Annex 1

Core Principles for Effective Banking Supervision [i]

Principle	Indian Position	Remarks
I. Preconditions for effective Banking Supervision		
Principle 1. An effective system of banking supervision will have clear cut responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protection for confidentiality of such information, should be in place.		
1(1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.		
Essential criteria: (i) Laws are in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.	The RBI (RBI), which was formed under an act of parliament, viz., the Reserve Bank of India Act, 1934 (RBI Act), has the sole responsibility of supervision and regulation of banks in India. The Banking Regulation Act, 1949 (BR Act), lays down the law relating to banking regulation and supervision.	
(ii) The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.	The laws supporting regulation and the guidelines and prudential norms issued by RBI from time to time provide a framework of minimum prudential standards that banks must meet. While by and large the prudential norms conform to the international standards, in some cases considering the special circumstances prevalent in the Indian	

	banking system, RBI has permitted some deviations from the international benchmarks. These deviations are being reviewed regularly and where considered desirable a movement towards achieving these benchmarks on a time bound basis is being made.	
(iii) There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.	Supervision of commercial banks (other than RRBs) is the sole responsibility of RBI.	
(iv) The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).	The RBI Act and the BR Act provide for participation of RBI in deciding when and how to effect resolution of a problem bank situation. However, its interventions have often been impeded because of the present provisions of law requiring the courts and Central Government's intervention.	
(v) Banking laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.	The banking laws are reviewed and updated from time to time considering the changing needs of the banking industry and the economy.	
Additional Criteria: (i) The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.	RBI's objectives as a supervisory agency is set out in the RBI Act and BR Act. The Department of Banking Supervision of RBI submits half-yearly and annual review notes on its performance to the Board for Financial Supervision (BFS) and the Central Board of RBI. An annual report on the working of RBI with detailed analysis of its annual accounts and an	

	assessment of Indian economy is also submitted to the Central Government under Section 53(2) of the RBI Act. The system is transparent.	
(ii) The supervisory agency ensures that information on the financial strength and performance of the industry under its jurisdiction is publicly available.	RBI ensures that information on financial strength and performance of the industry under its jurisdiction is publicly available. It produces and publishes, besides its Annual Report, a Report on Trend and Progress of Banking in India and several other reports and statistics on a periodical basis which provide information on the performance and strength of the banking industry.	
1(2) Each such agency should possess operational independence and adequate resources		
Essential Criteria: (i) There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and/or in each agency's ability to obtain and deploy the resources needed to carry out its mandate.	The RBI Act provides for operational independence to RBI. The Central Government, however, reserves the right to issue directions to RBI from time to time in public interest. There is no indication of industry interference in its functioning and it suffers from no limitation in obtaining and deploying the resources needed for carrying out its mandate.	
(ii) The supervisory agency and its staff have credibility based on their professionalism and integrity.	This is adequately ensured.	
(iii) Each agency is financed in a manner that does not unduly undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia:	RBI is so constituted and financed that its autonomy and independence are not undermined. It conducts effective supervision and oversight without facing any limitations and is able to raise the required resources therefor.	

• salary scales that allow it to attract and retain qualified staff; • the ability to hire outside experts to deal with special situations; • a training budget and program that provides regular training opportunities for staff; • a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and • a travel budget that allows appropriate on-site work.		
Additional Criteria : (i) The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law.	The Governor of RBI is appointed by the Central Government for a term not exceeding five years and is eligible for reappointment. The Central Government has powers to remove the Governor as per Section 11(1) of the RBI Act which does not provide for any reasons for removal.	
(ii) Where the head of an agency is removed from office, the reasons must be publicly disclosed.	The present Act does not specify the reasons for which the Governor can be removed. The law also does not place any obligation on the government to make the reasons for removal public.	In the interest of proper perception of RBI's independence and the independence of the office of the Governor/ Deputy Governors, it would be desirable to consider suitable amendments to the relevant provisions of law.
1 (3): A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.		
Essential Criteria:	The powers to issue licence to a company for	

(i) The law identifies the authority (or authorities) responsible for granting and withdrawing banking licences.	carrying on the business of banking (Section 22(1) of the BR Act) and the powers to revoke licence (Section 22(4) of the BR Act) are veste40d with RBI.	
(ii) The law empowers the supervisor to set prudential rules administratively (without changing laws).	RBI is vested with powers to issue directions/ guidelines on any aspect of banking vide Section 35A of the BR Act.	
(iii) The law empowers the supervisor to require information from the banks in the form and frequency it deems necessary.	Section 27 of the BR Act vests powers in RBI to call for any information from banking companies in the form and frequency it deems necessary.	
1 (4): A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.		
Essential Criteria: (i) The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.	The BR Act vests powers in RBI to ensure compliance with its provisions. Non- compliance with mandatory guidelines can invite monetary and/or non-monetary penalties (Sections 46 to 48 of the BR Act).	
(ii) The law permits the supervisor to apply qualitative judgement in forming this opinion.	Sections 35 and 22 of the BR Act provide for unrestricted access to RBI to all the records of a bank. RBI is free to apply qualitative judgement in forming its opinion about safety and soundness of a bank under its supervision.	
(iii) The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.	The BR Act provides for unrestricted access to RBI to all the records of a bank.	
(iv) When, in a supervisor's judgement, a	RBI has powers to issue directions to banks in	

bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to: • take (and/or require a bank to take) prompt remedial action. • impose a range of sanctions (including the revocation of the banking licence).	general or particular under section 35A of the Act in the public interest; or in the interest of banking policy; or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or to secure the proper management of any banking company generally. It has powers to impose a range of sanctions. However, the power to revoke licence of a bank is subject to government concurrence.	
1 (5): A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.		
Essential Criteria: (i) The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.	The BR Act provides for explicit protection to the supervisors under Section 54. No suit or other legal proceeding shall lie against RBI or any of its officers for anything done in good faith or in pursuance of the BR Act.	
(ii) The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.	The cost of legal action arising out of the discharge of official duties is met by RBI.	
1(6): Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.		

Essential Criteria: (i) There is a system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.	Information sharing between domestic regulatory bodies like Securities and Exchange Board of India (SEBI), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB), etc., are attended to on the basis of mutual understanding. RBI is also represented on the boards of these bodies. A High Level Committee on Capital Markets comprising of Governor of RBI, Chairman of SEBI and Finance Secretary of the Central Government serves as a forum for discussing key regulatory issues of common interest.	
(ii) There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.	RBI shares information with overseas supervisors based on reciprocity. However, RBI has not been seeking much information from home country supervisors of banks operating in India. A comprehensive assessment of the system of cooperation and information sharing is give in Chapter 8 of the report and in the relative Annexes 13 to 16.	
(iii) The supervisor: • may provide confidential information to another financial sector supervisor; • is required to take reasonable steps to ensure that any confidential information released to another supervisor will be treated as	RBI does exchange confidential information with domestic and foreign supervisory authorities on reciprocal basis and with clear understanding that the information will remain confidential and will be used for the purpose for which it is sought. The law does not prohibit such exchange. Maintenance of confidentiality is a precondition for release of information to other agencies. However, there is no legal requirement or any other mandatory provision requiring RBI to take	

confidential by the receiving party; • is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.	reasonable steps to ensure that any confidential information released to other supervisors will be treated as confidential by the receiving party. The information is shared subject to a condition that it shall be used only for the purpose for which it has been sought. However, this is not required due to any provision of law.	
(iv) The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.	The law provides such protection to RBI.	
II. Licensing and Structure		
Principle 2: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.		
Essential Criteria: The term "bank" is clearly defined in law or regulations.	The term banking company is clearly defined in Section 5 (c) of the BR Act.	
(i) The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.	The permissible activities of a banking company are clearly defined and listed in Section 6(1) of the BR Act.	
(ii) The use of the word "bank" and any derivations such as "banking" in a name are limited to licensed and supervised institutions in all circumstances where the	Section 7 of the BR Act limits the use of words such as "bank", "banker", or "banking" to a banking company only as part of its name or in connection with its business. No company can	

general public otherwise might be misled.	carry on the business of banking in India unless it uses as part of its name at least one of such words.	
(iii) The taking of proper bank deposits from the public is reserved for institutions that are licensed and subject to supervision.	Institutions, which can undertake such activity are licensed and supervised by RBI.	
Principle 3: The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.		
Essential Criteria: (i) The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law or regulation.	The criteria for licensing are set out in Section 22(3) of the BR Act. RBI has also set prudential norms including norms for capital adequacy, which are followed, in licensing banks.	
(ii) The criteria for issuing licences are consistent with those applied in ongoing supervision	The criteria for issuing licences laid down in the BR Act are consistent with major objectives of ongoing supervision.	
(iii) The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.	RBI has powers to reject an application for grant of licence if requisite criteria are not fulfilled or if the information provided is not adequate.	
(iv) The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.	As per Section 22 (3c) of the BR Act, general character of the proposed management is evaluated to ensure that it will not be prejudicial to the interests of present or future depositors.	
(v) The licensing authority determines the suitability of major shareholders,	The position is already obtaining.	

