

# **Core Principles for Effective Banking Supervision**

## **AN ASSESSMENT OF THE POSITION IN INDIA\***

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### **FOREWORD**

*The Basel Committee on Banking Supervision, which is a committee of banking supervisory authorities of G-10 countries, has been in the forefront of the international attempt in the development of standards and the establishment of a framework for bank supervision towards strengthening international financial stability. In 1997, in consultation with the supervisory authorities of a few non G-10 countries including India, it drew up the 25 'Core Principles for Effective Banking Supervision' which were in the nature of minimum requirements intended to guide supervisory authorities which were seeking to "strengthen their current supervisory regime". Being one of the central banks which was involved in the exercise of drawing up the Core Principles, the Reserve Bank of India had assessed its own position with respect to these Principles in 1998. The assessment had shown that most of the Core Principles were already enshrined in our existing legislation or current regulations. Gaps had been identified between existing practice and principle mainly in the areas of risk management in banks, inter-agency cooperation with other domestic/international regulators and consolidated supervision. Internal working groups were set up to suggest measures to bridge these gaps and their recommendations have been accepted by the Board for Financial Supervision and are now in the process of being implemented. Given the spread and reach of the Indian banking system, with over 60,000 branches of more than 100 banks, implementation is a challenge for the supervisors. However, the Reserve Bank of India is committed to the full implementation of the Core Principles. The Bank also serves on the Core Principles Liaison Group of the BCBS, which has been formed "to promote the timely and complete implementation of these principles world-wide". It gives me great pleasure to release this document is intended to provide the reader with a framework within which one can view the developments in the Indian Banking System in a proper perspective. The document reflects the position as existing on date and will be updated to reflect future changes. As supervision is a dynamic process, readers may refer to the Reserve Bank of India for the latest position or for any clarifications.*

**S.P. Talwar**  
*Deputy Governor*

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### ***Section I: Preconditions for Effective Banking Supervision***

#### **Principle I: Framework and Coordination**

***An effective system of banking supervision will have clear cut responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protection for confidentiality of such information should be in place.***

1.1 The Reserve Bank of India ("RBI"), an autonomous body created under an act of the Indian parliament i.e. The Reserve Bank of India Act, 1934, is entrusted, inter alia, with the sole responsibility of regulation and supervision of banks under the Banking Regulation Act, 1949. Section 35 of the Banking Regulation Act vests powers in RBI for inspection of books of any banking company at any time.

1.2 Both the regulatory and supervisory functions of RBI were earlier carried out through its Department of Banking Operations and Development ("DBOD") till December 1993, when a separate department entitled 'Department of Supervision (DOS)' was formed to take over the supervisory function, leaving regulatory functions to DBOD. In November 1994, RBI constituted the Board for Financial Supervision (BFS) under RBI (BFS) Regulations 1994 to give undivided attention to the prudential supervision and regulation of banks, financial institutions and non-bank financial institutions in an integrated manner. DBOD continues to perform the regulatory function pertaining to banks. However, DOS has since been bifurcated into Department of Banking Supervision (DBS) and Department of Non-Banking Supervision (DNBS). DBS is responsible for the supervision of commercial banks and their merchant banking subsidiaries. Both regulation and supervision of the development financial institutions (DFI's) are handled by the Financial Institutions Division (FID) of the DBS.

1.3 DNBS is responsible for supervision and regulation of Non-Banking Financial Companies (NBFCs). No NBFC can commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration from RBI. The NBFC with net owned funds of Rs.2.5 million and above (since enhanced to Rs.20 million effective from 20 April 1999) are mandatorily required to be registered with RBI. Maintenance of liquid assets at a specified percentage of public deposits is compulsory. RBI is empowered to give directions to NBFCs and can even prohibit NBFCs which do not adhere to a set of prudential norms from accepting deposits and impose penalties under the provisions of the RBI Act. A system of on-site examination based on CAMELS rating models and off-site surveillance of various statutory returns of NBFCs is in place. Besides, special formats for off-site surveillance of NBFCs with asset size of Rs.1 billion and above have been devised.

1.4 The BFS has been constituted under the aegis of RBI. It is an autonomous body and directs the policies and operations relating to supervision of banks, DFIs and NBFCs. The Governor of the Reserve Bank is the Chairman of the BFS while the Deputy Governor in-charge of supervision is the Vice-chairman. The other two Deputy Governors of the Bank, together with four non-official directors from the Central Board of the Bank, are the members of the BFS. Since its formation in November 1994, the BFS, which meets every month, has positioned a new strategy for on-site supervision of banks and a system of off-site monitoring, based on quarterly reporting system.

1.5 RBI has been given broad powers under Section 35A of the Banking Regulation Act to issue directions to banking companies in general or to any banking company in particular, if it is satisfied that these are required -

- a) in the public interest; or
- b) in the interest of banking policy; or
- c) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or
- d) to secure the proper management of any banking company generally.

1.6 The Central Government, after consultation with RBI, may acquire or amalgamate or reconstitute a banking company, which is being managed in a manner detrimental to the interest of its depositors or which has failed to comply with directions issued by RBI under the Banking Regulation Act. The RBI has powers to apply for winding up of a banking company that is unable to meet its commitments and / or its continuation is prejudicial to the interest of its depositors. The RBI can intervene in the bank's management if directors / management are not found to be 'fit and proper' in the course of operation. The RBI can cancel the licence of a banking company provided the conditions stated in Section 22(3) of the Banking Regulation Act are not fulfilled.

1.7 Section 7 of the RBI Act provides for operational independence to RBI while at the same time reserving the Central Government's right to issue directions to RBI from time to time in public interest. The management of RBI rests with the Central Board of Directors. The RBI is headed by the Governor who is appointed by the Central Government for a term not exceeding five years and is eligible for reappointment.

1.8 An annual report on the working of RBI with detailed analysis of its annual accounts and an assessment of the Indian economy is submitted to the Central Government under Section 53(2) of the RBI Act. The RBI compiles two financial statements viz. weekly statement of its affairs and annual balance sheet as at 30 June of each year in terms of Section 53 of the RBI Act, 1934 and transmits these to the Central Government. The Central Government publishes these statements in the Gazette of India. The RBI publishes fortnightly a consolidated statement containing aggregate liabilities and assets of all the scheduled commercial banks as per Section 43 of the RBI Act. The RBI brings out certain publications at regular intervals on the financial strength and performance of banking industry and state of economy. The publications include Banking Statistics, Report on Currency and Finance, Report on Trends and Progress of Banking in India (Section 36(2) of the Banking Regulation Act), Credit Information Review, and monthly RBI bulletin containing statistics on selective economic and banking indicators and weekly statistical supplements.

