Report of the Advisory Group on Banking Supervision

Part - I

Introduction

The financial fragility of domestic financial sector combined with the lack of transparency was identified as the contributing factors in the recent financial crises of South East Asian countries. Both the Mexican crisis of 1994 and the South East Asian crisis reiterated the need for developing adequate transparency standards so that timely availability of important macroeconomic data in the public domain could be ensured. In addition, lessons learnt from the South East Asian crisis was that transparency alone is not much of a help unless it is accompanied by appropriate standards and codes, which could be sector and even institution specific. This realisation has put pressure on international financial institutions to hasten development of a set of standards and codes for various segments of the financial sector.

In India, a number of committees and working groups have been constituted from time to time, especially during the last few years of the reform period, to examine the strength of the institutions and recommend various steps towards adhering to internationally acceptable practices, standards and codes. But, there was no institutional mechanism to co-ordinate the work of various institutions in this endeavour and in particular on the need for evolving sound standards based on established best practices in fiscal, financial and accounting areas and for adopting transparency standards while adhering to the codes. To fill this gap, in December 1999, the Reserve Bank of India in consultation with the Government of India, appointed a Standing Committee on International Financial Standards and Codes.

In view of the fact that there are a number of codes in different subject areas, the Standing Committee considered that the task of collection of information on international standards and codes, studying them for their immediate relevance and applicability to Indian conditions as enormous. It, therefore, constituted ten Advisory Groups to cover varied specialised subject areas. The present group constituted under the chairmanship of Shri M.S. Verma, then Honorary Adviser to Reserve Bank of India and, former Chairman, State Bank of India, was entrusted with the responsibility

of advising on matters relating to banking regulation and supervision. The composition of this Advisory Group is given in Appendix I.

The broad framework for the working of the Advisory Group included:

(i) To study present status of applicability and relevance and compliance in India of the relevant standards and codes;

(ii) To study the feasibility of compliance and the timeframe within which this can be achieved given the prevailing legal and institutional practices in India;

(iii) To compare the levels of adherence in India vis-à-vis industrialised countries and also emerging economies particularly to understand India's position and prioritise actions on some of the more important codes and standards; and

(iv) To chalk out a course of action for achieving the best practices.

The composition of the Group is given in Appendix I. As of now, the Group had 12 meetings and has finalised its recommendations with reference to four major areas in banking regulation and supervision, viz., corporate governance in banks, transparency in banks, supervision of cross-border banking and internal rating practices adopted by banks in India.

The interim report is organised as follows: While Section II gives a brief summary of the above-mentioned four papers, Section III narrates briefly the Group's agenda in the coming months in its preparation of the second and the final part.

I place on record my sincere appreciation to each and every member of the Group for their contributions. I also thank Dr. R. Kannan, Convenor of this Group and other Co-convenors, Shri B. Mahapatra, Shri M. Sebastian, and Shri G. Sreekumar for their excellent contributions. The report is the result of an excellent teamwork and I would add unhesitatingly that every member of this team has enjoyed working together. I also thank Ms. Shubra Bhattacharjee for her able assistance.

Section II: Summary

(a) Corporate governance in banks

The Advisory Group on Banking Supervision has tried to evaluate the current status on corporate governance in banks in India against the international standards and codes as set out in the paper on Enhancing Corporate Governance in Banking Organisations (September 1999) prepared by the Basle Committee on Banking Supervision (BCBS) of the Bank for International Settlements (BIS). The evaluation of the Group and its suggestions on those items on which compliance is not up to the best international standards have been presented in a simple tabular form indicating the Group's views on the current position in India and the Group's remarks, indicating, wherever necessary, its own views or suggestions as regards further action in that area.

The Group recognised that banks and financial institutions are of various types, constituted under different statutory provisions. It has broadly taken into account the systems and practices prevalent in the "commercial" banks. The Group feels that the character of a bank's ownership is not a critical factor in establishing corporate governance practices. The quality of corporate governance should be the same in all types of banking organisations irrespective of their ownership. However, since within an overall generalised level, the depth and extent of compliance of the standards of corporate governance may vary from bank to bank, it is desirable that all banks remain above a certain benchmark representing an acceptable standard of corporate governance. From this level there will have to be a sustained progress towards the best international standards which would need to be achieved within a reasonable timeframe.

There is an urgent need to follow the best practices in the banks in respect of constitution and functioning of the Boards. It is, therefore, suggested to streamline the process of induction of directors into banks' Boards and their initial orientation. The Boards of banks do not seem to subject themselves to any measure of accountability or performance either set by themselves voluntarily or made applicable to them externally. This leaves them, largely, without any accountability either to the institution itself or to the supervisor. The stress on accountability generally ends up with efforts to fix accountability at the management level for loans/advances that go bad. Accountability for non-performance, at any level including that of the Board of

Directors is nearly absent. This situation calls for correction. The current standards of transparency would need to be raised. A fair beginning has been made in this regard but the approach of the banks and the applicable accounting standards will have to be changed for achieving greater transparency in banking operations and accounting. While the structure of the Board and senior management is revealed in the balance sheet, details of their experience, qualifications, incentive structure, etc., are not always available publicly. Transactions with affiliated and related parties are not disclosed in the balance sheets of banks. All such information should be available in the public domain. Further, though Section 20 of the Banking Regulation Act, 1949, prohibits loans and advances to directors and their connected parties, there is no statutory restriction on dealings with large shareholders. A similar provision on the lines of Section 20 of the Banking Regulation Act, 1949, on connected lending will have to be made in respect of large shareholders too. A definition of large shareholding would, of course, need to be provided.

The Boards of banks are required to form Committees for risk management, audit, compensation, nomination, etc. The Audit Committees in banks are quite well established in discharging their functions. Risk management systems in banks have been introduced recently. It is practicable for big banks to put in place independent risk management functions. However, small banks lack the expertise in this area. They will, therefore, have to be provided encouragement as well as technical support and given special attention so that they can imbibe risk management practices in as short a time as possible. A timeframe of two to three years is considered adequate for the purpose. Banks do not have compensation or nomination committees.

Members of Board of Directors are required to give their valuable time to the governance of banks. In this context, there is a need to have some ceiling on the number of Boards and the number of Committees a director can work at a time.

Because of Reserve Bank of India/Government ownership of banks (in the public sector), there is some overlap in the role of the Reserve Bank of India as owner/owner's representative and as the regulator/supervisor. This overlap needs to be corrected so that Reserve Bank of India can perform its regulatory/supervisory role without any hindrance.

Government ownership of banks is not conducive to any serious and urgent corrective action by the regulator against any one of them. The limitations of the legal process have also come in the way even where corrective action like removal of the incompetent management is contemplated.

It is desirable that performance measurement, currently confined mostly to unit level, is extended downward to individuals and a linkage between contribution and remuneration/reward is established. It should be possible to do so easily if a consensus can be achieved between the unions and the management on converting the present flat- and performance-unrelated remuneration structure prevalent in most banks into a performance-related remuneration structure. There is an urgent need to review the current practice and link performance with remuneration.

(b) Enhancing bank transparency

Public disclosure of information and resultant market discipline constitute key elements of an effectively supervised, safe and sound banking system. On the other hand, lack of transparency tends to negatively distort risk perceptions in the market and increases the intrinsic fragility of individual banking institutions apart from bearing seeds of systemic disturbances.

The Advisory Group on Banking Supervision has made an assessment of the current position in regard to bank transparency in India against benchmarks/ principles enunciated in the Basle Committee paper on 'Enhancing Bank Transparency' (September 1998). While compliance with the Core Principles for Effective Banking Supervision under the harmonised assessment methodology has been separately dealt with, this assessment essentially focuses on the further elaboration of the Core Principles relating to bank transparency suggested in the September 1998 paper.

Considering the growing complexities in product risk profiles and activities of banks, the Basle Committee on Banking Supervision (BCBS) has recognised that the minimum standards or guidelines for public disclosure set out in its paper do not necessarily assure a sufficient level of transparency in the market for all institutions. The effectiveness of the public disclosure measures would require that information disclosed results in adequate transparency. The market should be able to reward the better managed banks. Further, having regard to the competitive and legal issues

involved in public disclosures and the need to strike a balance between transparency and confidentiality obligations, the Advisory Group has made its assessments on the basis of observed disclosure practices as well as legal and regulatory stipulations in this regard.

In India, banks' financial reporting broadly encompasses financial performance and financial position (excluding liquidity) and accounting policies. As regards information on basic business management and corporate governance, wide range of practices are prevalent ranging from very little information to elaborate disclosures. Irrespective of the size and nature of a bank's operations, the scope and content of information provided tend to be more or less standardised with limited disaggregation and detail.

The levels of disclosure in the balance sheet of Indian banks need to be improved further. Some desired areas of disclosure have been indicated in the main report. Efforts have to be made to come close to internationally followed standards of disclosure within the next two to three years. Reserve Bank of India may take the Institute of Chartered Accountants of India into confidence and consider issuing comprehensive guidelines on necessary disclosures in a bank's balance sheet. Since disclosures in India are still in an evolutionary stage, and additional disclosures are getting added to the disclosure requirements, it would also be desirable to review and update the guidelines from time to time until the Indian disclosures fully match the international standards in this regard. Initially, updating of these guidelines may be undertaken at shorter, say, biennial intervals. A co-ordinated approach between the ICAI and RBI may be adopted for this purpose.

The Group, on examination of the current practices as against the standards suggested by BCBS, feels that several changes need to be made in disclosure practices. These are broadly classified below under the following categories: (1) General balance sheet disclosures, (2) Risk management and (3) Management and internal control.

General balance sheet disclosures

The following disclosures need to be made in relation to bank's income, profits, etc.:

a. Complete breakdown of income to facilitate a meaningful assessment of the quality of income and inter-bank comparison.

b. Break-up of contribution of different activities to assess the diversification in the bank's business and individual contribution of different businesses.

c. Factors that impact current and next year's profitability should be discussed explicitly in Management Discussions and Analysis.

d. Information detailing maturity and repricing structure of assets and liabilities.

e. Cumulative provisions held against loan losses with the movement in provision accounts.

f. Full disclosures of off-balance sheet items with notional amounts and fair value of off-balance sheet transactions, commitments and contingent liabilities.

g. Details of risk weighted assets, leverage ratio, restrictions on distributions, including the impact on earnings, etc., need to be furnished uniformly.
h. Details of collateralised deposits or similar such liabilities or commitments wherever banks have resorted to them for managing their liquidity.

Risk management

More disclosures on risk management are essential. It should be possible for banks to begin providing these disclosures in two to three years time by when it can be made mandatory. Specifically, the disclosures related to risk management that need to be provided relate to the following:

a. Disclosures relating to management of risks by banks such as calculation of capital requirement for credit risks, capital requirements for market risks and data relating to broad value at risk, stress/back testing information. Alongside disclosures on capital allocation, details of future capital plans will also have to be made available.

b. Details about risk mitigating tools, which may include various limits, classification of exposures and information about the types of counterparties (exposure to banks, commercial and government entities, domestic and international exposures and subordinate assets).

c. Discussion of operational, legal and strategic risks may be made mandatory in the management's letter/directors' report to the shareholders.

d. Business activities that create credit risks.

e. Details as to ageing schedule of past due loans and other assets, concentration of credit, aggregate exposures by counterparty credit quality, etc.

f. Impact of interest rate risk on bank's net interest margin or impact of foreign exchange risk on unhedged exposures.

g. Detailed information on interest rate risk and the extent of interest rate sensitive assets and liabilities and off-balance sheet exposures are not furnished since ALM and other bank risk management tools are still in their infancy in India. A beginning can be made by prescribing disclosure of quantitative information about the nature and extent of interest rate sensitive assets and liabilities.

h. Summarised data for significant concentrations of foreign exchange exposure by currency, broken down by hedged and unhedged exposures.

i. Detailed information on investments in foreign subsidiaries (translation risk) or foreign exchange transactions risk, the earnings impact of foreign exchange transactions and effectiveness of hedging strategies.

j. Disclosures on "Value at risk" and "Earnings at risk". To begin with, these may be prescribed in selected areas of activity, e.g., foreign exchange, treasury activities and investments.

k. Except for cash flow statement, detailed information on liquidity risk exposure is currently not being furnished. With the concept of ALM expected to stabilise in Indian banking in the ensuing years, detailed disclosures on liquidity risk exposure will be possible. A more detailed statement of cash flow than at present showing sources and uses of funds should be prescribed for disclosure.

l. Details about the diversity of funding options and contingency plan should form part of the management's letter on managing liquidity risks.

Management and internal control

The ability of the accounting as well as internal control and management systems to support the growing size and diversity of business is the main operational risk faced by the banks. Increasing frauds and deficiencies in follow-up are manifestations of the risk intensifying. A discussion in the management's letter/Directors' report on this issue along with a discussion on the sufficiency of the technology used by the bank and fall back positions in the event of their failure may be prescribed.

Disclosure by banks regarding the following items need to be made uniform in the following areas:

i. broad structure of board committees and membership, senior management structure with responsibilities and reporting lines and the basic organisational structure.
ii. Information on qualifications and experience of the board and senior executives.
iii. Information on incentive structure within a bank, remuneration policies, the use of performance bonuses and stock options.
iv. Summary discussion of the philosophy and policy of executive and staff compensation and the role of the board in setting compensation.
v. Nature and extent of transactions with affiliates and related parties.
vi. General information on the institution's culture.

The progress in efforts on promoting high quality disclosure standards will have to be gradual but sustained. While there will be some key disclosures which must find place in the balance sheets of all banks as prescribed by the RBI, individual banks should be encouraged to make additional and innovative disclosure which they consider relevant to their business and balance sheet.

It needs to be ensured that a beginning is made with disclosures that are more relevant in our context than with those which are more sophisticated and have relevance only in a more complex situation. A gradual process of disclosure needs to be followed so that key elements remain in focus.

(c) Supervision of Cross-border Banking

In the changing world-wide scenario of banking, particularly the integration of markets, there is now an overall need to strengthen further the system of cross-border supervision. The main concerns in the area of cross-border supervision relate to sharing of information between the Reserve Bank of India and overseas supervisors, consolidated supervision and stronger internal control over operations of foreign branches of Indian banks operating abroad and of branches of foreign banks operating in the country.

The Group has made an assessment of India's position with respect to cross-border supervision as against the standards laid down under four basic documents brought out by the Basle Committee on Banking Supervision. These are (i) Principles for the Supervision of Banks' Foreign Establishments (Basle Concordat, May 1983), (ii) Information Flows Between Banking Supervisory Arrangements (April 1990), (iii) Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments (July 1992) and (iv) The Supervision of Cross-border Banking (October 1996). The Group's assessment is detailed in a tabular form.

The specific recommendations of the Group are given under three main heads, viz., (a) Issues relating to nature of supervision, (b) Issues relating to information sharing and (c) Suggested changes in approach and methods of supervision. A roadmap towards achieving international standards has also been provided.

There is need for a greater interaction with the controlling office (not only the immediately superior office) and the home office regulator. A full understanding of the overall operations of the bank involved is considered necessary. While supervising the branches of foreign banks operating in India, RBI looks mainly at the solvency of the branch. The solvency of the parent bank needs to receive a more pointed attention even if the responsibility to monitor is only general. For supervision of subsidiaries of foreign banks which have branches in India as also for subsidiaries of Indian banks abroad, RBI would need to develop a more focussed policy. At present, the supervision of the subsidiary does not seem to attract enough attention of the regulator.

In the case of Indian subsidiaries of foreign banks engaged in activities not coming within the regulatory purview of Reserve Bank of India, the liquidity position of such subsidiaries is not monitored by RBI.

The principle of consolidated supervision is unexceptionable. Reserve Bank of India needs to move in that direction. The accounting standards as well as the regulatory provision need to be reviewed from this angle. A major obstacle in this regard which is faced by us is multiplicity of regulators on mutually exclusive basis. A suitable mechanism to co-ordinate their approaches shall have to be found. RBI is, at present, a little away from the stage of consolidated supervision. It needs to move in that direction gradually but at a fast nick. The first step in this direction would be to pay more attention to the operation of subsidiaries even if their accounts are not consolidated with that of the parent entity, which is the subject of RBI's regulation. RBI should also begin encouraging Indian banks and foreign entities operating in India to submit to consolidated supervision.

Reserve Bank of India's supervisory stance is aimed at exercising comprehensive and consolidated supervision of the global activities of the Indian banks. However, in this regard it faces constraints in countries where the local laws do not permit the home supervisor to conduct onsite inspection/examination of records. There is no legal or other hindrance to parent supervisors from other countries conducting such inspections of Indian branches of banks under their supervisory jurisdiction. A country-wise analysis will have to be made and suitable action taken to address the constraints.

While Indian laws do not prohibit inspection of foreign bank branches by the respective parent supervisor, this is not reciprocated by all countries. A country-by-country review would need to be made and appropriate action taken to enter into suitable arrangements with the host country regulation. This should receive urgent attention in relation to those countries which do not permit inspection by the parent country supervisor.