transparency of ownership structure and source of initial capital.		
(vi) A minimum initial capital amount is stipulated for all banks.	Section 22(3) (d) of the BR Act provides for ensuring adequacy of capital structure before grant of licence. Minimum requirement for paid-up capital and reserves and transfer to reserve fund have also been prescribed in the Act. Minimum assigned capital required to be brought in by a foreign bank has also been prescribed. However, while the minimum capital requirement laid down in the BR Act prescribes the start-up capital requirements for new private sector banks or foreign banks, it does not contain any enabling provision for RBI to decide capital of banks on case to case basis.	Although it has been considered so far that the powers available with RBI to prescribe and vary capital adequacy are sufficient to keep control on the initial capital brought and subsequently maintained by banks, it is felt that its powers to decide requirement of capital on case by case basis should be clearly defined in law.
(vii) The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include; (1) skills and experience in relevant financial operations commensurate with the intended activities of the bank and (2) no record of criminal activities or adverse regulatory judgements that make a person unfit to uphold important positions in a bank.	Fit and proper test is applied to evaluate the directors and senior management.	At present RBI does not conduct a strict evaluation of the directors' skill and experience in relevant activities which banks undertake. The acceptability of a director is evaluated more in general terms based on a proforma statement provided by the applicant bank. It is felt that RBI should be applying stricter norms for the 'fit and proper' test it applies to evaluate the directors so that the quality of the boards of banks is controlled better.
(viii) The licensing authority reviews the proposed strategic and operating plan of the bank. This includes determining that an appropriate system of corporate governance	The operating plans and control and future expansion plans are reviewed with a view to ensuring that the business strategy of banks is sound and that the board is largely professionally	

will be in place.	managed. Suitable guidelines and prudential norms issued from time to time are also in place to ensure continued surveillance over the bank and its board. The functioning of board and its committees and adequacy of controls exercised by head office of banks over their branches and other offices is evaluated and rated as part of CAMELS rating done during on-site inspections.	
(ix) The operational structure is required to include, inter alia, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.	Operational structure of banks is examined as part of licensing process.	
(x) The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.	Projected financial statements are obtained for three years to study viability of the proposed strategic plan. Financial strength of promoters is evaluated.	The present pre-licensing review of the operational structure of an applicant for banking license is rather brief. At a time when complexity of bank products is growing and the delivery is increasingly becoming multi-channel, operational risks are increasing. RBI may, therefore, adopt a more detailed and stricter approach while reviewing the operational structure of a proposed bank (License applicant). Banks seeking license 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.
(xi) If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.	RBI is both the licensing as well as the supervising authority.	
(xii) In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of "no objection") of the home country supervisor is obtained.	RBI insists on prior consent of the home country regulator.	
(xiii) If the licensing, or supervisory authority determines that the licence was knowingly based on false information, the licence can be revoked	RBI can cancel the licence of a bank if the banking company ceases to carry on banking business in India; or it fails to comply with any of the conditions imposed under Section 22(1), Section 22(3) or Section 22(3A). As per common law, any consent obtained through misrepresentation of facts is no consent. On this basis also, RBI can revoke the licence of a banking company that is obtained based on false information.	
Additional Criteria: (i) The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed	Yes.	
(ii) At least one of the directors must have a sound knowledge of each of the types of	By virtue of Section 10A(2) of the B R Act, not less than 51 per cent of the total number of	While generally the position appears to be in order, with the changing market

financial activities the bank intends to pursue.	members of the Board of Directors of a banking company should have special knowledge or practical experience in accountancy, agriculture, banking, co-operation, economics, finance, law, small scale industry, etc.	for financial products and technology, a greater stress is required on professionalism and expertise of the board members. It would, therefore, be preferable to stipulate clearly that boards should have at least one director with a sound knowledge of each type of financial activity the bank intends to pursue. Particular areas are risk management, transfer pricing, etc.
(iii) The licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the licence approval are being met.	The compliance with conditions imposed on new banking companies is monitored through quarterly system of on-site supervision till annual financial inspection commences. The required procedures are thus in place.	
Principle 4: Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling in existing banks to other parties		
Essential Criteria: (i) Law or regulation contains a clear definition of "significant" ownership.	Substantial interest is defined in law. The BR Act contains the definition of substantial interest.	The definition provided in Section 5(ne) of the Banking Regulation Act appears to be fixing the threshold for substantial interest rather low. This may have to be re-examined.
(ii) There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular	There is no specific provision in law requiring obtention of prior supervisory approval for proposed change in ownership or exercise of voting rights over a threshold.	The position in this regard is not quite satisfactory and is open to controversy. Specific legal provision should therefore be made to rectify the situation.

threshold or change in controlling interest.		
(iii) The supervisor has the authority to reject any proposal for a change in significant ownership or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.	RBI has requisite powers to reject/prevent any proposal for a change in significant ownership or controlling interest in a bank. This power too is derived from RBI's general powers to issue directions under Section 35A of the Banking Regulation Act.	--Do--
Additional Criteria: (i) Supervisors obtain from banks, either through periodic reporting or on-site examinations, the names and holdings of all significant shareholders, including, if possible, the identities of beneficial owners of shares being held by custodians.	RBI receives a half-yearly return on 'ownership and control' from all domestic banks. The return contains details of top ten shareholders. Any significant change in ownership is also examined during onsite inspection.	Similar provisions would need to be put in place also in respect of foreign banks operating in India.
Principle 5: Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.		
Essential Criteria: (i) Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval.	Formation of subsidiaries by banks requires prior approval of RBI. Banks are allowed to set up subsidiaries or make significant investment only in companies that are undertaking business authorised under Section 19(1) of the B R Act. Suitable ceilings for investments in subsidiaries and for acquisition both in relation to banks' own capital and that of the investee company have been prescribed.	
(ii) Laws or regulations provide criteria by which to judge individual proposals.	RBI examines viability of the proposed subsidiary or acquisition before granting permission.	

(iii) Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment	All major acquisitions are looked into from the point of view of their impact on the bank and its ability to manage the investment/ acquisition well.	
(iv) Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital	Laws and regulations clearly define the extent to which investment/ acquisition can be made without the prior approval of the supervisor. Beyond that limit, however, save in clearly stated exceptions, no investments/ acquisitions are permissible in law.	
III. Prudential Regulations and Requirements		
Principle 6: Banking supervisor must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.		
Essential Criteria: (i) Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basel Capital Accord.	This position obtains.	
(ii) The required capital ratio reflects the risk	Bank-specific capital ratios have not yet been	As advanced risk management systems

profile of individual banks, in particular credit risk and market risk. Both on balance sheet and off-balance-sheet risks are included	introduced. However, market risk has been introduced for investment positions, foreign exchange open position and for open position in gold/silver/platinum. Both off- and on-balance sheet risks are included.	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.
(iii) Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.	The components of capital have been defined as per Basel norms.	
(iv) Capital adequacy ratios are calculated and applied on a consolidated bank basis.	The line of business of subsidiaries is different resulting in varied capital prescriptions being made by respective regulatory agencies. As such, CAR is calculated on solo basis. However, under prudential regulations of the central bank, any equity investment in subsidiaries is required to be deducted from Tier I capital of the parent bank.	
(v) Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.	The BR Act vests powers in RBI to initiate action for non-compliance of any of its directions/regulations including non-adherence to capital ratios. RBI is also working on prompt corrective actions, which will be triggered in certain circumstances, one of which is fall in CRAR below specified limits.	RBI is constrained in its measures against banks which fail to meet the requirements in respect to capital adequacy largely because of their government ownership. Where the bank is owned by the government, RBI has shown forbearance in view of implied government guarantee. Such forbearance cannot be long term and specific measures against banks failing to meet the capital adequacy requirement need to be stipulated in the interest of overall soundness of the