1.9 The RBI equips its officers with latest techniques of supervision through ongoing training programmes organised at its own staff colleges viz. Reserve Bank Staff College, Chennai; College of Agricultural Banking, Pune; Bankers Training College, Mumbai; and Institute for Development and Research of Banking Technology, Hyderabad. Besides, the RBI regularly deposes its officers to training programmes, seminars and conferences conducted by international

bodies, Central Banks of other countries and international organisations like Bank for International Settlements and the International Financial Institutions.

1.10 On-going analysis of off-site returns is carried out in a computerised environment. The RBI has initiated steps to move from Local Area Networking (LAN) to Wide Area Networking (WAN) with a view to connect its Regional Offices and commercial banks through VSAT based connectivity by December 2000.

1.11 The banking laws are reviewed and updated from time to time considering the changing needs of the banking industry and economy. The Banking Regulation Act was last amended in 1994. An expert committee set up in February 1999 on the recommendations of the Committee on Banking Sector Reforms is engaged in the task of examining various banking laws and all relevant banking related legislations. The committee is expected to submit its recommendations by December, 1999.

1.12 The RBI has the necessary powers to issue licence to a company for carrying on the business of banking. The RBI is vested with powers to issue guidelines on any issue relating to functioning of banks. This helps the Bank in laying down prudential guidelines for sound management of banks. It has issued several mandatory guidelines on liquidity maintenance, capital adequacy, income recognition, asset classification and provisioning, connected lending and prudential norms on large exposures. The Banking Regulation Act vests powers in RBI to ensure compliance with its provisions. Non-compliance with mandatory guidelines can invite monetary and / or non-monetary penalties.

1.13 The Banking Regulation Act provides for explicit protection to the supervisors under Section 54. No suit or other legal proceeding shall lie against RBI or any of its officers for anything or any damage caused or likely to be caused by anything done in good faith or intended to be done in pursuance of the Banking Regulation Act.

1.14 RBI shares relevant information with overseas supervisors on request. Information from overseas supervisors is received with the understanding that this would remain confidential. Information needs of domestic regulatory bodies like Securities and Exchange Board of India (SEBI), National Bank for Agricultural and Rural Development (NABARD), National Housing Bank (NHB), etc, are attended to on mutual understanding. A High level Committee on Capital Markets consisting of Governor of RBI, Chairman of SEBI and Economic Affairs Secretary of the Central Government, serves as a forum for discussing common regulatory issues.

## **Section II: Licensing and Structure**

### **Principle-II: Permissible Activities**

*The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of word 'bank' in names should be controlled as far as possible.*

2.1 The permissible activities of a banking company are listed in Section 6(1) of the Banking

Regulation Act, 1949. Section 6(2) specifically prohibits a banking company from carrying on any form of business other than those referred to in Section 6(1). The term "banking" as defined in Section 5 means "the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, or otherwise". A banking company means any company that transacts the business of banking in India. Any company other than banking company accepting deposit of money from the public merely for the purpose of financing its business is not deemed to transact the business of banking. A banking company could be either a public sector bank, privately held bank, foreign bank or co-operative bank. The first three types of banks are called "commercial" banks by practice. Commercial banks are divided into certain distinct categories depending on their method of establishment and pattern of ownership, namely public sector banks, i.e. (State Bank of India, its 7 associate banks and 19 nationalised banks), "old" private sector banks i.e. those which were in existence before the guidelines for floating new private banks were issued in 1993, "new" private sector banks, foreign banks, and Regional Rural Banks (RRBs). The scope of the supervision of the BFS is currently limited to all commercial banks other than RRBs. Recently, urban co-operative banks, which are included in the second schedule of the RBI Act, 1934, have also been brought under the ambit of the BFS.

2.2 The permissible activities of banks in India are defined in the Banking Regulation Act that allow banks to undertake both commercial banking and investment banking. However, banks are not allowed to undertake mutual fund business departmentally. Similarly, banks cannot yet undertake insurance business. Banks are permitted to set up subsidiaries only for undertaking activities that are permissible under Section 19 of the Banking Regulation Act. Banks are not allowed to trade in commodities or become members of the stock exchange.

2.3 In India, besides banks that accept public deposits, there are other institutions like development financial institutions (DFIs) and non-banking financial companies that also accept deposits of money that are not repayable on demand. The DFIs have been brought under the supervisory ambit of the DBS since April 1995. The RBI has also recently framed detailed regulations for supervision of these entities that are part of the financial system. Besides these entities, corporate bodies other than banks can also accept retail deposits. The supervision of the RBI does not extend to such corporates, and the acceptance of deposits by corporates is regulated by the Government of India under Acceptance of Deposits Rules, 1993 framed under the Companies Act, 1956.

2.4 Section 7 of the Banking Regulation Act limits the use of words such as "bank", "banker", or "banking" to a banking company only as part of its name or in connection with its business. Further, no company shall carry on the business of banking in India unless it uses as part of its name at least one of such words. The Central Government, on the recommendation of the RBI, may exempt any banking company or class of banking companies from any of the provisions of the Banking Regulation Act (Section 53 of the Banking Regulation Act).

### **Principle-III: Licensing of Banks**

*The licensing authority must have the right to set criteria and reject applications of establishments that do not meet the standards set. The licensing process at minimum should*

***consist of an assessment of the bank's ownership structure, directors and senior management; its operating plan and internal controls and its projected financial conditions, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.***

3.1 Section 22 of the Banking Regulation Act provides that a company intending to carry on banking business must obtain a licence from RBI except such of the banks (public sector banks and RRBs), which are established under specific enactments. The RBI issues licence only after "tests of entry" are fulfilled. These tests include minimum capital, ownership structure, bank's operating plans and controls, ability of the bank to pay its present and future depositors in full, quality of management and whether the licensing of the bank would be in the public interest. Section 22(3) of the Banking Regulation Act provides that the RBI may require to be satisfied by an "inspection of books of the company and methods of operation of the company or otherwise" regarding the capital structure, proposed management etc. prior to grant of licence. By virtue of Section 10A(2) of the Banking Regulation Act, not less than 51% of the total number of members of the Board of Directors of a banking company should have special knowledge or practical experience in accountancy, agriculture, banking, cooperation, economics, finance, law, small scale industry, etc.

