Chapter 1

Introduction

1.1 Various developments during the 1990s have underlined the importance of financial stability and transparency in providing overall economic stability. It was widely accepted that lack of transparency with regard to the systems and practices adopted by a country in managing its financial sector would encourage speculation which, unless reined in, may become self-fulfilling. It was also recognised that countries need to adhere to certain internationally laid down standards and codes in various areas so that their transacting partners across the world can derive comfort from such adherence and thereby are assured of reduced vulnerability to internal and external shocks. With a view to promoting and assisting in the task of adoption and implementation of international financial standards in India, a ***Standing Committee on International Financial Standards and Codes*** was set up in December 1999. The Committee has been entrusted with the task of monitoring developments in global standards and codes being evolved by standard setting bodies as part of the effort to create a sound international financial architecture and to consider all aspects of applicability of these standards to the Indian financial system.

1.2 In view of the fact that there are a number of codes in different subject areas, the Standing Committee considered the task of collection of information on international standards and codes and 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, former Chairman, State Bank of India, and then Honorary Adviser to Reserve Bank of India, was entrusted with the responsibility of advising on matters relating to banking regulation and supervision. The Chairman coopted the following as members of the Group:

a. Shri Janki Ballabh, Chairman, State Bank of India (then Deputy Managing Director, State Bank of India)
b. Shri K.R. Ramamoorthy, Chairman, Vysya Bank Ltd.
c. Shri H.N. Sinor, Managing Director, ICICI Bank Ltd.

Dr. R. Kannan, Adviser, Department of Economic Analysis and Policy, Reserve Bank of India, was the Convenor of the Group. Shri B. Mahapatra, General Manager, Department of Banking Operations and Development, and S/Shri M. Sebastian and G. Sreekumar, Deputy General Managers, from the Department of Banking Supervision of Reserve Bank of India, assisted the Group as Co-convenors.

Scope of the Group's work

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

(i) To study the 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 to 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.

1.4 Though "regulation" and "supervision" are often used interchangeably, one needs to make a distinction between "regulation" which refers to the laying down of the ground rules that define the operating environment, "monitoring" which refers to the process of ensuring that the ground rules and regulations are complied with, and "supervision" which is the process of ensuring stability of the overall system and soundness of individual institutions[i]. Though the name of the Group only refers to "Banking Supervision", the Group has defined its scope to include both banking regulation and supervision. This approach is in line with the approach adopted by the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements (BIS) in setting "Core Principles for Effective Banking Supervision" which cover both regulatory and supervisory aspects.

1.5 Banks' role in countering money laundering has assumed a great deal of importance in recent years. The ***Core Principles for Effective Banking Supervision*** have set some principles in these regards and the Group has given its views on them. There have also been other attempts at framing ground rules for ensuring that banking channels worldwide are not misused for laundering the proceeds of various criminal activities. These include the forty recommendations of the ***Financial Action Task Force on Money Laundering*** (The FATF Principles) of the Organisation for Economic Cooperation and Development (OECD), the private initiative made by 11 major international private banks in October 2000, also known as the ***Wolfsberg AML Principles***, the BIS paper on ***Prevention of Criminal Use of the Banking System for the Purpose of Money-Laundering*** (December 1998) and the consultative paper on ***Customer Due Diligence for Banks*** brought out by the BCBS in January 2001. The Group considered it a little premature to go into these separately since significant changes are already under way and are likely to occur soon with the enactment of the Money Laundering Bill which has already been placed before the Parliament.

1.6 Since the standards and codes in respect of banking supervision have been prepared keeping in view the structure and working of internationally active banks, these are most relevant in the case of such banks. However, with a view to ensuring uniformity of standards and providing a level playing field within a country, these are best applied across the banking sector. Accordingly, the Group, at the outset itself, decided that the scope of its assessment of the Indian position in respect of regulation and supervision shall extend to the whole of the commercial banking sector as it is understood in India. This comprises the State Bank Group, nationalised banks, private sector banks and foreign banks operating in the country. The applicability of these standards to other segments such as cooperative banks, Regional Rural Banks and Local Area Banks (which are only a few in number and are of recent origin), was not looked into by the Group in view of their much smaller share in the overall banking sector and the fact that these operate within an entirely different regulatory and supervisory framework. Most of the standards under discussion have no immediate relevance to these banks. The Group, however, recommends that, in view of the scope for regulatory arbitrage, where market players switch channels to avoid regulation, and the likely contagion effects these banks may have on the bigger segments, through the payments system or otherwise, the concerned departments of Reserve Bank of India may separately examine the gaps in respect of regulation and supervision of these banks vis-à-vis the standards set for the commercial banking sector to the extent they are relevant and applicable.

The Group's Approach

1.7 The Group had in all 22 meetings apart from several informal discussions among its members. While the self-assessments made by certain other countries of their banking regulation

and supervisory systems were restricted to the level of adherence vis-à-vis the BCBS document on the ***Core Principles for Effective Banking Supervision***, the present Group thought it fit to go beyond these principles and address other related issues listed below, which in the opinion of the Group, have an important bearing on the quality of regulation and supervision and indicate the direction in which banking regulation in India too should be moving in the near future. During the course of its meetings, the Group took up for discussion, the following important areas relating to banking regulation and supervision where internationally accepted best practices are already in place.

(a) Core Principles

(b) Corporate Governance

(c) Internal Control

(d) Management of Credit Risk

(e) Loan accounting, transparency and disclosures

(f) Financial Conglomerates

(g) Cross-border Banking

1.8 The above different facets of banking regulation and supervision have been ordered in what is felt to be a logical sequence of importance in ensuring banking soundness. Thus, the **Core Principles** refer to the minimum requirements to be met as essential conditions for ensuring sound banking supervision. Good **Corporate Governance** is essential to a bank's soundness and no level of high achievement in other areas can be a substitute for it. Similarly, effective **Internal Control** is of almost equal importance since this is the first layer of discipline over any bank's functioning. Managing **Credit Risk** is one of the oldest functions of a bank and banks' ability in ensuring profitability of its operations on a sustained basis hinges upon its success in this area. Market discipline is essential to ensure sound functioning of banks. Similarly, the health of banks is often a barometer of a country's financial soundness and ability to meet its liabilities. In this context, adhering to internationally accepted practices in respect of **Loan accounting, transparency and disclosure** play an important role in disciplining banks and in avoiding unwarranted speculation. Adherence to basic principles in respect of supervising **Financial Conglomerates** is necessary in this era of deregulation and overlapping of market activities to ensure that there are no gaps in supervision. Finally, increased **Cross-border banking** has given rise to the need to ensure that poorly supervised activities in one jurisdiction do not jeopardise the soundness of systems elsewhere.

Outline of the report

1.9 The above areas have been separately discussed in Chapters 2 to 8 which are followed by a conclusion in Chapter 9 summarising the Group's views. Chapter 10 provides an overview of the Group's major recommendations. incorporating, in brief, the Group's broad recommendations. It is possible that there is a degree of overlap between some of the areas covered by these chapters. Hopefully, such overlap is minimal and occurs only where repeat references are unavoidable. The background papers which formed the basis for the Group's assessment were mostly those prepared by the BCBS and have been annexed with appropriate references in the relative chapters. It may be noted in this connection that the Group had earlier submitted Part I of its report covering four areas relating to corporate governance, disclosures, cross-border banking and internal rating systems. With a view to providing an integrated view of the subject, the Group has decided to merge the earlier report in the present one. Certain changes have been

made to the presentation of the parts already submitted to ensure consistency with other parts of the report.

Acknowledgements

1.10 The Chairman would like to place on record his sincere appreciation of the contribution made by each and every member of the Group. The Group is also thankful to Dr. R. Kannan, Convenor, and the Co-convenors, S/Shri B. Mahapatra, M. Sebastian, and G. Sreekumar, for their excellent contributions. The able assistance provided by Ms. Subhra Bhattacharjee, Research Officer, Department of Economic Analysis and Policy, Reserve Bank of India, is also acknowledged. The report is the result of an excellent teamwork and it may be added that every member of the team has enjoyed working together.

Chapter 2

Core Principles

2.1 Introduction

2.1.1 The rationale for regulation and supervision is well established. This includes, among other things, the asymmetry of information between different parties to banking transactions. The interconnectedness of financial organisations and the rapidity with which contagion effects are transmitted across institutions and markets have spurred a great deal of debate globally on the adequacy of the international financial architecture. The pivotal position occupied by banks in the financial system as well as their susceptibility to crises of confidence and irrational panics automatically make them the focal point for any initiative to strengthen the financial system.

2.1.2 Recent multilateral initiatives focusing on international financial stability bear a common theme that for ensuring stability on a sustained basis there can be no substitute for sound financial supervisory regimes. Minimum standards and codes that have emerged as a result of these initiatives essentially serve as basic reference points for domestic supervisory authorities to address weaknesses in their systems as expeditiously as practical. Such initiatives in the context of banking supervision aim at ensuring the achievement of minimum accepted standards in supervisory arrangements across the world.

2.1.3 In this context, the ***Core Principles for Effective Banking Supervision*** (September 1997) enunciated by the BCBS was intended to provide a valuable minimum benchmark against which existing supervisory arrangements could be evaluated and appropriate corrections effected. While these principles represent the basic elements of an effective supervisory system, the BCBS had clearly recognised the need for individual national supervisory authorities to spell out and address risks and circumstances unique to their jurisdiction. To this extent it may be necessary to treat these benchmarks as broadly indicative rather than exhaustive.

2.1.4 In line with its mandate, the Group has made a detailed assessment in regard to qualitative levels of compliance with the Core Principles in India using the methodology suggested by BCBS[ii]. The detailed assessment is given in Annex 1. The assessments made by the Group point to a high level of general compliance in regard to most of the principles when evaluated against the recommended essential and additional criteria. Apart from technical compliance wherein a principle is accepted and incorporated in law or policy, the actual ground level percolation and implementation of the essential elements and spirit of these broader measures would determine the quality of compliance. The specific areas where focused initiatives are called for in order to achieve full compliance with the principles are discussed below.

2.2 Operational independence of the supervisor

2.2.1 In order to ensure operational independence of the supervisor, it is necessary to provide for in law that the head of the supervisory agency can be removed only for reasons clearly specified. Where the head of the agency is removed, the reasons must be publicly disclosed. In India, as per the provisions of the RBI Act, the Central Government has the powers to remove the Governor of RBI. The relevant provision, however, does not require the reasons for such removal to be specified. The law also does not place any obligation on the government to make the reasons of removal public. In the interest of proper public perception of RBI's independence, it would be desirable to consider suitable amendments to the relevant provisions of law making it obligatory

on the part of the government to make public the reasons for removal of the Governor/Deputy Governors from office.

2.3 Licensing and structure

2.3.1 The regulation of banks in India receives legal support mainly from the provisions contained in the Banking Regulation Act, 1949. The BR Act is now more than 52 years old and at least in regard to some of its provisions appears to be falling short of the current requirements. The changes in the financial sector environment since its enactment have been enormous. Some of the existing provisions, unless reviewed and revised, will not help achievement of the objectives with which these were initially put in place.

2.3.2 While provisions for minimum capital requirement for private sector banks and foreign banks are available in the BR Act and RBI has the powers to prescribe and vary requirements in respect of capital to exercise necessary entry level controls, the Group feels that such powers to decide requirement of capital on case by case basis would need to be clearly defined in law.

2.3.3 The present pre-licensing review of the proposed operational structure of an applicant seeking banking licence is very brief. At a time when complexity of banking products is growing and the delivery is increasingly becoming multi-channel, operational risks are increasing. A stricter review of the proposed arrangements and standards for internal control as well as the management's philosophy and business objectives at the pre-licensing stage will greatly mitigate possible hazards during the subsequent stages. Banks seeking licence should be asked to state in detail their operational standards and procedures, internal control procedures and arrangements facilitating oversight of banks' various activities by the supervisor.

2.3.4 At the fundamental level, the risk taking behaviour of banking institutions emanates from the quality of the Board of Directors and the standards of corporate governance supported by them. Hence, RBI should apply stricter norms for the 'fit and proper' test while evaluating directors and the quality of the board. Apart from qualification and experience, this should include an assessment of the character, philosophy and value system espoused by the individual.

2.3.5 Considering the rapidity with which changes are taking place in technology and financial markets, greater stress is required on professionalism and expertise of the board members. It needs to be stipulated clearly that at least one of the directors should have sound knowledge in each type of activity the bank intends to pursue. Necessary amendment will have to be made to Section 10 A(2) of the Banking Regulation Act which deals with general qualifications for board members of banking companies.

2.3.6 The definition provided in Section 5(ne) of the Banking Regulation Act determines a low threshold for "substantial interest". This may have to be re-examined. There is no specific provision in law requiring banks to obtain the prior approval of the supervisor for any proposed changes in ownership or exercise of voting rights over a 'threshold'. It would be desirable to make such a provision. Similar provisions in respect of "significant shareholdings" and changes therein would need to be put in place for foreign banks operating in India.

2.4 Capital adequacy

2.4.1 Though regulations require all banks to calculate and maintain minimum capital adequacy ratios, RBI is constrained and has shown forbearance in its measures against banks that fail to meet these requirements because of their government ownership. Such forbearance cannot be

long term and specific measures against banks failing to meet capital adequacy requirement need to be stipulated in the interest of the overall soundness of the system.

2.4.2 As advanced risk management systems are introduced and get stabilised in banks in the next 2/3 years, RBI should gradually move towards setting bank-specific capital ratios based on the risk profile of individual banks. Until advanced risk management systems are introduced, banks will not be in a position to assess minimum capital requirements in line with their individual risk profile. It may, therefore, be necessary for RBI to assist and guide banks in their efforts to stabilise advanced risk management systems. It should encourage the larger and more capable banks to complete the process early so that they can act as leaders and models for the smaller and not so well equipped banks. Only by continuous encouragement and regulatory pressure will the system, as a whole, be able to improve its risk management systems and raise it to international standards.

2.4.3 Currently, capital adequacy is calculated for banks on a solo basis without taking into consideration the risks emanating from their subsidiaries. The current stipulation of deducting the value of any equity investment in a subsidiary from the Tier I capital of the parent does not satisfactorily ensure risk-based capital adequacy on a consolidated basis.

2.5 Management of credit risk

2.5.1 Banks in India are yet to acquire adequate expertise in sophisticated credit risk mitigation techniques. Until banks improve their expertise, properly controlled credit risk environment will not be established. RBI has to guide banks in these regards and enable them to enhance their expertise.

2.5.2 Off-balance sheet items should receive more attention than they do at present. These should also be classified, like funded exposures, and a note to that effect should be provided in banks' financial statements.