RBI is presently not insisting on separate approvals of the home country supervisors of a foreign bank for every new branch which it wants to open in India. Such approvals are also not insisted upon from the home country supervisor of the banking

group (where the bank is part of a banking group and the banking group's home country is different from the home country of the bank). RBI needs to consider the desirability of following the recommended approach.

RBI could supplement its own supervisory mechanism by making it a regular practice of using external auditors to look specially in certain selected areas and report to it independently.

A periodic review would need to be made of the supervisory systems and standards of host supervision where Indian banks have a presence.

Host authorities in a large majority of cases remain inadequately informed about the parent bank's difficulties. A more comprehensive system of information sharing based on mutuality and reciprocity needs to be established.

RBI has so far not been seeking much information from the parent authorities of banks operating in India. In certain areas of their operations, particularly about the internal controls exercised by the concerned head offices of banks, more information is desirable. In regard to the quality of control exercised by the Head office of foreign banks, whose branches are operating in India, RBI may increase its reliance on the parent country supervisor and convey to them its expectation about being informed about the extent and quality of control maintained by the head office over its branches operating in India.

RBI is not receiving from any of the parent supervisors, advices about the levels of materiality which would trigger their concern. Similarly, RBI is also not informing other host supervisors about such levels of materiality the breaching of which in respect of its Indian bank branches abroad, may trigger supervisory concern. The parent supervisor may define levels of materiality in respect of major financial parameters, the failure to meet with which or the occurrence of certain significant adverse events should be reported by the host supervisor to it. In order to make this practice effective, the two supervisors would need to come to some kind of mutual agreement so that their perception about the triggers identified are common and the manner in which their respective concerns following the appearance of triggers are to be expressed do not vary too much.

Greater mutual understanding on the issue of prior consultation with host supervisors, in the likely event of supervisory action against specific banks, would need to be developed amongst the supervisors. RBI should insist on such information sharing as one of the terms on which it permits a foreign bank to open its branch in India.

There is a case for incorporating strict legal provisions with regard to ensuring confidentiality of supervisory information so that such information is not shared with any agency, including central or state level vigilance/investigative agencies, but only when specifically called for by a court of law. As a related BIS document states, it needs to emphasised, even in the event of a court demanding supervisory information, that making such information public may result in the drying up of such information and thus adversely affect the quality of supervision in the long run. The present legal provisions in India in respect of confidentiality of information available with the home supervisor (RBI) do not seem to be providing sufficient protection of information. More clearly defined laws would be needed for this purpose.

Without objective reciprocity on the issue of sharing information between supervisors, information flow may become very uneven making cross-border supervision difficult. Provision of unhindered/unqualified access to information to the home supervisor may be made a condition for permitting a bank to open offices abroad.

A country-wise analysis will have to be made to ensure reciprocity in passing on information to the home supervisor on certain qualitative aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are the home supervisor.

(d) Banks' internal rating systems

While so far no minimum standards or codes in respect of internal rating systems for banks have been suggested, probably in view of the country-specific requirements in this regard, BIS has published a study on the range of practices in the internal rating systems of banks. The Group thought it fit to assess the Indian position vis-à-vis these practices, since developments in this area will assume importance in the near future and are vital in improving the competitiveness of the Indian banking system and in ensuring its long term stability.

Use of internal rating systems is still in its infancy in India. In fact, banks are generally still in the process of putting in place more sophisticated risk management practices. This is because, in a highly regulated environment, some of the major risks were practically absent in the system. Banks in India are handicapped in implementing internal rating systems due to the following reasons: (a) lack of qualified personnel, (b) absence of reliable high frequency historical data which will facilitate any meaningful modelling and (c) lack of proper appreciation of risk management concepts at the middle and senior management levels.

The internal rating approach, as practised by most of the banks in India, measures risk by quantitative mode. The important inputs in risk rating systems of the Indian banks in India are financial analysis, projections and sensitivity and incidence of industrial and management risks. Banks in India need to adopt at an early date systems of internal rating requiring measurement of probability of default (PD), loss given default (LGD) and exposure at the time of default (EAD).

Credit rating in India is mostly unidimensional, i.e., there is an overall grade for the borrower and the same grade is applicable for all facilities. The credit rating systems as developed by banks in India is largely based on their experience and broadly take into account financial factors, industry specific factors and management factors. These factors are generally rated separately and due weights are assigned (which is again based on the experience of respective banks). To arrive at an overall risk rating, the above factors are aggregated and calibrated to arrive at a single point indicator of risk associated with the credit decision. Banks in India have to move towards multidimensional rating systems as there is no other reliable method of assessing risks where the activities of the clients themselves and the facilities enjoyed by them are multidimensional.

In the Indian context, it would be necessary to strengthen the MIS and data collection machinery in the banks to ensure integrity and reliability of the data. In view of the wide network of branches and the fact that most of the branches in semi-urban and rural areas have not been computerised, collection of the relevant data would have to be ensured before statistical models for drawing meaningful conclusions can be used.

It will take another three to five years before the whole banking system can expect to come to the level of risk management envisaged in the BIS paper. This presupposes extensive computerisation and the right kind of MIS. Banks should build historical database on the portfolio quantity and provisioning/charge off to equip themselves to price the risk. The bigger banks must however be encouraged to expedite the process of transition from elementary levels of risk management to levels of greater sophistication more expeditiously. In doing so, they may be encouraged to obtain external assistance, e.g., from consultants, so that wherever necessary the available in-house expertise gets duly supplemented.

Rating systems could be put to various uses by banks. Internationally, these are used for management reporting, pricing, decisions on reserve levels, allocation of economic capital, compensation for relationship managers and setting credit limits. Only a few banks are using the rating systems for management reporting and for pricing of loans. None of the banks are using internal ratings for decisions on reserve levels, allocation of economic capital, compensation or for setting credit limits. The banks which are not following the practice of using internal rating for management reporting and pricing may be advised by the Reserve Bank of India to do so.

Systematic risk management has only recently been introduced in Indian banks. Most banks are in the process of setting up a system which is critical and simple. Sophistication will be introduced only with passage of time as the banks increase their affinity with the existing system and have improved their MIS substantially. Most of the concepts discussed in the background paper are yet to be introduced to most of the banks.

Banks in India would have to formulate a medium term strategy to implement risk aggregation and capital allocation mechanism. Reserve Bank of India may consider guiding the banks to more sophisticated risk management concepts in a time bound manner. It may consider directing some more capable and better equipped banks to adopt more advanced and sophisticated practices without waiting for the whole banking system to attain the same level of proficiency in risk management. Such banks, acting as forerunners, could provide models for other banks to convert to.

Section III: Ongoing assessments

Having assessed the position of Indian banking in respect of the four major areas of supervisory concern, viz., corporate governance, transparency, cross border supervision and banks' internal rating systems, the other major area left to be covered is that of core principles for effective banking supervision. The group considered it desirable to address this issue in somewhat greater detail as in this regard the BIS has set the benchmarks more clearly and in a way provided a distinction between the essentials and improvements thereupon. The group intends examining the present position of the Indian banks in respect of both. There are other connected areas as well which the group now intends taking up although these have already received some consideration along with the other issues. These are:

a. Sound practices for loan accounting and disclosures
b. Early warning indicators
c. Principles for the Management of Credit Risk including Banks' Interactions with highly leveraged institutions and Best Practices for Credit Risk Disclosure
d. Intra-group transaction and exposures and risk concentration principles
e. Consolidated supervision with emphasis on conglomerates
f. Framework for internal control systems in banks

As these issues are discussed in detail, some repetitions may occur. On all such occasions, however, the context of the consideration will naturally be wider. The group is of the view that such emphasis on these issues is merited.

Appendix – I

Advisory Group on Banking Supervision

List of Members

Name	Designation	
Shri M.S. Verma	Former Chairman, State Bank of India.	Chairman
Shri K.R. Ramamoorthy	Chairman, Vysya Bank Ltd.	Member
Shri H.N. Sinor	Managing Director, ICICI Bank Ltd.	Member
Shri Janki Ballabh	Deputy Managing Director, State Bank of India.	Member
Dr. R. Kannan	Adviser, Department of Economic Analysis and Policy, Reserve Bank of India, Central Office.	Convenor
Shri B. Mahapatra	General Manager, Department of Banking Operations and Development, Reserve Bank of India, Central Office.	Co-convenor
Shri M. Sebastian	Deputy General Manager, Department of Banking Supervision, Reserve Bank of India, Central Office.	Co-convenor
Shri G. Sreekumar	Deputy General Manager, Department of Banking Supervision, Reserve Bank of India, Central Office.	Co-convenor

Appendix – II: Corporate Governance in Banks in India

The Advisory Group on Banking Supervision has tried to evaluate the current status on Corporate Governance in banks in India against the international standards and codes as set out in the Basle Committee on Banking Supervision (BCBS) of the Bank for International Settlements' (BIS), paper on Enhancing Corporate Governance in Banking Organisations (September 1999). The evaluation of the Group and its suggestions on those items on which compliance is not up to the best international standards, are enclosed in a simple tabular form consisting of BIS standards / principles, current status in India and remarks.

Banks and Financial Institutions are of various types and constituted under different statutory provisions. The Group has broadly taken into account the systems and practices prevalent in the "commercial" banks. The Group feels that ownership of banks is not an important issue in establishing corporate governance practices. The quality of corporate governance should be the same in all types of banking organisations. Within an overall generalised level, the depth and extent of compliance of the standards of corporate governance vary from bank to bank. It is, therefore, desirable that all banks are above a certain benchmark signifying acceptable level of corporate governance. From here there will have to be a sustained progress towards the best international standards which would need to be achieved within a reasonable timeframe. Some of the important observations of the Group are furnished below:

Guidelines and norms for good corporate governance in banks and overall responsible corporate governance are still in formative stages and healthy conventions are still to be built up. The Reserve Bank of India as supervisor and SEBI as capital market regulator are gradually introducing measures which will lead to good corporate governance in banks and protection of depositors' and others' interests.

However, there is an urgent need to follow the best practices in the banks in respect of constitution and functioning of the Boards. It is therefore suggested to streamline the process of induction of Directors into banks' Boards and their initial orientation. The Boards of banks do not seem to subject themselves to any measure of accountability or performance either set by them voluntarily or made applicable to them externally.

This leaves them, largely, without any accountability either to the institution itself or to the supervisor. The stress on accountability generally ends up with efforts to fix accountability at the management level for loans/advances that go bad. Accountability for non-performance, at any level including that of the Board of Directors is nearly absent. The situation calls for correction.

The current standards of transparency would need to be raised. A fair beginning has been made in this regard but the approach of the banks and the applicable accounting standards will have to be changed for achieving greater transparency in banking operations and accounting. While the structure of the Board and senior management is revealed in the Balance Sheet, details of their experience, qualifications, incentive structure, etc. are not always available publicly. Transactions with affiliated and related parties are not disclosed in the Balance Sheets of banks. All such information should be in public domain. Further, though Section 20 of the Banking Regulation Act, 1949 prohibits loans and advances to directors and their connected parties, there is no statutory restriction on dealings with large shareholders. A similar provision on the lines of Section 20 of the BR Act, 1949 on connected lending will have to be made in respect of large shareholders too. A definition of large shareholding would, of course, need to be provided.

The Boards of banks are required to form Committees for Risk Management, Audit Committee, Compensation Committee, Nomination Committee, etc. The Audit Committees in banks are quite well established in discharging their functions. Risk Management systems in banks have been introduced recently. It is practicable for big banks to put in place independent risk management functions. However, small banks lack the expertise in this area. They will, therefore, have to be provided encouragement as well as technical support and given special attention so that they can imbibe risk management practices in as short a time as possible. A time-frame of two to three years is considered adequate for the purpose. Banks do not have Compensation and Nomination Committees.

Members of Board of Directors are required to give their valuable time to the governance of banks. In this context, there is a need to have some ceiling on the number of Boards and the number of Committees a Director can work at a time.

Because of Reserve Bank of India/Government ownership of the banks (in the public sector), there is some overlap in the role of the Reserve Bank of India as owner/owner's representative and as the regulator/supervisor. This overlap needs to be corrected so that Reserve Bank of India can perform its regulatory/supervisory role without any hindrance.

Government ownership of banks is not conducive to any serious and urgent corrective action by the regulator against any one of them. The limitations of the legal process have also come in the way even where corrective action like removal of the incompetent management is contemplated.

It is desirable that performance measurement, currently confined mostly to unit level, is extended downwards up to individuals and a linkage between contribution and remuneration/reward is established. It should be possible to do so easily if a consensus can be achieved between the unions and the management on converting the present flat and performance unrelated remuneration structure prevalent in most banks into performance related remuneration structure. There is a need to review the current practice and link performance with remuneration.

Enhancing Corporate Governance in Banking Organizations

BIS Principles[§]	**Current Status in India**	Remarks
A. Strategies and techniques basic to sound corporate governance		
1. Corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them.	Banks articulate corporate values, codes of conduct and standards of appropriate behaviour, etc., though these may not have been codified in any single document. Banks have also systems to ensure compliance with them.	Within an overall generalised level, the depth and extent of compliance of the standards of corporate governance vary from bank to bank. It is, therefore, desirable that all banks are above a certain benchmark signifying acceptable level of corporate governance. From here, there will have to be a sustained progress towards the best international standards which would need to be achieved within a reasonable timeframe.
2. A well-articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured.	Banks have well articulated corporate strategy decided by the Board of Directors. In pursuance thereof, performance budgeting system is followed, which measures, monitors and evaluates corporate success and the contribution of business units. Except for performance measurement, monitoring and evaluation for business units, there is no system of accountability for results for	It is desirable that performance measurement, currently confined mostly to unit level, is extended downwards up to individuals and a linkage between contribution and remuneration/reward is established. It should be possible to do so easily if a consensus can be achieved between the unions and the management on converting the present flat and performance-unrelated remuneration structure prevalent

[§] Basle Committee on Banking Supervision (BCBS), Bank for International Supervision, September 1999.

	individuals with the exception of the CEO, the Zonal / Regional / Branch Heads or Treasury Heads, etc.	in most banks into performance-related remuneration structure. A few banks in the private sector have taken a lead in this regard, but they are small and as of now represent a nominal percentage of banking business in the country.
3. Clear assignment of responsibilities and decision-making authorities, incorporating a hierarchy of required approvals from individuals to the board of directors.	Banks have clear delegation of powers to different levels of hierarchy for financial and non-financial sanctions.	
4. Establishment of a mechanism for the interaction and co-operation among the board of directors, senior management and the auditors.	The mechanism for interaction and co-operation among the board of directors, senior management and the auditors of the bank is fairly established.	
5. Strong internal control systems, including internal and external audit functions, risk management functions independent of business lines, and other checks and balances.	Banks definitely have a strong internal control system; internal and external audit functions and other checks and balances. However, the regulatory framework for risk management function in banks independent of business lines has recently been put in place. Banks are in different stages of implementation of risk management systems.	It is practicable for big banks to undertake risk management as an independent risk management functions. However, small banks lack the expertise in this area. They will, therefore, have to be provided encouragement as well as technical support and given special attention so that they can imbibe risk management practices in as short a time as possible. A time-frame of two to three years is considered adequate for the purpose.

6. Special monitoring of risk exposures where conflicts of interest are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the firm (e.g. traders).	There is a statutory provision (Section 20 of the BR Act, 1949) prohibiting loans and advances 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. However, where transactions are not barred by law, special monitoring of transactions with related parties, including large shareholders is not always subjected to special monitoring.	A similar provision on the lines of Section 20 of the BR Act, 1949 will have to be made in respect of large shareholders too. A definition of large shareholding would, of course, need to be provided.
7. The financial and managerial incentives to act in an appropriate manner offered to senior management, business line management and employees in the form of compensation, promotion and other recognition.	There is no performance related compensation in public sector banks and therefore, there is very little incentive or disincentive for good or bad performance. Some private sector banks have made efforts towards performance related compensation. Managerial incentive in the form of promotion and other recognition prevalent in banks both in private and public sectors, has generally proved inadequate.	Please also see our comments against A, 2 above. Unless performance related remuneration is introduced in public sector banks, which account for more than 80% of Indian banking system, performance of the system is not expected to improve. All banks must be encouraged to take steps to adopt this approach without any further loss of time.
8. Appropriate information flows internally and to the public.	Internal information flow is quite well established in banks. The standards of banks' disclosures are improving but still fall short of international standards.	Please see our remarks given in the Transparency document.

B. Organisational Structure to ensure the following "Forms of Oversight"		
1. Oversight by Board of Directors.	The organisational structure enables adequate oversight by Board of Directors.	
2. Oversight by individuals not involved in the day-to-day running of the various business areas.	The present system of control and audit in banks enables such oversight.	
3. Direct line supervision of different business areas.	Systems are in place which enables direct line supervision of different business areas.	
4. Independent risk management and audit functions.	A regulatory framework for risk management function in banks has recently been introduced. Banks are in different stages of implementation of risk management systems. However, audit functions are well developed. The independence of audit function is described in C, 3, xi, b.	
C. Sound Corporate Governance Practices		
1. Board to establish strategic objectives and a set of corporate values ('tone at the top") that are communicated throughout the banking organisation, timely and frank discussion of problems and prohibit/limit conflict of interest, self-dealing and related party transactions.	Most banks follow a budgetary system. Strategic objectives and set of values are often not defined very clearly and their communication throughout the organisation is quite uneven. Long-term problems and hindrances in the way of achieving organisational goals tend to receive attention only at higher levels of management. Please also see our comments at A, 6.	The banks need to develop mechanisms which can help them ensure percolation of corporate strategic objectives and set values throughout the organisation. Please also see our remarks at A, 6.