3.2 Foreign banks are allowed to operate through branches only. The 'tests of entry' criteria are also applied to branches of foreign banks. Besides these, the RBI examines dealings of the foreign bank with Indian parties, international and home country ranking where available, international presence, economic and trade relations with the home country and supervisory standards prevalent in the home country. The RBI also insists on prior consent of the home country regulator and ensures that the laws of the home country do not discriminate in any way against banks incorporated in India. A new foreign bank is required to bring in minimum assigned capital of USD 25 million, of which USD10 million shall be brought in at the time of opening each of the first two branches and balance USD 5 million at the time of opening of third branch. All the foreign banks are required to maintain minimum capital adequacy ratio of 8% on aggregate risk weighted assets of their Indian operations (being raised to 9% with effect from March 31, 2000). It is important to get home regulators' consent even in the case of opening a Representative Office, as once presence is allowed, it may be construed that the bank has fulfilled the "tests of entry".

3.3 As far as opening of branches by Indian banks overseas is concerned, the bank in India has to take prior approval of RBI for setting up a branch or subsidiary or joint venture. The factors considered while granting such permission include importance of the country as a centre of international finance, pattern of India's trade with and investment in the country concerned, size of Indian population and expatriates in the country, prevailing local banking laws, exchange control regulations, etc.

3.4 For opening a new branch in India, RBI permission is needed after approval of the Board of the bank. However, banks that have achieved 8% capital adequacy ratio; have earned net profit for three consecutive years; have non-performing loans not exceeding 15% of the gross loans and have minimum owned funds of Rs.1 billion, may be permitted to set up new branches and update extension counters into full-fledged new branches. The policy in this regard is revised

from time to time.

3.5 The norms for licensing of new banks have been tightened since 1993 when guidelines allowing entry of banks in private sector were formulated. The track record of the promoters is ascertained from other banks, supervisory/regulatory Departments as well as from SEBI, the Capital Market Regulator. Financial strength of the promoters (minimum paid-up capital required for new private banks is Rs.1 billion) and long-term viability are important factors.

3.6 The RBI is vested with powers under section 22(4) of the Banking Regulation Act to cancel a licence granted to a banking company provided the company ceases to carry on banking business; or is unable to pay its present or/and future depositors; or carrying on banking business by the company is detrimental to the public interest or to the interest of its depositors.

#### **Principle IV: Ownership Pattern**

***Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.***

4.1 Section 12(2) of the Banking Regulation Act restricts shareholders in a banking company from exercising voting rights on poll in excess of ten per cent of the total voting rights of all the shareholders of the banking company.

4.2 In terms of administrative circular issued by the RBI under Section 35(A) of the Banking Regulation Act, any transfer of shares in a banking company, which exceeds 5% of the paid-up capital of the bank requires acknowledgement by the RBI before the registration of the transfer in their books. While seeking acknowledgement from the RBI, the bank has to give a declaration that the proposed transferee is not likely to acquire either singly or along with the companies and concerns in the group a controlling interest in the bank.

#### **Principle V: Acquisition & Investments**

***Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.***

5.1 Banks are allowed to set up subsidiaries and make significant investment only in companies that are undertaking business authorized under section 19(1) of the Banking Regulation Act. This ensures that banks form subsidiaries only in financial services sector, and this requires prior approval of RBI. The RBI applies 'fit and proper' test and examines viability report of the proposed subsidiary before granting permission. Under Section 19(2) of the Banking Regulation Act, other investments by banks whether as pledgee, mortgagee or absolute owner in other companies cannot exceed 30% of the paid-up share capital or 30% of its own paid-up share capital, whichever is less. Investment by banks in a financial services company requires prior approval of RBI and is subject to a ceiling of 10% of the bank's paid-up capital and reserves. Aggregate investment in all the subsidiaries shall not exceed 20% of the bank's paid-up capital. In the case of investments in equity shares of companies not engaged in financial services,

investment in a year should not exceed 5% of incremental deposits of the previous year.

5.2 The RBI insists on arms length relationship between the bank and its subsidiary. As regards supervision, RBI has the authority to supervise companies undertaking non-banking financial services. The capital market related activities of such companies are also under the functional regulation of SEBI.

### **Section III: Prudential Regulations and Requirements**

#### **Principle VI: Capital Requirements**

*Banking supervisors must set minimum capital requirements for banks that reflect the risks that the banks undertake and must define the components of capital bearing in mind its ability to absorb losses. For internationally active banks these requirements should not be less than those established in the Basel Capital Accord.*

6.1 The RBI has prescribed a minimum Capital Adequacy Ratio (CAR) of 8% to be maintained by banks on a solo basis as per Basel norms, covering both on and off-balance sheet items. The components of CAR have been defined as per Basel norms and detailed guidelines were issued in 1992. Compliance with CAR for banks was phased in a gradual manner to give them time to raise the capital level. These transitional arrangements were different for banks with international presence, foreign banks and local banks. Presently all the banks except those dealing in gold/ silver / platinum are required to maintain 8% CAR. For banks dealing in gold / silver /platinum, minimum CAR is 9%. Banks' foreign exchange open position as well as open position in gold should carry 100% risk weight with effect from March 31, 1999.

6.2 Absolute amount of capital for new private sector banks and those dealing in gold / silver / platinum should not fall below Rs.1 billion and Rs.3 billion respectively. All the banks are required to attain 9% CAR by March 31, 2000. Certain structural adjustments have also been made in risk weights like assigning risk weight on investments in Government and other approved securities, and loans and advances guaranteed by the State Governments depending on the status of payment of interest and principal, effective from March 31, 2000.

6.3 Compliance with CAR is monitored through quarterly prudential reporting and on-site inspection of banks. Non-compliance and possible ways to achieve compliance are discussed with the top management of the banks. The banks not complying with the CAR norms may trigger supervisory / regulatory intervention.