2.5.3 Because of the existence of prescribed norms for loan loss provisioning, banks do not generally undertake an independent exercise for assessment of loan loss provisions and requirement of write-off. Banks have not developed sophisticated models and statistical tools for assessment of provisioning requirement that would reflect realistic repayment expectations. They are, however, moving towards that and once they acquire the expertise, the supervisor will no more be required to give structured provisioning norms.

2.5.4 The supervisor should require banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collaterals. As of now, in India, there is wide scope for improving the assessment of guarantees and worth of collateral. Banks have to enhance their capabilities in this regard. RBI may consider issuing suitable detailed instructions to banks in this regard.

2.6 Connected lending

2.6.1 A comprehensive definition of 'connected' or 'related parties' and 'large shareholdings' needs to be provided by law/regulator. In order to identify concentrations within banks' portfolios, "closely related groups" need to be explicitly defined and the supervisor should have the discretion, prescribed in law, in interpreting the definition on a case by case basis. Instead of relying on implied powers, as of now, RBI should have powers based on explicit legal

provisions. In a globalised market and while dealing with global entities, situations are likely to arise when such explicit legal provisions would be necessary for it to act decisively.

2.6.2 The definition of connected lendings also needs to be made more broad-based to include all types of connected parties irrespective of whether the banks and counterparties are in the public sector. This aspect of banks' lending has not been in focus largely because of their public sector character. With increasing privatisation these would assume criticality and the supervisor should have adequate mechanism to supervise and regulate this effectively.

2.6.3 While there are guidelines given by RBI in regard to connected lendings, the approach of banks in following the guidelines is not uniform. RBI requires to make its follow-up of this aspect of banks' lending stricter so that the risks related to such exposures are clearly understood and mitigated. While regulatory stipulations in this regard exist, the legal mandate to RBI to follow up and stipulate prudential limits either on a case by case or general basis is not clear cut.

2.6.4 Banks normally have in place procedures to prevent persons benefiting from loans from being associated with its appraisal or sanction. However, there is no clear cut requirement to this effect stipulated by the supervisor excepting in regard to directors. RBI may consider issuing specific instructions in this regard. In the interest of maintaining discipline, both in respect of credit sanction and capital adequacy, RBI may consider issuing instructions that loans to connected and related parties which are not collateralised fully may be deducted from banks' capital to the extent that these are not fully collateralised.

2.6.5 RBI should stipulate a stricter control and monitoring over such loans by banks. Banks should be instructed to monitor the total amount of such loans and introduce an independent credit administration process. There are at present no limits on aggregate exposures to connected and related parties by a bank. Such limit needs to be established.

2.7 Management of other risks

2.7.1 Liquidity, interest rate and operational risk management in banks continue to be at the basic level. Though there is now an appreciation of the existence of these risks, there is lack of expertise for their proper management. MIS, in most cases, continues to be not fully aligned to the requirements of proper risk management with the consequence that advanced practices like stress testing and contingency planning are still not in place.

2.7.2 A risk management oriented approach to supervision has been adopted by RBI in the last two years, i.e., since April 1999. The two years since RBI brought out its detailed guidelines on risk management would have given adequate time to the banks to restructure their MIS to the requirement of risk management systems and stabilise their systems. Banks, however, as yet do not have in place highly developed and sophisticated risk management systems notwithstanding the fact that risk identification, measurement and mitigation is being attempted on a more systematic basis. It is time now that banks are required to move forward to higher levels of sophistication in risk management and adopt the practice of undertaking scenario analysis, stress testing, contingency planning and periodic validation of the systems used to measure market risks. These capabilities must be in place in all banks latest by the end of the financial year 2002-2003. RBI may assist banks in hastening introduction of the more scientific and sophisticated risk management systems.

2.7.3 While Indian banks are moving towards holding capital against credit and market risks, it would be a little premature at this stage to require them to hold capital against risks other than

these. RBI may, however, consider setting fixed percentage for exposures to each country until banks are in a position to assess and provide for such risks on objective and scientific basis.

2.7.4 Banks should be required to include a statement on their risk management policies and procedures in their publicly available documents. However, since such a statement presupposes a clear understanding of the risk profile of banks by their top management and boards and a well defined policy and strategies for their management, any meaningful statement can be made only when adequate risk management systems are in place in all banks. RBI may therefore consider giving banks a timeframe within which this goal may be achieved. A timeframe of two years from now, i.e., end of the year 2002-2003, may be considered adequate for any preparation that may be needed to be made in this regard.

2.8 Functioning of the Board of Directors

2.8.1 While the role of the Audit Committee has evolved well over the past few years and will get defined even better in terms of the new Section 292-A in the proposed Companies Amendment Act, in banks and financial institutions, there needs to be a more specific focus on risk management. It is, therefore, recommended that risk management should be a specifically stipulated item for being covered in the directors' responsibility statement. The present laws relating to the responsibilities of the Board of Directors are mostly in general terms. These responsibilities should be made more specific with a clearly identified focus. Greater stress could be laid on the responsibility of the board in exercising control over all aspects of risk management.

2.8.2 While, in the course of the on-site inspection of banks, some assessment is made of the boards' and senior management's performance, such assessment rarely results in measures being taken by the regulator for improvement/change even where a case for such improvement/change seems strong. The difficulties are more in the case of public sector banks as the constitution of the boards and appointment of top management remain in the hands of the government. It is, therefore, suggested that a more formal and rigorous assessment of the boards' performance be undertaken by the regulator. It is further suggested that the regulator should rate the boards' performance with the provision that if the rating falls below a certain level it would trigger specified corrective action.

2.8.3 As RBI itself is moving towards "Risk-Based Supervision", internal audit at individual banks' level would also now have to be modified suitably so that their systems and MIS match the changing supervisory focus. Only a coordinated effort on the part of banks as well as RBI can result in a quick and smooth transition to "Risk-Based Supervision".

2.9 "Know Your Customer" Procedures

2.9.1 From time to time, RBI has issued guidelines in regard to 'Know Your Customer' policies and practices. While, internationally, in recent years, these procedures have been developed mostly to guard against activities relating to money laundering, in India these have been used more as fraud prevention measures. In the context of ever-increasing domestic and cross-border flows of funds, the implementation of these guidelines should be ensured by the supervisor and adherence thereto made more stringent as a part of a conscious anti-money laundering policy. With the passing of the anti-money laundering legislation which appears imminent and which takes into account the recommendations of the Financial Action Task Force, the enforcement of these measures would become easier. The regulatory requirements in these regards must meet the legal provisions and would need to be put in place.

2.10 Methods of ongoing banking supervision

2.10.1 Since the financial condition of individual banks can change drastically depending on their risk profile, which also includes their susceptibility to risks exogenous to the institution emanating from the system, RBI should consider moving over fully to a risk-based approach to supervision as early as possible.

2.10.2 The supervisory framework has been evolving from being transaction oriented to one which is more systems oriented. The condition of banks is reviewed both on the basis of off-site as well as on-site supervision. Since the quality of management can be considered to be the most important determinant of a bank's financial condition, reputation and standing, this aspect needs to be given greater weightage in supervisory assessments.

2.10.3 At present, the supervisor does not generally meet with the banks' board of directors or the external auditors. RBI may consider introducing such meetings in the interest of greater involvement of the banks' boards with supervisory concerns and actions in order to enrich the scope of examination of banks. The practice of RBI meeting with external (statutory) auditors could also be introduced. These changes can be expected to result in considerable advantage to the system of examination of banks' operations by RBI.

2.10.4 RBI may consider using independent and well qualified external auditors to examine specific aspects of banks' operations. Such specific reports, besides adding depth and quality to the on-site examination conducted by RBI, will also reduce its burden of having to conduct very extensive on-site inspections. Should RBI adopt this idea, it will have to clearly define its own role and responsibilities as against the external auditors who it will engage for looking into some specific aspects of banks' operations.

2.10.5 The laws and regulations in India do not establish the principles and norms for consolidated reporting of accounts. The system of drawing up financial and operational results on a consolidated basis has not been introduced. Recently, a number of measures have been introduced by RBI requiring banks to append the balance sheets of their subsidiaries to the balance sheet of the parent bank. The move towards consolidated accounting and supervision needs to be expedited. Steps need to be taken so that necessary legal provisions are introduced and banks are required to prepare consolidated accounts.

2.10.6 A formal framework for coordination between different regulators is essential. RBI may consider taking necessary steps to impress upon the government the need and urgency of achieving and maintaining a high level of coordination among different regulators.

2.11 Legal and other measures of support for the supervisor

2.11.1 RBI has powers to apply penalties and sanctions not only on banks but also on the management or Board of Directors. However, the public sector character of banks remains an important consideration in the supervisor deciding upon and initiating sanctions and/or penalties on banks. RBI should consider introduction of measures by which clear accountability can be fixed on individual directors and/or the board of directors for non-performance and/or negligence of their duties. Accountability, if fixed, should lead to penalties and, in extreme cases, if necessary, criminal prosecution.

2.11.2 The range of possible actions available to RBI should include imposition of conservatorship which can enable a bank in difficulty to gain some time until it completes

remedial measures. Conservatorship is a workable solution where a bank in difficulty has the intrinsic strength to get over the difficulties but needs extensive corrective action under a more reliable management. It would be, therefore, desirable to provide RBI specifically with powers to impose conservatorship.

2.11.3 As of now laws and regulations do not mitigate undue delays on the part of the supervisors in initiating appropriate corrective actions. However, a Prompt Corrective Action (PCA) framework is now being evolved with triggers identified for a range of mandatory and discretionary actions. It would also be desirable to extend the PCA concept further and define clear limits of forbearance that can be shown by the supervisor in any situation. RBI has circulated a draft PCA framework for comments. The Group's views on the proposed PCA framework are given as an appendix to this chapter.

2.11.4 In formulating its views on the proposed PCA framework and making suggestions in these regards, the changes/developments in the banking sector that have taken place in the last few years have been taken into account. The Group is of the view that while the three parameters which have been identified as critical and in relation to which PCA is contemplated under the framework are sufficient at this stage, these would need to be reviewed in the coming years in the light of developments in information technology, payment systems, and in other important areas influencing the banking sector. Accordingly, the triggers as well as the corrective action suggested in this paper would need review from time to time to reflect the changes in the operating environment. It is important to recognise that no PCA framework could be treated as lasting in nature. The other important point, in the opinion of the Group, is that PCA needs to have some mandatory elements in order that all stakeholders as well as the supervisors are prepared for a certain course of corrective action in the event of the performance of a bank or banks falling below a given level. This will lend strength to the system and is likely to keep the banks on greater alert against any deterioration in their performance.

2.11.5 RBI may consider having more interactions with the external auditors of banks. This will provide a deeper understanding of operations of banks and help in discharging supervisory functions better. It will complement the on-site inspections of RBI well. While the auditors are required by law to report matters of material significance to the shareholders, they do not have any legal responsibility of reporting such matters to the supervisor. A suitable legal provision obliging the statutory auditors of banks to report on such matters simultaneously to the regulator will strengthen the supervisory regime.

2.12 Supervision of internationally active banking organisations

2.12.1 RBI should practice consolidated supervision over internationally active banking organisations of which it is the home country supervisor. While the position in regard to supervision over foreign branches of Indian banks is fairly satisfactory, the position in regard to subsidiaries and joint ventures would need to be addressed. RBI has made a beginning in requiring banks to submit off-site returns in respect of their foreign subsidiaries and joint ventures on a solo basis.

2.12.2 RBI should look at the management's local oversight of foreign operations and ensure that it is particularly close when the foreign activities differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the locations where the principal activities are conducted. Since the business of a foreign unit always has some special characteristics, as supervisor, RBI should ensure that the oversight exercised by the management matches the requirement of the situation.

2.12.3 The supervisor should visit the offshore locations periodically and exchange information with the host country authorities during such visits. RBI's present approach, which is selective and, therefore, has some elements of ad-hocism, should be replaced by a system under which all foreign operations of Indian banks receive on-site supervisory oversight in a planned manner.

2.12.4 Quality of supervision in a country is one of the major factors of consideration before granting licence to an Indian bank to open a branch abroad. However, the assessment of the host country's quality of supervision should be more rigorous. It would be desirable to introduce a structured assessment and not permit banks to open offices in areas where the quality of supervision does not measure up to international standards.

2.12.5 It would be preferable to have formal arrangements between home and host country supervisors for sharing of information and supervisory concerns rather than having only informal arrangements as at present. RBI should endeavour to get into formal relationship with host country supervisors on the basis of MoUs. Proper understanding between home and host country supervisors helps improve the scope and quality of supervision.

2.13 Conclusion

2.13.1 The Reserve Bank of India, as supervisor, has clear responsibilities and objectives as regards supervision of banks. RBI is vested with sufficient powers to carry out its supervisory functions effectively and to address safety and soundness concerns. It is also so constituted and financed that its autonomy and independence are not undermined. A suitable legal framework is in place and these are reviewed and updated from time to time considering the changing needs of the banking industry and the economy.

2.13.2 The permissible activities of banks are clearly defined in law and the use of the word "bank" in names is restricted. RBI follows very strict licensing norms and these are reviewed periodically. It also has the powers to reject an application. While licensing banks, RBI makes a detailed assessment of the character of the proposed management and determines the suitability of the major shareholders, transparency of ownership structure and source of initial capital. Minimum capital is also prescribed. Fit and proper test is applied to evaluate the directors and the top management. The proposed strategic and operating plans of the banks and their viability are also reviewed. In the case of foreign banks, the prior consent of the home country supervisor is obtained. The compliance with the conditions imposed at the time of licensing is monitored through a quarterly system of on-site supervision.

2.13.3 Banks are required to fulfil minimum capital requirements which is broadly in conformity with the international norms. RBI has laid down detailed guidelines on income recognition, asset classification and provisioning covering both on- and off-balance sheet exposures in line with international standards. Wherever there are gaps in this regard, RBI is gradually but firmly moving the system towards international standards.

2.13.4 RBI relies on both on-site and off-site supervisory mechanisms in pursuit of its supervisory objectives. It also has regular interaction with bank management and a thorough understanding of banks' operations. The system of on-site inspection comprises of appraisal of asset quality and the impairment to asset values. The quality of assets is also monitored on quarterly basis through off-site monitoring returns. RBI seeks to ensure that the management information systems in banks enable identification of concentrations within their portfolios and also prescribes prudential limits to restrict single and group borrower exposures. In the course of on-site examination, among other things, the adequacy of credit and investment policies and

adherence thereto are looked into. There are laws, and banks' internal as well as supervisory guidelines to ensure that credit decisions are made free of conflicting interests and, where necessary, on arms length basis and free from inappropriate pressures from outside parties.