2. Board to set and enforce clear lines of responsibility and accountability for themselves as well as the senior management and throughout the organisation so that there is no unspecified or confusing and multiple accountability and lines of responsibility	Boards of very few banks are known to enforce clear lines of responsibility and accountability for themselves. In quite a few cases there is not enough clarity about their roles. Much of it is because of the manner in which the Boards are constituted. The lines for the responsibility and accountability for senior management and further down in the banks are, however, quite clearly defined leaving little room for unspecified or confusing and multiple accountability and lines of responsibility.	There is an urgent need to follow the best practices in the banks in respect of constitution and functioning of the Boards.
3. Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns:	Selection for nomination of individuals on banks' Boards is on the basis of his/her qualification considered suitable for the position. There is, however, no practice of pre-induction meeting/briefing or any post-induction orientation. As such, often a proper appreciation of their role in the banks' corporate governance takes time to develop. Instances of undue influence from management or outside concerns are rare.	This practice can be put in place forthwith.
i. understand their oversight role and duty of loyalty to bank and shareholders	Boards of Directors some time take longer than expected time to understand their role and obligation to the bank and the shareholders. New Board members seldom go through any orientation programme.	There is a need to streamline the process of induction of Directors into bank Boards and their initial orientation. Suitable arrangement can be put in place forthwith.
ii. serve as a "check and balance" to the management	The Boards as a body generally serve as a "check and balance" to the management. All members of the Boards individually may not be said to be feeling and conducting themselves as ideally as envisaged.	The process can be self sustaining once the responsibility and accountability are enforced.

iii. feel empowered to question the management and insist on explanation from the management	Do	
iv. recommend sound practices gleaned from other situations	Do	
v. provide dispassionate advice	Do	
vi. are not over extended	The system has till recently permitted Board membership to an individual in up to 20 companies. This number is now sought to be reduced. Being on a number of Boards does result in over-extension in some cases.	Members of Board of Directors are required to give their valuable time to the governance of banks. In this context, there is a need to have some ceiling on the number of Boards and the number of Committees a Director can work at a time. Relative SEBI guidelines limit membership of Board/ Committees. Whereas in the case of listed companies this will hold good, the same principle may be adopted in the case of all banking companies.
vii. avoid conflict of interest in their activities with and commitments to other organisations	The statutory provisions (Section 20 of the BR Act, 1949) prohibit loans and advances 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.	

	Disclosure of interest by Directors is mandatory and in case there is any likelihood of conflict of interest arising, the concerned Director is required to abstain from participating in the decision making process relating to that case.	
viii. meet regularly with senior management and internal audit to establish and approve policies, and monitor progress towards corporate objectives	The Board meets the senior management and internal audit regularly and establishes and approves policies and monitors progress towards corporate objectives.	
ix. abstain from decision making when incapable of providing objective advice	Yes.	
x. do not participate in day-to-day management of the bank.	Yes.	
xi. form committees for:		
a. Risk Management Committee	The regulatory guidelines for formation of Risk Management Committee are for a Committee of the Top Executives. Most banks are in a nascent stage of evolving risk management policies and practices.	Comprehensive risk management systems should be put in place in all banks at an early date. A time-frame of two to three years is considered adequate for the purpose.
b. Independent Audit Committee – comprising of external members, oversight of internal and external auditors, their appointment and dismissal, ensuring that management is	The present system of constituting an audit committee of the Board chaired by one of the non-executive directors is able to ensure performance in these tasks satisfactorily. Appointment and removal of auditors by the Boards of banks has to be with the prior approval of Reserve Bank of India.	

taking appropriate action, etc.		
c. Compensation Committee – oversight of remuneration of senior management, and other key personnel and ensuring compensation is consistent with bank's culture, objectives, strategy and control environment.	Public Sector Banks do not have Compensation Committees. The remuneration is fixed at the industry level uniformly for all banks at all levels of management with the approval of the Government of India. However, RBI approves the remuneration of CEOs of private sector banks.	There is a need to review the current practice and link performance with remuneration.
d. Nomination Committee – assessment of board effectiveness and directing the process of renewing and replacing board members	As of now, there is no Nomination Committee of the Board of Directors for nominating directors into the Boards of banks, except in the case of some private sector banks. There is also no established system to assess the effectiveness of the functioning of the Board members.	The desired change is possible after the ownership of the banks goes out of the Government's fold. The present system of nomination of directors on the Boards of banks is expendable.
4. Ensuring that there is appropriate oversight by senior management ("four eyes principle") – senior managers not overly involved in business line decision making, are knowledgeable for their assigned area and willing to exercise control over successful and key employees without the fear of losing them.	The oversight is by Senior Managers who are not overly in the business and are knowledgeable. The oversight and checks and controls carried out by senior management may have no risk of losing an employee since the employment market is very tight. However, this may result in de-motivation at the lower level.	
5. Effectively utilising the work conducted by internal and external auditors, in recognition	The importance and independence of internal as well as external audit is well recognised and communicated throughout the bank. Audit in banks is seen as a function	The position may be deemed satisfactory.

of the important control function they provide – recognising their importance and communicating this throughout the bank, enhance the independence and stature of auditors, utilising in a timely and effective manner their findings, ensuring their independence through the head auditor reporting to the board or board's audit committee, etc.	independent of operating departments and in most cases the head of audit reports directly to the Chairman / Board. External statutory auditors also present their report on the functioning of the bank to its Board directly.	
6. Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment – do not overly depend on short-term performance.	There is no performance related compensation in public sector banks and therefore, there is very little incentive or disincentive for good or bad performance. Some private sector banks have made efforts towards performance related compensation. Such cases which are not many are recent. However, it is difficult to say at this stage with any degree of certainty that these are always consistent with the control environment and is not overly dependant on short-term performance.	See remarks against item A .7
7. Conducting corporate governance in a transparent manner – Public disclosure is desirable in the following areas:		
i. Board structure (size, membership, qualifications and committees).	While the structure of the Board is revealed in the Balance Sheet, details of Committees and qualifications of the directors are not always available publicly.	This practice may be introduced.
ii. Senior management structure (responsibilities, reporting lines, qualifications and experience).	This disclosure is not there.	Indian banks may be encouraged to make this disclosure.

iii. Basic organisational structure.	This disclosure is not there.	Indian banks may be encouraged to make this disclosure.
iv. Information about incentive structure (remuneration policies, executive compensation, bonuses, stock options).	This disclosure is not there.	Indian banks may be encouraged to make this disclosure.
v. Nature and extent of transactions with affiliated and related parties.	This disclosure is not there.	Indian banks should be encouraged to make this disclosure.
D. Ensuring an environment supportive of sound corporate governance		
1. Government – through laws.	Guidelines and norms for good corporate governance in banks and overall responsible corporate governance are still in formative stages and healthy conventions are still to be built up. There are no laws as such which can be seen as supporting or facilitating corporate governance. It will be some time before tenets of good governance can be enacted in a piece of legislation. The Reserve Bank of India as supervisor and SEBI as capital market regulator are gradually introducing measures which lead to good corporate governance in banks and protection of depositors' and others' interests.	
2. Securities regulators, stock exchanges – through disclosures and listing requirements.	SEBI as the securities market regulator ensures healthy growth of capital markets and stands for the protection of the interest of shareholders. SEBI has stipulated disclosure and listing requirements and also reviews these on an on-going basis.	

3. Auditors – through audit standards on communications to boards of directors, senior management and supervisors.	The Institute of Chartered Accountants of India (ICAI) sets the accounting standards for banks in consultation with Reserve Bank of India. Standards on communication to Board of Directors, senior management and the Supervisors are, however, yet to be set and stabilise.	
4. Banking industry associations – through initiatives relating to voluntary industry principles and agreements on and publication of sound practices.	Banks’ industry level associations like the IBA, FEDAI, FIMMDA, etc. are active in taking initiatives relating to voluntary industry principles and agreements.	

Appendix III: Enhancing Bank Transparency

BIS principle	Indian Position	Remarks/ Roadmap for the Future
1.0 General Level		
1.1 The Basle Committee recommends that banks, in regular financial reporting and other public disclosures provide timely information, which facilitates market participants' assessment of banks. It has identified the following six broad categories of information, each of which should be addressed in clear terms and appropriate detail to help achieve a satisfactory level of bank transparency: ❑ financial performance; ❑ financial position (including capital, solvency and liquidity); ❑ risk management strategies and practices; ❑ risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks); ❑ accounting policies; and ❑ basic business, management and corporate governance information.	Banks' financial reporting broadly encompasses financial performance and financial position (excluding liquidity) and accounting policies. As regards information on basic business management and corporate governance, wide range practices are prevalent from elaborate disclosures to very little information.	All these six broad categories of information should be provided as public information
1.2 The scope and content of information provided and the level of dis-aggregation and detail should be commensurate with the size and nature of a bank's operations. The method	Irrespective of the size and nature of a bank's operations, the scope and content of information provided tend to be more or less standardised with less	

of measurement will however depend on applicable accounting standard	disaggregation and detail.	
1.3 In countries with less developed financial markets, supervisors may need to establish a more comprehensive supervisory reporting system covering these six broad categories of information to compensate for inadequacies in publicly disclosed information.	This principle is acceptable. The level of compliance in respect of each of the six broad categories is assessed in detail under item 2.0.	
2.0 Details in disclosure		
2.1 Financial Performance		
2.1.1 Information about the performance of a bank, in particular about its profitability, and the variability of those profits over time, is necessary to assess potential changes in financial position and future potential to repay deposits and liabilities, to make distributions to owners, and to contribute to capital growth. Information about profits and losses and their components over recent and earlier periods, helps form assessments of future financial performance and cash flows. It also helps assess the effectiveness with which a bank has employed its resources. Useful information includes basic quantitative indicators of financial performance, breakdowns of income and expenses, and management's discussion and analysis of financial performance.	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 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;	However, we would have to go beyond these disclosures to provide for more disaggregated information including data on variability of profits over time. Further areas of disclosure of information relating to financial performance could include: • Contribution of different activities and regions • Impact of non accrual and impaired assets on financial performance

	♦ Amount of provision made towards NPLs and provisions for income-tax for the year; ♦ Amount of subordinated debt raised as Tier II capital; ♦ 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 for 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.	• Effect of hedging activities on income and expenses • Income effect of securitisation
2.1.2 To assess the financial performance of a bank, it is essential to have a breakdown of income and expenses incurred. This information is necessary to assess the quality of earnings, to identify the reasons for	The income statement usually includes items for interest income and expense, fees and commissions, other non-interest income, operating expenses, charge for credit losses, any extraordinary items, tax	

changes in a given bank's profitability from year to year and to compare the financial performance of different banks. Information on financial performance typically includes an income statement that groups income and expenses by nature or function within the bank. The income statement usually includes items for interest income and expense, fees and commissions, other non-interest income, operating expenses, charge for credit losses, any extraordinary items, tax expenses and net income.	expenses and net income. However, complete breakdown of income is not furnished in banks' financial reporting making a meaningful assessment of the quality of income and inter-bank comparison difficult. Such break-up should be standardised and mandated for disclosure.	
2.1.3 The notes to the income statement provide additional detail on important income and expense categories.	Notes containing details where ever necessary are being given	
2.1.4 For the purpose of assessing sustainability of profits, it is essential that the impact of acquisitions and lines of business discontinued during the year be disclosed.	Mergers and acquisition as also discontinuance of a line of business are new for the Indian Banking industry. In the few cases in which these have occurred so far, only general assessments of their impact is given in the balance sheet.	Banks should be asked to make more quantitative assessment of their impact on profitability and disclose it in their balance sheet
2.1.5 Key figures and ratios should include the return on average equity, return on average assets, net interest margin (net interest income divided by average interest earning assets), and cost-to-income ratio.	All these ratios are disclosed as per the regulatory requirements in this regard.	

2.1.6 Business and geographical segment information aids in the analysis of past performance and assists in assessing future prospects. The user of financial information can achieve a better understanding of a bank's overall financial performance if the bank discloses the contribution of different activities and regions to overall financial performance. In particular, this information helps the user assess the extent of diversification in the bank's business and the contribution of specific business segments and regions that may be considered to be of a higher risk. It also facilitates awareness of the impact of significant changes, e.g., due to regional disturbances, on the bank as a whole.	A break up of contribution of different activities to assess the diversification in the banks business and contribution of different business lines is necessary. Banks should be asked to make these disclosures in their balance sheet. A time frame of two or three years may be stipulated for this purpose.	
2.1.7 Management has a detailed knowledge of the business that outsiders cannot have. Therefore, management can greatly assist both the market and supervisors by discussing the main factors that influenced a bank's financial performance for the year, by explaining differences in performance between the current year and previous years and by discussing factors they believe will have a significant influence on the bank's future financial performance.	This type of information is usually provided in management or director's report to the market or supervisors to arrive at meaningful inferences.	Factors that impact current and next years profitability should necessarily be discussed explicitly as part of the Management Discussions and Analysis.
2.1.8 In many countries, comprehensive accounting guidance is available on the	In India, ICAI guidelines on bank audit, which covers aspects of presentation and	The levels of disclosure in the balance sheets of Indian banks

presentation and disclosure of information about financial performance. Authoritative guidance has been issued by legislators, regulators, and national and international accounting standard-setters, and should be referenced to identify appropriate disclosures and to gain an understanding of why they are useful.	disclosure of financial information, is being followed. RBI has stipulated standards of disclosure from time to time based on international best practices.	can be improved further. Areas of disclosure have been indicated above. Efforts have to be made to come close to internationally followed standards of disclosure within the next two years.
2.2 Financial Position (including capital, solvency and liquidity)		
2.2.1 Market participants and supervisors need information about the financial position of an institution. Information about the financial position of a bank is useful in predicting the ability of the enterprise to meet its liabilities and financial commitments as they fall due. Information about the nature and amount of assets, liabilities, commitments, contingent liabilities, and shareholders' funds, both at points in time and averages over periods, including their maturity and repricing structure, is useful for assessing a bank's liquidity and solvency, and ultimately its financial strength, and the trends therein.	Information about the nature and amount of assets, liabilities, commitments, contingent liabilities and shareholders' funds are furnished in the financial statements and in notes to the accounts.	Information detailing maturity and repricing structure of all assets and liabilities should form part of the mandatory disclosure.
2.2.2 Information about institutions' provisions and allowances for losses and how these provisions and allowances are determined is important in assessing an institution's ability to withstand losses.	Charge of loan loss provisions made during the year and the basis of provisioning are now being disclosed. However, as yet cumulative provisions held against loan losses with the	These disclosures should be made mandatory

	movement in provisions accounts are not being disclosed.	
2.2.3 To assess an institution's financial position, it is essential to have a breakdown of assets and liabilities, and equity capital by type. Information on financial position typically includes a balance sheet that distinguishes different types of assets, liabilities and sources of equity capital. The balance sheet usually includes separate items for loans, trading securities, investment securities, tangible fixed assets (e.g., real estate), intangible fixed assets (e.g., goodwill), short-term debt and long-term debt.	Breakdown of assets and liabilities and equity capital by type and their distribution is given in the balance sheet. Information on securities held as investments and for the purposes of trading is also given separately. The format of balance sheet of banks provides for adequate breakdowns on both assets and liabilities side.	
2.2.4 Disclosure of off-balance-sheet items may include information about notional amounts and fair values or replacement values of off-balance- sheet transactions, and about commitments and contingent liabilities.	Commitments & contingent liabilities are being disclosed in the balance sheet.	Full disclosures with notional values and fair value of off-balance sheet transactions, commitments and contingent liabilities should be disclosed.
2.2.5 In notes to the balance sheet, additional information about the items in the balance sheet which is relevant to the needs of users may also be provided, e.g., fair value (trading account, loans, deposits, others).	Notes to consolidated balance sheet and income statements contain additional information relevant to users.	
2.2.6 Information about regulatory capital and its components is important in analysing the financial position of a bank (tier 1, tier 2, tier 3 – if applicable, risk-weighted assets, risk-	In India information is being furnished on regulatory capital (Tier-I & Tier-II) but details of risk weighted assets, leverage ratio, restrictions on	Disclosures relating to management of risks by the banks such as calculation of capital requirements for credit

