Annex II.1
Initiatives by the Board for Financial Supervision – 2007-08

During 2007-08, the Board for Financial Supervision (BFS) continued to exercise its supervisory role over those segments of the financial institutions that are under the regulatory purview of the Reserve Bank. The BFS met ten times during 2007-08 (July-June) and the major initiatives taken are set out below.

(i) The BFS deliberated upon the unprecedented growth in the exposure of banks to the real estate sector and related issues like improper documentation, frauds, incidence of NPAs and lack of registration system for equitable mortgages, among others. The Reserve Bank has been sensitising the banks in this regard and stressing the need for quality, due diligence and proper documentation, among others. At the instance of the BFS, the NHB has been advised to carry out a study on the arrangements in place for housing loans in order to get a better picture of the matter.

(ii) Keeping in view the irregularities observed in the functioning of an Indian bank abroad, a system for monthly reporting of incidents of overseas regulatory violations/breaches and related issues by banks, in any of the countries where they have a presence, to their boards of directors and the Reserve Bank was put in place. This prescription is in addition to the existing reporting requirements in this regard and the compliance officer of the bank shall be responsible for this reporting.

(iii) Against the backdrop of the steady improvement in the asset quality of the Indian banking system over the years, the BFS desired that this achievement be taken up as a case study by documenting the history of evolution of the current NPA scenario in India and highlighting the regulatory and institutional efforts made to bring down the NPAs. Accordingly, a comprehensive study on NPA management was carried out covering the position in the pre- and post-reform period and legislative, regulatory and institutional changes in the area.

(iv) The BFS felt that the incidences of common and recurring deficiencies pointed out in successive Annual Financial Inspection reports had a bearing on the level of corporate governance in banks and directed that the position of discomfort/governance issues may be examined bank-wise. Accordingly, separate formats were devised for public sector and private sector banks for evaluation of their performance in the area of corporate governance, touching upon the issues covered under the Banking Regulation Act, 1949; Clause 49 of the Listing Agreement as prescribed by SEBI; recommendations of the Ganguly committee and guidelines issued from time to time.

(v) The issue of sale of NPAs by banks was deliberated upon by the BFS, which directed that banks should clearly indicate the realisation cost and establish that the amount of settlement is larger than the NPV of the net realisable value of the securities, when taking decisions for sale of NPAs.

(vi) On the matter of outsourcing of services by banks, the BFS directed that the guidelines on the issue should clearly emphasise the enforceability requirement in the outsourcing contracts. All documents pertaining to the outsourcing contract should be made available for inspection. It would be obligatory on the part of banks to cover the outsourcing agencies under their internal audit and submit a confirmation report and compliance certificate in this regard to the Reserve Bank.

(vii) Two rounds of the SRP with regard to exposure of banks to sensitive sectors were undertaken. In regard to the exposure to real estate sector, banks were advised to put in place board approved policy specifying, *inter alia*, internal limits for such exposures, minimum rating for builders, minimum share of the promoters' contribution, requisite security cover, panel of approved valuers for giving valuation reports, and procedure for registration of documents and verification of the registration with the authorities.

(viii) After detailed deliberations on the efficacy of issuing instructions on matters such as the method of valuation to be adopted for property/land taken as security by banks, the BFS advised banks to go by the current market value of the land for valuation purpose. Accordingly, the Reserve Bank issued a mail-box clarification to all banks.

(ix) The BFS took note of the press reports on the substantial losses suffered by certain corporates on the cross-currency derivatives undertaken by them. The losses were on account of the continued fall in the value of the dollar *vis-à-vis* other European currencies and yen. On the directions of the BFS, banks with high off-balance sheet exposure were identified and a study was carried out on the nature of exposures and overall implications in the current scenario.

(x) The rising trend of banks accepting bulk deposits at higher interest rates attracted the attention of the BFS which querried the Reserve Bank about its comfort level regarding these kinds of deposits. A study was undertaken which revealed that the risk of concentration of deposits sourced from a few large depositors was high in the case of foreign banks, particularly those with a limited retail deposit base. Some private sector banks also had a significant degree of concentration risk, while for public sector banks, this risk was found to be low. The level of concentration risk had not changed significantly over the past three years. In comparison to other bank groups, new private sector banks paid higher rates of interest irrespective of the size of the deposits. Though the foreign banks paid the lowest rates of interest, they had a significant proportion of current deposits in the bulk deposits. This reliance on bulk deposits, including bulk current deposits, and short-term money market exposed the foreign banks to significant liquidity and earnings risk.

(xi) While deliberating on the review of the Indian banking system for the half-year ended September 2007, the BFS directed that a special study be carried out to examine: (a) centre-wise, sector-wise data on advances and deposits that would indicate the sectors which were experiencing strong growth; (b) whether the credit growth in the retail sector had slowed down; (c) whether NPAs in that area were growing; and (d) whether the data squared with the data compiled through other sources such as the Basic Statistical Returns data. The study has been undertaken and the report is awaited.