		system.
(vi) Regular (at least semi-annually) reporting by banks to the supervisor is required on capital ratios and their components.	Compliance with CRAR is monitored through quarterly prudential reporting and on-site inspection of banks.	
Additional Criteria: (i) For domestic, as well as internationally active banks, the definition of capital is broadly consistent with the Basel Capital Accord.	The position obtains.	
(ii) The supervisor clearly sets out the actions to be taken if capital falls below the minimum standards.	At present, RBI has not set out any specific course of action in the case of banks whose capital falls below the minimum standards. Such cases are reviewed periodically by the BFS on individual basis. However, RBI is now in the process of devising a framework for Prompt Corrective Action based on triggers such as fall in capital adequacy ratio or increase in non-performing loans beyond a level.	
(iii) The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile.	Risk-adjusted ratio for individual grouping of on- and off-balance sheet assets for arriving at capital adequacy ratio at the end of each quarter is prescribed by RBI. It is computed and reported by banks in detail to RBI as part of off-site return on capital adequacy.	
(iv) Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently,	Banks are at present assessing their capital adequacy in the light of standard risk weights for assets as advised by RBI. They are, however, not	RBI may assist and guide banks in their efforts to stabilise advanced risk management systems. It should

minimum requirements may be higher than the Basel Accord.	yet attuned to assess capital adequacy in relation to their individual risk profile. This can take place only after advanced risk management systems are introduced and get stabilised in all banks.	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.
(v) Capital adequacy ratios are calculated on both a consolidated and a solo basis for the banking entities within a banking group.	CRAR is, at present, calculated on solo basis only. However, any equity investment of a bank in subsidiaries is deducted from its Tier I capital.	
(vi) Laws or regulations stipulate a minimum absolute amount of capital for banks.	Minimum requirement for paid-up capital and reserves and transfer to reserve fund are prescribed in Sections 11, 12 and 17 of the BR Act. However, these minima which were specified in law more than five decades back are now outdated. RBI has prescribed a minimum capital for new private sector banks, which is insisted upon at the time of licensing. Existing banks, which do not fulfil the criteria for new banks, are also being advised to raise their capital to that level.	
Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.		
Essential Criteria: (i) The supervisor requires, and periodically verifies, that prudent credit-granting and	This is currently available.	

investment criteria, policies, practices, and procedures are approved, implemented, and periodically reviewed by bank management and boards of directors.		
(ii) The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment, including: • a sound and well-documented credit granting and investment process; • the maintenance of an appropriate credit administration, measurement and ongoing monitoring/ reporting process (including asset grading/ classification); and • ensuring adequate controls over credit risk.	In the course of on-site examination, adequacy of credit and investment policies and adherence thereto are looked into.	Banks in India are yet to acquire adequate expertise on sophisticated credit risk mitigation techniques. Until banks improve their expertise, properly controlled credit risk environment will not be established. RBI has to guide the banks in these regards and enable them to enhance their expertise.
(iii) The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's length basis, and free from inappropriate pressure from outside parties.	There are laws, and banks' internal as well as supervisory guidelines to ensure that credit decisions are made free of conflicting interests, on arms length basis and free from inappropriate pressures from outside parties.	
(iv) The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.	This practice is followed by banks at present.	
(v) The supervisor has full access to	Yes. It is available.	

information in the credit and investment portfolios and to the lending officers of the bank.		
Additional Criteria: (i) The supervisor requires that the credit policy prescribes that major credits or investments, exceeding a certain amount or percentage of the bank's capital, are to be decided at a high managerial level of the bank. The same applies to credits or investments that are especially risky or otherwise not in line with the mainstream of the bank's activities.	Banks generally follow a well laid out loan policy and have a structure for delegation of discretionary powers at different managerial levels under which credits are sanctioned or investments are made.	
(ii) The supervisor requires that banks have management information systems that provide essential details on the condition of the loan and investment portfolios.	Credit monitoring systems are in place in all banks. However, in the case of quite a few banks the adequacy of MIS can be questioned. In the light of recent developments in information technology, there is need and scope for improvement in credit-related MIS at banks.	
(iii) The supervisor verifies that bank management monitors the total indebtedness of entities to which they extend credit.	This is being done.	
Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.		
Essential Criteria: (i) Either laws or regulations, or the supervisor, sets rules for the periodic review by banks of their individual credits, asset	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.	

classification and provisioning, or the law/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.	The guidelines specify quarterly review of asset classification, income recognition and provisioning requirements.	
(ii) The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.	This is being done. 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.	
(iii) The system for classification and provisioning includes off-balance-sheet exposures.	The system of classification and provisioning include only such off-balance sheet items that are likely to get converted into on-balance sheet items.	Off-balance sheet items should receive more attention than at present. Like funded exposures, these should also be classified and a note to that effect should be provided in banks' financial statements.
(iv) The supervisor determines that banks have appropriate policies and procedures to ensure that loan loss provisions and write-offs reflect realistic repayment expectations.	RBI has determined the asset classification and provisioning norms and no discretion is left to the management of banks. Loss items have to be provided for in full. In case a bank chooses to write off, the compromise/ settlement should be as per the policy laid down by the board of the bank.	The supervisor has prescribed provisioning norms in accordance with which loan loss provisions are required to be made. Because of the existence of prescribed norms, 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.
(v) The supervisor determines that banks have appropriate procedures and organisational resources for the ongoing oversight of problem credits and for collecting past due loans.	Loan recovery policies of banks are studied during on-site inspections to assess adequacy of procedures and organisational set-up to recover past due loans.	
(vi) The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.	RBI has powers to give banks specific directions for ensuring adequacy of provisions under section 35A of the BR Act. RBI impresses upon banks to reduce exposure to certain sectors, if found excessive, and improve quality of credit appraisal, if found lacking.	
(vii) The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.	Quarterly detailed reporting of asset classification and provisioning is in place. Details in respect of top 30 non-performing loans such as balance outstanding, provisions held thereagainst and interest in arrears are called for and analysed.	
(viii) The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.	There are general instructions for periodic evaluation of the worth of collaterals including guarantees. However, practices followed in this regard are not uniform.	There is wide scope for improving the assessment of guarantees and worth of collaterals. Banks have to enhance their capabilities in this regard. RBI may also consider issuing suitable detailed instructions to banks in this regard.
(ix) Loans are required to be classified as impaired when there is reason to believe that principal and/or interest will not be paid according to the original loan agreement.	This practice is being followed. Loans are being classified as impaired even if the default in payment of principal/interest is less than two quarters.	
(x) The valuation of collateral is required to	See remarks against (viii) above.	

reflect the net realisable value.		
Additional Criteria: (i) Loans are required to be classified as non-performing when payments are contractually a minimum number of days in arrears (e.g. 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classifications for such loans.	A credit facility is classified as non-performing if interest and instalments of principal remain unpaid for two quarters after it has become past due. Rules regarding refinancing of loans that would otherwise fall into arrears are quite stringent. In any case, the regulator does not permit improved classification of loans, which escape falling into arrears due to refinancing.	
(ii) The supervisor requires that valuation, classification and provisioning for large credits are conducted on an individual item basis.	Asset classification and provisioning exercise is done account-wise.	
Principle 9 : Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers		
Essential Criteria: (i) A ”closely related group” is explicitly defined to reflect actual risk exposure. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.	As per RBI guidelines of July and November 1991, the guiding principle in identification of a group is commonality of management and effective control. The term ‘under same management’ is defined in Companies Act. RBI has the discretion to interpret the definition on a case by case basis.	The stress in the Basel paper is on unchallenged authority of the supervisor. Instead of relying on implied powers, RBI should have powers in terms of 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.
(ii) or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of	Prudential exposure norms have been prescribed both in respect of operations of foreign branches as well as for domestic lending to	

borrowers. “Exposure” include all claims and transactions, on balance sheet as well as off-balance sheet.	individual/group borrowers at 25/50 per cent of banks’ capital funds. Prudential exposure includes off-balance sheet exposure as well, which carries 50 per cent weight.	
(iii) The supervisor verifies that banks have management information systems that enable management to identify on a timely basis concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.	The MIS of banks enables concentration to be identified on solo, group and industry levels. The supervisor examines such concentrations through periodic returns received from banks as well as at the time of on-site inspection.	
(iv) The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.	A half-yearly reporting to management of banks on the exposure ceilings on solo as well as group basis is in place. The supervisor also monitors this exposure.	
(v) The supervisor regularly obtains information that enables concentrations within a bank’s credit portfolio, including sectoral and geographic exposures, to be reviewed.	This arrangement is in place. RBI compiles and publishes basic statistics bank-wise and group-wise on sectoral and geographic concentration of credit.	
Additional Criteria: (i) Bank’s are required to adhere to the following definitions: -10 percent or more of a bank’s capital is defined as a large exposure; -25 percent of a bank’s capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers. -Minor deviations from these limits may be acceptable, especially if explicitly temporary	An exposure of 15 per cent and above of bank’s capital funds is treated as large credit. Banks are required to adhere to prudential exposure limit of 25 per cent for individual borrowers and 50 per cent for groups of borrowers.	