based capital ratio), as well as information about equity capital (e.g., debt-to-equity ratio, restrictions on distributions). Information about the changes in the amount and types of capital, including the impact of earnings, dividends and capital issuances, is important in assessing the cushion available to absorb future potential losses and for the bank's ability to sustain growth over the near term. Management's discussion and analysis of a bank's financial position and changes therein, help the market better understand and form expectations based on them.	distributions, including the impact on earnings, etc., are not being furnished uniformly.	risk, capital requirement for market risk and data relating to broad values at risk, stress/ back testing information will have to be broadly introduced in banks' balance sheet. Along side disclosures on capital allocation, future capital plans will also have to be disclosed. It should be possible for banks to begin providing these disclosures in two to three years time by when it can be made mandatory.
2.2.7 Information about the nature and amount of assets pledged as collateral, e.g., to support deposits, other liabilities and commitments, and the amount of secured liabilities is useful in assessing the financial position of a bank and, in particular, the collectibility of claims on the bank in case of its liquidation.	Banks in India do not accept collateralised deposits or any other such liabilities or commitments.	Where there are occasions of the bank having availed of collateralized lines for managing their liquidity, the details should be provided.
2.2.8 As with guidance on presentation and disclosure of financial performance, comprehensive accounting guidance on the presentation and disclosure of information about financial position is available in many countries. Authoritative guidance has been issued by legislators, regulators, and national and international accounting standard-setters.	Guidance on presentation of statement representing financial position (balance sheet) is prescribed by Banking Regulation Act, Sec (29). Disclosure requirements are also being prescribed by the regulator from time to time.	RBI may consider issuing comprehensive guidelines on necessary disclosures in a banks balance sheet. Since disclosures in India are still in an evolutionary stage and additional disclosures are being added to the disclosure

		requirements, it would also be desirable to update these guidelines from time to time until the Indian disclosures fully match international standards in this regard. Initially, updating of these guidelines may be undertaken at shorted, say annual intervals. A co-ordinated approach between the ICAI and the RBI may be adopted for this purpose.
2.3 Risk Management strategies and practices		
2.3.1 Market participants and supervisors need information about a bank's management strategies and policies for managing and controlling risks. Risk management is a key factor in assessing the future performance and condition of a bank and the effectiveness of management.	Directors' report or management report forming part of the annual report contain information on bank's management strategies.	
2.3.2 Disclosures may include discussions of overall risk management philosophy, overall policy and methodologies, how risks arise, how risks are managed and controlled, and whether and how derivatives are used to manage risks. It may also be useful to discuss the risk management structure and risk measurement and monitoring (e.g., models, value-at-risk, simulation, credit scoring,	Although Risk Management is a rather recent concept, bank managements are gearing themselves suitably to be in a position to furnish in their annual reports details of their risk management philosophy, strategies and methodologies.	More disclosures on risk management are essential. Banks will have to take steps so that even before they start making detailed analytical disclosures about their risk management arrangements, they begin disclosing details about risk mitigating tools

capital allocation, etc.), monitoring process, model validation process, stress testing, back testing, the use of risk-mitigating tools (collateral/guarantees, netting agreements, managing concentrations), limits (e.g., credit limits, market risk limits), and periodic review of exposures.		being used by them, limits, exposure to banks, commercial and Government entities, international exposures, subordinate assets, classification of exposures and information about types of counter-parties.
2.3.3 In addition to overall risk management strategies, individual discussions of risk exposures need to include specific risk management strategies.		
2.3.4 It is a particular challenge for a bank to maintain transparency as risk management methods advance. Banks should strive to continue to provide meaningful information so the public understands the risk management techniques and measures used over time.		
2.4 Risk exposure		
2.4.1 Market participants and supervisors need qualitative and quantitative information about an institution's risk exposures, including its strategies for managing risk and the effectiveness of those strategies. Together with the disclosure of a bank's financial position, these help reflect its financial strength and viability and ultimately its ability	RBI has issued detailed guidelines for implementation of Asset – Liability Management in banks and financial institutions. This was followed by a comprehensive set of guidelines on implementing an integrated risk management system in banks which includes credit risk, market risk and	

to continue its business in times of stress.	operational risks. Once ALM and Credit Risk Management become fully operational banks in India will be in a position to measure and quantify various risks in addition to furnishing qualitative aspects of various risk exposures.	
2.4.2 A bank's risk profile, i.e., the risks inherent in its on- and off-balance- sheet activities at a point in time and its appetite for taking risk, provides information about the stability of an institution's financial position and the sensitivity of its earnings potential to changes in market conditions. Moreover, an understanding of the nature and extent of an institution's risk exposures helps assess whether a bank's returns are appropriate for the level of risk it has assumed.		
2.4.3 Disclosures of risk information assist in assessing the amount, timing and certainty of future cash flows. Given the dynamic financial markets in which banks operate, and the influences of increased global competition and technological innovation, a bank's risk profile can change very quickly. Therefore, users of financial information need measures of risk exposures that remain meaningful over time and which accurately reflect sensitivities to changes in underlying market conditions.		Measures such as VaR and/ or EaR, which sufficiently capture a bank's risk exposure, should also be disclosed at least on a quarterly basis along with quarterly operating results. Banks should also be encouraged to develop their own risk models, which

		appropriately capture their risk profile. Details of the model as well as the assumptions constraining it and the process employed for validating the model should also constitute part of the disclosure framework.
2.4.4 Traditionally, banks have focused on disclosing information about credit risk and market risk, including interest rate and foreign exchange risk, and, to a lesser extent, liquidity risk. In discussing each of these risk areas, an institution should present sufficient qualitative (e.g., management strategies) and quantitative information (e.g., position data) to help users understand the nature and magnitude of these risk exposures. Further, comparative information of previous years' data should be provided to give the financial statement user a perspective on trends in the underlying exposures.	Banks in India have already begun providing both qualitative (e.g. management strategies) and quantitative information (position data) in the balance sheet. Concept of comparative information of previous years has also been introduced.	Banks' annual reports do provide these information
2.4.5 Other risk exposures such as operational, legal and strategic risk are less easy to quantify, but may be highly relevant. Qualitative information should be given about the nature of the risks and how they are managed	Notes on account on the balance sheet contain details on legal risk. Other risks have so far not been forming part of the disclosures in the balance sheet	A discussion on legal, operational and strategic risks may be made mandatory in the Management letter/ Director's report to the share holders

2.4.6 Credit risk		
2.4.6.1 Disclosures should help the reader understand the magnitude of an institution's credit exposure on an aggregate basis as well as its significant components. Further, the user of financial information should be able to understand how an institution manages credit risk and whether or not those strategies have been effective.	Credit related disclosures in the bank's balance sheet are presumably limited to details of NPAs, provisions for loan losses and lending to some sectors which are considered sensitive.	As against item 2.3.2. It has been suggested that risk mitigating tools, limits, concentrations and exposures be disclosed. RBI may consider issuing some guidelines in this regard. It should be possible for some banks to make these disclosures about credit risk management in their balance sheet without much difficulty.
2.4.6.2 To achieve transparency, an institution should provide descriptive information about the business activities that create credit risk, its strategies regarding those business lines, and the nature and composition of the exposures that arise. Examples of useful disclosures include a discussion about business strategies, risk management processes and internal controls relating to activities that generate credit risk.	Business activities that create credit risks are not being separately identified. Quantitative information regarding gross positions e.g. loans, investments and off-balance sheet exposures are given. We need to ensure that we begin with disclosures, which are of greater relevance in our context including those which are sophisticated and have relevance in more complex situations.	We should follow a gradual process of disclosure on risk so that key elements remain in focus. Suggestions in this regard have been given while examining earlier items. The proposed guidelines to be issued by RBI will be able to take care of this phasing.
2.4.6.3 In addition, quantitative information should be provided regarding gross positions (e.g., loans, investments, trading and off-balance-sheet exposures), information about the types of counterparties (e.g., exposure to banks, commercial, and government entities; domestic and international exposures;		

subordinate assets, and secured and unsecured exposures), and significant concentrations of credit exposure. Further, information on potential credit risk exposure arising from existing derivative contracts is useful, since that exposure may change rapidly and substantially.		
2.4.6.4 Disclosures about the quality of the current loan and investment portfolios and other significant counterparty exposures provide important information about an institution's future earnings potential. Quantitative disclosures should include the amount of problem loans and other assets, an ageing schedule of past due loans and other assets, concentrations of credit, and aggregate exposures by counterparty credit quality. In addition, information should be provided about the allowances for credit losses and how those allowances have changed from period to period.	While aggregate amount of problem loans (NPAs) is given in the management report, details as to ageing schedule of past due loans and other assets, concentrations of credit, aggregate exposures by counter party credit quality, etc., are not given.	These disclosures will be helpful and may be made mandatory. In the phased increase of disclosures, these can be prioritized higher.
2.4.6.5 An understanding of an institution's credit risk position is facilitated through disclosure of risk management strategies. For example, disclosures about the use of collateral and guarantees, the use of credit scoring and portfolio risk measurement models and the organisation of the credit risk function and similar discussions about activities undertaken to manage credit	Disclosures in detail about risk management strategies are not currently being furnished, except brief description of the organisation of the credit risk management function. But disclosures on these are expected to improve in the ensuing years.	

exposures provide background information useful in assessing the significance of risk exposures. Information about the use of credit limits and internal credit ratings is also useful.		
2.4.7 Market risk		
2.4.7.1 As with credit risk, an institution should provide both quantitative and qualitative information regarding its market risk exposures. Market risk arises from the potential for changes in market rates and prices, including interest rates, foreign exchange rates, and equity and commodity prices. An institution's disclosures about each of these types of risk should be commensurate with the degree of exposure.	At present, except for depreciation in the value of investments arising out of interest rate risk, and equity price risk, the impact of interest rate risk on bank's NIM or impact of foreign exchange risk on unhedged exposures are not disclosed.	Disclosures in these areas may be prescribed.
2.4.7.2 Since *interest rate risk* is especially relevant to banks, management should provide detailed quantitative information about the nature and extent of interest rate-sensitive assets and liabilities and off-balance sheet exposures. Examples of useful disclosures for the banking book include breakdowns of fixed and floating rate items and the net interest margin earned. Other useful disclosures include the duration and effective interest rates of assets and liabilities. These disclosures should also identify assets and liabilities, and related gains and losses.	Such detailed information on interest rate risk and the extent of interest rate – sensitive assets and liabilities and off-balance sheet exposures are not furnished since ALM and other Bank Risk Management tools are just in their infancy in India.	A beginning can be made by presenting of quantitative information about the nature and extent of interest rate sensitive assets and liabilities.

2.4.7.3Disclosures should also provide information about the interest rate sensitivity of an institution's assets and liabilities. For example, disclosures about the effect on the value of assets, liabilities and economic equity given a specific change (increase or decrease) in interest rates can provide a useful summary measure of the institution's risk exposure.	-- do --	--do--
2.4.7.4 To facilitate understanding of *foreign exchange risk* exposures, institutions should provide summarised data for significant concentrations of foreign exchange exposure by currency, broken down by hedged and unhedged exposures.	Summarised data for significant concentrations of foreign exchange exposure by currency, broken down by hedged and unhedged exposures are not provided now.	This should be prescribed.
2.4.7.5 It is also helpful to disclose information about investments in foreign subsidiaries (foreign currency translation risk). This quantitative information should be supplemented with discussion about the nature of the currency exposure, how that exposure has changed from year to year, foreign exchange translation effects, the earnings impact of foreign exchange transactions and the effectiveness of risk management (hedging) strategies.	Detailed information on investments in foreign subsidiaries (Translation Risk) or foreign exchange transactions risk, the earnings impact of foreign exchange transactions and effectiveness of hedging strategies are not furnished.	
2.4.7.6 For larger institutions, " value-at-risk" (VAR) or "earnings-at-risk" (EAR) disclosures can provide summarised data about a market risk exposure. Typically, VAR	Disclosures on "Value at Risk" (VAR) and "Earnings at Risk" (EAR) are currently not provided. Banks should be encouraged to disclose this information	While these disclosures will have to be finally prescribed, in most cases banks have yet to gain experience in risk

and EAR disclosures are provided for interest rate and foreign exchange risk, but these models could also be used to summarise equity and commodity risk exposures.	on a voluntary basis to start with.	measurement. To be able to use models for this purpose efficiently they will need at least two years in case of larger banks and even more in case of smaller ones. RBI may consider a time frame of 3-4 years for prescribing these disclosures in the balance sheet. To begin with VaR and Ear may be prescribed in selected areas of activity e.g. foreign exchange, treasury activities and investments.
2.4.7.7 Specific disclosures relating to these models include the magnitude of the exposure on a daily, weekly or monthly basis, maximum and minimum values, and end-of-period values. To help the user understand such model-generated information, the assumptions used in calculations (e.g., confidence level, holding period, etc.) should also be disclosed. In addition, a histogram of the daily profits or exposures over the reporting period may facilitate an understanding of the volatility of risk exposures.		
2.4.8 Liquidity risk		
2.4.8.1 Liquidity is the ability to have funds available to meet the commitments of the	Except for cash flow statement, detailed information on liquidity risk exposure is	Being largely owned by the Government, Indian banks so

bank. To enable market participants to understand an institution's liquidity risk exposure, an institution should provide information about its available liquid assets, as well as its sources and uses of funds. For example, disclosures about short-term assets (e.g., cash and cash equivalents, repurchase agreements and interbank loans) and short-term liabilities (e.g., reverse repurchase agreements, commercial paper) provide basic information about an institution's liquidity profile. A cash flow statement shows the sources and uses of funds and provides an indication of an institution's ability to generate liquid assets internally. Information about concentrations of depositors and other fund providers, maturity information about deposits and other liabilities, and the amount of securitised assets, are useful in assessing an institution's liquidity.	currently not being furnished. However, with the concept of ALM expected to stabilise in Indian banking in the ensuing years, detailed disclosures on liquidity risk exposure will be possible.	far have had so serious concerns about liquidity. With the changing scenario, liquidity will become an issue. As more detailed statement of cash flow than at present (this statement is presently given in the balance sheet to meet the listing requirements of the stock exchange) showing sources and uses of funds should be prescribed for disclosures.
2.4.8.2 Descriptive discussion about the diversity of funding options and contingency plans provides additional perspective on the potential impact of liquidity risk to the institution.	Details about the diversity of funding options and contingency plan are also not provided.	This should form part of the management's letter/ Director's report on managing liquidity risks.
2.4.9 Operational and legal risks		
2.4.9.1 Institutions should also provide disclosures about operational and legal risks.	No such disclosures on operational and legal risk are made at present.	The ability of the accounting as well as internal control and

Operational risk disclosures should include information about the main types of such risk and should identify any specific problem (e.g., Year 2000) considered to be individually significant.		management systems to support the growing size and diversity of the business is the main operational risk faced by banks. Increasing frauds and deficiencies in follow up are manifestation of this risk intensifying. A discussion in the management letter/ Director's report on this issue along with a discussion on the sufficiency of technology used by the bank and fall back positions in the event of their failure may be prescribed. Details of transactions in nominal accounts pending reconciliation should also de disclosed.
2.4.9.2 Legal risk disclosures include legal contingencies (including pending legal actions) and a discussion and estimate of the potential liabilities. Qualitative information about how the bank manages and controls these risks should be given.	Note to the accounts in the disclosure on contingent liabilities carry details on pending legal action and estimate of potential liabilities.	
3.0 Accounting policies		
3.1 Market participants and supervisors need information about the accounting policies that	Significant accounting policies are being disclosed.	

have been employed in the preparation of financial reports. Accounting policies, practices and procedures differ not only between countries, but also between banks in the same country. Accordingly, users of accounting information need to understand how items are being measured to properly interpret the information. Disclosure of significant accounting policies on which financial reporting is based enables users to make reliable assessments of the bank's reported position and performance.		
3.2 Disclosure of accounting policies may be appropriate with respect to general accounting principles, changes in accounting policies/practices, principles of consolidation, policies and methods for determining when assets are impaired, recognising income on impaired assets and losses on non-performing credits, policies to establish specific and general loan loss allowances, income recognition, valuation policies (trading securities, investment securities, loans, tangible fixed assets, intangible fixed assets, liabilities, etc.), recognition/derecognition policies, securitisations, foreign currency translations, loan fees, premiums and discounts, repurchase agreements, securities lending, premises/fixed assets, income taxes, and derivatives (hedging, non-hedging, losses on derivatives).	-- do --	

4.0 Basic Business, management and Corporate governance information		
4.1 To accurately evaluate a bank's disclosures about its financial position and financial performance and its risks and risk management strategies, market participants and supervisors need fundamental information about the bank's business, management and corporate governance. Such information can help provide the appropriate perspective and context to understand a bank's activities. For example, management's discussion about the bank's position in the markets in which it competes, its strategy and its progress towards achieving its strategic objectives is important for assessing the bank's future prospects.	Directors' or top management report in the annual report contain detailed information about the bank's business management, its different activities, strategies and plans for the future. Discussion on corporate governance is now also forming part of these reports.	
4.2 The organisation of a bank, in terms of both its legal and management structure, provides information about an institution's key activities and its ability to respond to changes in the marketplace. Further, such information may provide an indication of the institution's efficiency and overall strength. Accordingly, it is appropriate to disclose information about the board structure (e.g., the size of the board, board committees, and membership), senior management structure (responsibilities, reporting lines), and the basic organisational structure (line of business structure, legal entity structure).	Recently, a beginning has been made by some banks in disclosing information about the broad structure with regard to Board Committees and membership, Senior Management structure with responsibilities and reporting lines and the basic organisational structure.	These disclosures should be prescribed for all banks uniformly.

