank frauds

In the context of growing incidence of large value frauds in banks a Working Group of experienced bankers was set up in June 1998 to conduct an in-depth study of frauds of Rs.1 crore and above reported by commercial banks during the last three years. The Group, after analysis of over 100 large value reported frauds, made several recommendations for improving the fraud prevention /monitoring system in banks. The report has been forwarded to the banks with advice to initiate immediate action.

Nostro Accounts- Reconciliation

Considering delay in adjustment of outstanding entries in nostro accounts of public sector banks a Working Group consisting of senior level officers from public sector banks and RBI was set up in March 1998 to suggest solutions. After analysing the important causes for large pending entries and the present system and procedure followed by banks in the area of reconciliation of nostro accounts entries, the Group suggested various measures for effective control and management of nostro accounts reconciliation which have been communicated to banks.

Non- SLR Investments

Considering the large proportion of investments in unquoted bond/ debentures made by banks through private placements under non- SLR category, a Technical Group, with officials drawn from Treasury Departments of banks, was set up in August 1998 to study and suggest appropriate measures. The Group was assigned the task of suggesting measures for regulating such investment and bringing in more transparency, accountability and risk perception. The recommendations of the Group were examined in consultation with experts on the subject and suitable prudential guidelines for valuation of SLR/Non SLR investments were issued to come into effect from September 30, 2000.

8. Corporate Governance and Management Guidance

The requirements of the corporate governance framework differ across institutions because of the different ownership structures of the commercial banks.

- Public Sector banks are largely owned by the Government. The majority holding in State Bank of India is held by RBI and State Bank of India holds majority shareholding in its seven associate banks. (These holdings are gradually being divested).

- The old private sector banks have traditionally been owned and controlled by communities, groups or regional interests.

- The new private sector banks are owned and managed by financial institutions or major corporates though the shareholding pattern is increasingly diversified with fresh issues of capital as part of start up covenants.

- The foreign banks are in essence branches of overseas entities though a Local Advisory Board provides general guidance.

- Even amongst financial institutions, there are both state owned and private sector entities.

The corporate governance framework in these institutions has been strengthened through regulation, supervision and through interaction with the management of these institutions. These measures cover responsibilities of the boards of banks, disclosure and transparency in published accounts, and shareholder and stakeholder rights and controls.

The rating on management (M) which has been introduced as part of the CAMELS supervisory process takes into account the working of the board and its committees including the Audit committee, effectiveness of the management in ensuring regulatory compliance and adequacy of control exercised by the head / controlling offices.

The audit function is an important element of the corporate governance process and the independence of this function is crucial to good corporate governance. Audit Committee of the Boards, constituted at the instance of RBI, perform the role of overseeing concerns about internal controls and recommendations for their improvement. To ensure both professionalism and independence of these committees, Chartered Accountant directors on the boards of banks are mandatory members and the Chairman or Chief Executive Officer is not to be part of the Audit Committee. Foreign banks are not insisted upon to have local audit committee for their Indian branches. Their branches have a compliance function that reports to their head office on the branches' compliance with RBI inspection findings and features arising out of internal inspections and statutory audit.

RBI has Nominee directors on the boards of all public sector banks and some of the old private sector banks. Further, the Government also nominates directors on the boards of all public sector banks. Of late, RBI has been withdrawing its nominees from the boards of well managed old private banks.

To improve the effectiveness of the non-official directors and bring in effective corporate governance at the board level in banks, guidelines have been issued focusing the attention of directors on certain areas such as (i) the prescribed calendar of reports / returns to be placed before the Board / Managing Committee of the bank (iv) corrective action required to be taken by the bank on issues of supervisory concern (v) adherence to the deadlines for complying with various action points committed under Monitorable Action Plan during discussions in Annual Financial Inspection findings as well as achievement of targets agreed during MoU discussions with RBI. Further, the guidelines also require the directors to keep watch on matters which come to the board of the banks as also what should have come to the board and to inform the Department of Banking Supervision on matters of supervisory concern

9. Transparency and Disclosure

RBI has always been committed to enhancing the element of transparency and adequate disclosures in the financial statements of banks. The formats of balance sheet and profit & loss account have been prescribed in the Banking Regulation Act, 1949, and banks have to strictly comply with this. The accounts and balance sheets are required to be duly audited by statutory auditors (including branch auditors) appointed with the approval of RBI. While international accounting standards are broadly followed, specific valuation standards have been prescribed in respect of investments and foreign exchange positions.