or related to very small.		
Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.		
Essential Criteria: (i) A comprehensive definition of "connected or related parties" exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgements about the existence of connections between the bank and other parties.	There are guidelines from RBI on connected lendings. These, however, do not fully cover all such lendings which may be deemed as connected.	A comprehensive definition of 'connected' or 'related parties' and 'large shareholdings' needs to be provided by law/ regulator.
(ii) Laws and regulations exist that exposures to connected or related parties may not be extended on more favourable terms (i.e., for credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding loans to non-related counterparties.	Section 20 of the BR Act prohibits lending to directors and certain other related parties in order to check unethical practices of granting loans and advances to relatives of directors of banks, directors of other banks and/or their relatives. These restrictions do not apply to loans and advances to the members of the Local Advisory Boards of foreign banks. However, aggregate of such loans and advances should not exceed 5 per cent of a bank's advances in India. As regards loans to related companies, i.e., banks' own subsidiaries or joint ventures, banks are required to maintain arms length relationship and sanction of such loans and advances is subject to procedures applicable to sanction of loans and advances to directors of other banks and their relatives. The subsidiary company is treated as any other company and all loans to such	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 managed.

	companies have to be made at commercial rates and are subject to limits that apply to similar companies. Sanction of loans and advances to senior officers of a bank and their relatives should ordinarily be by next higher sanctioning authority and the same should be reported to the board. The above norms equally apply to award of contracts.	
(iii) The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank’s board of directors.	RBI has issued guidelines that loans aggregating Rs. 25.00 lakh and above should be invariably approved by the boards of banks. Loans for less than Rs. 25.00 lakh could be sanctioned by competent authorities as per delegation of powers, but should be reported to the board.	
(iv) The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself	Banks normally have procedures in place to prevent persons benefiting from the loan being associated either with its appraisal or sanction. However, there is no clear cut requirement to this effect stipulated by the supervisor excepting in regard to the directors.	RBI may consider issuing specific instructions in this regard.
(v) Laws or regulations set, or the supervisor has the mandate to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralisation of such loans.	Laws or regulations do not set any limit on a general or case to case basis for loans to connected and related parties. There is also no clear-cut mandate with the supervisor to do so. While investments in subsidiaries are deducted from Tier I capital, this is not so in the case of loans and advances sanctioned to connected parties. Loans to subsidiaries should be sanctioned on 'arms length' principle basis, i.e., subject to commercial judgement.	Since the principle is that loans to connected and related parties are given on commercial basis maintaining an arms length relationship, these are not considered deductible from banks’ capital. In the interest of maintaining discipline, both in respect of credit sanction and capital adequacy, RBI may consider issuing instructions that such loans, if not fully collateralised, may be deducted from banks’ capital to the extent they are not collateralised.

(vi) The supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process.	While there are informal systems in banks which identify connected and related parties, loans at individual unit and group levels, the total amount of such loans is not generally kept in focus. Very few banks have independent credit administration process for such loans.	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.
(vii) The supervisor obtains and reviews information on aggregate lending to connected and related parties.	As above.	As above.
Additional Criteria: (i) The definition of "connected or related parties" established in law and/or regulation is broad and, generally, includes affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.	The term "connected lendings" includes directors of banks, firms /companies in which he is interested and individuals to whom director is a guarantor or partner, senior management and their relatives, directors of subsidiaries/trustees of mutual funds/venture capital funds established by banks and other banks.	The definition of connected or related parties should be made more broad based to ensure that all kinds of connected or related party lendings can be brought under its purview. 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.
(ii) There are limits on aggregate exposures to connected and related parties that are at least as strict as those for single borrowers, groups or related borrowers.	There are at present no limits on aggregate exposures to connected and related parties by a bank.	Such a limit needs to be established.
Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risk		
Essential Criteria:	Indian banks having overseas operations are	

(i) The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.	required to lay down internal guidelines on country and counterparty risk management and fix limits based on risk rating of the country. In the normal course, prudential exposure norms apply to all loans and investments overseas including loans to sovereign entities. RBI has issued detailed guidelines on risk management, wherein banks have been advised to classify countries into low risk, moderate risk and high risk considering country ratings given by international rating agencies. The exposure to each country will be monitored at least on a weekly basis till banks are equipped to monitor exposures on real time basis. However, banks have been advised to evaluate all exposures to problem countries on a real time basis.	
(ii) The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies.	Adequacy of banks' policies on country and counterparty risk identification, measurement and control are assessed during on-site inspection.	
(iii) There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices that are all acceptable as long as they lead to reasonable, risk-related, results.	While banks keep track of and have exposure limits for counterparty and country risks, sophisticated risk management systems are yet to be put in place by most Indian banks. Provisioning against country risks and transfer risks is not quite scientific and may not bear right relationship with the fluctuating levels of such risks.	RBI may assist banks in hastening introduction of more scientific and sophisticated risk management systems. Banks have already worked with the guidelines provided by RBI for more than two years and should now be able to move faster to higher levels and sophistication in risk management.
(iv) These include, inter alia: - The supervisor (or some other official	There are no guidelines from the supervisor regarding any fixed percentage of provisioning for exposure to each country. Banks take their	RBI may consider setting fixed percentage for exposures to each country until banks are in a position to

authority) decides on appropriate minimum provisioning by setting fixed percentage for exposures to each country. - The supervisor (or some other official authority) sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures. - The bank itself (or some other body such as the national bankers' association) sets percentage or guidelines or even decides for each individual loan on the appropriate provisioning. - The provisioning will then be judged by the external auditor and/or by the supervisor.	own decisions, the adequacy of which is assessed by independent auditors. The arrangement, however, being bank-specific is to a large extent subjective and does not reflect the exposure risk of the system to country risks and transfer risks.	assess and provide for such risks on objective and scientific basis.
(v) The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks.	Information on country risk is monitored through a quarterly return on country-wise and counterparty-wise exposure. RBI collates information on exposure to countries where there are restrictions on exchange remittance and also advises banks from time to time not to undertake further exposures on problem countries.	
Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.		
Essential Criteria: (i) The supervisor determines that a bank has suitable policies and procedures related to the	A risk management oriented approach to supervision has been adopted by RBI in the last two years, i.e., since April 1999. Banks, however,	The process has to be expedited.

identification, measuring, monitoring and control of market risk.	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.	
(ii) The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.	Banks have been advised to set internal limits on various market risks like liquidity risk, interest rate risk and foreign exchange risk.	
(iii) The supervisor has the power to impose a specific capital charge and/or specific limits on market risk exposures, including their foreign exchange business.	RBI has general powers under Section 35A of the BR Act to issue directions to banks on any issue of concern.	
(iv) The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) are adhered to.	These aspects are looked into during on-site examination.	
(v) The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' positions are revalued frequently, using reliable and prudent market data.	Banks are required to ensure segregation of front office, middle office and back office functions. Banks revalue their foreign exchange portfolios on a monthly basis. The investments are valued quarterly.	
(vi) The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.	Although these aspects of risk management are covered by RBI guidelines on the subject, these do not form part of commonly followed practices by all banks at present.	Two years since RBI brought out its detailed guidelines on risk management would have given adequate time to banks to restructure their MIS to the requirement of risk management

		systems and stabilise their systems. It is time now that banks are required to move forward and adopt the practice of performing 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 consider directing banks towards that goal.
(vii) The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.	RBI has the requisite skills and has arrangements in place to ensure continuous upgradation of these skills.	
Additional Criteria: (i) Either through on-site work, or through independent external experts, the supervisor determines that senior management understands the market risks inherent in the business lines/ products traded and that it regularly reviews and understands the implications (and limitations) of the risk management information that they receives.	Adequacy of risk management organisational structure, policies and procedures and adherence to the limits set are verified by RBI during on-site inspection. On these occasions, RBI's inspection teams also take a view on the senior management's appreciation of the risk scenario for banks and alert them wherever it finds it necessary.	Whereas a discussion with the senior management of banks is held by the RBI on-site inspection team by exception, such discussions should be made compulsory to ensure the senior management's full understanding of the risk situation. This will also help quicker stabilisation of risk management systems in banks.
(ii) The supervisor reviews the quality of management information and forms an opinion on whether the management information is sufficient to reflect properly the banks' position and exposure to market risk. In particular, the supervisor reviews the assumptions management has used in their stress testing scenarios, and the banks'	Quality of management information system is assessed during on-site inspection.	