2.13.5 RBI has issued detailed guidelines for risk management and is monitoring their implementation regularly. It is also fast moving towards putting in place a formal system of risk-based supervision of banks. Inspections are conducted using in-house expertise, whose skills are being constantly upgraded, and occasionally also through chartered accountants for specific targeted appraisals.

2.13.6 RBI also determines that banks have in place internal controls that are adequate for the nature and scale of their business. It has means of collecting, reviewing and analysing prudential reports and statistical returns from banks. RBI also has systems in place and makes ongoing efforts to ensure that banks maintain adequate records based on consistent accounting policies and that the financial statements prepared and published based on such records represent a true and fair state of the banks. These are also independently validated by external auditors and by RBI during on-site inspections. Local operations of foreign banks are also required to be conducted to the same high standards as are required of domestic institutions.

2.13.7 For banks whose condition demands initiation of appropriate action, RBI has the powers and does take necessary steps. These are in the process of being structured in a framework of Prompt Corrective Actions. The public sector character of banks, however, remains a limitation in the supervisor deciding upon and initiating remedial action in respect of banks.

2.13.8 The other areas where urgent action could be initiated are, guiding banks to put in place appropriate advanced risk management systems, achieving greater coordination, on a formal basis, with other supervisors, including overseas supervisors, introducing consolidated supervision, and giving an anti-money laundering orientation to the existing "Know Your Customer" requirements.

2.13.9 It may be concluded that the arrangements for supervision of banking in India is in almost complete and comprehensive agreement with most of the 25 core principles laid down by the BCBS with the exception of a few. Even in the case of those where the Group has observed significant gaps, these are not cause for any concern as of now and are capable of being bridged within a reasonable timeframe.

Appendix to Chapter 2: Prompt Corrective Action

Various banking crises have reinforced the need for having an efficient early warning system so that timely and adequate policy measures could be initiated to arrest any destablising effects and thereby arrest contagion. In both industrial and emerging market economies, mergers and rescue measure of banks are more common than outright closure of banks in view of the deleterious impact of precipitate action on the payment system in particular and on the economy in general. Outright closure is not contemplated by the national authorities as it has many social and political consequences. In this background, positioning Prompt Corrective Action (PCA) is considered as an important step so that the regulator/supervisor in consultation with the concerned bank could initiate corrective actions early in the remedial process. PCA is important as the cost of restructuring/liquidation of a bank only increases with delays in the initiation of appropriate policies. PCA includes various measures pertaining to supervision and monitoring of banks with potential troubles and those that are already troubled.

1. The Core Principles for Effective Banking Supervision (Principle 22) of BCBS clearly indicate that banking supervisors must have at their disposal sufficient supervisory measures complemented by legal sanctions to bring about timely corrective action when banks are showing signs of deteriorating compliance with various prudential norms relating to income recognition, asset classification, capital adequacy, etc.

2. The experience of various countries in this regard indicates that supervisors and regulators have both discretionary and mandatory actions. Although revoking the banking licence could be construed as an ultimate step, this is rarely resorted to. Once banks exhibit persistent deteriorating conditions, various actions, supportive as well as penal, are initiated ranging from restricting the current activities, placing a cap on their branch expansion, close scrutiny of asset transfers, examining the possibility of takeover or merger with healthier banks, etc.

3. As per the Banking Regulation Act, 1949, RBI has been taking bank-specific corrective actions when warranted. Various sections of the BR Act empower RBI to initiate appropriate corrective actions when banks start showing some kind of deterioration, but these are not properly structured. It has, therefore, been felt that an objective and rule-based set of corrective actions which are transparent in addressing problems of deteriorating banks would be necessary. Accordingly, RBI has formulated a draft PCA framework which is in the course of being finalised.

4. Under the proposed PCA framework, trigger points have been set up with reference to three principal parameters, viz., Capital to Risk Weighted Assets Ratio (CRAR), net NPA and Return on Assets. The PCA framework also mentions the rationale for classifying the rule-based actions into mandatory and discretionary. Under each of the three parameters, a trigger ratio is prescribed and once the problem bank reaches the trigger ratio, the PCA framework prescribes a set of mandatory and discretionary action to be taken. In case banks do not show any improvement despite these actions, RBI would be taking further steps mandatorily. While the PCA framework provides that, in exceptional cases, RBI will have the right to waive mandatory provisions, it is important to recognise here that misplaced flexibility could delay the positioning of corrective actions and in producing required results.

5. The proposed PCA framework of RBI prescribes three trigger points with respect to CRAR, two trigger points with respect to net NPAs and a single trigger point with respect to return on assets. Based on the level of the bank's performance, mandatory and discretionary actions are prescribed.

6. An important lacuna in this approach is that the three parameters are independently viewed and various mandatory and discretionary actions are to be initiated accordingly. However, these three parameters are interlinked and in assessing the actual state of health of a bank one has to take into account the various levels of deterioration/deviation from compliance, which are signified by the appearance of one or more of the identified trigger points, which means occurrence of one or more combination of events.

Conclusion

7. The Group is of the view that although the three parameters which form the PCA framework are sufficient at this stage these would need to be reviewed in the coming years in the light of developments in information technology, payment systems and in other important areas which influence the banking sector. It is important to recognise that no PCA framework should be treated as permanent in nature. The other important point, in the opinion of the Group, is that PCAs need to have some mandatory elements in order that all stakeholders as well as the supervisors are prepared for a certain course of corrective action in the event of the performance of banks falling below a given level. This will add strength to the system and is likely to keep banks on greater alert against any deterioration in their performance.

Chapter 3

Corporate Governance

3.1 The OECD has defined corporate governance as involving "a set of relationships between a company's management, its board, it shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources efficiently."

3.2 Corporate governance in banks assumes importance in view of the critical role of banks in any economy as financial intermediaries, repositories of vast credit-related information and as part of the payments system. The existence of sound corporate governance in banking organisations is fundamental to their own sound functioning and to the stability of the banking system as a whole. No amount of controls, systems and regulation can be a replacement for sound corporate governance. At its best, sound corporate governance in banks almost takes on a role akin to that of an efficient, well-informed and detached supervisory authority thereby facilitating sound banking supervision.

3.3 The BCBS has defined corporate governance, from a banking industry perspective, as involving "the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks:

- set corporate objectives (including generating economic returns to owners);
- run the day-to-day operations of the business;
- consider the interests of recognised stakeholders;
- align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- protect the interests of depositors."

3.4 While several basic standards put forward earlier by the BCBS had referred to corporate governance in some context or the other, a comprehensive set of standards focusing on corporate governance was set out by it in the paper on ***Enhancing Corporate Governance in Banking Organisations*** (September 1999). The paper, while reiterating the issues raised earlier, emphasises the importance of the OECD principles for banks. The Group 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 BCBS paper. The evaluation of the Group and its suggestions on those areas where compliance is not up to the best international standards have been presented in Annex 2. The main points arising therefrom are discussed in the following paragraphs.

Ownership and corporate governance

3.5 The Group, while recognising that banks and financial institutions are of various types, constituted under different statutory provisions, feels that the nature of a bank's ownership is not a critical factor in establishing sound corporate governance practices. The quality of corporate governance should be the same in all types of banking organisations irrespective of the nature of their ownership. Thus, the sound practices for corporate governance apply in equal measure, if

not more, to government owned banks also which dominate the Indian banking scene. Since the depth and extent of compliance of the standards of corporate governance may vary from bank to bank, within an overall generalised level, it is desirable that all banks meet a certain benchmark level representing an acceptable standard of corporate governance. From this level, there will have to be a sustained progress towards best international standards, the achievement of which within a reasonable timeframe will be targeted.

Constitution of boards

3.6 The banks need to follow the best practices in respect of constitution and functioning of the boards. It is, therefore, suggested that the process of induction of directors into banks' boards and their initial orientation may be streamlined. 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. This situation calls for correction.

3.7 Though selection for nomination of individuals on banks' boards is on the basis of his/her qualification considered suitable for the position, there is no practice of pre-induction meeting/briefing or any post-induction orientation. As such, often a proper appreciation of their role in banks' corporate governance takes time to develop. A system of pre-induction meetings as well as post-induction orientation for the newly appointed directors on the boards of banks needs to be introduced.

Boards and accountability

3.8 Good governance requires that boards establish strategic objectives and a set of corporate values that are communicated throughout the organisation. These are often not defined by the boards 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. Banks need to develop mechanisms which can help them ensure percolation of their strategic objectives and corporate values throughout the organisation.

3.9 Boards need to set and enforce clear lines of responsibility and accountability for themselves as well as the senior management and throughout the organisation. However, boards of directors in 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 this is because of the manner in which the boards are constituted. There is an urgent need to follow the internationally acknowledged best practices in banks in respect of constitution and functioning of boards.

3.10 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 a definite ceiling on the number of boards and the number of Committees a director can work in at a time.

Committees of the board

3.11 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. Introduction of systems for risk management in Indian banks is however rather recent and so are the risk management committees of the board. While it would be practicable for big banks to put in place independent and effective risk management systems and processes, smaller banks lack the expertise in this area and, therefore, will have to be given special attention by way of encouragement as well as technical support 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.

3.12 Save in a few small private sector banks, remuneration of employees is not linked to their performance. In the public sector banks, which account for more than 80 per cent of the country's banking sector, remuneration has so far been fixed at the industry level with the approval of the Government of India. In such a situation, there is hardly any room for linkage between individual performance and remuneration. For understandable reasons, therefore, public sector banks do not have a remuneration committee of the board. There is a need to review the current practice and link remuneration with performance.

3.13 It is desirable that performance measurement, currently confined mostly to operating units, e.g., branches, is extended to individuals and a linkage between performance and remuneration/reward is established. It should be possible to do so even in the public sector banks if a consensus can be achieved between the unions and the management on converting the present flat and unrelated to performance 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. Compensation Committees could be set up under the new arrangement.

3.14 Nomination Committees are expected to assess the effectiveness of the board and direct the process of renewing and replacing board members. As of now, there are no such committees 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. Such Committees and assessments would be desirable. The present system of nomination of directors on the boards of banks is neither appropriate nor effective in the entirely changed environment and is, therefore, expendable. Nomination Committees of the boards should be formed and allowed to function freely.

Transparency and corporate governance

3.15 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. Public disclosure is desirable in the areas of structure of the board and senior management, basic organisational structure, incentive structure and the nature and extent of transactions with affiliated and related parties. Though the structure of the board is normally revealed in the balance sheets of banks, details of committees of the board, and the qualifications of the directors are not always available publicly. Disclosures in respect of this and the other aspects mentioned above need to be encouraged.

3.16 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 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 and a clear definition of large shareholding would need to be provided.

Role of supervisor and government

3.17 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/conflict of interest.

3.18 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 management not found to be 'fit and proper' was contemplated.

Conclusion

3.19 Banks in India have in place a fairly robust framework for corporate governance in which modern practices of sound corporate governance can be incorporated and built up to further the interests of the individual banks and all the stakeholders. Thus, banks articulate corporate values, codes of conduct and standards of appropriate behaviour, etc., and have systems to ensure compliance with them. Banks also have well articulated corporate strategies decided by their boards. In pursuance thereof, performance budgeting system is followed, which measures, monitors and evaluates corporate success and the contribution of business units. Banks have clear delegation of powers to different levels of hierarchy for financial and non-financial sanctions. The mechanism for interaction and cooperation among the board of directors, senior management and the auditors is fairly established.

3.20 Either on their own or under the guidance of RBI, most banks have put in place processes designed to monitor performance and fulfilment of duties and responsibilities at different levels. RBI checks the governance practices at banks and brings to the management’s attention problems identified by it. It also emphasises accountability and transparency in banks, ensures that banks’ organisational structure provides for proper checks and balances, and proactively guides banks on sound corporate governance practices. The organisational structure of banks enables adequate oversight by their boards. The present system of control and audit in banks enables such oversight. Systems are in place which enable direct line supervision of different business areas.

3.21 The directors do not interfere in day-to-day management of banks. While loans and advances to directors or to related individuals and bodies are prohibited by law, disclosure of interest by directors is mandatory. 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.

3.22 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 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. The Board meets the senior management and internal audit regularly and establishes and approves policies and monitors progress towards corporate objectives. There is an independent audit committee of the board and the appointment and removal of auditors by the boards of banks have to be with the prior approval of Reserve Bank of India.

3.23 The process of induction of directors needs to be streamlined. Further, considering the complex challenges that banks are required to meet in the future, there would be need for directors who are conversant with risk management issues. In order to enhance effectiveness of boards, there would also need to be a ceiling on the number of boards that a director can be on at the same time. To increase the effectiveness of boards, there is need for separate committees for risk management, compensation and for nominations to the board. While boards need to set standards of accountability for themselves, there is also a need for enhanced transparency and disclosures in respect of various aspects of boards’ constitution and functioning.

3.24 Sound corporate governance in Indian banks is hindered to some extent by the government/RBI ownership of banks. While, in the case of government ownership, the regulator may find it difficult to enforce urgent corrective action including removal of incompetent and, at times, corrupt management, in the case of RBI ownership, it leads to an overlap between its ownership and supervisory roles.

3.25 There are no laws as such which can be seen as supporting or facilitating corporate governance and absence of such legislation is felt. However, as regulators, as the Reserve Bank of India and SEBI are gradually introducing measures which lead to good corporate governance in banks and protection of depositors' and others' interests.

Chapter 4

Internal Control

4.1 Introduction

4.1.1 A study of banking problems in general would indicate that absence of a healthy culture of internal control manifested most often in a lack of adequate and effective control systems, and non-compliance with those which are in existence, is at the core of many banking problems. The BCBS had issued a ***Framework for Internal Control Systems in Banking Organisations*** (September 1998) to enable supervisors to evaluate control systems in banks. As explained in the BCBS paper, "A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. A system of strong internal controls can help to ensure that the goals and objectives of a banking organisation will be met, that the bank will achieve long-term profitability targets, and maintain reliable financial and managerial reporting. Such a system can also help so that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage to the bank's reputation." The BCBS paper formed the basis of the Group's assessment of the level of compliance in India. The Group's assessment has been provided in Annex 3. The assessment, for obvious reasons, is not bank-specific and is, therefore, based on the Group's view on the systems existing in banks in India as a whole. Areas where, in the opinion of the Group, gaps exist in the present position obtaining in India vis-à-vis the principles and where necessary action could be initiated are discussed in the following paragraphs.