6.4 The question of computation of capital adequacy on a consolidated basis is under examination of the Bank.

#### **Principle VII: Loan & Investment Policy**

*An essential part of any supervisory system is the evaluation of a bank's policies and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.*



7.1 Under Section 21 of the Banking Regulation Act, the RBI is charged with the responsibility of determining the policy relating to advances by banks and of giving directions to them in this regard. Accordingly, RBI has asked banks to lay down transparent policies and guidelines for credit dispensation in respect of each of the broad category of economic activity. Similarly, RBI has issued guidelines on drawing up policies and procedure for managing investment portfolio. The banks are required to delegate powers to various functionaries for credit dispensation and investment decision-making.

7.2 In the course of On-site Examination, these policies and adherence thereto are looked into. The examination of the investment portfolio is done against the background of instructions issued by the RBI from time to time on investment policy, internal control systems, separation of client deals from the bank's own portfolio, prescription of accounting standards and overseeing systems of audit, review and reporting.

7.3 The examination of the loan portfolio centres around adequacy of policies, practices and procedures, operation of the scheme of delegation, classification of assets, loan loss provisioning for loans and investments, concentration risk, adherence to prudential exposure norms, scope and adequacy of audit and loan review functions and compliance with laws and regulations. Banks are also expected to put in place detailed operational guidelines based on the policy framework for day-to-day management of the portfolios. The adequacy of provisions for loan losses and for marking of investments to market, and concentration of credit are also assessed on quarterly basis through off-site monitoring returns. Concurrent audit of treasury operations by external auditors to confirm adherence to RBI guidelines is mandatory. Such reports are required to be put up to the top management of the bank on monthly basis.

7.4 The RBI has recently issued comprehensive guidelines on Risk Management Systems in banks after discussions with the banks. These guidelines propose vesting of risk management function with Asset-liability management committees. The banks have been advised to articulate risk-return philosophy, adopt credit risk mitigating tools like setting up of multi-tier credit approving system, prudential portfolio limits, loan grading, risk pricing, portfolio management and loan review mechanism.

7.5 The RBI has issued a manual of instructions to guide its inspection teams in analysing various portfolios of a bank.

### **Principle VIII: Asset Quality**

***Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.***

8.1 The RBI has laid down detailed guidelines on income recognition, asset classification and provisioning covering both on and off-balance sheet exposures in line with international standards. The non-performing assets (NPAs) are required to be classified into substandard, doubtful and loss assets depending on the age of irregularity and provisions are required to be

made taking into account the potential threat to realisability of the asset, as per RBI norms for each of the category and for each of the borrower. A credit facility is classified as non-performing if interest and/or instalment of principal have remained unpaid for two quarters after it has become past due. Any off-balance sheet exposure that is likely to devolve on bank has to be provided for. While computing NPA figures, value of collateral is not deducted from the balance outstanding. The banks have now been advised to provide for standard assets at a minimum of 0.25% with effect from March 31, 2000. Provisioning norms and age for classification of an asset as doubtful have also been made more stringent, and these are to be implemented in phases effective from March 31, 2001. An asset will be required to be classified as doubtful if it has remained in the sub-standard category for 18 months, instead of 24 months as at present. Further, banks will have to provide for not less than 50% on the assets which have become doubtful on account of these norms by March 31, 2001. The balance of the provisions required on this account will have to be made by March 31, 2002.

The banks are required to lay down loan recovery policy, compromise/ settlement policy and norms for valuation of collateral.

8.2 The system of on-site Inspection comprises of appraisal of asset quality and the impairment in the value of assets. The appraisal is an assessment of adherence to the prudential norms on income recognition, asset classification and adequacy of provisions for erosion in value of assets and adequacy of recovery policy. Significant divergence, if any, noticed in asset classification is not only taken up with the bank management, but also with the statutory auditors of the bank. The quality of assets is also monitored on quarterly basis through off-site monitoring returns. These returns not only help in monitoring the NPAs category-wise, but also movement in some of the top non-performing loans (NPLs) and provisioning therefor.

8.3 It is the sole responsibility of the bank management to ensure that adequate provisions as per the prudential norms are made. The statutory auditors of the bank have to certify adequacy of provisions as per RBI norms.

### **Principle IX: Portfolio Concentration and Large Exposures**

***Banking supervisors must be satisfied that banks have Management Information Systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.***

9.1 Prudential exposure norms have been prescribed both in respect of operations of foreign branches as well as for domestic lending to individual/group borrowers at 25/50 per cent of the bank's capital funds. To encourage flow of funds to the infrastructure sector, group borrower norm is fixed at higher level of 60% for companies engaged in this area. The banks may fix internally lower exposure norms with the approval of their Boards. The banks have also been advised to fix internal aggregate limits for exposure to different sectors as part of the Loan Policy. In case loans and advances are granted to Indian subsidiaries or joint ventures abroad, aggregate of such loans and advances shall not exceed 5% of unimpaired tier I capital of the bank. The adequacy of such limits and the reporting system in this regard is studied during the on-site inspection of loan portfolio.

9.2 A quarterly reporting to RBI on the exposure ceilings for off-site monitoring is in place. The banks are required to report top 20 borrowers with balances outstanding exceeding 15% of their capital funds. Besides, overseas offices of Indian banks report exposures to all large borrowers together with a separate statement for new borrowers.

### **Principle X: Connected Lending**

*In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on arms-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.*

10.1 Section 20 of the Banking Regulation Act prohibits loans and advances (other than for personal use) to directors or to any firm or company in which directors are interested or individuals in respect of whom any of its directors is a partner or guarantor. In respect of non-fund based facilities, which are not regarded as loans and advances within the meaning of Section 20 of the Banking Regulation Act, any devolvement on the bank resulting in creditor-debtor relationship between the bank and the director, etc. shall attract Section 20 of the Banking Regulation Act. Therefore, RBI has issued guidelines to ensure that no liability under non-fund based facility devolves on the bank. Further, in order to check unethical practices of granting loans and advances to relatives of directors of the bank, directors of other banks and / or their relatives, RBI has issued guidelines that such loans aggregating Rs.2.5 million and above should be invariably approved by the Board of the bank and the related Director shall not participate at the time of sanction of such loan. Loans for less than Rs.2.5 million which can be sanctioned by competent authorities as per delegation of powers, should be reported to the Board. These restrictions do not apply to loans and advances to the directors of foreign banks. However, aggregate of such loans and advances should not exceed 5% of the foreign bank's advances in India.