The task of moving towards greater disclosure by banks in India was taken up in 1982 when the formats of the financial statements were revised and expanded. Following the liberalization measures introduced in the beginning of this decade, the process and extent of disclosure by the banking system has been further enhanced. Over the past few years, banks have been advised to disclose key information on capital adequacy and composition, NPA's, provisions, investments and shareholding of Government. Banks are also required to disclose certain critical financial ratios on profitability and efficiency. More recently, banks have been asked to disclose maturity pattern of assets and liabilities, movement in NPA's and exposure to sensitive sectors.

As a part of its efforts to enhance the credibility of information available on Indian banking system, RBI publishes (since March 1998) bank-specific information on financial and performance indicators, including asset quality ratios, CRAR and earning ratios in its annual publication of 'Trends and Progress in Banking in India'

10. Internal controls and housekeeping in banks

(i) Internal Control Systems

The Bank periodically reviews the steps taken by the public sector banks in the internal control area through analytical reports covering the following areas:

- Reconciliation of inter-branch accounts
- Reconciliation of inter-bank accounts
- Reconciliation of nostro accounts, and

- Status of balancing of books of accounts
- Reconciliation of clearing differences

The banks were given definitive time frame to improve their internal clearing systems and the progress has been closely monitored and followed up by the Department of Banking Supervision.

(ii) Reconciliation of inter-branch accounts:

The close monitoring and periodical discussions with the Chairmen of banks by the Deputy Governor had an impact in reduction of old unreconciled entries in inter-branch accounts of banks, a fraud prone area. The continued pressure on banks has been yielding the desired results inasmuch as the unreconciled entries have been substantially reduced over the last three years.

To promote effective concern in reconciliation of debit entries in inter-branch accounts the concept of making provision for net debits outstanding for more than three years in inter –branch accounts has been introduced. The cut off period for provisioning has been reduced to more than two years from the period ended March 2001.

Similarly, to have an effective monitoring on remittance transactions, the banks have been advised not to route entries on account of such transactions through normal inter branch account but evolve a separate account for this purpose. The banks have also been asked to ensure that outstanding entries under remittance transactions are reconciled on a weekly basis.

Banks are required to ensure that the practice of forced matching of inter-branch entries should be subject to appropriate checks and balances. Any forced matching practice adopted by banks for adjustment of old unreconciled entries in inter-branch accounts should have the approval of their Audit Committee of the Board and the Board of Directors should be apprised of the full details of such practice. The statutory auditors of the bank should also look into the justifiability from the angle of fair accounting practice.

There has been considerable improvement in the reconciliation of inter-branch accounts in public sector banks and the position of un-reconciled entries pending for more than two years. Total number of un-reconciled entries over two years, which stood at 22.58 lakh entries (Rs. 50706 crore) as on March 31, 1996, had declined to 14.74 lakh entries (Rs. 3824 crore) as on March 31, 2000.

(iii) Balancing of books

A related concern that required a close monitoring was the progress in reducing the arrears in balancing of books at branches of banks. A reporting system for banks was introduced in July 1995 for monitoring progress in respect of banks having more than 5% of branches having arrears in balancing of books. A detailed report on banks which had arrears in balancing of books at branches accounting for more than 40% of business are reviewed at periodical intervals. There has been a considerable improvement in balancing of books in public sector banks since June 1997 inasmuch as the total number of branches where books were not balanced came down from 4245 as on June 30, 1997 to 1356 branches as on June 30, 2000. Further the number of branches with balancing arrears for more than two years had also come down from 1650 to 630 branches during the above period.

(iv) Reconciliation of Nostro accounts

A Working Group consisting of three bankers and a chartered accountant, (besides RBI officials) has gone into the system of accounting of Nostro accounts transactions by banks and proposed solutions for speedy reconciliation of Nostro accounts entries in pubic sector banks. Top Management of banks which have reported high pendency in this area are called for a monitoring discussion by the Deputy Governor and Executive Director. The number of entries pending for reconciliation in public sector banks had come down from 14.68 lakh entries (Rs. 224539 crore) as on March 31,1996 to 8.60 lakh entries (Rs. 83491 crore) as on March 31, 2000.

