Annex II.1

Review of Initiatives by the Board for Financial Supervision – 2006-07

With a view to strengthening the supervisory framework within the Reserve Bank, the Board for Financial Supervision (BFS) was set up in November 1994, with diverse professional expertise to provide 'undivided attention to supervision' and ensure an integrated approach to supervision of commercial banks and financial institutions. The BFS met 12 times during 2006-07 (July-June). The major initiatives taken by the BFS during the year were as follows:

(i) Since the introduction of the Basel I framework, the requirement of the capital funds by banks has increased manifold. The continued expansion of the Indian banks' balance sheets, proposed transition to the New Capital Adequacy Framework, which is more risk sensitive in nature, and additional capital requirements for operational risk are prompting banks to further shore up their capital funds. Taking note of the need for enhanced capital funds, banks' capital raising options were considered by the BFS during the year and detailed guidelines on introduction of additional instruments for raising capital, *i.e.*, Innovative Tier I instruments and Upper Tier II instruments were issued to banks.

(ii) Apart from the funds raised from outside, internal accrual forms an important part of the banks' capital funds. The increased profitability of Indian banks has substantially enhanced their capital funds. However, the BFS felt that some of the banks were following inappropriate practices/methods with regard to utilisation of floating provisions and appropriation of reserves. It observed that floating provision was being used by banks for smoothening of profit and its manner of utilisation lacked transparency. Accordingly, detailed guidelines were issued to banks, which *inter-alia* stipulated that the floating provisions can be used only for contingencies under extraordinary circumstances for making specific provision in the impaired assets after obtaining the board's approval and with prior permission of the Reserve Bank. Further, the banks' boards should lay down an approved policy defining extraordinary circumstances and the level to which floating provisions should be created. As regards appropriation of reserves, it was decided that in order to ensure that recourse to drawing down of the statutory reserves is done prudently and not in violation of any of the regulatory prescription, banks, in their own interest, should take prior approval from the Reserve Bank before any appropriation is made from the statutory reserves.

(iii) Under the Basel II framework, the adequacy of capital and the probability of losses incidental to a bank's operations are related to the risk level of its assets. The weighted assets approach did not give adequate attention to the concentration of risk on the liability side of banks. In the context of increasing importance and awareness of the concentration risk on the liability side of banks, the BFS had examined the matter in detail. In order to reduce the extent of concentration on the liability side of the banks, more particularly inter-bank liabilities (IBL), it was prescribed that IBL of a bank should not exceed 200 per cent of its net worth as on 31st March of the previous year. However, individual banks, with the approval of their boards of directors, could fix a lower limit for their IBL, keeping in view their business model. The banks whose CRAR is at least 25 per cent more than the minimum CRAR (9 per cent), *i.e.*, 11.25 per cent as on March 31, of the previous year, were allowed to have a higher limit up to 300 per cent of the net worth for IBL. The limit prescribed includes only fund based IBL within India (including inter-bank liabilities in foreign currency to banks operating within India). In other words, the inter-bank liabilities outside India were excluded. The existing limit on the call money borrowings prescribed by the Reserve Bank operates as a sub-limit within the above limits.

(iv) It was recognised that several banks had large and increasing exposures to sensitive sectors, especially the real estate sector which, given the inherent volatility in the prices, are considered to be risky. Accordingly, as per the directions of the BFS, a second round of supervisory review process (SRP) with regard to banks' exposure to sensitive sectors was initiated on individual banks selected based on off-site data. The process covered on-site focused examination to assess the risk exposures of individual banks with reference to their actual control environment, procedures and compliance with internal and regulatory norms. Accordingly, on-site scrutinies were conducted in select banks, which revealed that in view of the increase in the banks' exposure to the real estate sector, they had put in place certain policies to mitigate the associated risks. However, enhanced systems were not put in place by the banks in all cases to ensure that those policies were actually implemented while extending such loans to this sensitive sector.

(v) The BFS also took note of the risks arising on account of intra-group transactions of financial conglomerates in which bank is one of the counterparties. A monitoring mechanism for entities identified as financial conglomerates was put in place and as part of operationalisation of the same, the Reserve Bank has been obtaining data/information from the designated entities (DEs) for the 12 FCs under its purview. The analysis of FC returns had raised certain issues such as commonality of auditors, commonality of directors, certain directors being employees in other group companies, intra-group movement of executives having implications of 'arm's length' relationship/confidentiality of customer data, commonality of back-office arrangements/service arrangements between group companies, significant investments in the units of group mutual fund company and mortgage backed securities issued by group company, non-reporting of certain intra-group transactions, including large letter of comfort transaction. The half-yearly discussions held with the Chief Executive Officer (CEO) of the DEs in association with other principal regulators to address outstanding issues/ supervisory concerns and for strengthening of the FC monitoring mechanism had revealed several issues, *viz.*, absence of group-wide oversight mechanism, absence of enterprise-wide risk management, lack of group compliance policy, absence of a policy on intra-group transactions and exposures, lack of group-wide capital assessment, applicability of 'fit and proper' criteria for the directors, CEO and shareholders, issues relating to group-wide liquidity management policy, identification and management of concentration risk, implementation of the Reserve Bank's guidelines on outsourcing/ capital market exposure and frauds in the group entities.

(vi) The role and importance of urban co-operative banks (UCBs) in the Indian banking system has been duly recognised. However, several of the UCBs do not have adequate capital funds. The issue of augmenting the capital funds of UCBs was considered by the BFS. It was felt that UCBs should be allowed to issue four new instruments, *viz.*, non-convertible debentures/bonds, special shares, redeemable cumulative preference shares and long-term deposits to enable UCBs to raise capital at a premium. Special shares, which are non-voting in nature and perpetual, were suggested to keep them different from ordinary shares. It was further felt that the Reserve Bank may make an exception with regard to rating requirement to enable the commercial banks to invest in special shares and Tier II bonds issued by UCBs within the ceiling prescribed for investment in unlisted securities and that funds raised through new instruments should be exempted from the CRR/SLR.