ANNEXURE

Draft Guidelines for Consolidated Accounting and other quantitative methods to facilitate Consolidated Supervision

In view of the increased focus on empowering supervisors to undertake consolidated supervision of bank groups and since the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS) have underscored this requirement as an independent principle, the RBI set up a multi-disciplinary Working Group in November 2000 under the Chairmanship of Shri Vipin Malik. The Working Group was required to examine the feasibility of introducing consolidated accounting and other quantitative methods to facilitate consolidated supervision and to make recommendations accordingly. The Working Group submitted its report along with recommendations in this regard after detailed deliberations with the representatives of various banks and financial institutions as also with the officials of the Reserve Bank of India dealing with regulatory and supervisory aspects to ascertain the existing methodology, the supervisory concerns and the future requirements. A copy of the Report is enclosed.

2. The recommendations of the above Working Group were examined in the RBI and it has been decided to implement them with suitable changes, wherever considered necessary. Accordingly, the following draft guidelines to be followed by banks to aid consolidated supervision have been formulated on the basis of the Working Group's recommendations with suitable modifications to enable smooth implementation and transition.

Scope

3. Initially, consolidated supervision would be mandated for all groups where the controlling entity is an institution which comes under the regulatory/ supervisory purview of the RBI. Accordingly, the guidelines would be applicable to :

a) all banks in banking groups, i.e. where the bank is the parent/ controlling entity.

b) all banks which are promoted and "controlled" by banks or financial institutions or non-banking financial companies.

In due course, banks and non-banking financial companies in mixed conglomerates would be brought under consolidated supervision, where:

i) the parents may be non-financial entities, or

ii) the parents may be financial entities falling under the jurisdiction of other regulators like IRDA or SEBI, or

iii) the supervised institution may not constitute a substantial or significant part of the group.

Components

4. The components of consolidated supervision as proposed to be implemented by the RBI include:

a) Consolidated Financial Statements **[CFS]**, which are intended for public disclosure for market discipline.

b) Consolidated Prudential Reports **[CPR]** for supervisory assessment of risks which may be transmitted to banks (or other supervised entities) by other group members.

c) Application of certain prudential regulations like capital adequacy, large exposures / risk concentration etc. on group basis.

Consolidated Financial Statements (CFS)

5. All banks coming under the purview of consolidated supervision of RBI, whether listed or unlisted should prepare and disclose CFS from the financial year commencing from April 1, 2002 in addition to solo financial statements as at present.

6. CFS is required to be prepared in terms of Accounting Standard (AS) 21 and other related Accounting Standards prescribed by the Institute of Chartered Accountants of India (ICAI) viz. AS 23 and AS 27.

7. A parent presenting CFS should consolidate all subsidiaries – domestic as well as foreign, except those specifically permitted to be excluded under AS 21. The reasons for not consolidating a subsidiary should be disclosed in CFS. The responsibility of determining whether a particular entity should be included or not for consolidation would be that of the parents' Statutory Auditors.

Components of CFS

8. CFS should normally include consolidated balance sheet, consolidated statement of profit and loss, Notes on Accounts, other statements including cash flow statement and explanatory material that form an integral part thereof.

Format of CFS

9. Since AS 21 has not prescribed any format for publishing consolidated financial statements, banks may adopt the format furnished in Appendix A for presentation of their consolidated financial statements. The CFS is in addition to the bank's solo annual accounts prepared as per the formats prescribed under Section 29 of BR Act,1949.

Reference date

10. The financial statements used in the consolidation should be drawn up to the same reporting date. If it is not possible, AS 21 allows adoption of 6 month old balance sheet of subsidiaries and prescribes that adjustments should be made for the effects of significant transactions or other events that have occurred during the intervening period. Besides, in cases where the balance sheet date coincides with that of the bank, AS 21 does not make CAG audit of the accounts of subsidiaries of nationalised banks a pre-requisite.

Accounting policies

11. CFS should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to do so, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

12. If different entities in a group are governed by different accounting norms laid down by the concerned regulator for different businesses then, where banking is the dominant activity, accounting norms applicable to a bank should be used for consolidation purposes in respect of like transactions and other events in similar circumstances. In situations where no accounting norms have been prescribed by the regulatory authority and different accounting policies are followed by different entities of the group, balance of business may be used as a deciding factor for application of accounting norms. For

dissimilar items and circumstances, different accounting policies would have to be followed.