4.3 In addition, information should be provided about the qualifications and experience of the board and senior executives. This information may be helpful in assessing how an institution may perform in times of stress or how it may react to changes in the economic or competitive environment.	Information on qualifications and experience of the board and senior executives are being furnished.	--do--
4.4 Information about the incentive structure within a bank, including its remuneration policies, such as the amount of executive compensation and the use of performance bonuses and stock options, helps evaluate the incentives management and staff have to take excessive risks.	Information on incentive structure within a bank, remuneration policies, the use of performance bonuses and stock options are not given.	--do--
4.5 Useful information may include a summary discussion of the philosophy and policy for executive and staff compensation, the role of the board of directors in setting compensation, and compensation amounts.	Summary discussion of the philosophy and policy of executive and staff compensation, the role of the board in setting compensation are not provided.	--do--
4.6 In addition, banks should provide information on the nature and extent of transactions with affiliates and related parties. Such information is useful in identifying relationships that may have a positive or negative impact on a bank's financial position and performance. Further, it can help assess its susceptibility to the effects of affiliates on the bank's financial performance (contagion risk).	Nature and extent of transactions with affiliates and related parties are not disclosed.	--do--

4.7 Finally, institutions should consider providing general information that would help market participants and supervisors gain a broad understanding of the institution's culture. As indicated previously, banks should be innovative in identifying the types of information they provide and the methods by which they provide such data.	General information on the institution's culture is provided by some banks in the annual report as part of management discussion/ report	-- do--
4.8 Supervisors and public policy makers should focus their efforts on promoting high-quality disclosure standards, taking into consideration the recommendations presented in this paper, and on developing mechanisms that ensure compliance with those standards.	RBI and government are very focussed in their efforts on promoting high quality disclosure standards.	The progress shall have to be gradual but sustained. While there will be some key disclosures which must find place in balance sheet of all banks as prescribed by RBI, individual banks should be encouraged to make additional disclosures which they consider relevant to their business and balance sheet.

Appendix – IV: Supervision of Cross-border Banking

International efforts at streamlining the supervision of cross-border establishments have followed some banking crisis or the other originating in one country and having repercussions on a large number of other countries. It was following the failure of Bankhaus Herstatt in 1974 that the importance of collaboration between banking supervisors of different countries and concerted action to deal with banking institutions with cross-border presence was first recognised. It was natural that the initiative came from the BIS whose member countries which broadly coincided with those of the G10 and the OECD were the most affected by the crisis following the failure of Bankhaus Herstatt. These efforts resulted in the Basle Concordat of 1975 issued by the Basle Committee on Banking Supervision.

2. In the wake of further instances of bank failures, a revised Basle Concordat was issued by the BIS in May 1983 which replaced the earlier Concordat. The principles set out in this report, as stated therein, "are recommended guidelines of best practices in this area, which all members have undertaken to work towards implementing, according to the means available to them". In April 1990, certain practical aspects of these principles were elaborated in a Supplement to the Concordat.

3. In the wake of the failure of the Bank for Credit and Commerce International (BCCI), it was felt that greater efforts needed to be made to ensure that the principles contained in the Concordat and the supplement can be applied in practice. Accordingly, some of these principles were reformulated as minimum standards which G-10 supervisory authorities expect each other to observe. In July 1992, the Basle Committee on Banking Supervision (BCBS) brought out the "Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments".

4. In view of a number of problems experienced in the implementation of the above report, a working group set up by the BCBS and the Offshore Group of Banking Supervisors gave a set of detailed recommendations offering practical solutions. The twenty-nine recommendations of this group are set out in the document

"The supervision of cross-border banking" brought out by the BCBS in October 1996. As stated in the document, these recommendations "are aimed at improving and facilitating prudential supervision of banking risks with a view towards ensuring the soundness of individual credit institutions and the stability of the financial system as a whole.

5. The relevant documents published by the BCBS and having relevance for supervision of cross-border establishments are as follows:

a. Principles for the Supervision of Banks' Foreign Establishments (The Basle Concordat) (May 1983)

b. Information Flows Between Banking Supervisory Authorities (April 1990)

c. Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments (July 1992)

d. The Supervision of Cross-border Banking (October 1996)

6. Some of the principles contained in the papers at (a) and (b) above were reformulated and included in the paper at (c). Though the principles laid out in the above documents were for compliance by the G10 member countries, these have found a broad endorsement from a large number of non-G10 countries also. Progress in implementing the norms are being monitored in the biennial International Conference of Banking Supervisors. The Group's comments on the Indian position with regard to each of the recommendations contained in the above documents and the steps that may be required to be taken to reach the accepted standards are discussed in the annex to this note.

7. The major observations relating to deficiencies or gaps with regard to cross-border supervision in the Indian system are given below under the following heads:

a. Issues relating to nature of supervision
b. Issues relating to information sharing
c. Suggested changes in approach and methods of supervision

These are discussed in the following paragraphs.

Nature of supervision

8. In the changing world wide scenario of banking particularly the integration of markets, there is now an overall need to strengthen further the system of cross-border supervision. There is need for a greater interaction with the controlling office (not only the immediately superior office) and the home office regulator. A full understanding of the overall operations of the bank involved is considered necessary.

9. While supervising the branches of foreign banks operating in India, RBI looks mainly at the solvency of the branch. The solvency of the parent bank needs to receive a more pointed attention even if the responsibility to monitor is only general. For supervision of subsidiaries of foreign banks which have branches in India as also for subsidiaries of Indian banks abroad, RBI would need to develop a more focussed policy. At present, the supervision of the subsidiary does not seem to attract enough attention of the regulator.

10. In the case of Indian subsidiaries of foreign banks engaged in activities not coming within the regulatory purview of Reserve Bank of India, the liquidity position of such subsidiaries is not monitored by RBI.

11. The principle of consolidated supervision is unexceptionable. Reserve Bank of India needs to move in that direction. The accounting standards as well as the regulatory provision need to be reviewed from this angle. A major obstacle in this regard which is faced by us is multiplicity of regulators on mutually exclusive basis. A suitable mechanism to coordinate their approaches shall have to be found. RBI is, at present, a little away from the stage of consolidated supervision. It needs to move in that direction gradually but at a fast nick. The first step in this direction would be to pay more attention to the operation of subsidiaries even if their accounts are not consolidated with that of the parent entity, which is the subject of RBI's regulation. RBI should also begin encouraging Indian banks and foreign entities operating in India to submit to consolidated supervision.

12. Reserve Bank of India's supervisory stance is aimed at exercising comprehensive and consolidated supervision of the global activities of the Indian banks. However, in this regard it faces constraints in countries where the local laws do

not permit the home supervisor to conduct onsite inspection/examination of records. There is no legal or other hindrance to parent supervisors from other countries conducting such inspections of Indian branches of banks under their supervisory jurisdiction. A country-wise analysis will have to be made and suitable action taken to address the constraints.

13. While Indian laws do not prohibit inspection of foreign bank branches by the respective parent supervisor, this is not reciprocated by all countries. A country-by-country review would need to be made and appropriate action taken to enter into suitable arrangements with the host country regulation. This should receive urgent attention in relation to those countries which do not permit inspection by the parent country supervisor.

14. RBI is presently not insisting on separate approvals of the home country supervisors of a foreign bank for every new branch which it wants to open in India. Such approvals are also not insisted upon from the home country supervisor of the banking group (where the bank is part of a banking group and the banking group's home country is different from the home country of the bank). RBI needs to consider the desirability of following the recommended approach.

15. RBI could supplement its own supervisory mechanism by making it a regular practice of using external auditors to look specially in certain selected areas and report to it independently.

16. A periodic review would need to be made of the supervisory systems and standards of host supervision where Indian banks have a presence.

Information sharing

17. Host authorities in a large majority of cases remain inadequately informed about the parent bank's difficulties. A more comprehensive system of information sharing based on mutuality and reciprocity needs to be established.

18. RBI has so far not been seeking much information from the parent authorities of banks operating in India. In certain areas of their operations, particularly about the

internal controls exercised by the concerned head offices of banks, more information is desirable. In regard to the quality of control exercised by the Head office of foreign banks, whose branches are operating in India, RBI may increase its reliance on the parent country supervisor and convey to them its expectation about being informed about the extent and quality of control maintained by the head office over its branches operating in India.

19. RBI is not receiving from any of the parent supervisors, advices about the levels of materiality which would trigger their concern. Similarly, RBI is also not informing other host supervisors about such levels of materiality the breaching of which in respect of its Indian bank branches abroad, may trigger supervisory concern. The parent supervisor may define levels of materiality in respect of major financial parameters, the failure to meet with which or the occurrence of certain significant adverse events should be reported by the host supervisor to it. In order to make this practice effective, the two supervisors would need to come to some kind of mutual agreement so that their perception about the triggers identified are common and the manner in which their respective concerns following the appearance of triggers are to be expressed do not vary too much.

20. Greater mutual understanding on the issue of prior consultation with host supervisors, in the likely event of supervisory action against specific banks, would need to be developed amongst the supervisors. RBI should insist on such information sharing as one of the terms on which it permits a foreign bank to open its branch in India.

21. There is a case for incorporating strict legal provisions with regard to ensuring confidentiality of supervisory information so that such information is not shared with any agency, including central or state level vigilance/investigative agencies, but only when specifically called for by a court of law. As a related BIS document states, it needs to emphasised, even in the event of a court demanding supervisory information, that making such information public may result in the drying up of such information and thus adversely affect the quality of supervision in the long run. The present legal provisions in India in respect of confidentiality of information available with the home supervisor (RBI) do not seem to be providing sufficient protection of information. More clearly defined laws would be needed for this purpose.

22. Without objective reciprocity on the issue of sharing information between supervisors, information flow may become very uneven making cross-border supervision difficult. Provision of unhindered/ unqualified access to information to the home supervisor may be made a condition for permitting a bank to open offices abroad.

23. A country-wise analysis will have to be made to ensure reciprocity in passing on information to the home supervisor on certain qualitative aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are the home supervisor.

Suggested changes and timeframe

24. The suggested changes and areas where action needs to be initiated are highlighted below. Suitable timeframe within which such action can be completed is also indicated.

No.	Suggested changes/areas for action	Timeframe
a.	Need for greater interaction with the controlling office (not only the immediately superior office) and the home regulator.	Six months
b.	Consolidate supervision which will include a review of accounting standards and regulatory provisions.	One year
c.	Country-wise review to address constraints in countries where local laws do not permit the home supervisor to conduct onsite inspection/ examination of records.	Six months
d.	Review of supervisory systems and standards of host supervision where Indian banks have a presence.	One year
e.	Use external auditors to look into select areas and report independently to the supervisor.	Three months
f.	Approvals of the respective home country supervisor(s) of the bank and the bank's group to be insisted upon before granting permission to opening of each branch by a foreign bank.	One month
g.	Establishing comprehensive system of information sharing based on mutuality and reciprocity. This will include, among other things, i. quality of control exercised by the Head Office of foreign banks operating in India, ii. advising levels of materiality the breach of which would trigger supervisory concern, iii. prior consultation with host supervisors in the likely event of supervisory action against specific banks, iv. unhindered/unqualified access to information, v. country-wise analysis to ensure reciprocity in information sharing and vi. passing on of information to the home supervisor on certain qualitative aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are home supervisor.	One year
h.	Incorporating strict legal provisions to ensure confidentiality of supervisory information.	Six months

Conclusion

25. The main concerns in the area of cross-border supervision relate to sharing of information between the Reserve Bank of India and overseas supervisors, consolidated supervision and stronger internal control over operations of foreign branches of Indian banks operating abroad and of branches of foreign banks operating in the country. The Group is of the considered view that the gaps/deficiencies listed above are capable of being rectified within a reasonable timeframe and that they neither militate against provision of sound cross-border supervision nor are they serious enough to conclude that the level of adherence with the core principles and standards for cross-border supervision are inadequate.

Supervision of Cross-border Banking

A. Principles for the Supervision of Banks' Foreign Establishments[§]

No.	Minimum standards	Indian position	Remarks
I. General principles governing the supervision of banks' foreign establishments			
i.	Effective supervision between host and parent authorities is a central prerequisite for the supervision of banks' international operations. In relation to the supervision of banks' foreign establishments there are two basic principles which are fundamental to such cooperation and which call for consultation and contacts between respective host and parent authorities;		
	Firstly, that no foreign banking establishment should escape supervision; and	All foreign banking establishments in the country are subject to supervision.	
	Secondly, that the supervision should be adequate.	Systems are in place and have so far proved to be adequate. In the changing world-wide scenario of banking particularly the integration of markets, there is now a need to strengthen the system further. The first step would be a greater interaction with controlling office (not only the immediately superior office) and the home office regulator. A full understanding of the overall operations of the bank involved is considered necessary.	
	In giving effect to these principles, host authorities should ensure that parent authorities	This principle has as yet not received universal acceptance amongst regulators in regard to their cross	

§ BIS Paper, May 1983.

	are informed immediately of any serious problems which arise in a parent bank's foreign establishment. Similarly, parent authorities should inform host authorities when problems arise in a parent bank which are likely to affect the bank's foreign establishment.	border regulatory obligations. Host authorities in a large majority of cases remain inadequately informed about the parent bank's current and impending difficulties. A more comprehensive system of information sharing based on mutuality and reciprocity need to be established.	
II. Aspects of the supervision of banks' foreign establishments			
1. Solvency[1]			
	The allocation of responsibilities for the supervision of the solvency of banks' foreign establishments between parent and host authorities will depend upon the type of establishment concerned.	Supervision of banks in India mainly aims at ensuring the solvency of the banks and their ability to meet their liabilities as and when they arise.	
	For branches, their solvency is indistinguishable from that of the parent bank as a whole. So, while there is a general responsibility on the host authority to monitor the financial soundness of foreign branches, supervision of solvency is primarily a matter for the parent authority.	While supervising the branches of foreign banks operating in India, RBI looks mainly at the solvency of the branch. The solvency of the parent bank needs to receive a more pointed attention even if the responsibility to monitor is only general.	
	For subsidiaries, the supervision is a joint responsibility of both host and parent authorities.	For supervision of subsidiaries of foreign banks which have branches in India as also for subsidiaries of Indian banks abroad, RBI would need to develop a more focussed policy. At present, the supervision of the subsidiary does not seem to attract enough attention of the regulator.	
	For joint ventures, the supervision should normally, for practical reasons, be primarily the responsibility of the authorities in the country of incorporation.	This is our position as well.	

[1] Only the relevant portions from the document are included here.

2. Liquidity[2]			
	Allocation of responsibilities for the supervision of the liquidity of banks' foreign establishments will depend upon the type of establishment concerned.	Liquidity of branches of banks incorporated abroad and functioning in the country as well as those of Indian bank branches abroad are monitored.	
	For branches, host authorities will often be best equipped to supervise liquidity as it relates to local practices and regulations and the functioning of their domestic money markets. At the same time, the liquidity of all foreign branches will always be a matter of concern to the parent authorities, since a branch's liquidity is frequently controlled directly by the parent bank and cannot be viewed in isolation from that of the whole bank of which it is a part. Parent authorities need to be aware of parent banks' control systems and need to take account of calls that may be made on the resources of parent banks by their foreign branches. Host and parent authorities should always consult each other if there are any doubts in particular cases about where responsibilities for supervising the liquidity of foreign branches should lie.	Foreign banks operating in the country are required to bring in capital funds and minimum CAR is also stipulated for such branches. Systems are also in place whereby RBI can take into account calls that may have to be made by them on their parent banks. This is also periodically monitored. In the case of Indian banks with branches abroad, systems are in place for monitoring liquidity by means of periodical returns.	
	For subsidiaries, primary responsibility for supervising liquidity should rest with the host authority.	This principle is accepted with the provision that in the case of Indian subsidiaries of foreign banks engaged in activities not coming within the regulatory purview of Reserve Bank of India, the liquidity position of such subsidiaries is not monitored by RBI.	

[2] Only the relevant portions of the document are included here.

	For joint ventures, primary responsibility for supervising liquidity should rest with the authorities in the country of incorporation.		
	Within the framework of consolidated supervision, parent authorities have a general responsibility for overseeing the liquidity systems employed by the banking groups they supervise and for ensuring that these systems and the overall liquidity position of such groups are adequate.	RBI is, at present, a little away from the stage of consolidated supervision. It needs to move in that direction gradually.	The first step in this direction would be to pay more attention to the operation of subsidiaries even if their accounts are not consolidated with that of the present entity, which is the subject of RBI's regulation.
3. Foreign exchange operations and positions			
	As regards the supervision of banks' foreign exchange operations and positions, there should be a joint responsibility of parent and host authorities.	Internal control guidelines as well as proper reporting systems for foreign exchange operations are in place for both foreign branches of Indian banks and Indian branches of foreign banks. In so far as supervision of foreign banks' own exchange operations, as separate from their Indian branches' foreign exchange operations, is concerned, RBI does not take any supervisory stance. It is considered that it is neither feasible nor necessary to cover the overall angle at this stage. The joint responsibility mentioned in the concordat is taken to mean responsibility in respect of the foreign exchange operations of the branches of foreign banks operating in India.	