(v) Strengthening of internal audit /control system

Banks were advised to reconstitute the Audit Committee of the Board (ACB) with a view to making them more independent and with larger representation of non-executive directors. The ACBs are to be invariably headed by a Director who is a chartered accountant from among the non-executive directors of the bank. The minutes of ACB are to be placed before the Board of Directors on an ongoing basis to serve as a link between their functioning.

All public sector banks were advised to appoint a senior officer of the bank as Compliance Officer who should act as a nodal agency to ensure compliance of internal management controls as well as regulatory and guidance.

(vi) Audit system in banks

The Bank has evolved systems and norms of empanelment and appointment and remuneration of statutory auditors in banks and payments for special validation audit and provided guidance on accountability aspects under statutory audit of banks, quality and coverage of statutory audit reports, system of concurrent audit and its coverage in banks.

Further, the banks were advised to review the present system of concurrent audit immediately and incorporate necessary changes therein based on the guidelines of RBI. The banks are also to review once a year the effectiveness of the system and take necessary measures to correct the lacunae in implementation.

(vii) Fraud monitoring

The system of internal control and follow-up in respect of cases of large frauds of Rs.1 crore and above reported to the RBI is reviewed periodically. The emphasis on house keeping aspects has helped in detecting large frauds and instituting fraud prevention measures.

Banks are cautioned about the details of individuals/companies/firms/ proprietary concerns involved in perpetration of frauds, furnishing details of their directors/partners /guarantors/associates. In addition, modus operandi of new types of frauds is also circulated among banks and financial institutions, to put them on guard. RBI also conducts special scrutiny in respect of large value frauds at the branch/controlling office level to find out lapses contributing to the frauds.

All cases of frauds involving large amounts are analysed to identify the contributory factors and taken up with the banks concerned for remedial measures. The aspects relating to recovery, staff accountability and improvement in internal controls are also pursued with the banks which are advised in the process to report the fraud cases to Police/CBI, if not already done. Detailed instructions have been issued by Reserve Bank of India towards streamlining fraud prevention and control/monitoring system.

With a view to expediting the investigation of fraud cases, RBI reports cases involving Rs. 1 crore and above as also those revealing inter-state ramifications irrespective of the amounts to CBI. The banks are advised to examine staff accountability aspect in all cases. Obtaining photographs of accountholders while opening accounts is one of the measures introduced to control frauds.

In-depth examination of large value frauds reported by commercial banks was conducted by a Study Group under the Chairmanship of CMD of a public sector bank. The group indicated common types of frauds by giving the modus operandi thereof and recommended several measures for early detection and prevention of frauds including recommendations for improvement in internal control, house-keeping, vigilance, management, etc. Apart from implementing the recommendations the banks were advised to adopt certain measures to avoid delay in reporting. It has also been decided that if large value frauds were due to non-observance of prescribed internal control system, certain restrictions are to be placed on opening of new branches by these banks. The banks have been advised to scrupulously follow the time limit laid down by Chief Vigilance Commissioner (CVC) and the position of adherence to CVC guidelines reviewed by their board on a quarterly basis. If these guidelines are not strictly followed, the concerned banks should furnish a report to the CVC.

An Advisory Board on bank frauds was set up by the Governor, RBI with effect from March 1, 1997 under the Chairmanship of Shri S.S. Tarapore, former Member of BFS and Deputy Governor of RBI and five members drawn from areas such as law, administration, police, professional accounting and commercial banking. The Board has since been converted as Central Advisory Board on Bank Frauds and functions as part of the Central Bureau of Investigation (CBI) of Government of India. The Board advises on the cases referred by the CBI either directly or through the Ministry of Finance for investigation/ registration of cases against bank officers of the rank of General Manager and above. The Department of Banking Supervision is providing the secretarial assistance and RBI meets the cost of the functioning of the Board.