13. The investments in associates (other than those specifically excluded under AS 23) and subsidiaries should be accounted for under the "Equity Method" of accounting in accordance with Accounting Standard 23.

14. The investments in subsidiaries and associates (which are excluded under AS 23) should be accounted for as per AS 13 issued by the ICAI unless excluded by AS 13, in which case the relevant valuation principle will apply.

15. The investments in joint ventures should be accounted for under the ‘proportionate consolidation’ method as per Accounting Standard 27 on “Investments in Joint ventures” issued by ICAI.

Consolidated Prudential Reports (CPR)

16. In addition to the CFS, banks coming under the purview of consolidated supervision of RBI should also prepare CPR. Consolidated Prudential Reports will be initially introduced on half-yearly basis from September 30, 2002 as part of off-site reporting system on the lines of the existing DSB returns for the solo entities. The frequency of reporting would be subsequently reviewed and may be increased.

Scope

17. If the supervised institution is a holding company within the group, the supervised entity should submit CPR for the entities under the control of the supervised institution. In cases of exclusion, assessment of risks in such entities would be undertaken by RBI on an off -site basis or as a part of the on-site examination of the bank / FI.

18. CPR for Bank Groups should include information and accounts of related entities which carry on activities of banking or financial nature. Related entities would include all such subsidiaries and associates of a bank, together with ‘parallel’ or ‘sister’ banks and financial institutions which are controlled by the same shareholders as the bank itself. The test applied for identifying related entities is ‘common control’ and not only the size of the ownership stake or shareholding in the controlled entity. For consolidation in the

supervision context, the “related entity/ common control approach” replaces the subsidiary approach of AS 21. Banks should justify the exclusion or inclusion of any entity for the purpose of CPR.

19. In respect of a related financial entity established in a country which prevents repatriation of capital, the risks should be assessed qualitatively and investments should not be included in the asset. The countries having problem of repatriation and the cases where the investors are called upon to fund the losses should be identified by the banks required to submit the CPR and appropriately factored into the CPR. The banks should also consider the possibility where they may not be an 'investor' in the foreign entity but may be a subsidiary / associate of an entity from a similar foreign territory. The likely burden on the bank in this eventuality should also be appropriately factored into the CPR.

20. If a securities trading company is the parent, the bank in the group is required to consolidate and provide the consolidated prudential report since market risks of the parent could decisively impact the bank (the related entity).

21. Banking / Financial sub-group of the larger mixed group is required to consolidate the financials for the purposes of consolidated prudential report. For the parent company the 'balance of business test' may be applied for determining whether the non-bank parent company may be consolidated with the sub-group to which the supervised bank belongs. RBI confines CPR to the banking / financial sub group. The parent company, which is not a supervised institution, may not be consolidated in the CPR. Instead the information available in the CFS of the parent, drawn in accordance with AS 21 will be used.

22. The format of reporting for CPR purposes is enclosed in Appendix B. Two returns are proposed for CPR purposes viz CPR 1 comprising Consolidated Balance Sheet, Consolidated Profit & Loss Account, Select data on financial/risk profile of the group to be submitted at half-yearly intervals and CPR 2 which is an existing DSB return (DSB XII - Report on Operations of Indian Subsidiaries) and modified to include all subsidiaries and related entities(fellow subsidiaries/sister concerns) in India and foreign countries to be submitted at quarterly intervals. For the purpose of preparation of CPR,

the consolidation may exclude group companies which are engaged in (a) insurance business regardless of their status in the group - as parent or as related entity, and (b) businesses not pertaining to financial services.

23. As an appropriate MIS is a pre-requisite to support the CPR banks are advised to develop data base in this regard.

Application of Prudential Norms at group / on consolidated position

24. For the purpose of application of prudential norms on a group wide basis, a 'bank group' is defined as a Group of entities which include a licensed bank, which may or may not have subsidiaries. As a part of consolidated supervision the following prudential norms/ limits are prescribed for compliance on a bank group (consolidated) basis :

a) Capital Adequacy
b) Large Exposures
c) Connected Lending
d) Liquidity Ratios, mismatches, SLR, CRR (where applicable)

Capital adequacy

25. In the Monetary & Credit Policy Statement for the year 2000-01, it was indicated that the Basel Committee on Banking Supervision has proposed that the New Capital Adequacy Framework should be extended to include, on a consolidated basis, holding companies that are parents of bank groups. To fall in line with such international standards, banks have already been advised to voluntarily build in the risk weighted components of their subsidiaries into their own balance sheet on notional basis, at par with the risk weights applicable to the bank's own assets vide circular DBOD.No.BP.BC.169/ 21.01.002/ 2000 dated May 3, 2000. Banks were also advised to provide for capital shortfall in the subsidiary in their own books in a phased manner beginning from the year ending March 2001 to rectify the impairment to their net worth on switch over to consolidated accounting.