10.2 As regards loans to related companies i.e. the bank's own subsidiaries or joint ventures, the banks are required to maintain arms-length relationship and sanction of such loans and advances is subject to procedures applicable to sanction of loans and advances to directors of other banks and their relatives. The subsidiary company is treated as any other company and all loans to such companies have to be made at commercial rates and are subject to limits that apply to similar companies.

10.3 The investments in subsidiaries are deducted from Tier I Capital of the banks. The banks are also required to maintain arm's length relationship with promoter companies and cannot extend finance for acquisition of shares except for acquiring shares in overseas wholly owned subsidiaries or joint ventures provided such facility is backed by an approved refinance facility from EXIM bank.

10.4 Sanction of loans and advances to senior officers of a bank and their relatives should ordinarily be sanctioned by next higher sanctioning authority and the same should be reported to the Board. The above norms equally apply to award of contracts. The RBI examines connected

lendings as part of on-site inspection and through an off-site return on half-yearly basis.

10.5 In order to strengthen these provisions and making their application more stringent, the Bank is seeking legislative amendment to empower it to take appropriate steps to safeguard against siphoning of banks' funds through connected lending and to initiate criminal prosecution in such cases.

### **Principle XI: Country and Transfer Risk**

***Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying monitoring and controlling country risk and transfer risk in their international lending and investment activities and for maintaining reserves against such risks.***

11.1 Indian banks having overseas operations are required to lay down internal guidelines on country risk management and fix limits based on risk rating of the country. Limits should also be fixed for a group of countries in a particular risk category subject to a maximum ceiling fixed by RBI. In the normal course, prudential exposure norms apply to all loans and investments overseas including loans to sovereign entities. The overseas branches are governed by the host country regulations also. Adequacy of the bank's policy on identification, measurement and control of country risk is assessed during on-site inspection. It is also monitored through a quarterly return on country-wise counterparty exposure.

11.2 The RBI has formed a working group on risk management systems (including country risk). The group is also examining the issue of bringing about uniformity in the method of assessing country risk as also the reporting systems on key parameters.

### **Principle XII: Market Risk**

***Banking supervisors must be satisfied that banks have in place systems that accurately control market risks. Supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures if warranted.***

12.1 RBI has powers under Section 35A of the Banking Regulation Act to impose specific limits and /or specific capital charge on market risk exposures as part of the general powers to issue directions to banks on any aspect of their functioning. RBI has prescribed detailed operational guidelines on Asset-liability Management Systems in banks, effective from April 1, 1999.

12.2 The capital charge for some of the market risks already exist. Market risks in the Investment Portfolio are controlled through quantitative restrictions on the extent of exposure that banks can have in equity. Investment portfolio is classified into 'Permanent' and 'Current' categories with effect from 1992. At present, the banks are required to mark to market at least 70% of all approved securities and 100% of non-approved securities. The ratio of marking to market has been fixed at 75% of approved securities with effect from 31 March 2000. In addition, effective from March 31, 2000 Government and other approved securities are to be assigned 2.5% risk weight instead of 'nil' risk weight as earlier and requisite capital will have to

be maintained thereon.

12.3 The banks in general are not allowed to trade in commodities. Recently however, select banks have been permitted to deal in gold / silver / platinum. These banks must maintain 9% capital adequacy on all risk weighted assets including on the open position in gold / silver / platinum that carries 100% risk weight with effect from 31 March 1999.

12.4 Capital charge on market risk arising from open foreign exchange position is captured by assigning 100% risk weight. The banks have been advised to lay down maximum limits for Value at Risk (VaR) with the approval of their Boards. However, no additional capital charge is required based on VaR. The Basel Committee is looking into various risks and in the new Capital Accord, various methods are suggested to address these risks. Once these issues are finalized, RBI will come out with detailed guidelines on these issues.

12.5 The banks revalue their foreign exchange portfolios on monthly basis. The investments in securities/equities are valued quarterly.

### **Principle XIII: Risk Management Process**

***Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate Board and Senior Management oversight) to identify measures monitor and control all other material risks and where appropriate to hold capital against these risks.***

13.1 The RBI has issued detailed guidelines to banks for putting in place effective Asset-Liability Management (ALM) system with effect from April 1, 1999. Every bank has an Asset - Liability Committee (ALCO), headed by the Chief Executive Officer/Chairman and Managing Director or the Executive Director of the bank. The banks are expected to lay down policy on identification, measurement, monitoring and control of various kinds of risks such as liquidity risk, interest rate risk and currency risk and to review the policy from time to time to incorporate changes in business environment and the perception of the top management about the risks. To put in place a uniform ALM system, it is imperative for banks to have good management information system. To start with, the banks are required to ensure coverage of at least 60% of their assets and liabilities on actual basis. Liquidity risk, currency risk and interest rate risk should be measured through simple gap statements. The banks are required to achieve coverage of their entire business by April 1, 2000.

### **Liquidity Risk Management**

13.2 All banks are required to maintain Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) as per section 42(1) of RBI Act, 1934 and Section 24(2A) of the Banking Regulation Act, 1949 respectively. The method of computing these ratios has been defined in the respective sections of the Acts. The RBI has powers to modify CRR between 3% to 20% and SLR between 25% to 40% by notification in the Official Gazette. The RBI has advised the banks to monitor liquidity through maturity or cash flow mismatches. Future cash flows are to be bracketed in different time buckets. The banks are required to fix tolerance levels for various

maturity mismatches depending upon the bank's asset - liability profile, extent of stable deposit base, nature of cash flows, etc. Further, prudential limit on mismatches (negative gap) in cash flows during 1-14 days and 15-28 days should not exceed 20% of each of the cash outflows during these time buckets as per RBI guidelines. These tolerance levels are to be strictly enforced by April 1, 2000 when all the banks are supposed to be covering their entire business for ALM purposes. The RBI will be monitoring the liquidity position of banks through a periodic return on structural liquidity. The objective of RBI is to move to fortnightly reporting by April 1, 2000.

