Annex III.1
Initiatives by the Board for Financial Supervision – 2008-09 (July – June)

- With regard to the issue of revaluation of physical assets by the banks, the BFS expressed that it would not be in order for banks to revalue their operating assets such as the building from where the bank was functioning/conducting business and take the notional appreciation to the reserves as if the bank actually sold off this property. In this context, the issue of *Sale and leaseback*, in which one party sells a property to a buyer and the buyer immediately leases the property back to the seller, by banks were discussed and the BFS directed that proposals for sale of property by banks to its own subsidiaries/group entities and/or SPVs floated by the bank for subsequent lease back cannot be accepted.

- In the background of the global financial crisis, the BFS closely monitored the emerging signals across the global markets and the consequent ramifications on the Indian financial sector. As an additional measure, the BFS is now monitoring the Mark-to-Market losses in credit derivatives and other investment portfolio of overseas operations of banks in India on monthly basis. In this context, BFS also monitored the results of stress test of the credit portfolio of commercial banks in India to assess the resilience of banks under various stress scenarios as at end-March 2008 which revealed that, at system level, under none of the scenarios the CRAR declined below the stipulated minimum level. It was also seen that though the CRAR of some individual banks would decline below the minimum required level, the systemic impact would not be very high.

- In view of the emergence of the concerns in the media regarding forex derivatives, BFS directed that detailed information be called for in structured formats in respect of certain select banks at the top end of the exposures. A series of meetings were held with the Chairmen/CEOs of certain banks including foreign banks which had dealt with these products to discuss issues with regard to 'Suitability and Appropriateness' principles, risk management policies of corporates and cost cutting measures initiated by the banks and the Reserve Bank concerns in the matter were conveyed to them. A comprehensive report was placed before the BFS based on the discussions.

- While examining the issue of a bank undertaking activities through subsidiary route which the bank is not permitted to undertake under Section 6 of the Banking Regulation Act, 1949, the BFS decided that the activities which a bank itself is not permitted to undertake as per the provisions of Banking Regulation Act, 1949 cannot be undertaken by entities in which the bank has significant financial stake.

- With regard to the issues related to the outsourcing arrangements, the BFS laid specific emphasis on the availability of a proper documentation process/proper document preservation clause in the outsourcing contracts signed by banks with Third Party Service Providers. The Board emphasised that adherence to the Reserve Bank's guidelines could be ensured only if the records were proper and documentation complete. Absence of documents and records make it difficult to determine the legal rights and responsibility applicable to the bank and the outsourced agency and the very enforceability of the contract. The Board directed that (i) the outsourcing guidelines should clearly emphasise the enforceability requirement in respect of the outsourcing contracts and the contract should provide that all outsourcing documents are available for inspection by the Reserve Bank and bank's internal inspectors and (ii) audit of the outsourced agents/agencies should be an obligatory function for the internal audit of banks and (iii) a confirmation report and compliance certificate in this regard may be submitted to the Reserve Bank by the banks. Based on the directions of BFS, a circular was issued to all the commercial banks to plug the regulatory gaps regarding the submission of confirmation report and compliance certificate by banks.

- The retail credit practices among the commercial banks drew the attention of the BFS. The BFS was appraised that the practices in the retail credit business had evolved rapidly and were very different from traditional banking practices followed in this regard. In this regard, the BFS decided that while the banks cannot be restricted from use of the statistical models in this regard, it is essential to test the robustness, soundness and effectiveness of the models. The methods, assumptions deployed, samples used along with the sampling techniques need to be tested. It should also be verified that the provision requirements worked out under these techniques/models is at least equal to the requirements under the individual account assessment process as any diminution in the provision requirement assessment cannot be accepted. It was also felt that building quantitative abilities in the Bank including engagement of professionals was becoming very essential as use of models would be increasing, including in the context of the advanced methods under Basel II. Accordingly, it was decided that an inter-departmental team would undertake the evaluation exercise.
- With regard to the progress in the reconciliation of nostro accounts based on the quarterly reports received from banks, BFS accorded approval to a proposal, *inter alia*, to allow banks to transfer to profit and loss account (i) the credit balance arising out of the netting of entries pertaining to the period prior to April 1 1996 (ii) aggregate of individual unreconciled credit entries in nostro and mirror accounts 'less than USD 2500' and originated between April 1, 1996 and March 31, 2002 and parked in the blocked account.
- While deliberating on issue of sale of NPAs by banks particularly in the context of deficiencies observed in such procedures followed by banks, the BFS decided to inform the banks that the extant circular issued in October 2007 merely lays down the broad principles to be adopted by banks while entering into compromise settlements. Banks can continue to enter into compromise settlements based on the circumstances, facts of each case and their commercial judgement and should be able to justify the decision taken.
- In the context of merger of banks, the BFS opined that subordinated debt of the merged entity should be reissued just as equity is reissued. It also approved the proposal that in the Indian context in all cases of voluntary merger/compulsory merger and acquisition, the extent of admissible liability towards the Tier I and Tier II instruments would be laid down in the scheme of merger/amalgamation. Consequently, these instruments may have to be reissued.
- The BFS while deliberating on the present approach towards branch inspection, approved a proposal to revise the existing criteria for selection of branches for Annual Financial Inspection. In addition to the existing parameters including minimum stipulated coverage of advances, it was proposed to prescribe a mix of additional

parameters like 'branches with unusually high growth in business', 'branches with adverse internal rating', 'branches having unusually large number of accounts opened within a short period', and 'branches with significant quick mortality of advances'. More emphasis will be given to asset classification, post-disbursement supervision over advances, KYC/AML compliance, CTR/STR, and adequacy of customer service. Further, it is also proposed that under the Off-Balance sheet business, all types of derivative products offered by the bank should be checked on sample basis with a range of 10 per cent to 50 per cent of Off- Balance sheet transactions entered during the year depending on volume of business. These additional parameters will result in a dynamic process of identification of branches which would throw up a better sample of branches for inspection. The proposal was approved by the BFS and the necessary instructions have been circulated to all the Regional Offices.

- In the backdrop of recent sub-prime crisis, the BFS deliberated at length on the treatment/availability of assets of foreign banks in India for liquidation of global liabilities in a scenario like the present crisis. After exhaustive discussions on the academic literature and international legal position regarding ring fencing, differences in ring fencing of branches and subsidiaries, country wise practices of ring fencing and Indian legal position regarding ring fencing, the BFS directed that the status quo be maintained in the matter and also that the Reserve Bank may remain in preparedness for necessary action once the international principles and standards emerge in the matter.

- While looking into the interpretational issues in respect of group entities (subsidiaries, associates and joint ventures) which are required to be consolidated with the parent bank, the BFS directed that banks should record the intent of holding of the investment for a temporary period or otherwise at the time of investment in the subsidiary, associate and joint venture. In the absence of record of such intent by the Board at the time of such investment, the same would be taken into account for the purpose of consolidation.

- Continuing with its stress on fine tuning of supervisory rating model ever since its introduction, the BFS has accorded approval to revise the Earnings Appraisal component of the rating model by reducing the marks allotted to ROE (Return on Equity) in the 'Earnings Appraisal' component of the existing rating model was reduced from 60 to 30 marks and reintroducing the ROA (Return on Assets) parameter with 30 marks. All other parameters have also been retained with the existing marks. BFS further directed the revised model be implemented with effect from the inspection cycle of 2009-10.