26. Banking Groups, should maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 9 per cent on an ongoing basis from the year ending 31 March 2003. While computing capital funds, parent bank may consider the following points:

(i) Currently investment made by parent bank towards equity capital of the subsidiary is being deducted from the bank's Tier I capital. In line with the international best practice it is proposed to introduce the system of deduction of investments in *deconsolidated* entities in equal proportion from Tier 1 and Tier 2 capital with reference to the Group CRAR. This prescription would be relevant only in respect of investment in entities which are not being consolidated in the CPR.

(ii) Regulatory capital requirements of solo entities where the standards are more stringent than those for the banks should be treated as a minimum capital and where the capital adequacy norms are non-existent or relaxed, bank's standards may be used as a proxy for measuring capital adequacy standards at conglomerate level.

(iii) Risks inherent in *deconsolidated* entities (i.e., entities which are not consolidated in the CPR) in the group need to be assessed and any shortfall in the regulatory capital in the deconsolidated entities should be deducted (in equal proportion from Tier 1 and Tier 2 capital) from the group capital in the proportion of the Group's equity stake in the entity.

<u>Large Exposures</u>

27. As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, in addition to prudential limits on exposure by solo entities, bank groups should also adhere to the following prudential limits on

i) Single & Group borrower exposures

ii) Capital market exposures, and

iii) Exposures by way of unsecured guarantees and unsecured advances.

28. The operational details in this regard are furnished below.

i) Exposure by the bank group to a single borrower/ debtor should not exceed 10% of the capital funds of the group. Exposure by the bank group to a borrower/ debtor group should not exceed 30% of the capital funds of the group. The aggregate exposure on a borrower group can exceed the exposure norm of 30% by an additional 10% (i.e up to 40%) provided the additional exposure is for the purpose of financing infrastructure projects. Computation of capital funds, exposure etc. would be on par with the methodology adopted for banks.

ii) The bank group's aggregate exposure to capital markets should not exceed 2 per cent of their total assets (excluding intangible assets and accumulated losses) as on March 31 of the previous year. This ceiling will apply to exposure in all forms, including both fund based and non-fund based, to capital market. Within the total limit, investment in shares, convertible bonds and debentures and units of equity-oriented mutual funds should not exceed 10 percent of group's networth.

iii) The norms relating to unsecured guarantees and unsecured funded exposures on the lines of the guidelines issued to banks vide circular DBOD.No. 666/C.96/(Z)-67 dated May 3, 1967 as amended by circular No.DBOD. BP.BC.90/21.04.141/2001-02 dated April 18, 2002 are also extended to bank groups.

Connected Lending

29. Exposures assumed by the bank groups on connected persons in the group such as significant shareholders, key management personnel, directors, relatives/ entities controlled by each of the above, is also brought under the purview of supervisory focus in the context of the provisions of Section 20 of the B R Act.

30.Liquidity Ratios:

i) CRR & SLR requirements:

The existing liquidity requirements applicable to banks on a solo basis are extended to the consolidated position of the group. If the group is homogenous, liquidity compliance i.e., CRR and SLR should be ensured on a consolidated basis after netting out intra-group transactions and exposures. If the group is heterogeneous comprising non-banking and non-financial entities, compliance with the CRR/ SLR norms would be restricted to the banking entities on a consolidated basis. In respect of deposit taking

NBFCs within bank groups they should comply with the SLR requirement prescribed at solo level.

ii) Asset Liability Management :

Maturity wise distribution/ analysis of assets and liabilities should be disclosed on a consolidated basis in the CPR. Tolerance limits for near-term and short-term deficits/ mismatches in the first two time bands of 1-14 days and 15-28 days shall apply at the consolidated level to the bank group. Intra-group transactions and exposures should be excluded from this consolidation.