contingency plans for dealing with such conditions.		
(iii) The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as VaR.	RBI has the requisite skill to ensure that a model or any other risk management mechanism used by any of the banks supervised by it is not beyond its own understanding.	
Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against their risks.		
Essential Criteria: (i) The supervisor requires individual banks to have in place comprehensive risk management processes to identify, measure, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior management oversight.	RBI has issued detailed guidelines to banks for putting in place effective Asset Liability Management systems. Every bank has an Asset Liability Management Committee (ALCO), headed by the Chief Executive Officer/Chairman and Managing Director or the Executive Director. Banks are required to lay down policy on identification, measurement, monitoring and control of various kinds of risks such as liquidity risk, interest rate risk and currency risk and to review the policy from time to time to incorporate changes in business environment and the perception of the top management about the risks.	
(ii) The supervisor determines that the risk management processes address liquidity risk, interest rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (e.g., credit and market risk). These would include:	<u>Liquidity risk</u> RBI has advised banks to monitor liquidity through maturity or cash flow mismatches. Future cash flows are to be bracketed in different time buckets. Banks are required to fix tolerance levels for various maturity mismatches	Liquidity, interest rate and operational risk management in banks continue to be at the basic level. There is now an appreciation of the existence of these risks but lack of expertise for their proper management. MIS, in most cases,

- Liquidity: good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies. - Interest rate risk: good management information systems and stress testing. - Operational risk: internal audit, procedures to counter fraud, sound business resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.	depending upon their asset – liability profile, extent of stable deposit base, nature of cash flows, etc. To abide by the guidelines, banks have been advised to put in place adequate and efficient MIS. Liquidity in foreign currencies is measured and monitored through quarterly Maturity and Positions statements in four major currencies (USD, GBP, EURO, JPY) and all other currencies where the turnover in a currency is in excess of 5 per cent of total foreign exchange turnover. <u>Interest rate risk</u> Banks are expected to measure interest rate risk through traditional gap analysis. Each bank is required to set prudential limits on gaps for each time bucket considering total assets, earning assets and equity. Banks may fix prudent level for earnings at Risk (EaR) or Net Interest Margin (NIM). <u>Operational risk</u> All banks have a system of internal audit. RBI has issued various guidelines on putting in place appropriate checks/procedures to prevent occurrence of frauds. Banks also have to report large value frauds of Rs 10 million and above immediately on occurrence/detection to RBI along with details of systems and human failures, staff involvement, action taken against those	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. The pace of improving risk management systems needs to be accelerated. A timeframe of two years from now, i.e., by the end of the year 2002-2003, should be feasible for banks to graduate to risk management systems which will enable them to adopt advanced risk management practices.

	involved, etc. The above reporting is in addition to the regular quarterly reporting on all frauds for over Rs. 100,000.	
(iii) The supervisor issues standards related to such topics as liquidity risk, interest rate risk, foreign exchange risk and operational risk.	RBI has issued guidelines to manage liquidity risk, interest rate risk and currency risk. Banks have been advised to fix prudential internal limits for all kinds of risks.	
(iv) The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration undrawn commitments and other off-balance-sheet liabilities, as well as existing on-balance-sheet liabilities.	RBI has issued guidelines on management of liquidity based on residual maturity of assets, un-drawn commitments, and on- and off-balance sheet items. Liquid assets are clearly defined and only truly liquid assets are allowed to be treated as such.	
(v) The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed with the relevant business units.	Primary responsibility of adhering to laid down prudential limits and procedures rests with the relevant business units.	
(vi) The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.	RBI monitors the liquidity position of banks through a fortnightly return on structural liquidity. Banks are required to submit a monthly return on interest rate sensitivity for exposures in Rupee as well as foreign currencies to RBI. Besides off-site monitoring procedures, the annual on-site inspections ensure adherence to the set guidelines by banks.	
Additional Criteria: (i) The supervisor has the authority to require	RBI has the authority to impose and vary capital requirement for a bank. It has, however, not	While Indian banks are moving towards holding capital against credit and market

a bank to hold capital against risks in addition to credit and market risk.	adopted the practice of requiring banks to hold capital against risk other than credit and market risks.	risks, it would be a little premature at this stage to require them to hold capital against risks other than these.
(ii) The supervisor encourages banks to include a statement on their risk management policies and procedures in their publicly available accounts.	RBI does not at present require banks to include a statement on their risk management policies and procedures in their publicly available accounts.	We need to move towards this practice. However, since such a statement presupposes a clear understanding of the risk profile of bank 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.
(iii) Supervisors obtain sufficient information to enable them to identify those institutions carrying out significant foreign currency liquidity transformation.	Banks are required to fix aggregate and individual gap limits for each currency with the approval of RBI. They are required to adopt Value at Risk approach to measure the risk associated with forward exposures. RBI monitors currency risk through a monthly return on maturity and positions for on- and off-balance sheet items in foreign exchange.	
(iv) The supervisor determines that, where a bank conducts its business in multiple currencies, management understands and addresses the particular issues this involves.	The top management is involved in fixing and monitoring of limits on foreign exchange positions. Stress testing of foreign currency liquidity for large banks active in foreign	

Foreign currency liquidity strategy is separately stress-tested and the results of such tests are a factor in determining the appropriateness of mismatches.	exchange market has been prescribed.	
Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.		
Essential Criteria: (i) Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.	Corporate governance in banks and financial institutions has lately been receiving considerable attention. Recent amendments to the Companies Act addresses some major concerns about governance of these institutions. As per the new Section 292-A it would be mandatory for every public company having paid up capital of not less than Rs. 5 crore to constitute a Committee of the Board known as Audit Committee. The Annual Report of the Company shall disclose composition of the Audit Committee and the Audit Committee should have discussions with the auditors periodically about Internal Control Systems, the scope of audit including the observations of the auditors and review the half yearly and annual financial statements before their submission to the Board of Directors. This Committee has also been charged with the responsibility of ensuring compliance at the organisation-wide level with internal control systems.	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 recent amendments to the Companies 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 director's 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 clearly identified focus. Greater stress should be laid on the responsibility of the board in exercising control over all aspects of risk management.

	RBI has laid clear stress on the setting up of risk management systems and in its guidelines given to banks in this regard, spelt out clearly that every bank's board should articulate its risk management philosophy, policies and risk limits by assessing the banks' risk bearing capacity. These guidelines further add that: (a) Board should review the progress in implementation of the guidelines at half yearly intervals. (b) Constitute an independent Risk Management Committee or Executive Committee for evaluating overall risk assumed by the bank.	
(ii) The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organisational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address: - Organisational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business	RBI has issued a number of instructions / guidelines to banks requiring them to streamline their inspection and audit machinery, monitor treasury operations, introduce concurrent audit, introduce internal control systems for prevention of frauds, monitor cash flows in accounts, promptly reconcile inter-branch accounts, etc. and balance books periodically. RBI has also issued guidelines from time to time on definition and segregation of duties and responsibilities for different areas of business. Checks and balances principle is fundamental to banking. Each bank is required to have a written policy on delegation of powers for managing credit, investments, money market operations, foreign exchange operations, etc. There are separate internal	

origination, payments, reconciliation, risk management, accounting, audit and compliance). - Accounting procedures: reconciliation of accounts, control lists, information for management. - Checks and balances (or "four eyes principles"): segregation of duties, cross-checking, dual control of assets, double signatures. - Safeguarding assets and investments: including physical control.	control guidelines covering forex transactions conformity to which is verified during on-site inspections by RBI.	
(iii) To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.	The Director's Responsibility Statement as aforesaid aims at ensuring that the members of the boards of banks understand the underlying risks in banking business and are both committed to and legally responsible for control environment obtaining in the bank. The supervisor has the legal authority to require changes in the composition of the board and management although these go into play very late in the deteriorating performance scenario of the bank. In this context, the real issue relates to the public sector banks in which the regulator has, at least in practice, very little say in composition and continuance of the board and/or the senior management even in persistently deteriorating performance scenario. The prerogative lies with the owner, i.e., the government, which it rarely exercises.	While, in the course of the on-site inspection of banks, some assessment is made of the boards' and senior management's performance, such assessments rarely result in measures being taken by the regulator for improvement/change even where a case for such improvement/change seems strong. This is presumably so because 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 board's performance be undertaken by the regulator. It is further suggested that the regulator should adopt rating of the board's performance with the provision that if the rating falls below a certain level specified prompt corrective action

		should be triggered.
(iv) The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.	The regulator has issued clear guidelines governing internal control aspects of banks. At the time of on-site inspection, the supervisor ascertains whether the capacity of the back-office matches the activities of the front office/business organisation. Matching capabilities of back and front offices is an important test of the adequacy of internal control. Such matching obviously depends upon matched skills and resources which the supervisor ascertains.	
(v) The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practises and controls remain sufficient and appropriate for the bank's business. The supervisor determines that the audit function: - has unfettered access to all the bank's business lines and support departments; - has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations; - has sufficient resources, and staff that	Each bank has an internal audit department that inspects the bank's functioning periodically and reports to the Audit Committee. All exceptionally large branches (whose total deposits and advances are Rs. 100 crore and above) and large branches (whose total deposits and advances are Rs. 15 crore and above but below Rs. 100 crore) are subjected to concurrent audit so as to cover at least 50 per cent of banks' business operations (total of deposits and advances). The treasury functions of banks, viz., investments, funds management including inter–bank borrowings, bill rediscounting and foreign exchange, are also subjected to mandatory concurrent audit. Banks have sufficient resources and invest in training their staff to conduct internal inspections. They also avail of the training	As RBI itself is moving towards a "Risk-Based Supervision", individual bank audit functions would also now have to introduce appropriate modifications in their systems and MIS to meet 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".