B. Information Flows Between Banking Supervisory Authorities[§]

No.	Minimum standards	Indian position	Remarks
I. Authorisation			
1.	Host authorities should as a matter of routine check that the parent authority has no objection before granting a banking licence.	Before granting permission to a foreign bank for opening a branch in India, prior consent of the parent authority is ensured.	
2.	Where a host authority is unable to obtain a positive response from the parent authority, it should consider either refusing the application, increasing the intensity of supervision or imposing conditions on the grant of authorisation. In the latter case, it is recommended that the conditions (and any subsequent changes in the conditions) should be communicated to the parent authority.	RBI considers it essential to obtain the parent authorities' consent before allowing any foreign bank to open a branch in India.	
3.	Host authorities should exercise particular caution in approving applications for banking licenses from foreign entities which are not subject to prudential supervision in the parent country of joint ventures for which there is no clear parental responsibility. In such circumstances, any authorisation should be contingent on the host authority's capacity to exercise a parental role.	The principle is accepted. However, as yet there has been no occasion for RBI to permit opening of a bank in India where due to its joint venture character there is lack of clarity about the parent authority and its supervision over its foreign branches.	
4.	If the host authority follows the procedure outlined in sub-section (i), a parent authority which disapproves of its bank's plans to establish abroad	Indian banks are not permitted to open any branch abroad without permission of the Reserve Bank. Opening branches or making any	

[§] BIS Paper, April 1990.

	can recommend the host authority to refuse a licence. Parent authorities nonetheless should ensure that they have taken adequate steps to prevent their banks establishing in unsuitable locations or making inappropriate acquisitions. Where the parent supervisor imposes conditions on a foreign establishment, such conditions should be communicated to the host authority.	acquisition abroad is subject to a thorough appraisal. Conditions imposed on a foreign establishment are communicated to the host authority.	
II. Information needs of parent authorities			
1.	Host and parent authorities should seek to satisfy themselves that banks' internal controls should include comprehensive and regular reporting between a bank's foreign establishments and its head office.	While RBI ensures that the branches of Indian banks abroad are controlled properly by banks' head offices and that suitable control mechanisms for the purpose are in place, in regard to the quality of control exercised by Head office of foreign banks, whose branches are operating in India, the position is not as unambiguous.	The information flow between the branches (of foreign banks) and the quality of internal control is taken more as a matter between the branch and its HO. The approach is that such internal control is primarily the responsibility of the head office and also on the assumption that any deficiency will be brought to its notice by the bank's head office as well as the parent supervisor. It is suggested that RBI may increase its reliance on the parent country supervisor and convey to them its expectation about being informed about the extent and quality of control maintained by the head office on its branches operating in India.

2.	If a host authority identifies, or has reason to suspect, problems of a material nature in a foreign establishment, it should take the initiative to inform the parent supervisor. The level of materiality will vary according to the nature of the problem. Parent supervisors may wish to inform host authorities as to the precise level of materiality which would trigger their concern, for the level of materiality is principally a matter for the parent authority's judgement. However, the host authority is often in the best position to detect problems and therefore should be ready to act on its own initiative.	System for informing parent supervisor in respect of problems of a material nature is in vogue. However, no specific level of materiality is prescribed or conveyed in advance to host supervisors in respect of foreign establishments of Indian banks. RBI is not receiving from any of the parent supervisors advices about the levels of materiality which would trigger its concern.	The parent supervisor may define levels of materiality in respect of major financial parameters, the failure to meet with which or the occurrence of certain significant adverse events should be reported by the host supervisor to it. In order to make this practice effective, we think the two supervisors will need to come to some kind of mutual agreement so that their perception about the triggers identified are common and the manners in which their respective concerns following the appearance of triggers are to be expressed do not vary too much.
3.	Parent authorities may wish to seek an independent check on data reported by an individual foreign establishment. Where inspection by parent supervisors is permitted, host authorities should welcome such inspections. Where inspection by parent supervisors is not at present possible (or where the parent authority does not use the inspection process), the parent authority can consult the host authority with a view to the host authority checking or commenting on designated features of the bank's activities, either directly or through the use of the external auditor. Whichever	While Indian laws do not prohibit inspection of foreign bank branches by the respective parent supervisor, this is not reciprocated by all countries. The importance of both parent and host supervisor remaining fully informed and exchanging information about the condition of a branch operating abroad is well appreciated.	A country-by-country review would need to be made and appropriate action taken to enter into suitable arrangements with the host country regulation. This should receive urgent attention in relation to those countries which do not permit inspection by the parent country supervisor.

	method is chosen, it is important that the results obtained should be available to both host and parent supervisor.		
2.	If serious problems arise in a foreign establishment, the host authority should consult with the head office or parent bank and also with the parent authority in order to seek possible remedies. If the host authority decides to withdraw banking authorisation from a foreign establishment or take similar action, the parent authority should, where possible, be given prior warning.	Systems are in place for consulting with head office / parent bank and also with the parent authority whenever serious problems arise in a foreign bank branch operating in the country.	
III. Information needs of host authorities			
1.	Parent authorities should inform host authorities of changes in supervisory measures which have a significant bearing on the operations of their banks' foreign establishments. Parent authorities should respond positively to approaches from host authorities for factual information covering, for example, the scope of the activities of a local establishment, its role within the banking group and the application of internal controls and information relevant for effective supervision by host authorities.	Exchanges of such information between parent and host supervisors *suo moto* is not quite common. Reserve Bank has, however, been providing the host authorities with all such information that they have sought.	In its own turn, RBI has so far not been seeking much information from the parent authorities of banks operating in India. In certain areas of their operations, particularly about the internal about the internal controls exercised by the concerned head offices of banks, more information is desirable. RBI may consider taking steps in that direction.
2.	Where a parent authority has doubts about the standard of host supervision in a particular country	The quality of host supervision differs from country to country.	A periodic review would need to be made of the supervisory systems and

	and, as a consequence, is envisaging action which will affect foreign establishments in the territory concerned, advance consultation is recommended so that the host authority may have an opportunity to correct any inadequacies.	System of advance consultation with the host/parent supervisors is in vogue.	standards of host supervision where Indian banks have a presence.[3]
3.	In the case of particular banks, parent authorities should be ready to take host authorities into their confidence. Even in sensitive cases such as impending changes of ownership or when a bank faces problems, liaison between parent and host authorities may be mutually advantageous.	Parent authorities do not always take the host supervisors into confidence when there are significant events relating to some specific bank, such as impending change in ownership or merger, likely to take place. In the Indian context, this is probably due to the small contribution of Indian operations to the global business of these banks, with the exception of a few.	Greater mutual understanding on the issue would need to be developed amongst the supervisors.
4.	If a parent authority is intending to take action to protect the interests of depositors, such action should be coordinated to the extent possible with the host supervisors of the bank's foreign establishments.	Recent developments, particularly those in the South East Asian countries where large scale bank restructuring took place and is still taking place, show that parent authorities are not always following this as a norm.	RBI should insist on such information sharing as one of the terms on which it permits a foreign bank to open its branch in India.
IV. Removal of secrecy constraints			
1.	Information received should only be used for purposes related to the prudential supervision of financial institutions. It should not be released to other officials in the recipient's country not involved in prudential supervision.	Secrecy of supervisory information is ensured.	
2.	The arrangements for transmitting information should be reciprocal in the sense that a two-way	Sharing of information is reciprocal and need based.	

[3] Indian banks have branches in the following countries: Bahamas Islands, Bahrain, Bangladesh, Belgium, Cayman Islands, Channel Islands, Fiji Islands, France, Germany, Guyana, Hong Kong, Japan, Kenya, Maldives, Mauritius, Seychelles, Singapore, South Africa, South Korea, Sri Lanka, Sultanate of Oman, Thailand, United Arab Emirates, United Kingdom and United States of America.

	flow should be possible, but strict reciprocity in respect of the detailed characteristics of the information should not be demanded.		
3.	The confidentiality of information transmitted should be legally protected, except in the event of criminal prosecution. All banking supervisors should, of course, be subject to professional secrecy constraints in respect of information obtained in the course of their activities.	Confidentiality of supervisory information is ensured.	There is perhaps a case for incorporating strict legal provisions in this regard so that supervisory information should not be shared with any agency, including central or state level vigilance/investigative agencies, but only when specifically called for by a court of law. As a related BIS document states, it needs to emphasised, even in the event of a court demanding supervisory information, that making such information public may result in the drying up of such information and thus adversely affect the quality of supervision in the long run.
4.	The recipient should undertake, where possible, to consult with the supervisor providing the information if he proposes to take action on the evidence of the information received.	The actual position may vary from case to case. Usually, such consultation with supervisor, after the information has been parted with, does not take place.	Consultation with the supervisor providing the information should be stipulated by law in order to safeguard the integrity and credibility of supervisory system and has relationship of trust between parent and host supervisors.

V. External audit			
1.	The existence of adequate provision for external audit should be a normal condition of authorisation for new establishments. It would be advantageous for the audit firm to be one that audits the parent bank, provided the firm in question has the appropriate capacity and experience in the local centre. Where a foreign affiliate is audited by a different firm, the external auditor of the parent bank should normally have access to the audit papers of the affiliate.	Foreign establishments of Indian banks are usually submitted to an external audit in the host country. Similarly, foreign bank branches in India are submitted to external audit. Audit reports of Indian bank branches are available to the auditors of the parent bank.	
2.	Supervisors have an interest in the quality and thoroughness of audit. In the case of audits that are inadequately conducted, supervisors should address criticism to the local representative body of auditors and should be empowered, where necessary, to have the auditor replaced. As a means of raising auditing standards for international banks, internationally qualified auditors with experience of banking audit in the country concerned should be appointed. Where any doubt arises, host and parent authorities should consult.	In case of problems with quality and thoroughness of audit, RBI takes up with representative body of auditors. Systems are also in place for changing auditors and 'resting' them for a period in cases of noticeable deficiencies. The present arrangement in this regard is considered adequate.	
3.	External auditors may also be asked to verify the accuracy of reporting returns or compliance with any special conditions. It is recommended that all supervisory authorities should have the ability to communicate with banks' external auditors and vice versa. Any emphasis on the role of external auditors should, however, in no way be such as to	RBI at present is not normally following the practice of asking external auditors to verify the accuracy of reporting returns or compliance with any special conditions.	RBI could supplement its own supervisory mechanism by making it a regular practice of using external auditors to look specially in certain selected areas and report to it independently.

	as downgrade the need for sound internal controls, including provision for effective internal audit.		

C. Minimum standards for the supervision of international banking groups and their cross-border establishments[§]

No.	Minimum standards	Indian position	Remarks
1.	All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision	RBI's present position in this regard is to take a consolidated view of banks' operations without insisting on consolidation of its accounts with subsidiaries. It leaves it to the respective regulators of the subsidiaries to address the concerns arising out of their operations unless it believes that these will impact the operations of the parent bank very adversely. Going by the same logic, it also does not insist on consolidated supervision of banks which have branches in India, by the home country supervisor.	While RBI has found the present arrangement workable, the position is likely to change quite fast. Indian corporates including banks will be required to submit themselves to consolidated accounts and the supervisor too will insist on consolidated supervision. RBI should also begin encouraging Indian banks and foreign entities operating in India to submit to consolidated supervision.
2.	The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's and, if different, banking group's home country supervisory authority	RBI is presently not insisting on separate approvals of the home country supervisors of a foreign bank for every new branch which it wants to open in India. Such approvals are also not insisted upon from the home country supervisor of the banking group (where the bank is part of a banking group and the banking group's home country is different from the home country of the bank).	RBI needs to consider the desirability of following the recommended approach.

[§] BIS Paper, July 1992.

3.	Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor	The principle is acceptable.	Provision of unhindered/ unqualified access to information to the home supervisor may be made a condition for permitting a bank to open offices abroad.
4.	If a host country authority determines that say one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments	RBI has the power to impose restrictive measures including the prohibition of the creation of a banking establishment. In the event of any condition not being met to its satisfaction it can always impose a restrictive measure it chooses.	

D. The supervision of cross-border banking[§]

I. Improving the access of home supervisors to information necessary for effective consolidated supervision

No.	Minimum standards	Indian position	Remarks
1.	In order to exercise comprehensive consolidated supervision of the global activities of their banking organisations, home supervisors must be able to make an assessment of all significant aspects of their banks' operations that bear on safety and soundness, wherever those operations are conducted and using whatever evaluative techniques are central to their supervisory process.	Reserve Bank of India's supervisory stance is aimed at exercising comprehensive and consolidated supervision of the global activities of the Indian banks. However, in this regard it faces constraints in countries where the local laws do not permit the home supervisor to conduct on-site inspection/examination of records. There is no legal or other hindrance to parent supervisors from other countries conducting such inspections of Indian branches of banks under their supervisory jurisdiction.	A country-wise analysis will have to be made and suitable action taken to address the constraints.

[§] BIS Paper, October 1996.

2.	Home supervisors need to be able to verify that quantitative information received from banking organisations in respect of subsidiaries and branches in other jurisdictions is accurate and to reassure themselves that there are no supervisory gaps	In regard to the quantitative information received from banks in respect of their branches abroad, RBI depends upon the banks providing this information for their accuracy. Such cross checks as are there are also based on the information available from the banks themselves as RBI does not consider it necessary to collect any independent information for reassuring itself that there are no supervisory gaps. At present, the foreign operations of all Indian banks constitute a small part of their total operations, say, less than 20 per cent and therefore the current methodology is considered acceptable.	
3.	While recognising that there are legitimate reasons for protecting customer privacy, the working group believes that secrecy laws should not impede the ability of supervisors to ensure safety and soundness in the international banking system	We are in agreement with the view. Where safety and soundness in the international banking system is likely to come in question, customer privacy should have to lose priority.	
4.	If the home supervisor needs information about non-deposit operations, host supervisors are encouraged to assist in providing the requisite information to home supervisors if this is not provided through other supervisory means. The working group believes it is essential that national legislation that in any way obstructs the passage of non-deposit supervisory information be amended.	We are in agreement with the view. In India there is no legislation at present obstructing passage of non-deposit supervisory information either to the parent office or to the home supervisor of the branches of foreign banks.	
5.	Where the liabilities side of the balance sheet is concerned, home supervisors do not routinely need to know the identity of individual depositors.	We are in agreement with this view subject to a prior mutual agreement as regards what are "well-defined circumstances" in which the home	

	However, in certain well-defined circumstances, home supervisors would need access to individual depositors' names and to deposit account information.	supervisor would need access to individual depositor names and account information. Customer privacy cannot be easily and routinely compromised as it can have serious implication on the banking system. For this arrangement to work it will have to be the basis of mutuality between home and host supervisors and all supervisors would need to agree to it.	
6.	It should not normally be necessary for the home supervisor to know the identity of investors for whom a bank in a host country is managing investments at the customer's risk. However, in certain exceptional circumstances, home supervisors would need access to individual investors' names and to investment account information subject to the safeguards in paragraph 10.	Our views on the issue are the same as in the case of item (v).	
7.	The working group recommends that host supervisors whose legislation does not allow a home supervisor to have access to depositor information use their best endeavours to have their legislation reviewed and if necessary amended to provide for a mechanism whereby in exceptional cases a home supervisor, with the consent of the host supervisor, will gain access to depositor information subject to the same conditions as outlined in (viii) below.	No such restrictions exist in the country. Laws in India at present do not debar the sharing of depositor information by a branch of foreign bank with its parent office or the home supervisor.	

8.	In order to provide legitimate protection for bank customers, it is important that the information obtained by home supervisors especially that relating to depositors' or investors' names, is subject to strict confidentiality. The working group recommends that those host jurisdictions whose legislation allows foreign supervisors to have access to banks' depositor or investor information should subject such access (at the host country's discretion) to the following conditions • the purpose for which the information is sought should be specific and supervisory in nature; • information received should be restricted solely to officials engaged in prudential supervision and not be passed to third parties without the host supervisor's prior consent; • there is assurance that all possible steps will be taken to preserve the confidentiality of information received by a home supervisor in the absence of the explicit consent of the customer;	We are in agreement.	RBI is at present not specifying such conditions. It may consider stipulating these conditions whenever foreign supervisors are to be given access to bank's depositor or investor information.
	• there should be a two-way flow of information between the host and home supervisors, though perfect reciprocity should not be demanded.	We do not see any reason why perfect reciprocity should not be demanded. In fact, it is felt that without an understanding of perfect reciprocity it would be difficult to put such an arrangement in place.	