4.2 Management oversight and control culture

4.2.1 An effective oversight over internal control by the management requires, among other things, that the Boards of Directors of banks include in their activities, periodic discussions with management concerning the effectiveness of the internal control systems and ensure that the management has appropriately followed up on the recommendations and concerns on internal control weaknesses expressed by auditors and supervisory authorities. However, in India, the systems of periodic discussions by the board with the management or follow-up of evaluation and review reports is not very well established. The attention paid at the board level to evaluation and review reports on internal control systems in banks is mostly routine and more often than not receives limited attention except when a bank has got into some trouble because of failure/breakdown of the system. Such reviews and evaluations are generally not used as important tools of management information and control. Boards of most banks, particularly public sector banks, would need to undergo an attitudinal change towards such evaluations/ reviews so that they have a better and firmer say in the maintenance and improvement of internal control systems in banks. In depth discussions on periodic reports on internal control systems of banks between the management and their boards should be institutionalised. RBI may consider advising all banks to take steps in this regard.

4.2.2 Since internal control is the responsibility of every employee of a bank, it is essential that all personnel within the bank understand its importance and are actively engaged in the process. Therefore, establishing a strong control culture requires banks to regularly reorient and train their personnel so that they fully understand the importance of internal controls in their respective stations. The boards of banks should specifically pay attention to creating and sustaining a culture of control in banks.

4.2.3 The principles suggest that, in reinforcing ethical values, banking organisations should avoid policies and practices that may inadvertently provide incentives or temptations for inappropriate activities. Since, as yet, in India, there is very little incentive or disincentive for good or bad performance, it is important that criticality of internal controls is never lost sight of.

4.3 Risk assessment

4.3.1 Internal control should include an assessment of all the various risks facing banks, including credit, operational, legal and reputation risks. RBI has issued comprehensive risk management guidelines to banks in terms of which they are required to identify and assess all business and operational risks and formulate and put in place appropriate risk management systems. Scientific risk management is, however, still in the initial stages in most Indian banks, particularly the old private sector and public sector banks. The current situation calls for greater orientation of the banks' managements and their boards towards better understanding of risks and their management.

4.3.2 With a few exceptions, there is not much conscious effort in banks to measure different kinds of risk and decide the level of acceptability of such risks at the board level. RBI may consider outlining clearly the role of the boards of banks in risk management. Risk-based supervision of banks by RBI has to be mirrored in their boards' supervision and guidance.

4.3.3 Evaluation of risks affecting banks' strategies and objectives by the senior management has to be continuous and needs to be placed on a formal basis. On the basis of such evaluations, internal controls will have to be revised to appropriately address any new or previously uncontrolled risks.

4.4 Control activities

4.4.1 Control activities need to be seen as a part of day-to-day work rather than in addition to the daily operations. As part of fostering an appropriate control culture within the bank, senior management should ensure that adequate control activities are defined at every business level and are an integral part of the daily functions of all relevant personnel. While in most Indian banks such checks and controls are in place, there is no uniformity in regard to the standards of compliance. Control activities in these banks are more procedure driven than as means of conscious and proactive risk management. Although the procedures established do help in management of risk to some extent, compliance with these procedures at the operating levels, which includes the frontline, is not with the understanding and awareness that the objective behind the given procedures is risk management. Lack of such awareness affects the quality of compliance. An assessment of the control environment and the involvement of the top management in fostering a strong control culture should be a mandatory part of the on-site supervision process adopted by RBI for each bank.

4.5 Information and communication

4.5.1 Effective internal control requires that there are adequate and comprehensive internal financial, operational and compliance data as well as external market information about events and conditions that are relevant to decision making. Information should be reliable, timely, accessible, and provided in a consistent format. The quality and timeliness of MIS in most of the banks in the public sector and some in the private sector leave much scope for improvement. Low level of computerisation and networking is largely responsible for data quality issues in

MIS. The quality of MIS is an area of potential risk both from the point of view of internal control and regulatory oversight and the banks have to recognise it as such.

4.5.2 RBI has issued detailed guidelines to banks regarding the development and implementation of appropriate record management policies and processes. Although generally there are established policies and procedures in this regard, as most of the records continue to be maintained manually, retrieval, presentation and analysis of data are invariably lagged.

4.5.3 The responsibility of ensuring appropriate information systems covering all activities and the integrity of such systems is enjoined on the senior management of banks. However, greater awareness needs to be promoted among senior management in regard to security, risk and controls in computerised environment.

4.6 Monitoring

4.6.1 Monitoring overall effectiveness of banks' internal controls is an important responsibility of the senior management. The monitoring has to be continuous and systems have been evolved in most developed economies which enable ongoing daily monitoring of internal control/risk management systems. However, monitoring of key risks on a daily basis is not common in the Indian system. Such monitoring excepting in the case of market risks for treasury related operations, is yet to be accepted in Indian banks as a part of normal day to day operations.

4.7 Evaluation by supervisors

4.7.1 Activities or situations that have historically been associated with internal control breakdowns in banks require special attention of the supervisors. Similarly, it has to be seen whether changes in banks' environment necessitate changes in the internal control systems. While these do receive the attention of supervisors in India, the supervisor's on-site inspection of banks is at present not fully tailored to specific banks' environment and is thus not quite individualised. RBI may consider taking steps so that such inspections are individualised and a more bank-specific approach is adopted in on-site inspections. As this happens, specific changes in a particular bank's operating environment will automatically receive special consideration of the supervisor leading to better evaluation of the bank's risk management and internal control systems.

4.8 External auditors

4.8.1 Supervisory efforts could be fruitfully supplemented by the use of external auditors. It would be more efficient if RBI would leverage the findings of the external auditors of the bank in addition to its own on-site supervisory findings. RBI may also consider engaging external auditors for specific area audit/inspection of banks and utilise their reports for supervisory oversight as is done by some other regulators. The specific areas could include reviews of business processes and transaction testing.

4.8.2 While weaknesses in internal control are communicated by external auditors either orally or in writing to the management, there is no practice of external auditors directly communicating their observations and concerns to the supervisors. As stated elsewhere in the report, such sharing of material information with the supervisors may be made legally mandatory for the external auditors.

4.9 Conclusion

4.9.1 The boards of banks in India have the responsibility for approving strategies and policies and setting acceptable levels for risk exposures. It is also their responsibility to ensure that senior management monitors the effectiveness of internal control systems. RBI has prescribed a set of mandatory reviews that need to be undertaken by the board or specialised committees of the board. Internal control strategies, policies and procedures are typically approved by the board and communicated to all levels of hierarchy for implementation.

4.9.2 Banks in India have a well-documented and communicated organisational structure that clearly shows lines of reporting responsibility and authority and provides for effective communication throughout the organisation. Corporate values, codes of conduct, standards of appropriate behaviour, etc., are well articulated and these emphasise the importance of internal controls. Bank managements endeavour to ensure that all levels of personnel understand their roles in the internal controls and are fully engaged in the process. There is appropriate segregation of duties and personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest are normally identified, minimised, and carefully monitored through a system of management audit. Organisational structure of banks ensures appropriate multi-directional information flows across the organisation. Policies and procedures affecting duties and responsibilities of staff are communicated to all concerned personnel.

4.9.3 Banks have systems of periodic internal audit and inspection by persons specially designated for the purpose. Such periodic evaluation of internal control systems are properly documented and reviewed by senior managements at different levels. These audits/inspections are effective means of determining effectiveness of controls for both the operating level staff as wells as the senior management responsible for the effectiveness of the internal control systems. Internal control has been integrated into the operating environment. Thus, banks have introduced systems for ongoing monitoring through concurrent auditors who monitor the effectiveness of internal controls on an ongoing basis. Frequency of internal audits, which is normally once a year or linked to the internal ratings of banks, is increased whenever there is a change in the management's perception of risks emanating from the activities at particular branches. Internal audit function is independent from day to day functioning of banks and has access to all activities conducted by the banking organisation.

4.9.4 RBI requires all banks to have effective internal control systems consistent with the level of their activities and risks. RBI also evaluates the adequacy and effectiveness of the internal control systems in banks during the onsite inspection process. This is factored in the risk assessment of banks under the CAMELS framework. Necessary follow-up action is taken to ensure that the banks concerned take appropriate corrective action.

4.9.5 RBI has issued comprehensive risk management guidelines to banks in terms of which they are required to identify and assess all business and operational risks and formulate and put in place appropriate risk management systems. Scientific risk management is, however, still in the initial stage in most of the banks, particularly the old private sector and public sector banks. The current situation calls for greater orientation of the banks' managements and their boards towards better understanding of risks and their management. Monitoring of key risks also needs to be on a daily basis.

4.9.6 The other areas where appropriate action could be initiated are in the areas of performance related compensation, quality of MIS and in increasing awareness about the risks involved in and the controls required in working in a computerised environment. However, it may be concluded that the overall level of compliance by the Indian banking system with the principles laid out in the paper is high.

Chapter 5

Credit Risk

5.1 .Management of credit risk

5.1.1 Management of credit risk assumes great importance in environments where there is a predominance of lending in the overall asset portfolio and where credit histories on borrowers and other counterparties are not well documented and are unavailable. Effective management of credit risk is all the more critical in a scenario of increasing liberalisation and globalisation as a result of which the economic fortunes of banks' clientele can and do undergo quick and substantial changes. The Group has tried to assess the quality of credit risk management in banks in India on the basis of the principles laid down in ***Principles for Management of Credit Risk*** (September 2000) brought out by the BCBS. Comments with regard to the related aspects of internal rating systems in banks and banks' interactions with highly leveraged institutions are given at paragraphs 5.2 and 5.3 below. The Group's detailed views with regard to management of credit risk have been tabulated in Annex 4. Areas in which, in the opinion of the Group, gaps exist and wherein corrective action can be initiated, are summarised below.

5.1.2 With regard to measurement and monitoring of credit risks, the Group considers that the following aspects of risk management practices of Indian banks merit urgent review. The gap between these practices and the relative international benchmarks is noticeable and in the interests of the soundness and international credibility of the system, it would be desirable to bridge these at an early date.

(a) Though banks in India monitor individual credits, the determination of provisions for loan losses are formulae-based. Such provisioning detracts attention from specific risks attendant to individual credits as also to specific sections of the total credit portfolio.

(b) While most banks have information systems which enable them to measure credit and concentration risks in all on-balance sheet exposures, the information system is not being used to capture and keep in focus risks attached to off-balance sheet activities.

(c) Although while assessing individual credit, banks generally take into consideration potential future changes in the economic scenario, the likely adverse impact of all such changes on the credit portfolio under conditions of stress is most often not examined. This denotes a certain degree of unpreparedness and lack of strategy on the part of the banks for managing such risks.

5.1.3 Risk management on scientific basis is a recent phenomenon in Indian banks which have so far not focused hard enough on their strategies for credit risk management. While, therefore, most of them have defined loan policies duly approved by their Board of Directors, clearly stated strategies for risk management do not form part of most such policies. This reveals inadequacies of the risk management policies applied hitherto by banks in India as well as the limitations of the MIS on which these systems have been built. Banks in India have to pay attention to improving their MIS as well as the credit risk management systems and strategies within as short a timeframe as possible. In the absence of a clear strategy, shared and well understood throughout the organisation, credit risk management will remain patchy and lack uniformity of approach.

5.1.4 The core principles recommend and the Group agrees that banks must establish a system of independent, and ongoing assessment of their credit risk management processes. The results of such reviews should be communicated directly to the senior most management and the Board of Directors of the bank for any remedial action that may be necessary.

5.2 Banks' internal rating systems

5.2.1 While no minimum standards or codes have been suggested so far in respect of internal rating systems for banks, probably in view of the country-specific requirements in this regard, the BCBS has published a study on the range of practices in the internal rating systems of banks (***Range of Practice in Banks' Internal Ratings Systems,*** January 2000). Since developments in this area will be vital for improving the competitiveness and long term stability of the Indian banking system, the Group thought it fit to assess the Indian position vis-à-vis these practices. The background paper which was the basis for this assessment is given at Annex 5.

5.2.2 Use of internal rating systems in Indian banks is still not extensive as most banks are still in the process of putting in place sophisticated risk management practices. Lack of qualified personnel, absence of reliable high frequency historical data which can facilitate meaningful modelling and lack of proper appreciation of risk management concepts at the middle and senior management levels are important handicaps faced by Indian banks in their developing internal rating systems extensively.

5.2.3 Credit rating in India is mostly unidimensional, i.e., there is an overall rating given to the borrower and the same rating is applicable for all facilities extended by the bank to him. The credit rating systems as developed by banks in India are 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 obtain a single point indicator of risk associated with the client. A move towards multidimensional rating systems is overdue 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.

5.2.4 The internal rating approach, as practised by most banks in India, measures risk in quantitative mode. Important inputs in risk rating systems of banks in India are financial analysis, projections and sensitivity and incidence of industrial and management risks. Systems of internal rating which include measurements of probability of default (PD), loss given default (LGD) and exposure at the time of default (EAD) are still not widely used. Banks should urgently adopt systems of internal rating which are more risk-oriented and can capture, inter alia, the above mentioned elements of risk.

5.2.5 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 for setting credit limits. Only a few banks are using the rating systems and that too for management reporting, setting credit limits and for pricing of loans. Use of these systems for internal ratings, decisions on reserve levels, or allocation of economic capital, is still rare.

5.2.6 It would be necessary to strengthen the MIS and data collection machinery in banks to ensure integrity and reliability of 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 reliable and relevant data will have to be ensured before statistical models can be used for drawing meaningful conclusions.

5.2.7 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 BCBS paper. This presupposes extensive computerisation and the right kind of MIS. Banks shall have to build historical database on the portfolio quantity and provisioning/charge off to equip themselves for pricing risks properly. All banks cannot be expected to be able to do so in the very near future. However, the bigger banks must expedite the process of transition from elementary levels of risk management to levels of greater sophistication. They may be encouraged to engage, wherever considered necessary, external assistance, e.g., from consultants, so that the available in-house expertise gets duly supplemented.

5.2.8 Banks in India will 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 follow.

5.3 Highly Leveraged Institutions

5.3.1 The near-failure of Long Term Capital Management, the high-profile US-based hedge fund, in 1998 had brought into focus the special care that needs to be taken by banks in dealing with Highly Leveraged Institutions (HLIs). The BCBS had, in this regard, brought out a set of principles titled ***Banks' Interactions with Highly Leveraged Institutions*** (January 1999). HLIs have been defined for the purpose of the BCBS paper as those which are subject to little or no direct regulatory oversight, are required to make only limited disclosures and take on significant leverage.

5.3.2 In view of their high leverage, lack of adequate disclosure and the increase in their activities in recent years, HLIs represent a special type of counterparty risk to banks and to the financial system as a whole. Supervisory responses to the potential problems posed by HLIs would have to take into account the credit exposures arising out of transactions with HLIs, particularly the off-balance sheet exposures. The responses will have to include more stringent capital requirements for such exposures, and setting out of policies, procedures and documentation for taking on such exposures. These may further include, inter alia, established policies and procedures for information gathering, due diligence and credit analysis of HLIs' activities, setting of overall credit limits for HLIs and close monitoring of credit exposures vis-à-vis HLIs. The BCBS principles, along with the Group's comments on the Indian position, have been given in Annex 6.