are suitably trained and have relevant experience to understand and evaluate the business they are auditing; - employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.	facilities offered by RBI for this purpose. Additionally, many banks have also instituted separate "system audits" which focus on whether the internal procedures and controls are being adhered to at the operational level and whether the existing systems are adequate and commensurate with the requirement of the changing business environment.	
(vi) The supervisor has access to the reports of the audit function.	This position obtains. Extant RBI guidelines to its supervisors require them to have a comprehensive evaluation of audit function with reference to such reports.	
Additional Criteria: (i) In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.	Though banks in India have a unicameral board structure, routine executive functions including sanctioning of credit are vested with management committees constituted from out of the board members, as in the case of Audit Committee of the Board. The board includes, at a minimum, 51 per cent members with practical experience or special knowledge in areas of accountancy, agriculture, banking, cooperation, economics, finance, law, small scale industry, etc.	
(ii) The supervisor requires the internal audit function to report to an Audit Committee.	All audit reports are placed before the Audit Committees of banks for their perusal. In that sense, the audit function of banks reports to the Audit Committee of the board and the board itself. The board's Audit Committee, however, does not exercise any administrative control over the audit function of the bank.	

(iii) In those countries with a unicameral board structure, the supervisor requires the Audit Committee to include experienced non-executive directors.	This position obtains.	
Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.		
Essential Criteria: (i) The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.	These issues receive the supervisor's attention adequately. While banks have their individual policies about identification of customers and those acting on their behalf, the focus so far has been more on prevention of frauds against banks rather than money laundering. A specific law against money laundering is, however, expected to be enacted shortly.	
(ii) The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-money-laundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.	The Draft Bill on Money Laundering makes it obligatory for every financial institution and intermediary to maintain a record of all transactions or series of interconnected transactions exceeding the value of Rs. 25 lakh in a month. They are required to furnish information on these transactions to the Commissioner of Income Tax having jurisdiction over such financial institutions or intermediaries. The financial institutions or intermediaries would also be required to verify and maintain the records of identity of all clients in the prescribed	

	manner for five years from the date of cessation of transaction between the client and the financial institution. The enactment will adequately take care of the requirement.	
(iii) The supervisor determines that banks have formal procedures to recognise potentially suspicious transactions. These might include additional authorisation for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions	Banks have also been advised to be careful while dealing with clients who deposit and withdraw large sums of money in cash. Such transactions of Rs. 10 lakh and above are to be closely monitored. All banks have dual authorisation for transactions involving large sums. Definition of large sum is left to the discretion of banks. During on-site examination, large value transactions are looked into.	
(iv) The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank's policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money laundering requirements	Anti-Money Laundering law is likely to be passed shortly. The relative bill is already before the Parliament. The regulatory requirements in these regards have also not been clearly defined.	With the passage of the bill, regulatory requirements matching therewith will also need to be put in place.
(v) The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money laundering compliance.	No dedicated official for Anti-Money Laundering compliance is required to be designated.	--Do--
(vi) The supervisor determines that banks have established lines of communication both to management and to an internal	Existing instructions require banks to report all cases of frauds. Reporting of frauds, case by case, for more than Rs 100,000 is in place. Such frauds	

security (guardian) function for reporting problems.	are reported to banks' top management as well as to RBI under the reporting system prescribed by RBI. This vigilance function in banks coordinates with RBI as well as the Central Vigilance Commission (for government owned banks). RBI has advised banks to report frauds immediately to the concerned investigative agency particularly in respect of large value frauds.	
(vii) In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.	Each fraud of above Rs. 100,000 is reported individually and frauds for Rs. 100,000 and below are reported in consolidated form. Banks are also required to report suspicious transactions to their controlling offices. Further, the draft Money Laundering Bill also has a provision requiring banks to report suspicious activities to the agency which will administer the Act.	
(viii) Laws, regulations and/or banks' policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.	There are extensive guidelines and internal service rules which provides necessary protection to legitimate reporting. Various statutes relating to government revenue collection, criminal procedure code and related laws also enable such reporting to the competent authority in confidence by a member of public.	
(ix) The supervisor periodically checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money laundering obligations.	At the time of inspection, sample check is done of recently opened accounts with a view to seeing whether the prescribed 'Know Your Customer' instructions on account opening are being followed. RBI has the general powers to proceed against banks for violations of its regulations. So far, money laundering is sought to be discouraged by the different instructions issued by various	

	departments of RBI and by Government of India. Now, a draft bill on Prevention of Money Laundering containing detailed guidelines and reporting system is in the final stages of legislation before the Indian Parliament.	
(x) The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.	Modus operandi of frauds reported to RBI is shared with banks operating in India so as to check repetition of similar frauds. In case of need or where the fraud may have cross-border ramifications, this data had been shared in the past with overseas supervisors.	
(xi) The supervisor determines that banks have a policy statement on ethics and professional behaviour that is clearly communicated to all staff.	Banks have code of conduct for its staff and all staff members sign an undertaking to comply with code of conduct rules at the time of joining the bank.	
Additional Criteria: (i) The laws and/or regulations embody international sound practices, such as compliance with the relevant forty Financial Action Task Force Recommendations issued in 1990 (revised 1996).	The Financial Action Task force (FATF) recommendations and other international best practices are taken into account while framing regulations on fraud and other abuse of banking system.	
(ii) The supervisor determines that bank staff is adequately trained on money laundering detection and prevention.	The training process is expected to commence as soon as the Prevention of Money Laundering Bill gets enacted by the Parliament.	
(iii) The supervisor has the legal obligation to inform the relevant criminal authorities of any suspicious transactions.	It is a well established convention under the Indian polity. RBI has specifically advised banks to immediately report all frauds and attempts to defraud banks to the concerned investigative agency besides informing RBI.	

(iv) The supervisor is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.	RBI shares such information, on specific request, with relevant judicial authorities.	
(v) If not performed by another agency, the supervisor has in-house resources with specialist expertise on financial fraud and anti-money laundering obligations.	RBI has specialised expertise on financial fraud and also seconds its supervisors to the Central Bureau of Investigation to exchange experience and to gain and share relevant expertise.	
IV. Methods of Ongoing Banking Supervision		
Principle 16: An effective banking supervisory system should consist of some form of both on- site and off-site supervision.		
Essential Criteria: (i) Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focussing on safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to: - provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks; - determine that information provided by banks is reliable;	Over the past 4/5 years RBI has been changing its supervisory framework from a transaction based framework to a system-based framework. It has both on-site and off-site inputs. Accuracy and reliability of information is verified in the course of on-site inspection conducted by RBI officials. Since 1995, on-site inspections are based on CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) model and aim at evaluation of banks' safety and soundness, appraisal of the quality of board and management, compliance with prudential regulations and analysis of key financial factors such as capital, earnings and liquidity to determine banks' financial soundness and continued solvency. Independent verification of the corporate governance function is covered as part of management evaluation under the CAMELS based on-site inspection.	