	Before taking consequential action, those receiving information will undertake to consult with those supplying it.	Such consequential action shall only be supervisory and prudential.	
9.	If a host supervisor has good cause to doubt a home supervisor's ability to limit the use of information obtained in confidence solely for supervisory purposes, the host would retain the right not to provide such information.	It is not quite clear how this provision can coexist with the provision suggested earlier that secrecy laws should not impede the ability of the supervisors to ensure safety and soundness in the international banking system. (Item (iii) above). Also, without objective reciprocity on the issue of sharing information between supervisors, information flow may become very uneven making cross-border supervision difficult.	
10.	Subject to appropriate protection for the identity of customers, home supervisors should be able at their discretion, and following consultation with the host supervisor, to carry out on-site inspections in other jurisdictions for the purposes of carrying out effective comprehensive consolidated supervision. This ability should include, with the consent of the host supervisor and within the laws of the host country, the right to look at individual depositors' names and relevant deposit account information if the home supervisor suspects serious crime as defined in section (d). If a host supervisor has reason to believe that the visit is for non-supervisory purposes, it should have the right to prevent the visit taking place or to terminate the inspection.	We are in agreement with this view.	

11.	It would avoid potential misunderstandings if a standard routine were laid down for conducting cross-border inspections along the lines recommended.	Standard routine is not implemented as of now. Nor is it demanded of parent supervisors inspecting branches in India. A standard routine for conducting cross-border inspection as proposed would be difficult.	
12.	In those countries where laws do not allow for on-site inspections use their best endeavours to have their legislation amended. In the meantime, host supervisors should, within the limits of their laws, be willing to co-operate with any home supervisor that wishes to make an inspection. The working group believes that the host supervisor should have the option to accompany the home supervisor throughout the inspection.	We agree. Inspections by the home supervisors are not impeded in any way in India.	
13.	It is important that the confidentiality of information obtained during the course of an inspection be maintained. Home supervisors should use their best endeavours to have their legislation modified if it does not offer sufficient protection that information obtained for the purposes of effective consolidated supervision is limited to that use.	We agree. However, the present legal provisions in India in respect of confidentiality of information available with the home supervisor (RBI) do not seem to be providing sufficient protection of information. More clearly defined laws would be needed for this purpose.	
14.	In the event that a home supervisor, during an on-site inspection in a host country detects a serious criminal violation of home country law, the home supervisor may be under a strict legal obligation to pass the information immediately to the appropriate law enforcement authorities in its home country. In these circumstances, the home	We agree.	

	supervisor should inform the host supervisor of the action he intends to take.		
15.	In order to carry out effective comprehensive consolidated supervision, home supervisors also need information on certain qualitative aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are the home supervisor. All members of the working group agree that it is essential for effective consolidated supervision that there are no impediments to the passing of such qualitative information to the home supervisor.	There is no restriction in India for passing on such information to other country supervisors regarding the branches of banks under their jurisdiction.	A country-wise analysis will have to be made to ensure reciprocity in this arrangement.

II. Improving the access of host supervisors to information necessary for effective host supervision

16.	In the case of information which is specific to the local entity, an early sharing of information may be important in enabling a potential problem to be resolved before it becomes serious. The home supervisor should therefore consult the host supervisor in such cases and the latter should report back on its findings. In particular, it is essential that the home supervisor inform the host supervisor immediately if the former has reason to suspect the integrity of the local operation, the quality of its management or the quality of internal controls being exercised by the parent bank.	We are in agreement with this view. This arrangement is likely to improve supervisory efficiency.	

17.	A home supervisor should have on its regular mailing list for relevant material all foreign supervisors which act as hosts to its banks.	This may not be necessary as it could lead to much flow of sparingly needed information between the supervisors. Any information, wherever required is likely to be available on demand or already made public by the concerned supervisor, e.g., on their web sites.	
18.	While the working group agrees that home supervisors should endeavour to keep host supervisors apprised of material adverse changes in the global condition of banking groups, the Group recognises that this typically be a highly sensitive issue and that decisions on information-sharing necessarily will have to be made on a case-by-case basis.	There cannot be a settled principle on this since it has to be decided on a case-by-case basis.	

III. Ensuring that all cross-border banking operations are subject to effective home and host supervision

19.	The working group has formulated a set of principles of effective consolidated supervision which could be used by host supervisors as a checklist to assist in determining whether a home supervisor is meeting the Minimum Standards.	The checklist provided by the working group can act as a good tool for assessing the capabilities of any supervisor to exercise consolidated supervision. However, any assessment of this nature can become arbitrary and lead to considerable difference of opinion between the host and home supervisors. Unless, therefore, there is a general consensus amongst all supervisors on the scope and methodologies of exercising consolidated supervision and until there is an agreement between most supervisors	The principle of consolidated supervision is unexceptionable. Reserve Bank needs to move in that direction. The accounting standards as well as the regulatory provisions need to be reviewed from this angle. A major obstacle in this regard which is faced by us is multiplicity of regulators on mutually exclusive basis. A suitable mechanism to co-ordinate

		on its acceptance as the common mode of supervision, this approach if insisted upon could become counterproductive.	their approaches shall have to be found.
20.	Regional group procedures might be used to support the implementation of the Minimum Standards, as the Offshore Group is now doing.	Our views are as expressed in regard to item xix.	
21.	The working group recommends that other regional groups consider the possibility of using a checklist similar to the one used by Offshore Group as a means of establishing which of their members might be certified as meeting certain general criteria.	Our views are as expressed in regard to item xix.	
22.	The Basle Committee encourages its member countries to assist the Offshore Group or another regional group in the fact-finding verification process, but any decision-making regarding membership of a regional group should be left to the group alone. The Committee has asked its Secretariat to maintain a list of competent persons (for example, retired supervisors) who are available to undertake exercises of this nature.	No comments.	
23.	The supervisor that licenses a so-called shell branch has responsibility for ensuring that there is effective supervision of that shell branch. No banking operation should be permitted without a licence, and no shell office should be licensed without ascertaining that it will be subject to effective supervision. In the event that any host	RBI's position on these issues is the same as stated in the BIS document. It does not permit any banking operations without a licence. It also does not allow opening of any kind of branch of an Indian bank, unless it is satisfied that the branch will be subject to effective supervision.	

	supervisor receives an application to license a new shell branch that will be managed in another jurisdiction, that supervisor should take steps to notify both the home supervisor and the appropriate host supervisor in the other jurisdiction in order to establish that there will be appropriate supervision of the branch before approving the application.		
24.	Home supervisors should not authorise their banks to establish or acquire offices in any host jurisdiction without satisfying themselves in advance that such offices will be subject to appropriate supervision.	This is being ensured while granting permission for opening of branches abroad.	
25.	Where the home authority wishes to inspect on-site, they should be permitted to examine the books of the shell branch wherever they are kept. The working group believes that in no case should access to these books be protected by secrecy requirements in the country that licenses the shell branch.	We are agreeable to this suggestion.	
26.	The working group recommends that home or host supervisors be vigilant to ensure that parallel-owned banks (where a bank in one jurisdiction has the same ownership as a bank in another jurisdiction, where one is not a subsidiary of the other) become subject to consolidated supervision, if necessary by enforcing a change in group structure as indicated by the Minimum Standards.	We are in agreement with this suggestion.	

27.	Any home supervisor that licenses a banking entity has a responsibility to monitor its operations on a world-wide basis.	This is being ensured.	
28.	No entity should be allowed to use the word "bank" in its name if it is not conducting banking activities and being supervised as a bank.	This is provided for in law.	
29.	The working group believes the Basle Committee should advise all host countries to be extremely cautious about approving the establishment of cross-border operations by banks incorporated in under-regulated financial centres, and even more cautious about accepting other financial institutions conducting banking activities from those centres.	RBI's approach on these issues is in line with the thinking of the working group.	

E. Role of Supervisors

1. Board of directors and senior management are ultimately responsible for the performance of the bank. Supervisors typically check that a bank is being properly governed and bring to management's attention any problem that they detect through their supervisory efforts.	The Reserve Bank of India as supervisor checks the governance practices at banks and brings to the management's attention the problems identified by them.	Because of R.B.I./Government ownership of the banks (in the public sector), there is some overlap in the role of the R.B.I. as owner/owner's representative and as the regulator/supervisor. This overlap needs to be corrected so that R.B.I. can perform its regulatory/supervisory role without any hindrance.

2. Attentive to any warning signs of deterioration in the management of the bank's activities.	The Reserve Bank of India as supervisor, through on and off site supervision mechanisms, is attentive to warning signs of deterioration in management of a bank's activities.	Government ownership of banks, however, stands in the way of any serious and urgent corrective action on the part of R.B.I. as regulator. Laws of the land and the implied delay in the judicial system have also come in the way even where corrective action like removal of the incompetent management is contemplated.
3. Issue guidance to banks on sound corporate governance and pro-active practices.	The Reserve Bank of India as supervisor pro-actively and timely issues guidance to banks on sound corporate governance practices.	
4. Sound corporate governance considers interest of all stakeholders, including depositors, whose interests the supervisors should protect.	The basic spirit of banking supervision in India is to ensure that banks follow principles of sound banking and that the interests of all stakeholders, including depositors, are protected.	
5. Should expect banks to implement organisational structure to ensure checks and balances.	The Reserve Bank of India as supervisor ensures that banks have organisational structure to ensure proper checks and balances.	
6. Emphasise accountability and transparency.	The Reserve Bank of India as supervisor emphasises accountability and transparency in banks.	The standards of transparency would need to be raised. A fair beginning has been made in this regard but the approach of the banks and the applicable accounting standards will have to be changed for achieving greater transparency in banking

		operations and accounting. The stress on accountability largely ends up with efforts to fix accountability for loans/advances that go bad. Accountability for non-performance, at any level including that of the Board of Directors is nearly absent. This issue needs urgent attention.
7. Determine that board and senior management have in place processes that ensure they are fulfilling all of their duties and responsibilities.	Either on their own or under the guidance of Reserve Bank of India as supervisor, most banks have put in place processes designed to monitor performance and fulfillment of duties and responsibilities at different levels.	The Boards of banks, however, do not seem to subject themselves to any measure of accountability or performance either set by them voluntarily or made applicable to them externally. This leaves them as largely without any accountability either to the institution itself or to the supervisor. The situation calls for correction.

Appendix V: Banks' Internal Rating Systems [§]

BIS Principle	Position of banks in India	Remarks
A. Definition and uses of rating system 1. Internal Rating approach should normally take into account the following : a) Borrowers probability of default (PD),i.e. the probability that the borrower may not be able to fully/ partially meet his commitment towards principal and interest; b) The facility's loss given default (LGD), i.e., the percentage of exposure that is lost when the default occurs; c) The level of exposure at the time of default (EAD); d) The credit's expected loss (EL), which is the function of these variables. EL equals default probability times the loss given default. This is the loss that is expected to devolve on the bank in respect of an asset, on the basis of historical data; e) The unexpected loss (UL) associated with these and possibly due to other	a) The Internal Rating approach, as practiced by most of the banks in India, measures the risk by quantitative mode. b) Such a system presently takes into account only the probability of default. c) A system for measuring expected and unexpected losses is yet to be put in place in most banks. d) The important inputs in risk rating systems of banks in India are financial analysis, projections and sensitivity and incidence of industrial and management risks. e) RBI guidelines on risk management systems in Banks state that risk management process should encompass quantifying the risk through estimating expected loan losses i.e. the amount of loan losses that bank would experience over a	The objective of risk quantification systems like credit ratings should be to establish a scientific basis to assess and price credit risk taking into account the "expected loss" and to critically estimate the requirements of Economic Capital (Risk Capital) based on estimations of "unexpected loss". Banks in India need to adopt at an early date systems of internal rating requiring measurement of PD, LGD, EAD. The present MIS of banks will therefore have to be suitably redesigned and their systems enabled to capture the required data in convenient and reliable manner.

[§] BIS Paper, January 2000.

characteristics of the borrowers and exposures. Unexpected loss represents the volatility in the rate of recovery and deviations from the estimated probability of default at certain confidence levels. While reserves and provisions are expected to care of the expected loss component, the unexpected loss is to be covered by Economic Capital.	chosen time horizon and unexpected loan losses.	
2. Banks have different approaches to rating system because of factors such as a) Differing emphasis on quantitative and qualitative risk factors; b) Importance of each institution's credit culture and historical experience; c) Differing judgements regarding complexity and opaqueness of risks associated with each transaction; d) Differing responses to inherent difficulties in quantifying loss characteristics; e) Different risks management and other uses to which rating information and risk measures are put.	a) Banks in India normally follow internal rating systems in which both qualitative and quantitative risks factors are measured and taken into account. These systems are, however, simple and not in a position to assess more opaque risks attached with complex transactions. b) Risk measurement techniques are yet to be used for quantifying loss characteristics as such.	With growing size and complexity of operations and increasing orientation of banks towards management of risks, there is a need for the banks in India to restructure their rating systems enabling these to capture market dynamics.

<table>
<tr><td></td><td></td><td></td></tr>
<tr><td>3. There are many specific areas where the ratings system differ from each other as under.

a) Banks may rely on unidimensional rating system or a multidimensional system taking other factors into consideration. For example in a two dimensional rating the borrower will have an overall credit rating with separate rating for each facility.

b) Internal process by which an assigned rating could be oriented largely to broad and subjective criteria as judged by experienced credit staff;

c) Even when specific and objective criteria are applied, these criteria may be implemented through traditional financial analysis or instead through some degree of reliance on formal statistical models.</td><td>a) Banks in India normally use a unidimensional credit rating, i.e. there is an overall grade for the borrower and same grade is applicable for all facilities.

b) The credit rating system, as developed by banks in India is largely based on their experience and broadly take into account Financial factors, factors which are industry specific and management factors.

c) Above factors are generally rated separately and due weights are assigned (which is again based on the experience of respective banks)

d) To arrive at overall risk rating, the factors mentioned above are aggregated (after adjusting for their weights in the scale) and calibrated to arrive at single point indicator of risk associated with credit decision</td><td>a) Banks in India have to move towards multidimensional rating systems as there is no other reliable method of assessing risks where the activities of the clients themselves and the facilities enjoyed by them are multidimensional.

b) It is desirable that the chosen model provides for rating of multidivisional companies and greenfield projects.</td></tr>
<tr><td colspan="3">B. Basic architecture of Internal Rating Based approach to capital :</td></tr>
<tr><td>Internal Rating Based approach to regulatory capital should have three basic elements :

1) To become eligible for IRB approach, a bank</td><td>a) RBI, in their guidelines for Risk Management Systems in Banks, have stipulated that credit risk management process should be articulated in bank's</td><td>a) Any successful approach in this context would require familiarity of the functionaries with the rating process.</td></tr>
</table>

has to demonstrate that its Internal Rating system and processes are in accordance with minimum standards and sound practice guidelines which will be set up by Basel Committee. These guidelines would ensure the quality, usefulness and integrity of the key statistics that would form the basis of the bank's capital requirements. 2) If the bank's internal system/ procedures meet these requirements, bank need to provide to supervisors exposure amounts and estimates of key loss statistics association with these exposures (such as PD) by internal rating grade. These exposures would include both outstanding balances as well as some percentage of committed but undrawn amounts. Banks would provide information based on their own rating systems, in accordance with minimum standards and sound practice guidelines that would be set forward by the Basel Committee. 3) Based on the banks estimate of Probability of Default (PD) and estimates of Loss Given Default (LGD) and other potential asset characteristics, bank's exposure would be assigned to capital "buckets". Each bucket would have a risk weight that incorporates	loan policy, duly approved by the Board. b) This process for Banks in India can start only after Basel Committee sets forward the minimum standards and sound practice guidelines for Internal Rating approach.	b) A comprehensive risk rating system should serve as a single joint indicator of diverse risk factors. c) In the Indian context it would be necessary to strengthen the MIS and data collection machinery in the banks to ensure integrity and reliability of the data is beyond doubt. d) The ratings should facilitate the functionaries by informing them of the quality of loan at any moment of time.

unexpected loss associated with estimates of PD, LGD and other losses. These risk weights would be developed by bank supervisors taking into account intrinsic risk of the asset and minimising incentives for banks to bias the assignment of Internal Rating, or to engage in capital arbitrage.		
C. Range of Practice in the Rating System Structure		
1. Range in Rating Systems a) Average number of grades reported by banks covering non-impaired corporate loan is 10. The range normally falls between 2 and 20. b) Average number of problem grades reported by banks is 3. c) The measure of ability of well-functioning rating system is the largest percentage of total rated exposures falling in a single grade. On an average, banks normally have 30% of rated exposure within a single grade.	a) Banks in India have normally between 6-8 rating grades for non-impaired corporate loans. b) Banks in India have normally 3 rating grades for problem loans. c) This could be the position for banks in India also. However we need to get more data on this aspect of the present rating system of the banks in India.	
D. A key element of rating system structure is the focus on characteristic of the borrower (obligor) as opposed to specific details of transaction/ facility		
a) Majority of banks have adopted a explicit obligor dimension, that is, they assign a rating which reflect the risk that borrower will default on any of its obligations.	Internal Rating Systems in the Indian banking system is mostly with obligor dimension. This rating reflects the risk that the borrower will default in any of its obligations. Rating of individual facilities is	

b) One third of the banks utilise a two dimensional rating i.e. the ratings system includes both an obligor grade and a facility grade. Facility grades for different loans could differ based on collateral taken, seniority or other structural attributes of the loan. c) Among those banks with two- dimensional rating systems, a small number appears to assign an obligor rating and as second "LGD" rating that explicitly evaluates likely recovery rates for each transaction in the event that a default were to occur. d) In practice even banks which have only an obligor rating system in place, may implicitly take into consideration the riskiness of facilities for pricing, profitability analysis and in allocation of economic capital; in such cases, facility type LGD is mechanically derived based on the type of loan, the presence and type of collateral, and possibly other factors, in effect, outside of the rating system. In light of the above practices, it would appear that only a minority of banks do not take into consideration of the facility characteristics in their grading process.	yet uncommon although some banks, in recent years, have introduced differential pricing for term loans through an unique benchmark rate. However, despite the prevalence of 'only obligor' rating system, most banks in India do take into consideration, through analysis of quantitative and qualitative data, the riskiness of different facilities, profitability analysis of the various lines of business of the obligor, quality of the management, developments at the industry/business levels, etc. in arriving at the rating.	
E) Categories of Rating Process :		
There are three main categories of rating processes under; a)Statistical based processes: In this process, the credit rating models typically include both quantitative	Banks in India use a combination of both statistical based processes and constraint expert judgement processes. The expert judgement process is not in vogue especially for large corporates.	