Annex VII.1
Financial Stability Forum (FSF) Report: Status

In the wake of the turmoil in global financial markets, the FSF brought out a report in April 2008 identifying the underlying causes and weaknesses in the international financial markets. The proposals made by the FSF and status in regard to each in India are narrated below:

Proposal 1. *Strengthened Prudential Oversight of Capital, Liquidity and Risk Management*

(i) Capital requirements:

- *Raise Basel II capital requirements for certain complex structured credit products;*
- *Introduce additional capital charges for default and event risk in the trading books of banks and securities firms;*
- *Strengthen the capital treatment of liquidity facilities to off-balance sheet conduits.*

Changes will be implemented over time to avoid exacerbating short-term stress.

(ii) Liquidity:

Supervisory guidance to be issued for the supervision and management of liquidity risks.

(iii) Oversight of risk management:

Guidance for supervisory reviews under Basel II will be developed that will:

- *Strengthen oversight of banks' identification and management of firm-wide risks;*
- *Strengthen oversight of banks' stress testing practices for risk management and capital planning purposes;*
- *Require banks to soundly manage and report off-balance sheet exposures;*

Supervisors will use Basel II to ensure banks' risk management, capital buffers and estimates of potential credit losses are appropriately forward looking.

(iv) Over-the-counter derivatives:

Authorities will encourage market participants to act promptly to ensure that the settlement, legal and operational infrastructure for over-the-counter derivatives is sound.

Status

The road-map for the implementation of Basel II in India has been designed to suit the country-specific conditions. The phased implementation process got underway with the Basel II Accord being made applicable to foreign banks operating in India and Indian banks having operational presence outside India with effect from March 31, 2008. All other commercial banks (except Local Area Banks and RRBs) are encouraged to migrate to Basel II in alignment with them but in any case not later than March 31, 2009. The process of implementation is being monitored on an on-going basis for calibration and fine-tuning.

The minimum capital to risk-weighted asset ratio (CRAR) in India is placed at 9 per cent, one percentage point above the Basel II requirement. Further, regular monitoring of banks' exposure to sensitive sectors and their liquidity position is also undertaken. In India, off-balance sheet vehicles in the form of SPVs for the purpose of securitisation are in existence for which extensive guidelines, in line with the international best practices, have already been issued. Liquidity facilities to such SPVs are subject to capital charge. Banks were required to put in place appropriate stress test policies and relevant stress test frameworks for various risk factors by March 31, 2008.

In order to further strengthen capital requirements, the credit conversion factors, risk weights and provisioning requirements for specific off-balance sheet items including derivatives have been reviewed. Further, in India, complex structures like synthetic securitisation have not been permitted so far. Introduction of such products, when found appropriate, would be guided by the risk management capabilities of the system.

The Reserve Bank had issued broad guidelines for asset-liability management and banks have flexibility in devising their own risk management strategies as per board-approved policies. However, in regard to liquidity risks at the very short end, the Reserve Bank has taken steps to mitigate risks at the systemic level and at the institution level as well. The Reserve Bank has introduced greater granularity to measurement of liquidity risk by splitting the first time bucket (1-14 days, at present) into three time buckets, *viz.*, next day, 2-7 days and 8-14 days. The net cumulative negative mismatches in the three time buckets have been capped at 5 per cent, 10 per cent, and 15 per cent of the cumulative cash outflows.

The Reserve Bank had recognised the risks of allowing access to unsecured overnight market funds to all entities and, therefore, restricted the overnight unsecured market for funds only to banks and primary dealers (PD). Since August 2005, the overnight call market is a pure inter-bank market. Accordingly, trading volumes have shifted from the overnight unsecured market to the collateralised market.

Greater inter-linkages and excessive reliance on call money borrowings by banks could cause systemic problems. The Reserve Bank has, therefore, introduced prudential measures to address the extent to which banks can borrow and lend in the call money market. On a fortnightly average basis, call market borrowings outstanding should not exceed 100 per cent of capital funds (*i.e.*, sum of Tier I and Tier II capital) in the latest audited balance sheet.

Recognising the potential of 'purchased inter-bank liabilities' (IBL) to create systemic problems, the Reserve Bank had issued guidelines in March 2007 prescribing that IBL of a bank should not exceed 200 per cent of its net worth (300 per cent for banks with a CRAR more than 11.25 per cent).

Proposal 2. *Enhancing Transparency and Valuation*

(i) Robust risk disclosures:

- *The FSF strongly encourages financial institutions to make robust risk disclosures using leading disclosure practices at the time of their mid-year 2008 reports.*
- *Further guidance to strengthen disclosure requirements under Pillar 3 of Basel II will be issued by 2009.*

(ii) Standards for off-balance sheet vehicles and valuations:

Standard setters will take urgent action to:

- *Improve and converge financial reporting standards for off-balance sheet vehicles;*

Develop guidance on valuations when markets are no longer active, establishing an expert advisory panel in 2008.