5.3.3 While Indian banks do not generally have dealings with HLIs, with increasing globalisation, the possibility of such interactions taking place and on an increasing scale is quite on the cards. It is, therefore, felt necessary to have necessary guidelines in this regard in place. Such guidelines may also have to take care of situations where HLIs or highly leveraged individuals, by means of cross holdings disguised by intricate methods, may be able to camouflage their high leverage.

5.4 Conclusion

5.4.1 The boards of banks in India have responsibility for approving and periodically reviewing the loan policies of banks, which cover credit risk policy and strategy. Banks have sound and well-defined credit granting systems. The credit granting criteria include a clear indication of banks' target markets and a thorough understanding of the borrower or counterparty. The purpose and structure of credit, and its source of repayment are also clearly identified.

5.4.2 Systems for monitoring overall composition and quality of credit portfolio and for monitoring individual credits and credit risk-bearing portfolios are in place. Banks ensure that the credit granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Connected lending to their directors or to parties in which the directors are interested are statutorily prohibited. The regulator has also prescribed maximum exposure limits to individual and group borrowers. There are also systems in place to report exceptions to policies, procedures and limits to the appropriate authority. For credits where quality is deteriorating, banks have systems in place for early remedial action.

5.4.3 Through on- and off-site supervisory systems, RBI conducts independent evaluation of a banks' strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio. RBI has issued comprehensive risk management guidelines to banks. However, scientific credit risk management systems are yet to stabilise in Indian banks. Impact of changes in economic conditions on the credit portfolio is not analysed in a sophisticated manner. Further, while there are information systems to measure credit and concentration risks in all on-balance sheet exposures, the attention given to off-balance sheet activities is rather inadequate. Necessary guidelines for interactions with highly leveraged institutions also need to be put in place. It would, therefore, appear that management of credit risk in Indian banks admits of considerable improvement. The banks should be focussing far more on credit risk strategies in their loan policies. RBI may consider guiding banks to more sophisticated risk management concepts in a time bound manner.

Chapter 6

Loan accounting, transparency and disclosures

6.1 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. Practices followed by banks with regard to loan accounting and disclosures relating thereto affect the overall quality of financial reporting and transparency. Towards improving market discipline over banks through better transparency and disclosures, BCBS has brought out three papers laying down sound practices in respect of loan accounting, bank transparency and credit risk disclosures. These are discussed in the following paragraphs.

6.2 Loan accounting

6.2.1 The Group has examined the present system of loan accounting in Indian banks vis-à-vis the sound practices as laid down in the paper on ***Sound Practices for Loan Accounting and Disclosure*** (July 1999) prepared by the BCBS. The evaluation of the Group and its suggestions for further course of action on certain items have been given in Annex 7. The important suggestions made in this regard are described below.

6.2.2 The basis of loan classification in India is currently objective. It is based on record of recovery of interest and principal coupled with current assessment about their realisability. Although, internationally, in most banking systems, an asset is classified as sub-standard after 90 days of payment delinquency, Indian banks have not yet adopted this practice. This is, however, being introduced from the year ending 31 March 2004. The present practice is largely due to the current trade/business practices followed in the country, which permit a long payment cycle. Further, the basis of classification in India is conservative in as much as the value of collaterals is not taken into account for risk classification of loans. However, while creating allowances for doubtful assets, the value of collateral is reckoned at a progressive discount up to three years beyond which there is no further discounting of the value of collaterals. The difficulty with this approach, however, is that if the loan does not migrate to loss category (for which 100 per cent provision is required to be made), the accounts remain under-provided as, up to the end of the third year, on the secured portion of a debt in the doubtful category, the maximum provision created is 50 per cent. This may result in under-provisioning in some cases, a loophole that needs to be plugged in view of the limitations in the legal system in the country for realisation of collateral.

6.2.3 The extant rule-based provisioning requirements need to be tightened and gradually brought at par with the internationally accepted standards in this regard. Within a given timeframe of, say, 3-5 years, the level of provisions on standard assets should be gradually raised to international standards. Similarly, even on the secured portion of doubtful debts, provision beyond 50 per cent will have to be stipulated if the condition and realisabilty of collaterals so demand. Over a period of time, the formulae-based system of classification and provisioning will have to give way to a more closer to reality assessment of the realisabilty of assets, relying on a risk assessment-based system. This changeover will be facilitated as the changes in the legal system reduce delays and make it more efficacious.

6.2.4 For a group of small homogenous loans, banks should be asked to adopt portfolio-based approach and determine impairment on that basis as well. In such cases, a higher provisioning even on standard loans comprising a particular portfolio should be considered.

6.2.5 While, at present, a formulae-based system for provisioning on impaired loans is being followed, the extent of provisioning is not being determined scientifically based on analysis of arrears, ageing of balances, migration analysis or use of various statistical methodologies. While some small private sector banks have made a recent move in this direction, public sector banks constituting more than 80 per cent of the system continue to base their provisioning on the general guidelines given by Reserve Bank of India. Banks should be asked and encouraged to place their system of provisioning on more scientific lines, closer to their own specific actual situation. Now that they have already put a credit risk management system in place, it should not be difficult for them to adopt analytical and statistical methods. Reserve Bank of India should also consider issuing suitable guidelines. Migration to a suitable provisioning system can be achieved in the next two financial years, i.e., by the end of March 2003 and Reserve Bank of India should attempt to lead banks towards that.

6.2.6 In preparing its future guidelines on provisioning, RBI may undertake ratio analysis of relationship of overall provisioning to past due and impaired loans, and to total loans, over time and across institutions. RBI may also, while asking the banks to report to it their respective figures, instruct them to undertake such an analysis on their own and make it a part of their mandatory disclosures.

6.2.7 At present, all banks irrespective of their size, scope and complexity of operations, are required to make the same credit risk disclosures. Reserve Bank of India may take early steps to introduce the concept of materiality in the matter of disclosures. Among other things, banks should be asked to disclose qualitative information on their credit risk management and control policies and practices in the Management's Note to the Balance Sheet. Banks should also be advised to disclose information about significant concentrations of credit risks, business segment-wise general and specific provisions and movement in provisions.

6.3 Enhancing bank transparency

6.3.1 The Group has made an assessment of the current position in regard to bank transparency in India against benchmarks/ principles enunciated in the BCBS 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 further elaboration of the Core Principles relating to bank transparency suggested in the September 1998 paper. A detailed point-wise analysis of the Indian position vis-à-vis the principles is given in Annex 8.

6.3.2 Information on the extent of credit risk faced by banks and the methods used to keep such risks under control are important to market participants to arrive at a judgement on the overall soundness of banks. Disclosures regarding credit risk assume importance in view of this and because of the role of credit risk in bank failures. The BCBS had brought out a paper on ***Best Practices for Credit Risk Disclosure*** (September 2000) "to encourage banks to provide market participants and the public with the information they need to make meaningful assessments of a bank's credit risk profile". The Group's views on the Indian position vis-à-vis these best practices are given in Annex 9. Some of the important observations made in the above two annexes are summarised below.

6.3.3 Considering the growing complexities in product risk profiles and activities of banks, the 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 Group has made its assessments on the basis of observed disclosure practices as well as legal and regulatory stipulations in this regard.

6.3.4 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.

6.3.5 The levels of disclosure in the balance sheets of Indian banks need to be improved further. 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 (ICAI) 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 for RBI to undertake from time to time comprehensive reviews and update the guidelines regularly 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 coordinated approach between the ICAI and RBI may be adopted for this purpose.

6.3.6 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. The areas in which more disclosures are considered desirable are the following: (A) Balance sheet presentation, (B) Internal control and management system, (C) Management of credit risk and (D) Management of risks in general.

A. General balance sheet disclosures

6.3.7 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 and regions to financial performance 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 all 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.

B. Internal control and Management Systems

6.3.8 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 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.

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

(a) broad structure of board committees and membership, senior management structure with responsibilities and reporting lines and the basic organisational structure.

(b) Information on qualifications and experience of the board and senior executives.

(c) Information on incentive structure within a bank, remuneration policies, the use of performance bonuses and stock options.

(d) Summary discussion of the philosophy and policy of executive and staff compensation and the role of the board in setting compensation.

(e) Nature and extent of transactions with affiliates and related parties.

C. Credit Risk Disclosure

6.3.10 Credit risk disclosures are at present uniform and are not adapted to the size and nature of banks' operations in accordance with the materiality concept.

6.3.11 The following disclosures relating to credit are not being made as of now:

(a) qualitative information about the nature of credit risk and description of how credit risk arises in those activities

(b) Information on management, structure and organisation of banks' credit risk management function.

(c) Information on credit risk management and control policies and practices.

(d) Information on techniques and methods for managing past due and impaired assets.

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

(f) Information on use of credit scoring and portfolio credit risk measurement models.

(g) Balances of credit exposures, including current exposure and, where applicable, future potential exposure, by major categories.

(h) Information about credit exposures by major categories of counterparties and by geographic areas.

(i) Information about significant concentrations of credit risk.

(j) Effect of credit risk mitigation techniques, including collateral, guarantees, credit insurance and legally enforceable netting arrangements.

(k) Information in respect of other credit mitigating instruments, such as securitisation, factoring and forfaiting, etc.

(l) Summary of information about contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.

(m) Summary of information about the internal rating process and the internal credit ratings of its credit exposures.

6.3.12 Exposure to sensitive sectors such as real estate and capital markets are being disclosed. Banks also disclose the extent of lending to the priority sector. However, banks may also be advised to disclose business line-wise exposure which is not being done as of now.

6.3.13 While provisions made during the year are disclosed, these are not being classified by asset category. Information on cumulative provisions held against bad assets are also not being disclosed.

D. Management of Risks

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

(d) 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.

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

(f) 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.

(g) 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.

(h) 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.

Management's letter/Directors' report to the shareholders

6.3.15 Effective market discipline requires that the management's letter/ directors' report to the shareholders contain certain minimum levels of disclosure. Among other things, detailed discussions on operational, legal and strategic risks may be made mandatory in such letters/reports to the shareholders. Similarly, details about the diversity of funding options and contingency plan should form part of the management's letter on managing liquidity risks.

6.4 Conclusion

6.4.1 Basic guidelines for classification of loans have been provided by RBI. In addition, banks have their own documented policies of loan classifications which are formulated with the RBI guidelines as the base. The policies are well documented and objectively followed. While the value of judgements in risk classification of loans is not denied, their role in the process is limited and not pronounced.

6.4.2 The exercise of accounting/classification of loans into four categories is carried out on an on-going basis and for the purpose of valuation, allowances (provisions) are created at the time of yearly closing of balance sheet. Banks also have proper internal control systems approved by the boards for recording, documentation, loan review procedures, etc.

6.4.3 The selection and application of accounting policies and procedures by Indian banks conform to fundamental accounting concepts. Banks identify and recognise impairment in a loan on an on-going basis primarily based on record of recovery. Availability of collateral is not considered while recognising impairment of loans since the legal system in India is at present not conducive for effective enforceability of lenders' rights. However, banks have been given certain flexibilities in respect of loans which are restructured.

6.4.4 The present provisions are rule-based and as of now, not so much based on analytical and statistical methods. These, therefore, tend to be ad hoc and do not always bear close relationship with the realisable value of assets. RBI's risk management guidelines require banks to set up a loan review mechanism for determining, inter alia, the adequacy of loan loss provisioning.

6.4.5 Banks in India are making standard disclosures as per the guidelines given by RBI. While the quality and extent of disclosures have been gradually improving, and the management note to

the balance sheet is now expected to cover a number of areas about which disclosures have not been made in the past, generally qualitative changes in the portfolio including its credit quality do not yet form part of disclosures.

6.4.6 Banks disclose information on their accounting polices, practices and methods used to account for loans and determine specific and general allowances. An impaired loan is restored to accrual status only when it has returned to unimpaired status unless if it has been restructured. Through on-site inspection and off-site returns, RBI evaluates banks' policies and practices for assessment of loan quality based on the regulations set by it. RBI also satisfies itself that the methods employed by banks to calculate provisions are as per its guidelines.

6.4.7 There are, however, no disclosures in respect of several key areas such as detailed breakup of income and the contribution of various regions and business lines to financial performance. In respect of credit, the gaps include information on concentrations of credit, recourse arrangements and expected losses from such arrangements, movement in provisions, impaired and past due loans by geographical regions and by major categories of borrowers and provisions against each category, and credit risk management and control policies and practices.

6.4.8 The progress in efforts on promoting high quality disclosure standards will have to be gradual but sustained. RBI has been adopting such an approach in moving towards international loan accounting, transparency and disclosure standards. While there will be some key disclosures which must find place in the balance sheets of all banks as prescribed by RBI, individual banks should be encouraged to make additional and innovative disclosures which they consider relevant to their business and balance sheet. It, however, needs to be ensured that a beginning is made with disclosures that are more relevant in our context than with those which are sophisticated and have relevance only in a very complex situation. A gradual process of increasing disclosures needs to be followed so that key elements always remain in focus.

Chapter 7

Financial Conglomerates

7.1 Supervision of Financial Conglomerates

7.1.1 Financial conglomerates are groups of companies engaged in banking and other activities, such as securities and insurance businesses which have been traditionally, by legislation, regulation or otherwise, kept separate in many countries. Issues relating to supervision of financial conglomerates have assumed importance in recent years with the gradual removal of barriers between these businesses. Consolidated supervision has become an essential tool for supervision of financial conglomerates and the practice of the same on an ongoing basis has been listed as one of the "Core Principles for Effective Banking Supervision" by the BCBS.

7.1.2 The main supervisory concerns in respect of financial conglomerates are the following: (a) the risk of contagion from non-banking entities which are members of the group and may or may not be regulated, (b) risk of excessive exposure to such financial conglomerates (c) transparency of legal and managerial structures, (d) quality of management in individual units and across the group, (e) access to and sharing of prudential information (f) consolidation of financial reports and (g) moral hazard arising from the impression that non-regulated entities are also being monitored.

7.1.3 Such issues have been addressed during the last decade by the BCBS, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). A Joint Forum on Financial Conglomerates (Joint Forum) was established in 1996 under the aegis of these bodies. The Joint Forum, after a series of consultations with various interested parties, brought out papers covering subjects it considered critical in the context. The subjects covered in the papers referred to above were:

a. Capital Adequacy Principles
b. Supplement to the Capital Adequacy Principles
c. Fit and Proper Principles
d. Framework for Supervisory Information Sharing
e. Principles for Supervisory Information Sharing
f. Identification of 'Coordinator' and Principles of Coordination
g. Supervisory Questionnaire

The Joint Forum's focus has been, primarily, on diversified financial firms with complex organisational and management structures whose large scale activities cross national and sectoral boundaries. The above papers have been published as ***Supervision of Financial Conglomerates*** (February 1999).