### **Interest rate Risk Management**

13.3 The banks are expected to measure interest rate risk through traditional gap analysis supplemented by sophisticated techniques wherever possible. Each bank is required to set prudential limits on gaps for each time bucket considering total assets, earning assets and equity. The bank may fix prudent level for earnings at risk (EaR) or Net Interest Margin (NIM). The RBI intends to move over to modern techniques of interest rate risk measurement like Duration Gap Analysis, Simulation and Value at Risk when banks acquire sufficient expertise and sophistication in collating requisite information. The banks are required to submit a quarterly return on interest rate sensitivity for exposures in Rupee as well as in foreign currencies to RBI with effect from June 1999. The reporting periodicity is proposed to be made monthly by April 1, 2000.

### **Currency Risk Management**

13.4 The banks are required to assign 100% risk weight to their open position in foreign exchange with effect from March 31, 1999. Besides, they are required to fix aggregate and individual gap limits for each currency with the approval of RBI. They are required to adopt Value at Risk approach to measure the risk associated with forward exposures. The RBI monitors currency risk through a monthly return on maturity and positions for both on and off balance sheet items in foreign exchange.

13.5 The RBI has recently issued guidelines on management of overall risk management covering the major risks faced by the banks. Introduction of appropriate Risk Management Systems in the banks is on top of the regulatory agenda of the RBI and RBI is fully committed to introducing these systems on par with international practices. Efforts made by banks in introducing and enforcing risk management system are being monitored at regular intervals and during on-site inspections.

### **Principle XIV: Internal Controls**

*Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility, separation of the functions that involve committing the bank, paying away its funds, and proper accounts for its assets and liabilities reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well*

*as applicable laws and regulations.*

14.1 RBI has issued a number of instructions/guidelines to banks to streamline their inspection and audit machinery, introduce concurrent audit, monitor treasury operations, introduce internal control system for prevention of frauds, monitor cash flows in accounts, promptly reconcile inter-branch accounts, and balance books periodically. The RBI has also issued guidelines from time to time on segregation of duties and responsibilities in front office, mid office and back office for treasury operations. Each bank is required to have a written policy on delegation of powers for managing credit, investments, money market operations, foreign exchange operations, etc.

14.2 All exceptionally large branches (whose total of deposits and advances are Rs1 billion and above) and large branches (whose total of deposits and advances are Rs0.15 billion and above but below Rs1 billion) are subjected to concurrent audit so as to cover at least 50% of bank's business operations (total of deposits and advances). The treasury related transactions and specialized activities like portfolio management services and credit card business are also subjected to concurrent audit. Each bank has an internal audit department that undertakes audit of bank's operations periodically. With a view to strengthening the corporate governance function, the banks have set up an Audit Committee of the Board (ACB) for supervising the internal audit function. The non-official Chartered Accountant Director is necessarily to be member of the ACB. The Chairman / Managing Director/ Chief Executive Officer does not participate in Audit Committee meetings.

14.3 Examination and evaluation of the adequacy and effectiveness of the Internal Control System in the banks form one of the important aspects during on - site inspection by the RBI.

14.4 All domestic banks have been advised to name the General Manager in-charge of Audit and Inspection function as Compliance Officer, who should ensure ongoing compliance with instructions issued by the RBI and Government of India.

14.5 The RBI is vested with powers to remove managerial and other persons from the office of a banking company and appoint additional directors on the Board of a bank to secure proper management of the banking company in public interest as per Section 36-AA and 36-AB of the Banking Regulation Act.

## **Principle XV: Know Your Customer**

***Banking supervisors must determine that banks have adequate policies, practices and procedures in place including strict 'Know Your Customer' rules that promote high ethical and professional standards in the financial sector and prevent the bank being used intentionally and unintentionally by criminal elements.***

15.1 In India 'Know Your Customer' Rules are in place right from the beginning. There are specific directions for obtaining proper introduction while opening Deposit Accounts. Requirement of obtaining photographs of account holders before opening accounts has been prescribed. Numbered accounts are not permitted in India. The banks have also been advised to

be careful while dealing with clients who deposit and withdraw large sums of money in cash. Such transactions of Rs 1 million and above are to be closely monitored.

15.2 Number of instructions have been issued by the RBI and the Government of India to discourage money laundering. A draft bill on money laundering has also been prepared based on the recommendations of a committee set up for the purpose for enactment.

15.3 A system of reporting frauds on banks involving an aggregate of Rs.0.1 million and above to RBI on a case by case basis is in place. All frauds below Rs.0.1 million are also to be reported to the RBI in consolidated form, category wise. Frauds are required to be classified in seven categories viz. misappropriation and criminal breach of trust, fraudulent encashment through forged instruments, manipulation of books of accounts, operation of fictitious accounts and conversion of property, unauthorized credit facilities extended for reward or for illegal gratification, negligence and cash shortages, cheating and forgery, irregularities in foreign exchange transactions and any other type of fraud. Banks are also required to report all cases of frauds to the concerned investigative agencies immediately. The RBI maintains a database of frauds and their modus operandi and this information is shared with banks to enable them to prevent occurrences of such frauds.

#### **Section IV: Methods of Ongoing Banking Supervision**

##### **Principle XVI: Instruments of Supervision**

*An effective banking supervisory system should consist of some form of both on-site and off-site supervision.*

16.1 The main instrument of supervision in India is the periodical on-site inspection of banks that is supplemented by off-site monitoring and surveillance. Since 1995, on-site inspections are based on CAMELS (Capital adequacy, asset quality, management, earning, liquidity and systems and controls) model and aim at achieving the following objectives:

- i) Evaluation of bank's safety and soundness,
- ii) Appraisal of the quality of Board and top management,
- iii) Ensuring compliance with prudential regulations,
- iv) Identifying the areas where corrective action is required to strengthen the bank,
- v) Appraisal of soundness of bank's assets,
- vi) Analysis of key financial factors such as capital, earnings, and liquidity and determine bank's solvency,
- vii) Assessment of the quality of its management team and evaluation of the bank's policies, systems of management, internal operations and control, and



- viii) Review of compliance with banking laws and regulations as well as supervisory guidance conveyed on specific policies.