11. Core Principles for Effective Banking Supervision

The Bank has continued with the post-liberalisation strategy of setting prudential norms based on international best practices within which banks are left free to operate. The compliance of the Bank with the Basel Committee’s Core Principles on Banking Supervision was gone into in great detail and the gaps in supervision were addressed by setting up seven in-house groups to make necessary recommendations. The reports of these groups were discussed by the BFS in a specially convened session and the agenda set for action to be taken to bridge the gaps. Since then, the compliance is being monitored on a regular basis. The BFS also authorised the release in the public domain of the assessment of compliance, and this document is being shared with overseas supervisory agencies and international financial institutions. The IMF also completed an assessment using the revised methodology of the Core Principles which was in line with the Bank's own assessment.

RBI’s efforts in this area have been well recognised in international forums and in August 1999, it was made a Member of the Core Principles Liaison Group (CPLG) of the Basel Committee for Banking Supervision, which has been set up to promote the implementation of the Core Principles world-wide. RBI has also examined the proposed New Capital Adequacy Framework currently under discussion by the BCBS, and has communicated its response to the Basel Committee. RBI is also represented on the Working Group of Capital of the Core Principles Liaison Group, which has been constituted to obtain the inputs of the non G-10 countries in the international standard setting exercise.

12. Future Agenda

Consultative Process: One of the major changes brought about in the supervisory functioning is to introduce a consultative process with banks preceding the introduction of major measures. The guidelines on Asset-Liability Management (ALM) and on comprehensive Risk Management Systems have been finalised in 1999 on the basis of feedback received from banks and the banks advised to implement the guidelines. The supervisory focus in the coming years will be to monitor the progress of implementation of these systems and to ensure their full coverage. Consultative process has also been followed while introducing the guidelines for investment in non-SLR securities and review of reporting system covering overseas branches of Indian banks.

Risk-Based Supervision: A risk based supervisory regime as a means of more efficient allocation of supervisory resources is also being considered. The risk based supervision project, which is being guided by international consultants with the assistance of Department for International Development (UK), would lead to prioritisation of selection and determining of frequency and length of supervisory cycle, targeted appraisals, and allocation of supervisory resources in accordance with the risk perception of the supervised institutions. The Risk Based Approach will also facilitate the implementation of the supervisory review pillar of the proposed New Capital Accord, which requires that national supervisors set capital ratios for banks based on their risk profile.

Prompt Corrective Action: To guard against regulatory forbearance and to ensure that regulatory intervention is consistent across institutions and is in keeping with the extent of the problem, a framework for Prompt Corrective Action has been developed. The PCA framework, which will link regulatory action to quantitative measures of performance, compliance and solvency such as CRAR, NPA levels and profitability, has been circulated for discussion and suggestions to a wider audience of banks and interested public, and would now be considered by the BFS before being implemented.

Consolidated Supervision: An approach of consolidated supervision that, while leaving the responsibility of supervision of bank subsidiaries to their respective regulators, will allow bank supervisors to obtain a consolidated view of the operations of bank groups has been approved. This will also require greater coordination between the different supervisors in the financial sector. Quarterly reporting by parent banks on key areas of functioning of subsidiaries has been introduced from the quarter ending September 2000. The banks are now being required to annex the financial statements of their subsidiaries along with their annual accounts. A Working Group has been set up to look into the introduction of consolidated accounting and it would submit its report by May 2001. Thus, the components of this diversified approach are being gradually put in place.

Upgrading Reporting Systems: With the increasing reliance upon off-site reporting as an instrument of supervision, upgradation of systems has been a focus area of the BFS and this focus will continue in the future. The project under way to move the surveillance database to RDBMS with a data-warehousing component will provide line supervisors the ability to closely monitor banks and detect vulnerabilities in the system at an incipient stage.

Skills Upgradation: The skill-set required by supervisors has changed radically over the past few years. With the introduction of technology and new products and the move towards risk-based supervision, the demands on supervision have also increased. Thus, meeting the training needs of supervisors in this changing environment will be a priority area and will be monitored continuously.

In the coming years, the RBI will continue to guide the development of supervisory prescriptions and practices along the lines of international best practices based on global standards so as to strengthen both the supervisory regime as well as the Indian banking system.