- obtain additional information needed to assess the condition of the bank.		
And (2) uses off-site work as a primary tool to : - review and analyse the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information; - monitor trends and developments for the banking sector as a whole.	Financial condition of individual banks is reviewed on the basis of both off-site as well as on-site work. Pursuant to the new supervision strategy approved by the BFS, RBI has introduced a formal Supervisory Reporting System since 1995. Analysis of the returns is done for individual banks, peer groups and industry as a whole for various macroeconomic indicators. These analyses help in detecting early warning signals.	The supervisory returns and prudential reports called for from the commercial banks have to provide means for detecting early warning signals of weakening financial position, if any.
(ii) The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.	On-site inspection is also used to validate supervisory information received in the form of off-site returns. RBI verifies compliance with prudential regulations and legal requirements through annual on-site inspection and quarterly off-site supervisory returns.	
(iii) The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximise the synergy and avoid supervisory gaps.	Frequency of inspections is generally annual, which can be varied depending on the financial position, methods of operation and compliance record of the bank. For instance, weak banks are now under quarterly monitoring regime including on-site visits. Periodical on-site inspection system is supported by off-site monitoring, periodicity whereof could be increased depending on bank-specific conditions.	
Additional Criteria: (i) The supervisor has procedures in place to	The results of on-site inspections and off-site monitoring are put up to top management and	

assess the effectiveness of on-site and off-site functions, and to address any weaknesses that are identified.	BFS, which give directions. The directions may encompass the functioning and methodology of the supervisory process. The effectiveness of the Department of Banking Supervision of RBI is also reviewed.	
(ii) The supervisor has the right to access copies of reports submitted to the board by both internal and external auditors.	The supervisor has access to all records of banks.	
(iii) The supervisor has a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal control environment. Off-site and on-site work is prioritised based on the results of that assessment.	Depending on supervisory concerns based on off-site supervisory returns, off-site and on-site work is prioritised. On-site inspection uses CAMELS based rating methodology. Off-site surveillance uses critical ratios and also does analysis around CAMELS, peer-group and sectoral benchmarks in arriving at early warning signals.	
(iv) The supervisor is legally required to treat as confidential information received as part of the supervisory process. However, the supervisor is given powers under the law to disclose information in certain defined circumstances. The law prevents disclosure of confidential information unless the supervisor is satisfied that it will be held confidential by the recipient, or unless disclosure is otherwise required by law.	Any information collected by RBI during the course of supervisory process is kept confidential as per Section 45-E of the RBI Act. However, RBI has powers to disclose information in public interest in a consolidated form and in accordance with the practice and customary usage among bankers or as permitted by law.	
(v) The supervisor is able to reasonably place reliance on internal audit work that has been competently and independently performed.	Each bank has an internal audit/inspection department. The effectiveness of internal audit work of banks is assessed during the course of on-site inspection. Supervisory concerns thrown	

	up by internal audit/ inspection provide leads for on-site inspection. The supervisor is able to reasonably place reliance on internal audit work that has been performed by banks competently and independently.	
Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.		
Essential Criteria: (i) Based on the risk profile of individual banks, the supervisor has a programme of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational maters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems etc.	Contact with banks is continuous. The findings of on-site inspection are discussed first by inspection teams with banks' Chief Executive Officer. This is followed by a meeting of top management of RBI with banks' management to discuss matters of supervisory concerns identified during on-site inspection. The overall CAMELS rating is communicated to banks' management. Banks are consulted before introduction of major reporting changes and senior bank officers are associated with the working groups and committees set up by RBI to examine/deliberate on regulatory/supervisory issues.	In the meetings with banks, the supervisor as of now does not involve the non-executive directors. RBI may consider introducing this practice which can be expected to ensure better involvement of the entire board with the concerns of the regulator as also its assessment as regards the performance of the board.
(ii) The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews and regular meetings.	The supervisor has a thorough understanding of the activities of its banks accomplished through off-site and on-site surveillance mechanism at its disposal.	
(iii) The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments,	Such arrangements are in place.	

including breach of legal and prudential requirements.		
(iv) As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.	Quality of management is one of the parameters considered to arrive at CAMELS rating of banks during on-site inspection. Quality of management also plays important role while granting and continuing license to banks.	
Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.		
Essential Criteria: (i) The supervisor has the legal authority to require banking organisations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.	Under Section 27 of the B R Act, RBI has powers to call for any information at any time from a banking company relating to its affairs necessary for the purposes of the Act. Presently, RBI receives prudential reports and statistical returns from banks on a solo basis only. RBI receives quarterly/half-yearly/yearly statutory returns on various aspects like assets and liabilities, profitability, capital adequacy, large exposures, asset quality, connected lendings, maturity profile of foreign exchange positions and interest rate sensitivity for overseas operations. The statutory reporting on interest rate and liquidity risk pertaining to domestic operations have been introduced from the quarter ending June 1999. Recently, BFS has directed that banks should also be asked to submit reports on their subsidiaries covering capital adequacy, asset quality, large credits, profitability, and ownership and control to enable a consolidated view of banks to be taken.	

(ii) Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used.	The system of drawing up the financial and operational results on a consolidated basis has not yet been introduced, as it is not yet required by law. BFS has decided not to insist on consolidation of accounts at present and instead to confine its role to taking a consolidated view of the activities of the group.	For consolidated supervision, consolidation of accounts of the supervised units would be essential. Steps need to be taken so that the necessary legal provisions are introduced and banks are required to prepare consolidated accounts.
(iii) The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.	Prudential returns are required to be signed by the Chief Executive Officer or a whole time director of banks to ensure high-level involvement. Any inconsistency or inaccuracy in reporting is taken up with the top management of the bank. Submission of any wrong information to RBI can invite imposition of penalties specified in Section 46(1) of the BR Act.	
(iv) The information that is required to be submitted includes standardised prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on- and off-balance sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.	The balance sheet format, and prudential and statistical reports are standardised. In addition to data on loan classification and provisioning, banks are required to report net non-performing loans ratio, provisions held and adequacy thereof. Off-site returns cover areas such as assets and liabilities, profitability, capital adequacy, large exposures, asset quality, connected lendings, ownership and control, maturity profile of foreign exchange positions, interest rate sensitivity for overseas and domestic operations and structural liquidity.	
(v) The supervisor has the authority to	Section 27(2) of the BR Act provides for powers	

request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or the assessment of the risks of the bank.	to call for information on any business or affairs with which the banking company is concerned. RBI is in a position to call for any information about related companies of banks through the concerned bank.	
(vi) The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.	Prudential and statistical returns are used to create database on each bank. The database helps in critical analysis bank-wise, peer group-wise and for the industry as a whole. First signal reports are generated peer group-wise, which throw up adverse selected financial indicators. Half-yearly review of performance of entire banking industry is also undertaken. Off-site analysis forms an important input for on-site inspection.	
(vii) In order to make meaningful comparisons between banking organisations, the supervisor collects data from all banks and all other relevant entities within a banking organisation on a comparable basis and related to the same dates (stock data) and periods (flow data).	Supervisory data are called in a manner that it gives a clear picture of the supervised units on a comparable basis. The bases of the data collected are kept common so that peer group and industry-wise comparisons are possible.	
(viii) The supervisor collects data from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.	RBI collects information on quarterly, half-yearly or annual basis commensurate with the nature of information that is sought. Frequency for submission of returns is same for all banks. However, as and when required, RBI can call for ad-hoc returns from specific banks for specified purposes.	

Principle 19 : Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.		
Essential Criteria: (i) The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.	Examinations are conducted using in-house examiners and occasionally through chartered accountants for specific targeted appraisals. RBI has a manual containing planning process, responsibilities of examiners, objectives of examination and formats of reporting the output. Along with the corporate office, branches accounting for 50 per cent of advances of a public sector bank and 60 per cent of advances of a private sector bank and foreign bank, all 'very large', 'exceptionally large' and specialised branches conducting major lending business like industrial finance, corporate finance and international finance and branches with special problems noticed or categorised as 'unsatisfactory' by banks are covered. Besides, one third (subject to a maximum of 12 offices) of the total controlling offices is subjected to inspection. All annual financial inspections are conducted based on CAMELS pattern. RBI holds annual meetings with banks to discuss findings of the examination and suggest corrective steps to improve performance.	
(ii) The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting	The balance sheet and profit and loss account of banks are to be audited by qualified statutory auditors, whose appointment, reappointment and removal is subject to prior approval of RBI (Section 30 (1A) of the BR Act). Section 30 (1B)	

supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.	of the BR Act gives powers to RBI to appoint external auditors or direct the statutory auditors of a bank to conduct special audit.	
(iii) The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.	The accounting profession in India is well established having been in place for 50 years. The Institute of Chartered Accountants of India (ICAI) is a self-regulatory organisation for the profession and RBI interacts with ICAI to discuss application of accounting standards. However, RBI does not generally use the services of external auditors for examination of specific aspects of banks' operations.	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.
(iv) The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.	Section 35(2) of the BR Act casts duty on every director, officer or employee of banks to produce all such records, accounts and other documents. Under Section 35(3) of the Act, an Inspecting Officer of RBI may examine on oath any director, officer or employee of a banking company in relation to its business.	
(v) The supervisor has a programme for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns such as that for capital adequacy be examined at least annually by the auditors and a report	Accuracy and reliability of supervisory returns are verified by in-house examiners of RBI during the course of annual financial inspection. The statutory auditors are at present required to verify the calculation of the net demand and time liabilities and maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) by	