16.2 The domestic banks are rated on CAMELS model while foreign banks are rated on CACS model (capital adequacy, assets quality, compliance and systems). The frequency of inspections is generally annual, which can be increased / reduced depending on the financial position, methods of operation and compliance record of the bank. The inspection teams base their reports on the primary records at selective representative cross section of branches, controlling offices and the head office of the bank. Besides, the inspection team uses pre-inspection feedback from other departments of the RBI about specific aspects to be looked into. Other inputs used for on-site inspection are off-site surveillance reports, market reports, internal audit and concurrent audit reports of the bank, Long Form Audit Reports (LFAR) and report forming part of annual accounts given by the statutory auditors and RBI nominee directors' reports/communications. On-site findings and areas of concern are discussed with top management of the bank and corrective steps taken by the bank are followed up by RBI.

16.3 To ensure continuity in supervision, RBI also undertakes targeted appraisals of specific portfolios at control site, commissioned audits of specific areas by external auditors and monitoring visits for follow-up or review of selected areas of concern.

16.4 RBI is gradually moving towards a risk-based supervisory framework that is based on both off-site and on-site inputs. Pursuant to the new supervision strategy approved by the BFS, the RBI has introduced a formal Supervisory Reporting System. The reporting is essentially prudential in content and tri-monthly in periodicity. The total package of Supervisory Returns for commercial banks (designated DSB Returns) comprises 12 Reports (9 to be filed at quarterly intervals, 2 at half-yearly intervals and 1 at yearly interval). Analysis of the returns is done for individual bank, peer group and industry as a whole. These analysis help in detecting early warning signals.

16.5 In the first tranche, 7 returns (5 for foreign banks) on assets and liabilities, capital adequacy, profitability, asset quality, large exposures, connected lendings and ownership and control were introduced in November 1995 and came into effect as from end-December 1995. The annual return on bank profile came into effect from 1997. The second tranche of four ALM returns covering interest rate sensitivity for on balance sheet and off-balance sheet exposures in rupee and foreign exchange, structural liquidity for rupee exposures and maturity and positions for exposure in foreign exchange have been introduced from end-June 1999.

## **Principle XVII: Supervisory Contact**

***Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.***

17.1 The contact between supervisors and banks is almost continuous. Senior executives at Regional office of RBI meet the bank management if serious supervisory issues crop up. Senior Executives at Central Office of RBI meet annually top management of banks to discuss matters

of supervisory concerns identified during on-site inspection. The overall CAMELS rating is communicated to the bank management. Supervisory concerns emanating out of off-site supervision are also communicated to banks on an ongoing basis.

17.2 Meetings are also held with banks for various purposes like discussions on Resource Management. Banks are often consulted before introduction of major reporting changes and senior bank officers are often associated with the working groups and committees set up by the RBI to examine / deliberate on regulatory / supervisory issues. RBI Nominee Directors on the Boards of banks are also required to report bimonthly on the important policy decisions taken by the bank in particular highlighting supervisory issues, if any.

### **Principle XVIII: Prudential Reports and Statistical Returns**

***Banking supervisors must have means of collecting reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.***

18.1 Under Section 27 of the Banking Regulation Act, RBI has powers to call for any information at any time from a banking company relating to its affairs. Presently, RBI receives prudential reports and statistical returns from banks on a solo basis only. Although financial and operating results are not currently drawn on a consolidated basis, the introduction of this is being examined by the RBI. During the course of on-site examinations, the operations of the subsidiaries and joint ventures and the control of the parent banks over them are studied. RBI undertakes inspection of merchant banking subsidiaries of banks. The off-site supervisory returns received by RBI are used to prepare bank-wise, peer group-wise and sector-wide analysis reports, which are seen by the top management of RBI and matters of supervisory concerns emanating from such analysis are taken up with the banks.

18.2 Any inconsistency or inaccuracy in reporting is taken up with top management of the bank. Submission of any wrong information to RBI can invite imposition of penalties specified in Section 46(1) of the Banking Regulation Act.

### **Principle XIX: Independent Validation & External Audit**

***Banking supervisors must have a means of independent validation of supervisory information either through on-site examination or use of external auditors.***

19.1 The supervisory information is mainly received in the form of DSB Returns. The prima facie validation of the information is taken care of in the EDP software itself. Besides this, during the inspection of banks, the DSB Returns and other information furnished by the bank are verified with regard to their accuracy.

19.2 The balance sheet and profit and loss account of the bank are to be audited by statutory auditors appointed by RBI in case of public sector banks. Private sector banks and foreign banks in India appoint their auditors with prior approval of RBI. Any divergence, noticed during on-site inspection in compliance with laid down prudential norms, is required to be discussed with statutory auditors of the bank by the bank management.

19.3 The RBI has powers to order for special audit for specific area or a specific period (Section 30 (1A) of the Banking Regulation Act). The statutory auditors may be directed to certify correctness of any information furnished by the banks to RBI. The statutory auditors, among other things, are at present required to verify the calculation of the net demand and time liabilities made by banks for maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) by them. The auditors also certify the accuracy of Income Recognition and Asset Classification, Capital Adequacy calculations, etc. In the recent past, the external audit mechanism has been used for verification of inter-branch/inter-bank reconciliation, FCNR (A) accounts, import bills, etc.

### **Principle XX: Consolidated Supervision**

*An essential element of bank supervision is the capability of the supervisors to supervise the banking group on a consolidated basis.*

20.1 The on-site inspection reports of the banks include comments on earning performance of the bank's subsidiaries and joint ventures. In addition, the RBI conducts inspection of merchant banking subsidiaries of banks. The banks are required to conduct internal audit / inspection of their subsidiaries as a measure of control over them. Periodical review notes on these subsidiaries put up to the banks' Board are sent to RBI.

20.2 Private sector banks are required to annex the balance sheet and profit and loss accounts of their subsidiaries to the annual report of the bank. Public sector banks generally give a brief description of the performance of their subsidiaries in the Directors' report that forms part of the annual accounts of the bank. The question of publishing balance sheet and profit and loss account of subsidiaries as an annexure to the annual report of the public sector banks is also being examined in connection with the introduction of a system of consolidated supervision.