(financial rating etc.) and some qualitative but standardised (industry, payment history/ credit report) factors. Normally this approach has more prominent role in small corporate lending than for middle market or large corporates. b) Constraint expert judgement process : In this, the raters base their rating on statistical models, but are permitted to adjust this rating to an explicitly limited degree based on judgement factors. However the raters may adjust the final grade up or down by no more than two gradations based on judgement. Around 20% of the banks use this approach for their large corporates, while a similar number used this approach for middle market and smaller corporates. c) Expert judgement process: In this process ratings are assigned using considerable judgmental elements. Over half the banks use this process for large corporates and a similar number noted its use for both middle and smaller corporates..		
F. Risk factors considered in assigning grades		
1. Main considerations in assessing borrowers : I. Financial statements such as Balances sheets, Income statements, cash flow statements etc. Those banks relying heavily on the statistical default models use specific type of financial data (e.g., specific ratios that described leverage, debt service coverage, and the like), while those banks relying on more judgmental analysis may allow discretion to the rater	All these factors are taken into account by banks in India while assigning grades to the borrowers in most cases.	

on analysis of these data. II. Historical and trend data of the above financial statements. Some banks use three or more years of data. III. Industry and peer group analysis. In this case supporting industry analysis is provided by internal economic analysis units or outside vendors, so that the different raters within the same institution would tend to incorporate a common view of the industry's outlook across all borrowers. IV. Management experience and competence (especially in areas where constrained expert judgement is used) V. Ownership structure, reputation, quality of financial information provided, the purpose for which the loan is provided, environmental liabilities etc. VI. Country risk in case of cross border lending. Country risk is universally considered using a "sovereign ceiling" rule (the rating of the counterparty cannot exceed the rating of the sovereign in which it is incorporated or has its principle place of business. 2. Main considerations in assessing facilities : i. Facility characteristics such as third party guarantee, collateral and seniority / subordination of the obligations are taken into account taken into account while assigning a grade to an exposure and/or analysing internal profitability or capital allocations. ii. Most banks allow bank guarantees to affect the rating by effectively transferring the risk to the guarantor, or,	a) These factors are taken into account by banks in India while assessing facilities for the borrowers. b) Some of the banks in India go by the principle that availability of collateral should not influence the risk rating as collaterals help in taking a business decision while credit rating facilitate a credit	

alternatively, using the more favourable of the borrower or guarantor rating. iii. Banks providing facility grades generally did not consider the liquidity of the instrument being rated in assigning that grade. iv. The decision to take a provision for loan losses is also considered explicitly as a factor in assigning facility ratings. v. Maturity of the facility is considered in allocating economic capital for credit risk. 3. Use of statistical default models : Normally internally developed models are used. These models also appear to rely on similar inputs such as balance sheet ratios, trend analysis etc. In some banks vendors provided models such as KMV's Credit Monitor are used. These are being primarily for large corporate and international borrowers. 4. Use of external rating : Wherever available, external rating is used is assigning internal grades, mainly in cases where expert judgement based process of internal rating is used. Normally these external ratings are available only for large corporates and mainly in North America and UK.	decision. Use of default models is still not common in Indian banking. In India, external ratings are used more in investment decisions rather than in credit rating process. In India also, the ratings are available only for big corporates.	
G. Time Horizon		
a) Majority of the banks described the time horizon for internal rating as one year or in many cases the maturity of transaction is question. Many banks described the horizon as ambiguous, or alternatively	Indian banks normally assign an internal rating for one year after which it will be revised/ renewed.	

allow raters to determine the horizon on a case- by-case basis. c) Banks follow "either point in time" or "through the cycle" orientation. In the former process, the rating reflects an assessment of borrower's current conditions or most likely future conditions over the chosen time horizon. The latter process requires the assessment of borrower's riskiness based on worst case scenario (i.e. its conditions under stress). In this case, a borrowers rating would tend to stay the same over the course of the credit/ business cycle. d) c) Banks claiming to use to use a through- cycle-process, are likely to take into account longer term negative prospects and unlikely to rely very heavily on long term projections of improvement in borrower's ability to repay as a basis for assigning a favourable internal rating. Of course, such perspective is wholly consistent with sound credit risk management.	Indian banks follow "point in time" orientation for rating process.	
H. Measuring Loss Characteristics by Grade		
1) Banks attempt to estimate the loss characteristics of internal rating grades for various reasons including : i) Allowing for more accurate pricing, profitability and performance analysis. ii) Monitoring the structure and migration of the loan portfolio. iii) Assisting in the loan loss reserving process.	While only a very few banks in India have developed internal rating systems, even those that have such a system are yet not attempting to estimate the loss characteristics of different grades. One big hurdle in this area has been lack of availability of reliable data which is due to manual operations. Unless the risk management systems of banks in India are raised to a sufficiently high level of detail and sophistication the objectives behind measuring loss characteristics by	The banks have just begun adopting risk management systems with any degree of sophistication. It will be some time, say another 3/5 years before the whole banking system can expect to come to the level of risk management

iv) Providing an input to portfolio credit risk models and economic capital allocation process. v) Evaluating the accuracy and consistency of rating criteria (i.e., to determine whether different assets in the same grade have the same loss characteristics).	grade as stated here will not receive the desired focus.	envisaged in the note. This presupposes total computerisation and the right kind of MIS. The bigger banks must however be encouraged to expedite the process of transition from the elementary levels of risk management to levels of greater sophistication more expeditiously. In this they may not be having in-house expertise and may therefore be encouraged to obtain external assistance, e.g., from consultants, etc.
I. Methods for estimating loss characteristics		
Rating system rely on criteria that are expected to provide information about a borrower's / facility's perceived riskiness or loss characteristics. The process of inferring loss characteristics requires information about borrower and asset characteristics as well as information about historical loss experience that can be used to associate loss characteristics to grades. These requirements can be met in following two ways. i) Banks can analyse its internal data on loss experience	As above	As above

of various asset classes over a sufficiently long period. ii) If a bank has reconciled its grading with those of external credit assessment institution, then it can use the institution's published data on loss experience. A key consideration in relying on such external data is the comparability of such data to a bank's own portfolio. Comparability could become difficult due to reasons such as differences in the composition of the bank's own portfolio, the potential differences between the performance of publicly traded bonds and that of loans .		
J. Survey Results on Probability of Default (PD)		
1) Many banks did not have sufficient data for specifying loss characteristic based on their own default history but a number relied on internal data for analysing the performance of borrower segments such as retail or middle market customers. Though, many banks have initiated data gathering over the past five years, majority of banks rely on data provided by major rating agencies, public data banks or consulting company's data. 2) To use the data provided by external agencies, banks must assume correspondence between their rating grades and those of external agencies by 'mapping' to the grades of the latter. 3) This is more easily done in case of borrowers who have issued publicly rated bonds, as the ratings of various financial data by external agencies can be easily compared with grades given internally for the	a) Banks in India are yet to use their internal default data to arrive at PD, though some banks are attempting this process. b) In view of the wide network of branches and the fact that many of the branches in rural and semi-urban areas have not been computerised, many operational constraints are faced by banks in building up a reliable database.	a) MIS and data collection machinery in the banks would need to be strengthened to see that integrity and reliability of data is beyond doubt. b)The probability of default could be derived from past behaviour of the loan portfolio, which is the function of loan loss provision/charge offs for the last 5 years or so.

same borrower. 4) There are difference in banks' approach towards the conceptual definitions of defaults and loss in assigning ratings. The Models Task Force will continue to analyse the degree to which the use of such different definitions of default and loss at banks, and in the data sources used to quantify the loss characteristics of each internal grade, affect the comparability of PD estimates within the banks, as well as across banks and countries. 5) Many banks have started to track the migration of loans between rating grades. Some banks are relying on this data in checking the calibration of PD and LGD, and validating the internal consistency of the rating process. 6) Some banks are using statistical default models foe calculating average PDs for each internal grades. Such models are in assigning and/or reviewing the assignment of internal grades.	The banks in India have yet to begin using statistical default models for calculating average PDs for each internal rating grade.	
K. Survey results on Loss Given Default (LGD)		
1) One third of banks apply facility-specific LGD estimates to their exposures for use in internal capital allocation and/or profitability analysis system. Among the remaining majority of banks, many indicated that they did not at present estimate LGD, possibly because they do not at present operate capital allocation or profitability analysis system that make use of LGD estimates.	Banks in India are yet to go in for LGD estimates though some banks are making efforts in this direction.	It is desirable that banks build historical data base on the portfolio quantity and provisioning/ charge off to equip themselves to price the risk.

2) General factors considered important for estimating LGD are as under : i) Borrower's attributes (such as borrower's grade, country of incorporation, size, industrial sector and other factors which may affect the unsecured value remaining in the defaulted borrower, whether it continues to operate after default or is in liquidation) ii) Facility characteristics(including the existence of credit mitigation techniques such as seniority of the structure, realisable value of the collateral taken, and the value of any other forms of credit risk mitigation such as the third party guarantee) iii) Bank specific characteristics(such as the internal policy towards recovery), and iv) Exogenous factors (such as the economic cycle) 3) With respect to secured facilities, banks use a variety of techniques and data sources to arrive at estimates of the value of both financial and physical forms of collateral. Some banks distinguish between "normal" and "forced sale" valuations. Some banks also request, based on the terms of the contract, additional collateral and /or other risk mitigants to maintain the expected recovery ratio. 4) As regards data used for measuring LGD, nearly all banks rely on data from their own historical records. 5) Like in the case of quantifying PDs, those banks seeking to quantify LGD also retain different definitions		

of what constitutes “default” as well as “loss”, and relied on different assumptions about direct and indirect costs, and the time taken to ultimate workout. **N.B.:** Models Task Force found survey responses insufficient to glean a consensus on a common framework or “right” LGD estimate for loans of various types. Hence it has urged banks to collect data on LGD as part of an overall approach to assessing and measuring more systematically the amount of credit risks to which they are exposed.		
L. Survey Results on Exposure at Default (EAD)		
a) It would appear that those banks that typically estimate EAD for facilities with uncertain drawdown ,such as a standby line of commitment were those banks that were using some form of capital allocation model. In these cases, EAD is equated to the sum of (1) balances actually drawn and (2) committed but undrawn exposures multiplied by a factor of “x”. Key variables having a bearing on the EAD estimate included current outstandings, committed funds, facility structure, and borrower ratings. In the calculation of conversion factor few banks made distinctions in terms of maturity. b) To an even greater degree than with LGD, banks rely heavily on internal data and studies based on their own historical experience while estimating EAD values. The banks that estimate a facility’s EAD for	Banks in India are yet to go for estimation of EAD, though some banks are attempting on these lines.	

use in capital allocation and profitability systems do so based only loosely on historical or statistical analysis, and incorporate substantial elements of business judgement and conservatism into these figures.		
M. Applications of Rating systems.		
The rating system is normally used in the following areas: 1) Management Reporting: Normally a summary reporting is made to senior management for the purposes of monitoring the risk composition of the rated portfolios. In some case the report can contain borrower specific information, such as shifts in rating classes for a single customer. 2) Pricing: The types of applications range from calculation of cost of funds to assigning grade specific risk premiums. At some more sophisticated institutions, the cost of capital is explicitly considered in pricing decisions. 3) Decisions on reserve levels: One third of the banks relate the level of reserves to the rating classes. Remaining banks also implicitly consider the rating information when determining reserves. 4) Economic capital allocation: About half the banks surveyed use rating information for attributing economic capital to product or business lines.	1) The rating system is being put to similar use by some banks in India also. 2) Internal rating grades are used for pricing by some banks. 3) In the Indian system, reserves are created/provisions made on the rating of individual accounts and not in aggregate for a whole grade. Even though a uniform reserve is created for all standard assets, this reserve is the same across different grades as longs the relative advances are standard, i.e., performing. 4) This is being attempted here 5) Neither the compensation package nor performance accountability is in any manner related to the rating categories.	The banks which are not following this practice as of now may be advised by RBI to do so.

5) Compensation for relationship managers: One third of the banks base compensation for relationship managers on ratings. A number of banks which calculate risk adjusted return on economic capital on rating information also noted that they base incentive-based compensation on this measure. 6) Setting of credit limits: More than half the banks indicated that limits are set based on rating categories. A few banks explicitly noted that loan approval authority is tied to rating categories.	6) Internal rating grades are not being used for this purpose. The exposure limits to borrowers and sanctioning powers are mostly independent of the rating category in which a particular loan proposal may be falling.	
N. Oversight and Control of Internal Rating System :		
1)Though primary responsibility for initially proposing rating for borrowers varied widely, ratings for large corporates must be approved by credit staff, although the rating may be initially proposed by relationship managers. 2) Most of the banks indicated that credit culture was very important in ensuring accuracy and consistency of rating assignments. 3) All the credit decisions are documented adequately. 4)There was little information provided on loan review units, although some banks indicated that loan review staff reviewed loans on a sampling basis, usually, from riskier loans or in growing areas of lending concentration. 5) All banks conduct a formal review of each risk rating atleast once a year. The frequency of review depends	1) Some banks follow this practice here as well whereby rating is initially recommended by the relationship manager and reviewed by the credit department. 2) Strong credit culture is in place in many of the banks in India. 3) All credit decisions are documented adequately. 4) Many banks in India conduct credit audits of large loans within three to six months of sanction and disbursal. 5) All banks conduct formal renewal of risk rating once a year. Periodical reviews are done on risky exposures. 6) Periodical review of ratings system is also	

on the riskiness of the loan and collateral. 6)In addition to formal review, many use credit scoring model as a monitoring tool to identify exposures whose riskiness may be increasing and thus potentially prompt further review. 7)Normally all the rating systems are developed internally, sometimes in co-operation with outside consultants. 8) Many banks emphasised that their systems continue to undergo additional enhancements in a periodical manner. 9)All rating systems are extensively documented and the documentation is made available to relevant staff. 10) A third of the banks do backtesting of their internal rating process and use these results to modify either the rating process or the PDs associated with each grade.	undertaken. 7) The rating systems are mostly being developed internally. Some banks use scoring models to identify riskiness of exposures. 8) This is true of India as well. 9) The rating systems are well documented and the documentation is made available to the concerned staff. 10) The rating processes are reviewed periodically but backtesting is not yet in vogue.	
O. Future steps for supervisors		
1) Supervisors need to consider the following : i) More closely aligning regulatory capital charges to underlying risk. ii) Ensuring that the new supervisory standards provide incentives for banks to continue to refine risk measurement processes. iii) Ensuring that banks do not move away from established sound credit management policies, and	Systematic risk management has only recently been introduced in Indian banks. Most banks are in the process of setting up a system which is simple. Sophistication will be introduced only with passage of time as the banks increase that affinity with the existing system and have improved their MIS substantially. Most of the concepts discussed here are yet to be introduced to the banks	a) Allocation of economic capital on the basis of risk or variability of returns has gained international acceptance and supervisors are planning to evaluate

iv) Addressing the degree of comparability of rating systems and their output. 2) In order to arrive at uniform method for Internal Rating, the following have to be considered by the supervisors: i) Key measurement uncertainties, together with different techniques and data sources which represent source of measurement inconsistency should be considered explicitly in an IRB framework. ii) There appear to be relatively limited set of data sources and techniques available to banks for estimating loss characteristics such as PD, LGD and EAD. iii) Banks seem to have greater difficulty in attributing LGD estimates to their exposures that they have for PD. iv) Different approaches used by banks in assigning internal rating will require different approaches to supervisory review and validation. v) While many banks have developed advanced risk measure capabilities, it is not clear whether the information so derived is genuinely integrated to the risk management of the bank.		the internal capital adequacy assessment of banks. b) Banks in India would have to formulate a medium term strategy to implement Risk Aggregation and Capital Allocation mechanism. c) RBI may consider guiding the banks to more sophisticated risk management concepts in a time bound manner. It may consider directing some more capable and better equipped banks to adopt higher practices without waiting for the whole banking system. Such banks acting as leaders could provide models for other banks to convert to.