7.1.4 The 'Capital Adequacy Principles' paper outlines measurement techniques and principles to facilitate the assessment of capital adequacy on a group-wide basis for financial conglomerates. The Supplement to this paper illustrates situations that can be faced by supervisors in practical applications of the measurement techniques. The 'Fit and Proper Principles' paper provides guidance to ensure that supervisors of entities within a financial conglomerate are able to exercise their responsibilities of assessing whether those entities are soundly and prudently managed. The 'Framework for Supervisory Information Sharing' paper

sets out a general framework for facilitating information sharing between supervisors of regulated entities within internationally active financial conglomerates. The 'Principles for Supervisory Information Sharing' paper provides to supervisors involved in the oversight of regulated financial institutions residing in financial conglomerates guiding principles with regard to supervisory information sharing. The 'Ten Key Principles on Information Sharing' issued by the G-7 Finance Ministers in May 1998 which complement the principles of the Joint Forum are annexed to this paper. The 'Coordinator' paper provides guidance to supervisors for identification of coordinator/coordinators and principles for coordination in emergency and non-emergency situations. The 'Supervisory Questionnaire' is a tool to assist supervisors in better understanding each others' objectives and approaches. The present Indian position with regard to the principles set forth in the above papers (excluding the Supplement to the Capital Adequacy Principles paper and the Supervisory Questionnaire) is given at Annex 10. The main points arising therefrom are summarised below.

7.1.5 Consolidation of accounts and presentation of consolidated financial results of all group entities is still not essential under the generally accepted principles of accounting in India. The emergence of financial conglomerates with regulated entities engaged to a significant extent in atleast two out of the three activities of banking, insurance and securities business is rather recent in India. Principles and systems for their regulation as entities in a conglomerate and for coordination between the concerned different regulators are also to be developed as yet. Urgent attention would need to be paid to develop suitable mechanisms in order to detect and provide for situations of double gearing and other similar problems posed by financial conglomerates.

7.1.6 Generally, existing regulations ensure that unregulated entities do not normally exercise material or controlling influence on operations of regulated entities. However, in the absence of any clear guidelines or established practices on this issue, the approach adopted in this regard is not uniform. RBI should, therefore, ensure that fitness, propriety or other qualification tests are applied to managers and directors of other unregulated entities in a conglomerate if they exercise or can exercise a material or controlling influence on the operations of regulated entities.

7.1.7 Shareholders with shareholding beyond a threshold, say 10 per cent, are often in a position to exert material influence on regulated entities. The regulator, however, does not, as a matter of uniform policy apply any fitness, propriety or qualification tests on all such shareholders. Considering the potential of risk contained in such a situation, it would be desirable to put in place arrangements for applying fit and proper tests on all shareholders with shareholdings beyond a specified threshold say 10 per cent. Suitable legal provisions would need to be introduced in the Banking Regulation Act empowering RBI clearly in this regard.

7.1.8 Fitness, propriety or other qualification tests need to be applied on a continuous basis so that occurrence of any event which raises any doubt about fitness and propriety of a manager, director or a shareholder (with shareholding beyond a specified level), results in the test being applied.

7.1.9 It needs to be ensured that supervisors communicate with the supervisors of other regulated entities within the conglomerate when managers, directors or key shareholders are deemed not to meet their fitness, propriety or other qualification tests. Arrangements for exchange of information between all regulators involved in regulation of different entities in a conglomerate should be formalised.

7.1.10 RBI may consider introducing the concept of primary supervisor. In the context of almost all major banks going in for insurance as well as securities business, designating one of the

supervisors as the primary supervisor will substantially improve much needed coordination between different supervisors (regulators) and add to the scope and quality of the overall supervision of the conglomerate.

7.1.11 RBI shares information with other supervisors more with the force of set practices and conventions than with the support of clearly stated legal provisions. In order to place the arrangement on firmer footings and in keeping with the currently accepted international practices the desirability of suitably enacting these powers needs to be considered.

7.1.12 The emergence of conglomerates on the Indian business/finance scene is recent. But soon regulation and supervision of different entities in a conglomerate by different regulators will be a common occurrence and practices like designating a coordinator for information sharing will have to be considered in the interest of comprehensive regulation and safety and security of the system as a whole. The advent of MNCs many of which are large conglomerate, will accentuate this need. RBI may urgently consider the desirability of introducing and participating in a scheme of formalised coordination between different regulators and designation of one of the regulators involved as a coordinator with clearly assigned roles and responsibilities.

7.2 Risk Concentrations Principles

7.2.1 The structure of financial conglomerates gives rise to the possibilities of excessive risk concentrations. The BCBS has put forward certain principles in this regard in its paper on ***Risk Concentrations Principles*** (December 1999). The Group's views with regard to the position in India vis-à-vis these principles are given in Annex 11. The main points arising therefrom are summarised below.

7.2.2 RBI should consider issuing appropriate guidelines requiring banks to ensure that they and their subsidiaries and joint ventures put in place adequate risk management processes covering group-wide risk concentrations as well. It would also be useful to stipulate norms for concentration and exposure limits in respect of all associated entities on solo as well as consolidated basis. It is considered essential that the supervisor develops a clear understanding of the risk concentration at the conglomerate level. This issue would need to be pursued through the regulated entities.

7.2.3 To ensure that financial conglomerates have controls in place to manage their risk concentrations, RBI may issue instructions to banks to ensure that their up-stream and down-stream units have appropriate controls in place to manage their risk concentrations. For such controls to be effective, it is preferable to prescribe limits linked to the unimpaired regulatory capital of the bank.

7.2.4 Comprehensive management information and reporting system at the conglomerate level would have to be insisted upon by RBI to build a sound risk management approach. Conglomerates should have in place a process to identify their principal risks, a comprehensive measurement system, a system of limits to manage large exposures and other risk concentrations and processes of stress testing and scenario and correlation analysis.

7.2.5 Disclosure in respect of risk concentrations should be made mandatory. However, the process of disclosure on risk needs to be gradual so that key elements remain in focus. Suggestions in this regard have been given while examining issues involved in enhancing bank transparency. RBI may also consider requiring banks to make public the management's assessment of risk concentrations across sectors on a group-wide basis.

7.2.6 While the type of information usually provided in the annual report and management or director's report to the market or supervisors generally allow the users to arrive at meaningful inferences in regard to financial condition, solvency, earnings performance and brief risk profile, such disclosures on a consolidated basis are currently not mandatory. RBI currently requires banks to only append the financial statements in respect of subsidiaries/ joint ventures along with the financials of the parent unit.

7.2.7 Some arrangements for information sharing between domestic regulatory bodies exist. However, notwithstanding mechanisms for coordination having been established, the level of actual coordination is not very high and seldom provides the regulators opportunities to take coordinated supervisory actions. Urgent steps are required to be taken so that coordination between different regulators is of a high order and enables them to take coordinated supervisory action, particularly in the area of risk management by the different entities of a conglomerate. The range and scope of information exchange among sectoral supervisors needs to be made broader and multi-point. It would also be useful to have a structured agenda so that all material issues with cross-sectoral implications receive appropriate attention.

7.2.8 At present RBI has not articulated a general approach on how to deal with risk concentrations at the group level apart from issuing guidelines to banks to have arms length relationship in their commercial transactions with subsidiaries. RBI may consider including material risk concentrations at the conglomerate level as one of the possible triggers for corrective action under the framework of Prompt Corrective Action (PCA) which it is developing.

7.3 Intra-Group Transactions and Exposures

7.3.1 The Joint Forum of the BCBS, IOSCO and IAIS had, brought out in December 1999, a paper on ***Intra-Group Transactions and Exposures Principles*** "to provide banking, securities and insurance supervisors principles for ensuring through the regulatory process the prudent management and control of intragroup transactions and exposures by financial conglomerates". While Intra-Group Transactions and Exposures (ITEs) are a source of synergy within groups that reduce costs and enhance profits, they are also a potential source of contagion. The principles enunciated by the Joint Forum are aimed at enabling supervisors ensure an appropriate balance between the benefits and risks of ITEs. The Group's views on the adherence by the Indian system to these principles, to the extent they are applicable, are given in Annex 12. The main points are summarised below.

7.3.2 ITEs are at present not subject to compulsory public disclosure. In the interest of effective consolidated supervision and for ensuring due transparency in the dealings between the units of a conglomerate, public disclosure of ITEs should be made compulsory. Suitable regulations as well as accounting principles would need to be put in place to ensure such disclosure.

7.3.3 Risk management systems that are being put in place in banks need to take into account the special risks posed by ITEs. Systems need to be put in place to monitor material ITEs of the regulated financial entities on a timely basis, as needed, through regular reporting or by other means to help form a clear understanding of the ITEs of the financial conglomerate.

7.4 Coordination amongst supervisors

7.4.1 Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate. Close coordination and liaison between supervisors is a

precondition for effective supervision over regulated entities individually as well as over the groups these entities comprise. Mechanisms aimed at ensuring full coordination and free flow of information between different regulators needs to be put in place urgently.

7.5 Conclusion

7.5.1 The banking system in India is fast moving towards more complicated organisational structures, on account of which key aspects of institutional cross holdings and other sources of potential risk may not be apparent. It is, therefore, necessary to put in place policies and systems for systematic sharing of information among the supervisors. The other initiatives required relate to consolidated supervision, ensuring availability of reliable, timely and comprehensive MIS and reporting requirements in the institutions, introduction of scientific risk management systems and practices, public disclosures of risk concentrations and appointment of coordinators amongst supervisors to facilitate information sharing and coordinated supervisory initiatives.

Chapter 8

Cross-border Banking

8.1 Context

8.1.1 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 in 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 Basel Concordat of 1975 issued by the BCBS.

8.1.2 In the wake of further instances of bank failures, a revised Basel 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.

8.1.3 In the wake of the failure of the Bank for Credit and Commerce International (BCCI) in 1991, 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 BCBS brought out the "Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments".

8.1.4 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 to ensuring the soundness of individual credit institutions and the stability of the financial system as a whole".

8.1.5 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 Basel 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)

8.1.6 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 Annexes 13 to 16 respectively.

8.2 Cross-border supervision in the Indian system

8.2.1 The Group's major observations relating to deviations or gaps in the Indian system vis-à-vis international standards in respect of cross-border supervision 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

Nature of supervision

8.2.2 While supervising the branches of foreign banks operating in India, RBI looks mainly at the solvency of the branch. However, the solvency of the parent bank needs to receive a more pointed attention of a host country even if responsibility to monitor it is only general. Further, in the case of Indian subsidiaries of foreign banks engaged in activities not coming within the purview of Reserve Bank of India, the liquidity position of such subsidiaries is not monitored by RBI. It would thus appear that 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 proactive and focused policy. With the growing complexities of an internationally integrated financial market this aspect of supervision merits much more attention than it has received so far.

8.2.3 The principle of consolidated supervision being unexceptionable, Reserve Bank of India 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 coordinate their approaches shall have to be developed. RBI is, at present, not exercising its supervision on a consolidated basis although it has begun moving in that direction. Even at this stage, it needs to pay more attention to the operations of the subsidiaries of the entities it supervises whether or not their accounts are consolidated with that of the parent entity. RBI should also begin encouraging Indian banks and foreign entities operating in India to submit to consolidated supervision.

8.2.4 Although Reserve Bank of India's current supervisory stance aims at exercising comprehensive and consolidated supervision of the global activities of the Indian banks, 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 such legal or other hindrance to the parent supervisors from other countries conducting such inspections of the Indian branches of banks under their supervisory jurisdiction. Since reciprocity in these matters is important, country-wise analysis will have to be undertaken and suitable action taken where RBI faces

constraints in its efforts to exercise consolidated supervision of the global activities of Indian banks.

8.2.5 The Group is of the view that RBI should have greater interaction with the home supervisors of foreign banks operating in India. It is presently not insisting on separate approvals of the home country supervisors of a foreign bank for every new branch which that bank 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 may consider the desirability of following the recommended approach as it will provide it with an opportunity to share with the home supervisors their latest views on the foreign entity under its supervisory charges in India.

8.2.6 Commonality of approach between the home and the host supervisors of supervised entities enables both the supervisors to exercise better supervision and helps them manage risks more comprehensively. Also, adequate information about the methods and standard of supervision of the counterpart supervisor helps the other concerned supervisor in calibrating and adjusting its own supervisory methodologies and standards in relation to the common supervised entity. It is, therefore, recommended that RBI may consider reviewing as a matter of regular practice the supervisory systems and standards of host supervision in countries where Indian banks have a presence.

8.2.7 RBI could supplement its own supervisory mechanism by using external auditors to look specially into certain selected areas and report to it independently. This it can do both in its capacity as the home and the host supervisor.

Information sharing

8.2.8 Host supervisors often remain inadequately informed about the parent bank's difficulties. It is, therefore, necessary that a more comprehensive system of information sharing based on mutuality and reciprocity be established.

8.2.9 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 relating to the internal controls exercised by the concerned head offices of foreign banks operating in India, more information in regard to the quality of control exercised by their head offices is desirable. RBI may clearly convey to the home country supervisor its expectations about receiving from the home supervisor, information about the extent and quality of control maintained by the head office over its branches operating in India.

8.2.10 RBI does not receive at present 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 its own supervisory concerns. The parent supervisors need to define and share with the host regulators 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 supervisors to them. In order to make this practice effective, the two supervisors would need to come to some kind of mutual agreement so that their perceptions 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.

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

8.2.12 Without full reciprocity between supervisors on the issue of sharing information, its flow may become very uneven making cross-border supervision difficult. Unhindered and unqualified exchange of information between the home and the host supervisor may be prescribed by RBI as a precondition for permitting a bank to open offices abroad.

8.2.13 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 be 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.

Suggested changes and timeframe

8.2.14 The suggested changes and areas where action needs to be initiated are highlighted below. An estimated timeframe within which such action could be completed is indicated.