## **Section V: Information Requirements**

### **Principle XXI: Adequate Records & Financial Statements**

*Bank supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business and that the bank publishes on a regular basis financial statements that fairly reflect its condition.*

21.1 RBI is committed to enhance and improve increasing the levels of transparency and disclosure in the annual accounts of banks. The formats for preparation of financial statements are prescribed under Section 29 of the Banking Regulation Act. The financial statements are prepared based on accounting standards prescribed by Institute of Chartered Accountants of India (ICAI) except those that have been specifically modified by RBI in consultation with ICAI keeping in view the nature of banking industry. The banks are mandated to disclose additional information as part of annual financial statements:

- Capital Adequacy Ratio;
- Tier I ratio;
- Tier II ratio;
- Percentage of shareholding of the Government of India in nationalised banks;
- Net NPL ratio;
- Amount of provision made towards NPLs and provisions for income-tax for the year;
- Amount of subordinated debt raised as Tier II capital (by way of explanatory notes / remarks in the balance sheet as well as in Schedule 5 relating to other liabilities and provision);
- Gross value of investments, provision for depreciation on investments and net value of investments separately for within India and outside India;
- Interest income as percentage to working funds;
- Non-interest income as a percentage to working funds;
- Operating profit as a percentage to working funds;
- Return on assets; business (deposits and advances) per employee;
- Profit per employee;
- Maturity pattern of certain assets and liabilities;
- Movement in NPLs;
- Foreign currency assets and liabilities;
- Lending to sensitive sectors as defined from time to time.

21.2 It is mandatory for all the banks to get their annual accounts audited every year by statutory auditors appointed by the RBI or appointed with approval of RBI. The auditors are required to report whether the financial statements exhibit a true and fair view of affairs of the bank.

21.3 Adequacy and accuracy of records maintained are verified during on-site inspection. Guidelines on minimum record maintenance in computerised environment have been issued by RBI.

21.4 As per Section 31 of the Banking Regulation Act, banks incorporated in India are required to publish their balance sheet and profit and loss account together with the auditor's report in a newspaper in circulation at the place where the bank has its principal office. Further, banks have been advised to publish its annual accounts in abridged form in additional newspapers, journals, etc. to give wider coverage to bank's operations. They should also furnish copies to the concerned Regional Office and Central Office of RBI, where these are examined and taken up with the bank, if considered necessary.

## **Section VI: Formal Powers of Supervisors**

### **Principle XXII: Supervisory Intervention**

*Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements such as minimum capital adequacy ratios when there are regulatory violations or where depositors are threatened in any other way. In extreme circumstances this should include the ability to revoke the banking licence or recommend its revocation.*

22.1 The RBI is vested with powers to issue directions under the Banking Regulation Act where necessary in the interest of banking policy, in public interest or where the affairs of the banking company are being conducted in a manner detrimental to the interest of the depositors. The Banking Regulation Act also gives RBI wide powers to obtain any information from the supervised institutions (Section 27), issue directions on any aspect of their business (Section 35A), appoint nominees on their boards, cause change of management (Section 36AA and 36AB), cancel their licence (Section 22(4)), take monetary and non-monetary penal measures (Section 46 to 48), cause merger / amalgamations, impose restrictions or even close the bank.

22.2 Regulatory violations in complying with prudential requirements could lead to imposition of monetary penalties and issue of letters of displeasure to the bank's management. In extreme cases, the Top Management of the bank or the Directors on the Board may be replaced. In the case of banks do not meet capital adequacy regulations, restrictions on branch expansion, assets expansion and setting up of subsidiaries are imposed. RBI has also the authority to restrict declaration of dividend by private banks to bring about corrective action.

## **Section VII: Cross-border Banking**

### **Principle XXIII: Global Consolidated Supervision**

*Banking supervisors must practice global consolidated supervision over their internationally active banks, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.*

23.1 Since 1983, detailed instructions on operations of overseas branches and merchant banking subsidiaries of Indian banks- ranging from asset-liability mismatches to country exposure limits

etc. have been issued. Special Off-site Monitoring System called RALOO (Returns on Assets and Liabilities of Overseas Operations) Returns has to be submitted by the banks to RBI at quarterly intervals on the working of foreign branches. The overseas segment of a bank is targeted for annual appraisal, called portfolio appraisal, by the RBI based on records maintained at Head Office, to ensure that they comply with regulations and prudential norms framed by the home and host countries. Besides, the foreign branches of Indian banks are subjected to inspection by RBI when deemed necessary and by the bank regularly. As indicated earlier, the RBI is examining the question of putting in place a prudential reporting system on global consolidated basis.

#### **Principle XXIV: International Coordination**

*A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved (primarily host-country supervisory authorities).*

24.1 RBI maintains regular contact with overseas supervisors and also serves on important international forums connected with bank supervision. It was one of the non-G 10 member countries consulted in the Core Principles formulation exercise and is now represented on the Core Principles Liaison Group set up by the BCBS (Basel Committee on Banking Supervision). It has also been represented on key international forums of Central Bankers / bank supervisors such as the Working Group on Strengthening Financial Systems. Supervisory officials, during visits to foreign countries, generally call on the overseas supervisory authorities for exchange of views. While issuing licence to a foreign bank to open a branch in India, the RBI considers adequacy of supervisory and regulatory systems in existence in the home country. Besides, a system of exchange of information in respect of foreign banks operating in India and also the branches of Indian banks operating overseas is being put in place.

#### **Principle XXV: Host Country Obligations**

*Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consoli-dated supervision.*

25.1 Country of origin does not confer any special status on foreign banks operating in India. They are generally subject to the same legislation and regulatory requirements as applicable to domestic banks. RBI has the necessary powers to share supervisory information with overseas supervisors.

### **ADDENDUM**

#### **Principle IX: Portfolio Concentration and Large Exposures**

Mid-term review of Monetary and Credit policy for 1999-2000 has introduced reduction in prudential exposure ceiling on individual borrowers from existing level of 25% of the bank's

capital funds to 20% effective from April 1,2000 with a view to moving closer to the international standard of 15%. Existing level of exposure in excess of 20% as on October 31, 1999 would be brought down to 20% over a period of two years (i.e. by end October, 2001).

**Principle XII: Market Risk**

The policy has also introduced risk weight of 2.5% on all investments effective from March 31, 2001 to cover market risk.

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\* **Prepared by the Research Cell of the Department of Banking Supervision.**