(iii) Transparency in structured products:
Market participants and securities regulators will expand the information provided about securitised products and their underlying assets.

Status

The Reserve Bank has, over the years, issued guidelines on valuation of various instruments/ assets in conformity with the international best practices while keeping India-specific conditions in view. In order to encourage market discipline, the Reserve Bank has developed a set of disclosure requirements which allow the market participants to assess key pieces of information on capital adequacy, risk exposure, risk assessment processes and key business parameters which provide a consistent and understandable disclosure framework that enhances comparability. Banks are also required to comply with the Accounting Standard (AS) on Disclosure of Accounting Policies issued by the Institute of Chartered Accountants of India (ICAI).

In recognition of the fact that market discipline can contribute to a safe and sound banking environment and as part of the ongoing efforts to implement the Basel II Accord, the Reserve Bank issued guidelines on minimum capital ratio (Pillar 1) and market discipline (Pillar 3) in April 2007 and guidelines for Pillar 2 (supervisory review process) were issued in March 2008. Under these guidelines, non-compliance with the prescribed disclosure requirements would attract a penalty, including financial penalty.

Proposal 3. *Changes in the Role and Uses of Credit Ratings*

Credit rating agencies should:

- *Implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process;*

- *Differentiate ratings on structured credit products from those on bonds and expand the information they provide.*

Regulators will review the roles given to ratings in regulations and prudential frameworks.

Status

The Reserve Bank has undertaken a detailed process of identifying the eligible credit rating agencies whose ratings may be used by banks for assigning risk weights for credit risk. Banks should use the chosen credit rating agencies and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Banks are not allowed to 'cherry pick' the assessments provided by different credit rating agencies. If a bank has decided to use the ratings of some of the chosen credit rating agencies for a given type of claim, it can use only the ratings of those credit rating agencies, despite the fact that some of these claims may be rated by other chosen credit rating agencies whose ratings the bank has decided not to use. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

Banks must disclose the names of the credit rating agencies that they use for the risk weighting of their assets, the risk weights associated with the particular rating grades as determined by the Reserve Bank through the mapping process for each eligible credit rating agency as well as the aggregated risk weighted assets as required.

In India, complex structures like synthetic securitisations have not been permitted so far. As and when such products are to be introduced, the Reserve Bank would put in place the necessary enabling regulatory framework, including calibrating the role and capacity building of the rating agencies.

Proposal 4. *Strengthening the Authorities' Responsiveness to Risks*

- *A college of supervisors will be put in place by end-2008 for each of the largest global financial institutions.*

Status

In the Indian context, there has been exchange of supervisory information on specific issues between the Reserve Bank and few other overseas banking supervisors/regulators. Supervisory cooperation has been working smoothly and efficiently.

The Mid-Term Review of October 2007 had announced the constitution of a Working Group to lay down a road-map for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators, consistent with the framework envisaged in the Basel Committee on Banking Supervision (BCBS). A Working Group was constituted in March 2008 and is in the process of finalising its Report. A number of overseas regulators of countries such as the USA, the UK, Canada, Hong Kong, Australia and Singapore have been formally approached to share systems and practices, including legal positions, in the matter of supervisory cooperation and sharing of information with overseas regulators. The response from a few countries has been received and is being examined. The 'Supervisory College' arrangement for this purpose is also being examined by the Group.

Proposal 5. *Robust Arrangements for Dealing with Stress in the Financial System*

- *Central banks will enhance their operational frameworks and authorities will strengthen their cooperation for dealing with stress.*

Status

In the Reserve Bank, there is an institutional arrangement in place to oversee the functioning of the financial markets on a daily basis. There is a Financial Market Committee monitoring and assessing the functioning of different financial markets. Based on such an oversight, appropriate and prompt action is taken, whenever necessary.

The Reserve Bank has the necessary framework for provision of liquidity to the banking system, in terms of Sections 17 and 18 of the Reserve Bank of India Act, 1934. The regular liquidity management facilities of the Reserve Bank include the LAF, OMO and MSS besides standing facilities such as export credit refinance (ECR) and the liquidity facility for standalone PDs. The Reserve Bank can undertake purchase/sale of securities of the Central or State Governments and can purchase, sell and rediscount bills of exchange and promissory notes drawn on and payable in India and arising out of *bona fide* commercial or trade transactions for provision/absorption of liquidity for normal day-to-day liquidity management operations as also for provision of emergency liquidity assistance to the banks under the lender of last resort function.

The Reserve Bank is empowered under the existing legal framework to deal with the resolution of weak and failing banks. The Deposit Insurance and Credit Guarantee Corporation (DICGC) offers deposit insurance cover in India. The Banking Regulation Act provides the legal framework for voluntary amalgamation and compulsory merger of banks under Sections 44 (A) and 45, respectively. The mergers of many weak private sector banks with healthy banks have improved overall stability of the system.

Source: Annual Policy Statement for the Year 2008-09, Reserve Bank of India.