	Suggested changes/areas for action	**Timeframe**
(a)	Establish arrangements for greater interaction with the controlling office (not only the immediately superior office) and the home regulator.	Within one year
(b)	Insist on consolidated supervision which will include a review of accounting standards and regulatory provisions.	Within two years
(c)	Undertake country-wise review to address constraints in countries where local laws do not permit the home supervisor (RBI) to conduct onsite inspection/ examination of records.	Within one year
(d)	Review supervisory systems and standards of host supervision where Indian banks have a presence.	Within six months
(e)	Use external auditors to look into select areas and for reporting independently to the supervisor.	Within six months
(f)	Insist upon approvals of the respective home country supervisor(s) of the bank and the bank's group before granting permission to opening of each branch by a foreign bank.	Within six months
(g)	Establish comprehensive system of information sharing based on	Within one

	mutuality and reciprocity.	year
(h)	Have in place strict legal provisions to ensure confidentiality of supervisory information.	Within one year

8.3 Conclusion

8.3.1 In the changing world-wide scenario of banking, particularly in the context of the growing integration of markets, there is now an overall need to further strengthen the system of cross-border supervision. There must be greater interaction, information sharing, understanding and mutuality between the home office supervisor and the host supervisor so that there is full understanding of the overall operations of the supervised entity on both sides.

8.3.2 For RBI, the main concerns in the area of cross-border supervision relate to sharing of information with 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. However, the Group is of the considered view that as at present the differences observed from the internationally accepted best practices do not dilute the principles of sound cross-border supervision significantly and are such that can be upgraded to match the international levels within a reasonable timeframe.

Chapter 9

Conclusion

9.1 Levels of compliance with standards and codes cannot be considered in a vacuum. These are bound to vary depending upon the prevailing statutes and legal systems, institutional infrastructure and, above all, the thrust and direction of a country's economic and social policies. Thus, for countries which are in earlier stages of development, several of the standards may not be relevant. This has been the Group's finding also while assessing the overall compliance in India vis-à-vis the various principles discussed in this report. However, considering that the operating environment of the banking system in India is fast acquiring the same levels of sophistication as those available in more advanced countries, with progressive deregulation and sustained globalisation, it would be necessary for the system to move towards the best practices available in such countries. Towards this end, keeping in view the likely changes in the immediate future, necessary rules and regulations and standards of supervision that would foster sound banking should be in place. This would instil greater confidence not only among the domestic deposit holders and investors but also among the foreign investors to enhance prospects of business and investment. The Group is of the considered view that, given the level of complexity and development of the Indian banking sector, the level of compliance with the standards and codes is of a high order. Wherever there are significant gaps, these can be remedied within a reasonable timeframe and, as such, are not causes for immediate concern provided that necessary amendments to laws, wherever required, are put in place without delay.

9.2 By the very nature of its assessment, the Group's recommendations are quite detailed and do not lend themselves easily to condensation. The Group's detailed recommendations are available in the various chapters of this report and the annexes thereto and, therefore, no attempt has been made to summarise them here. As the Group's assessment is confined to the position in respect of commercial banks (other than Regional Rural Banks), separate examination would be required in respect of regulation and supervision of cooperative banks, Regional Rural Banks and Local Area Banks vis-à-vis the standards to the extent they are relevant and applicable.

Corporate governance

9.3 Corporate governance in banks and financial institutions has been the focus of attention in the past few years although the predominantly public sector character of the banking sector has often blurred this focus. However, the Group feels that the nature of a bank's ownership should not be a critical factor affecting the type and quality of corporate governance. The quality of corporate governance should be the same in all types of banking organisations irrespective of their ownership. There must be minimum benchmarks and acknowledged best practices which all banks must achieve. Beyond this benchmark, the extent of compliance with the standards and quality of corporate governance may vary from bank to bank depending upon the efficiency and approach of their respective managements and boards.

9.4 In the short run, it needs to be ensured that the directors on the boards of banks are conversant with complex issues such as risk management that banks need to tackle and that they are not overcommitted elsewhere. Separate committees for risk management, compensation and nominations would increase their effectiveness. While setting accountability standards for boards, there is also a need for enhanced transparency and disclosures in respect of various aspects of boards' constitution and functioning.

Management Information System

9.5 The quality and timeliness of MIS in most of the banks in the public sector and some in the private sector leave much scope for improvement. Low level of computerisation and absence of networking is largely responsible for data quality issues in MIS. The quality of MIS is at present an area of potential risk both from the point of view of internal control and regulatory oversight. It would be necessary to strengthen the MIS and data collection machinery in banks to ensure integrity and reliability of data. This is also necessary for banks to move towards more sophisticated means of managing the risks inherent in their functioning.

Risk Management

9.6 A recurring theme in this report is the need to put in place scientific risk management systems in banks. RBI has issued comprehensive risk management guidelines to banks in terms of which they are required to identify and assess all business and operational risks and formulate and put in place appropriate risk management systems. Scientific risk management is, however, still in the initial stages in most of the banks, particularly the old private sector and public sector banks. The current situation calls for greater orientation of the banks' managements and their boards towards a better understanding of risks and their management. Banks are handicapped in implementing a reliable credit rating and other risk management systems due to (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.

9.7 It will take another three to five years before the whole banking system can expect to come to the expected level of risk management. This presupposes extensive computerisation and the right kind of MIS. Banks would need to build historical databases on the portfolio quantity and provisional/charge off so that they equip themselves to price the risks properly. It is desirable that some of the more capable and better equipped banks are advised to expedite the process of transition from elementary levels of risk management to levels of greater sophistication. They may be encouraged to obtain external expert assistance, e.g., from consultants, so that, wherever necessary, the available in-house expertise is supplemented and the process gets hastened. Such banks, acting as forerunners, could act as models for other banks to follow.

Loan accounting

9.8 In the past decade, considerable progress has been made in the management of NPAs, asset classification and provisioning therefor. Still much requires to be done. The extant rule-based provisioning requirements need to be tightened and gradually brought at par with the internationally accepted standards in this regard. Over a period of time, the formulae-based system of classification of assets and provisioning will have to give way to a more realistic assessment of the realisability of assets, relying on a risk assessment-based system. However, a system of provisioning based on risk assessment as regards the realisability of a debt and the value of collaterals held thereagainst can take root only if the present lacunae in the relevant legal provisions and the system itself, which make it debtor friendly, are removed.

Transparency and disclosure

9.9 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 increase the intrinsic fragility of individual banking institutions apart from bearing seeds of system disturbances. There are quite a few areas of banks' operations disclosures regarding which are yet minimal or absent. A fair

beginning has been made in this regard but the applicable accounting standards as also the approach to the banks towards disclosures will have to be changed for achieving greater transparency which the market participants look for.

9.10 At present, all banks irrespective of their size, scope and complexity of operations, are required to make the same credit risk disclosures. There is need for introducing the concept of materiality in the matter of disclosures. Among other things, banks should be asked to disclose qualitative information on their credit risk management and control policies and practices in the Management's Note to the Balance Sheet. Banks should also be advised to disclose information about significant concentrations of credit risk, business segment-wise general and specific provisions, movement in provisions and cumulative provisions held against impaired assets. These and similar other disclosures relating to credit risk should be made mandatory in the interest of good governance and a satisfactory credit discipline. There is also need for disclosures on transactions with affiliated and related parties and large shareholders.

9.11 Efforts have to be made to come close to internationally followed standards of Balance sheet/Accounting disclosures within the next two to three years. Reserve Bank of India may take the Institute of Chartered Accountants of India (ICAI) into confidence and consider issuing comprehensive guidelines on necessary disclosures in banks' balance sheets.

Internal Control

9.12 The inability 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 banks. Increasing frauds and deficiencies in follow-up are manifestations of the risk intensifying. The management's letter/Director's report should, therefore, contain a statement on the issue along with a statement on the sufficiency of the technology used by the bank and fall back positions in the event of their failure.

9.13 Boards of most banks, particularly public sector banks would need to undergo an attitudinal change towards such evaluations/reviews so that they have a better and firmer say in the maintenance and improvement of internal control systems in the banks. Indepth discussions on periodic reports on internal controls systems of banks between the management and their boards should be institutionalised. Monitoring of key risks by the senior management on a day to day basis has yet to be accepted in Indian banks as a part of the normal daily operations excepting in the case of market risks for the treasury related transactions. RBI, on its part, may consider taking steps so that on-site inspections are individualised and more bank-specific in its approach. RBI may also consider leveraging the findings/reports of the external auditors of banks by even engaging them for specific area audit/inspection of banks and utilise their reports for supervisory oversight as is done by some other regulators.

Supervision of Conglomerates

9.14 The emergence of financial conglomerates is rather recent in India. Consolidation of accounts and presentation of consolidated financial results of all group entities is still not essential under the generally accepted principles of accounting in India. Principles and systems for their regulation as entities in a conglomerate and for coordination between the concerned different regulators are also to be developed as yet. Urgent attention would need to be paid to develop suitable mechanism in order to detect and provide for situations and double gearing and other similar problems posed by financial conglomerates.

9.15 The present regulatory regime in India is such that unregulated entities cannot normally exercise material or controlling influence on operations of regulated entities. However, there are no unambiguous legal provisions or regulations in place effectively barring this eventuality. RBI should, therefore, ensure that fitness, propriety or other qualification tests can be applied to managers and directors of other unregulated entities in a conglomerate if they can or there is any possibility of their exercising a material or controlling influence on the operations of regulated entities. It would be desirable to put in place arrangements for applying fitness, qualification and propriety tests on all shareholders with shareholdings beyond a specified threshold. Suitable legal provisions would need to be introduced in the Banking Regulation Act empowering RBI clearly in this regard.

9.16 In order to ensure coordination amongst the supervisors of the different entities in the conglomerate introduction of the concept of 'primary supervisor' may be considered. Designating one of the supervisors as the primary supervisor will substantially improve much needed coordination between different supervisors (regulators) and add to the scope and quality of the overall supervision of the conglomerate.

Cross-border Supervision

9.17 In the changing world-wide scenario of banking, there is an overall need to strengthen further the system of cross-border supervision. A full understanding of the overall operations of the bank involved is considered necessary. Without objective reciprocity on the issue of sharing information between supervisors, information flow may become very uneven. Provision of unhindered and unqualified access to information to the home supervisor may be made a condition for permitting a bank to open offices abroad. Country-wise analyses will have to be made to ensure reciprocity between home supervisors in sharing information on certain qualitative aspects of the business undertaken by branches and subsidiaries of banking organisations outside the jurisdiction of their respective home supervisors.

Future direction of supervision

9.18 For the future, the regulators in India would have to guide the system forward to meet international standards in respect of transparency, market discipline, corporate governance standards and advanced risk management practices. There would be need for greater coordination between supervisors across borders and within the country. Effective supervision of financial conglomerates, which would become a part of the banking landscape in the near future, would require that such coordination is based on formal arrangements which may include appointment of separate coordinators and, where considered necessary, primary regulators, for each group. The methods of supervision would have to become increasingly risk-based with greater reliance on the boards of banks themselves and the external auditors. Supervision which moves along this direction would pave the way for a healthy and sound banking system.

Chapter 10

Summary of major recommendations

10.1 The Group's recommendations are fairly detailed and do not lend themselves easily to condensation. However, the major recommendations, which, in the opinion of the Group, needs to be highlighted are listed below:

(a) Core Principles

(i) Powers to RBI to decide on capital requirements on a case by case basis needs to be clearly defined in law. (Paragraph 0)

(ii) A stricter review of the proposed arrangements and standards for internal control as well as the management's philosophy and business objectives at the pre-licensing stage of banks will greatly mitigate possible hazards during the operational stages. (Paragraph 0)

(iii) RBI should apply stricter norms for the 'fit and proper' test while evaluating directors and the quality of the board. (Paragraph 0)

(iv) While fixing the definition of "substantial interest" at a higher level, it would be desirable to require banks to obtain the prior approval of the supervisor for any proposed changes in ownership or exercise of voting rights over the 'threshold'. (Paragraph 0)

(v) Forbearance in taking measures against banks that fail to meet minimum capital adequacy ratios cannot be long term and specific measures against such banks need to be stipulated in the interest of the overall soundness of the system. (Paragraph 0)

(vi) RBI should also gradually move towards setting bank specific capital ratios based on their individual risk profiles. (Paragraph 0)

(vii) RBI may assist and guide banks in their efforts to stabilise advanced risk management systems. Larger and more capable banks may be encouraged to complete the process early so that they can act as leaders and models for the smaller and not so well equipped banks. (Paragraph 0)

(viii) A system for classification of off-balance sheet items on the lines of the extant system of classification of funded exposures should be put in place and a note to that effect provided in banks' financial statements. (Paragraph 0)

(ix) RBI may consider issuing suitable detailed instructions requiring banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral. (Paragraph 0)

(x) "Closely related groups" need to be explicitly defined and the supervisor should have the discretion, prescribed in law, in interpreting the definition on a case by case basis. (Paragraph 0)

(xi) RBI may consider issuing instructions to the effect that loans to connected and related parties which are not fully collateralised may be deducted from banks' capital to the extent that they are not collateralised. (Paragraph 0)

(xii) Banks should be instructed to monitor the total amount of loans to connected and related parties and introduce an independent credit administration process. Limits on aggregate exposures to connected and related parties by a bank need to be established. (Paragraph 0)

(xiii) Advanced risk management capabilities must be in place in all banks latest by the end of the financial year 2002-2003. RBI may assist banks in hastening introduction of the more scientific and sophisticated risk management systems. (Paragraph 0)

(xiv) Banks should be required to include a statement on their risk management policies and procedures in their publicly available documents. (Paragraph 0)

(xv) A more formal and rigorous assessment of the boards' performance must be undertaken by the regulator. The regulator should adopt rating of the boards' performance with the provision that, if the rating falls below a certain specified level, prompt corrective action should be triggered. (Paragraph 0)

(xvi) In the context of globalisation and ever increasing domestic and cross-border flows of funds, the implementation of "Know Your Customer" guidelines should be verified by the supervisor and adherence thereto made more stringent. (Paragraph 0)

(xvii) RBI should consider moving over to a risk-based approach to supervision as early as possible. (Paragraph 0)

(xviii) Quality of management needs to be given greater weightage in supervisory assessments. (Paragraph 0)

(xix) RBI may consider introducing meetings with banks' boards and external auditors in the interest of greater involvement of the board with supervisory concerns and actions in order to enrich the scope of examination of banks. (Paragraph 0)

(xx) RBI may consider using independent and well qualified external auditors to examine specific aspects of banks' operations. (Paragraph 0)

(xxi) The move towards consolidated accounting and supervision needs to be expedited. Steps need to be taken so that necessary legal provisions are introduced and banks are required to prepare consolidated accounts. (Paragraph 0)

(xxii) RBI may impress upon the government the need and urgency of achieving and maintaining a high level of coordination among different regulators. (Paragraph 0)

(xxiii) The public sector character of banks remains an important consideration in the supervisor deciding upon and initiating sanctions and/or penalties on banks. RBI should consider introduction of measures by which clear accountability can be fixed on individual directors and/or the board of directors for non-performance and/or negligence of their duties. (Paragraph 0)

(xxiv) The range of possible actions available to RBI should include imposition of conservatorship which can enable a bank in difficulty to gain some time until it completes remedial measures. (Paragraph 0)

(xxv) A suitable legal provision obliging the statutory auditors of banks to report on matters of material significance to the regulators will strengthen the supervisory regime. (Paragraph 0)

(xxvi) RBI should practice consolidated supervision over internationally active banking organisations of which it is the home country supervisor. RBI should endeavour to get into formal relationship with host country supervisors on the basis of MoUs. (Paragraphs 0 to 0)

(b) Corporate governance

(i) The quality of corporate governance should be the same in all types of banking organisations irrespective of their ownership. (Paragraph 0)

(ii) The process of induction of directors into banks' boards and their initial orientation may be streamlined. (Paragraph 0)

(iii) Banks need to develop mechanisms which can help them ensure percolation of their strategic objectives and corporate values throughout the organisation. (Paragraph 0)

(iv) Boards need to set and enforce clear lines of responsibility and accountability for themselves as well as the senior management and throughout the organisation. (Paragraph 0)

(v) Linkage between contribution and remuneration/reward should be established. Compensation Committees of the board could be set up for the purpose. (Paragraph 0)

(vi) Nomination Committees to assess the effectiveness of the board and direct the process of renewing and replacing board members are desirable. (Paragraph 0)

(vii) Disclosures in respect of committees of the board and qualifications of the directors, incentive structure and the nature and extent of transactions with affiliated and related parties need to be encouraged. (Paragraph 0)

(viii) A provision on the lines of Section 20 of the Banking Regulation Act, 1949, which prohibits loans and advances to directors and their connected parties, will have to be made in respect of large shareholders also. Information on transactions with affiliated and related parties should be disclosed. (Paragraph 0)

(ix) There is some overlap in the role of the Reserve Bank of India as owner/owner's representative and as the regulator/ supervisor, which should be corrected. (Paragraph 0)

(x) Government ownership of banks is not conducive to any serious and urgent corrective action by the regulator. (Paragraph 0)

(c) Internal control

(i) Boards of banks, should modify their approach towards on internal controls so that they have a firmer say in the maintenance and improvement of internal control systems. Discussions between the managements and boards of banks on quality of internal control systems should be institutionalised. (Paragraph 0)

(ii) The boards of banks should specifically pay attention to creating and sustaining a culture of control in banks. (Paragraph 0)

(iii) There is need for greater orientation of the bank's managements and their boards towards better understanding of risks and their management. (Paragraph 0)

(iv) RBI may consider outlining clearly the role of the boards of banks in risk management. Risk-based supervision of banks by RBI has to be mirrored in their boards' supervision and guidance. (Paragraph 0)

(v) Evaluation of risks affecting banks' strategies and objectives by the senior management has to be continuous and should be placed on a formal basis. Such evaluations of risk management system and internal controls help in addressing appropriately any new or previously uncontrolled risks. (Paragraph 0)

(vi) An assessment of the control environment and the involvement of the top management in fostering a strong control culture should form an important part of the on-site supervisory process. (Paragraph 0)

(vii) The quality of MIS is an area of potential risk both from the point of view of internal control and regulatory oversight. It needs to be identified as such. (Paragraph 0)

(viii) More awareness needs to be promoted among senior management in regard to security, risk and controls in computerised environment. (Paragraph 0)

(ix) RBI may consider taking steps so that on-site inspections are made more bank-specific. (Paragraph 0)

(x) RBI may consider the practice of engaging external auditors for specific area audit/ inspection of banks and utilise their reports for supervisory oversight as is done by some other regulators. (Paragraph 0)

(d) Credit Risk

(i) The gaps with regard to monitoring of credit risk relate to the formulae-based determination of loan loss provisions, a somewhat lenient approach to off-balance sheet activities and inadequate attention to the impact of changes in the economic scenario on banks' credit portfolio under stressful conditions. (Paragraph 0)

(ii) Banks need to improve their MIS as well as the credit risk management systems and strategies within as short a timeframe as possible. (Paragraph 0)

(iii) Banks must establish a system of independent, ongoing assessment of their credit risk management processes and the results of such reviews

should be communicated directly to the Board of Directors and senior management. (Paragraph 0)

(iv) Since the activities of the clients and the facilities enjoyed by them are multidimensional, banks must move towards multidimensional credit rating. (Paragraph 0)

(v) Banks should adopt more risk-oriented systems of internal rating so that in the process they can capture elements of risk like probability of default (PD), loss given default (LGD) and exposure at the time of default (EAD) which are hitherto not being captured. (Paragraph 0)

(vi) Banks shall have to build historical database on the portfolio quantity and provisioning/charge off to equip themselves for pricing risks properly. The bigger banks must expedite the process of transition from elementary levels of risk management to levels of greater sophistication. (Paragraph 0)

(vii) Banks in India would have to formulate a medium term strategy to implement risk aggregation and capital allocation mechanism. RBI may consider guiding the banks to more sophisticated risk management practices in a time bound manner. (Paragraph 0)

(viii) Guidelines in respect of dealings with highly leveraged institutions should be put in place. (Paragraph 0)

(e) Loan accounting, transparency and disclosures

(i) As per extant guidelines, if a loan under the doubtful category does not migrate to the loss category (for which 100 per cent provision is required to be made), the account remains under-provided as, after three years in the doubtful category, only a maximum of 50 per cent provision is created on the secured portion. This loophole needs to be plugged in view of the limitations with which realisation of collateral suffers in the country. (Paragraph 0)

(ii) Within a given timeframe of, say, 3-5 years, the level of provisions on standard assets should be raised to international standards. Similarly, even on the secured portion of doubtful debts, provision beyond 50 per cent will have to be stipulated if the condition and realisabilty of collaterals so demand. (Paragraph 0)

(iii) The formulae-based system of classification and provisioning should give way to a more closer to reality assessment of the realisabilty of assets, relying on a risk assessment-based system. (Paragraph 0)

(iv) Portfolio-based approach to provisioning may be considered in the case of groups of small homogenous loans. (Paragraph 0)

(v) Banks have put in place credit risk management systems which are also being streamlined and improved. With the help of these systems, banks should now be able to adopt analytical and statistical methods for determining their requirements and provisioning/charge-off. (Paragraph 0)

(vi) In preparing its future guidelines on provisioning, RBI may undertake ratio analysis of overall provisioning to past due and impaired loans, and to total loans, over time and across institutions. Banks also may be asked

to undertake such an analysis and make it a part of their mandatory disclosures. (Paragraph 0)

(vii) At present, all banks irrespective of their size, scope and complexity of operations, are required to make the same credit risk disclosures. RBI may take early steps to introduce the concept of materiality in the matter of disclosures. (Paragraph 0)

(viii) The levels of disclosure in the balance sheets of Indian banks should be gradually improved so that, within the period of next two to three years, these meet the international best practices in these regards. A coordinated approach between the ICAI and RBI may be adopted for this purpose. (Paragraph 0)

(ix) Several changes need to be made in disclosure practices. These have been classified in Chapter 6 under the following categories: (1) General balance sheet disclosures, (2) Internal control and management systems, (3) Credit risk disclosure and (4) Management of risks. (Paragraphs 0 to 0)

(x) Among other things, detailed discussions on operational, legal and strategic risks may be made mandatory in management's letter/directors' report to the shareholders. (Paragraph 0)

(f) Financial Conglomerates

(i) Urgent attention would need to be paid to develop suitable mechanisms in order to detect and provide for situations of double gearing and other similar problems related to supervision of financial conglomerates. (Paragraph 0)

(ii) RBI should ensure that fitness, propriety or other qualification tests are applied to managers and directors of the unregulated entities in a conglomerate if they exercise a material or controlling influence on the operations of the regulated entities. (Paragraph 0)

(iii) Considering the potential of risk contained in such a situation, it would be desirable to put in place arrangements for applying fit and proper tests also on all shareholders with shareholdings beyond a specified threshold. Suitable legal provisions would need to be introduced in the Banking Regulation Act empowering RBI clearly in this regard. (Paragraph 0)

(iv) Fitness, propriety or other qualification tests need to be applied on a continuous basis so that occurrence of any event which raises any doubt about fitness and propriety of a manager, director or a shareholder (with shareholding beyond a specified level), results in the test being applied. (Paragraph 0)

(v) Arrangements should be formalised for exchange of information between all regulators involved in regulation of different entities in a conglomerate. (Paragraph 0)

(vi) RBI may consider introducing the concept of primary supervisor in order to improve coordination between different supervisors (regulators) and add to the scope and quality of the overall supervision of the conglomerate. (Paragraph 0)

(vii) RBI may urgently consider the desirability of introducing and participating in a scheme of formalised coordination between different regulators and designation of one of the regulators involved as a coordinator with clearly assigned roles and responsibilities. (Paragraph 0)

(viii) RBI should consider issuing appropriate guidelines requiring banks to ensure that they and their subsidiaries and joint ventures have adequate risk management processes covering group-wide risk concentrations as well. (Paragraph 0)

(ix) To ensure that financial conglomerates have controls in place to manage their risk concentrations, RBI may issue instructions to banks to ensure that their up-stream and down-stream units introduce appropriate controls to manage their risk concentrations. (Paragraph 0)

(x) Comprehensive management information and reporting system at the conglomerate level would have to be insisted upon by RBI to build a sound risk management approach. (Paragraph 0)

(xi) Public disclosure of risk concentrations may be made mandatory. (Paragraph 0)

(xii) Any such information which helps the market or the supervisors to arrive at meaningful inferences in regard to financial condition, solvency, earnings performance and risk profile, should be provided on solo as well as a consolidated basis. (Paragraph 0)

(xiii) Where more than one supervisor is involved, they should be able to take coordinated supervisory action, particularly in the area of risk management by the different entities of a conglomerate. The range and scope of information exchange among sectoral supervisors should be made broader and multi-point. (Paragraph 0)

(xiv) RBI may consider including material risk concentrations at the conglomerate level as one of the possible triggers for the prompt corrective action framework. (Paragraph 0)

(xv) In the interest of effective consolidated supervision and for ensuring due transparency in the dealings between the units of a conglomerate, public disclosure of Intra-group Transactions and Exposures (ITEs) should be made compulsory. Suitable regulations as well as accounting principles would need to be put in place to ensure such disclosure. (Paragraph 0)

(xvi) Risk management systems that are being put in place in banks need to take into account the special risks posed by ITEs. Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate. (Paragraphs 0 and 0)

(g) Cross-border Banking

(i) 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 proactive and focused policy. (Paragraph 0)

(ii) More attention needs to be paid 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 begin encouraging Indian

banks and foreign entities operating in India to submit to consolidated supervision. (Paragraph 0)

(iii) RBI faces constraints in countries where the local laws do not permit the home supervisor to conduct onsite inspection/examination of records. A country-wise analysis will have to be made and suitable action taken to address the constraints. (Paragraph 0)

(iv) Separate approvals of the home country supervisors of a foreign bank should be insisted upon for every new branch which that bank wants to open in India. This will provide RBI with an opportunity to share with the home supervisors their latest views on the foreign entity under its supervisory charges in India. (Paragraph 0)

(v) A periodic review would need to be made of the supervisory systems and standards of host supervision where Indian banks have a presence. (Paragraph 0)

(vi) Host supervisors often remain inadequately informed about the parent bank's difficulties. It is, therefore, necessary that a more comprehensive system of information sharing based on mutuality and reciprocity be established. (Paragraph 0)

(vii) In regard to the quality of control exercised by the Head office of foreign banks, whose branches are operating in India, RBI may convey to the home country supervisors its expectations about receiving from the home supervisor, information about the extent and quality of control maintained by the head office over its branches operating in India. (Paragraph 0)

(viii) 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. (Paragraph 0)

(ix) 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 conditions on which it would permit a foreign bank to open its branch in India. (Paragraph 0)

(x) Provision of unhindered/ unqualified access to information to the home supervisor should be made a condition for permitting a bank to open offices abroad. (Paragraph 0)

(xi) The present legal provisions in India in respect of confidentiality of information available with the home supervisor (RBI) do not provide sufficient protection of information. More clearly defined laws would be needed for this purpose. (Paragraph 0)

10.2 Considering the level of complexity and development of the Indian banking sector, the level of compliance with the standards and codes is of a high order. Some of the principles, as discussed at various places in the report, are not immediately relevant in view of the state of development of the system. Wherever there are significant gaps, these can be remedied within a reasonable timeframe.

List of abbreviations

ACB	Audit Committee of the Board
ALCO	Asset Liability Management Committee
ALM	Asset Liability Management
BCBS	Basel Committee on Banking Supervision
BCCI	Bank for Credit and Commerce International
BFS	Board for Financial Supervision
BIS	Bank for International Settlements
BR Act	Banking Regulation Act, 1949
CAMELS	Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Systems and controls
CAR	Capital Adequacy Ratio
CEO	Chief Executive Officer
CPC	Credit Policy Committee
CRAR	Capital to Risk-Weighted Assets Ratio
CRR	Cash Reserve Ratio
EAD	Exposure at the time of Default
EaR	Earnings at Risk
EL	Expected Loss
FATF	Financial Action Task Force on Money Laundering
FEDAI	Foreign Exchange Dealers' Association of India
FIMMDA	Fixed Income Money Market and Derivatives Association of India
HLI	Highly Leveraged Institution
IAIS	International Association of Insurance Supervisors
IBA	Indian Banks Association
ICAI	Institute of Chartered Accountants of India
IOSCO	International Organisation of Securities Commissions

IRDA	Insurance Regulatory and Development Authority
ITEs	Intra-Group Transactions and Exposures
LAB	Local Area Bank
LGD	Loss Given Default
MIS	Management Information System
MoU	Memorandum of Understanding
NABARD	National Bank for Agriculture and Rural Development
NHB	National Housing Bank
NIM	Net Interest Margin
NPA	Non-Performing Asset
OECD	Organisation for Economic Cooperation and Development
PCA	Prompt Corrective Action
PD	Probability of Default
RBI	Reserve Bank of India
RBI Act	Reserve Bank of India Act, 1934
RRB	Regional Rural Bank
SEBI	Securities and Exchange Board of India
SLR	Statutory Liquidity Ratio
UL	Unexpected Loss
VaR	Value at Risk

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[i] Following Goodhart, C.A.E., P. Hartmann, D. Llewellyn, L. Rojas-Suarez, and S. Weisbrod (1998): *"Financial Regulation: Why, How and Where Now?"*, Routledge in association with the Bank of England, London.
[ii] The assessment has been made using the harmonised assessment methodology given in "Core Principles Methodology" Basel Committee on Banking Supervision, 1999. (http://www.bis.org/publ/bcbs61.pdf)