submitted to the supervisor.	banks on sample basis. The auditors also certify the income recognition and asset classification procedures, capital adequacy calculations, etc.	
Additional Criteria: (i) The supervisor meets with management and the board of directors each year to discuss the results of the supervisory examination or the external audit. Such visits should allow for the supervisor to meet separately with the independent board members.	The Principal Inspecting Officer of the RBI meets the Chief Executive Officer of the bank on conclusion of inspection to discuss the findings of on-site inspection. The top management of RBI meets the CEO of banks annually to discuss serious issues of concern thrown up by on-site inspections. The on-site reports are also discussed by the top management of RBI with the boards of banks in case major supervisory concerns are noticed.	The supervisor does not generally meet with the boards and external auditors of banks. RBI may consider introducing such meetings in the interest of greater involvement of the board with supervisory concerns and actions in order to enrich the scope of examination of banks.
(ii) The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.	RBI does not generally meet with the external auditors of banks. They do not submit any report to RBI orally or in writing.	The practice of RBI meeting with external (statutory) auditors could be introduced. It is expected to result in considerable advantage to the system of examination of banks' operations by RBI.
Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.		
Essential Criteria: (i) The supervisor is aware of the overall structure of banking organisations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.	The approach now adopted by BFS is to obtain a consolidated view of banks' operations without insisting on consolidation of accounts for the present. Supervision of subsidiaries will be left to the regulator of the subsidiary. However, in order to facilitate full consolidation when found necessary, amendments to the Act are being sought which will enable RBI to call for consolidation of accounts. Till then, banks will be	

	asked to annex the accounts of their subsidiaries with their accounts to enable supervisors to take a consolidated view of their operations.	
(ii) The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.	While conducting on-site inspections, the performance of subsidiaries and joint ventures is examined and any supervisory concern relating to their performance and control by parent bank are indicated in the report on the parent bank. In the past RBI has followed the practice of conducting inspection of merchant banking subsidiaries of banks. This was done based on the conditions imposed for such inspection at the time of licensing such subsidiaries. There is now a rethinking on inspections.	A complete disassociation of the RBI from supervision of merchant banking subsidiaries of banks may not be desirable. In the interest of a consolidated view of supervision, the regulator of the parent body (banks) should keep itself informed of the goings on in the subsidiary. Exchange of information with SEBI on these matters would be unavoidable.
(iii) The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.	For the purpose of inspection, Section 35 of the BR Act defines 'banking company' to include all subsidiaries outside India and all branches inside and outside India. Subsidiaries in India are supervised by other agencies depending upon the nature of their activities. RBI has discontinued its inspection, leaving it to the concerned supervisory agency of these subsidiaries as they fall within the supervisory ambit of the capital markets regulator, the Securities and Exchange Board of India (SEBI).	
(iv) There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organisation.	In the initial stages of formation of subsidiaries or affiliates, there were no other regulatory agencies in India to exercise control over such bank-affiliated entities. As the regulatory system evolved, Securities and Exchange Board of India, Insurance Regulatory and Development	

	Authority, etc. have come into being. In the light of such developments, RBI has embarked on a review of the conditions governing the initial licensing of these subsidiaries and affiliates and rework the modalities for assessing the impact of these institutions on the parent bank. Taking into account the regulatory jurisdiction of other agencies, an arrangement is being worked out to evolve a problem redressal mechanism to deal with specific situations where a subsidiary's functioning can cause an impact on the parent bank.	
(v) Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organisation. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.	The regulators have the capabilities to impose prudential regulations on the respective entities falling under their jurisdiction. As the line of activity of the subsidiaries are different from the parent bank, like activity specific subsidiaries for housing, credit cards, factoring, asset management, software, etc., it was considered that it may not be feasible to impose prudential standards on a consolidated basis in India.	
(vi) The supervisor collects consolidated financial information for each banking organisation.	Private sector banks are required to annex the balance sheet and profit and loss accounts to their annual reports. Public sector banks generally give a brief description of the performance of the bank’s subsidiaries and the group in Directors’ report that forms part of the annual accounts of banks. They are now required to annex the accounts of their subsidiaries also.	
(vii) The supervisor has arrangements with functional regulators of individual business	Subsidiaries are supervised either by departments of RBI such as Department of Non-banking	A formal framework for coordination between different regulators is essential.

vehicles within the banking organisation group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.	Supervision and Internal Debt Management Cell or by other agencies such as SEBI and NHB.	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.
(viii) The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organisation is not compromised.	This authority is being exercised through the parent bank.	
Additional Criteria: (i) For those countries that allow corporate ownership of banking companies: - the supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilises the authority in practice to determine the safety and soundness of the bank; - the supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank, and	Corporate ownership of banks is not allowed at present.	

- the supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.		
Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.		
Essential Criteria: (i) The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.	RBI has the authority to hold management of a bank responsible for ensuring that financial record keeping system and the data they produce are reliable. Section 46 of the BR Act vests powers in RBI to impose penalties for submission of unreliable information. DSB returns are required to be signed by a whole time director or Chief Executive Officer of banks. In case of submission of incorrect or incomplete information, it is treated as non-submission of return and invites penalty under Section 46 of the BR Act.	
(ii) The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.	It is mandatory for all banks to get their annual accounts audited every year by external auditors who are appointed with the approval of RBI. The auditors are required to report specifically whether the financial statements exhibit a true and fair view of the affairs of the bank.	
(iii) The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external	Adequacy and accuracy of records maintained by banks are verified during on-site inspection by RBI.	

audits		
(iv) The supervisor ensures that there are open communication lines with the external auditors.	RBI does not at present interact with the external auditors of banks. Some of the senior members of the audit profession are represented on the Central Board of RBI and the BFS of RBI. This provides for interaction and communication with the auditing fraternity. Audit Committee of the BFS lays down and reviews policies concerning audit of banks and financial institutions. Besides, one more Chartered Accountant from the Central Board and president of ICAI attend these meetings as invitees. Regular consultation with audit profession also takes place through meetings of Bank Audit Committee, which decides on the accounting standards and audit coverage.	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 be a good supplement to the on-site inspections of RBI.
(v) The supervisor provides instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.	RBI has issued guidelines on preparation of various supervisory reports. These reports are based largely on internationally accepted accounting principles.	
(vi) The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.	RBI has laid down stringent asset classification and provisioning norms. Banks are required to lay down norms for valuation of collateral and value of collateral is not reduced from non-performing loans. Banks are required to provide for standard loans at the rate of 0.25 per cent from March 31, 2000. Current investments are marked to market. Declared net profits are net of provisions	

	necessary for non-performing assets, liabilities and off-balance sheet items.	
(vii) Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.	Scope of statutory audit is defined in Section 30 of the BR Act. As per Section 31 of the BR Act, banks incorporated in India are required to publish their balance sheet and profit and loss account together with the auditor's report in a newspaper in circulation at the place where the bank has its principal office. Further, banks have been advised to publish their annual accounts in abridged form in additional newspapers, journals, etc. to give wider coverage to banks' operations. There are at present no set regulations or laws, which can make public issuance of individual bank financial statements subject to RBI's prior approval.	Existing regulatory and legal provisions in regard to preparation and publishing of financial statements of banks are considered adequate.
(viii) The supervisor has the ability to treat as confidential certain types of sensitive information.	Section 34 A of BR Act gives right to RBI to decide whether the information sought in any proceeding is of confidential nature considering the principles of sound banking. Further, RBI has powers to publish any information obtained under BR Act if it is in public interest and in such consolidated form as it may think fit (Section 28 of BR Act). Thus, RBI has implied powers to treat sensitive information confidential.	
(ix) The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have audited in accordance with internationally accepted auditing practices	The formats for preparation of financial statements are prescribed under Section 29 of the B R Act. The financial statements are prepared based on accounting standards prescribed by the ICAI except those that have been specifically modified by RBI in consultation with the ICAI	

and standards.	keeping in view the nature of banking industry.	
(x) The supervisor has the right to revoke the appointment of a bank’s auditors.	Prior permission of RBI is necessary for removal of statutory auditors (Section 30(1A) of BR Act). Further, in case professional incompetence is noticed, banks are advised to report to the ICAI, which initiates appropriate action.	
(xi) Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognised by the supervisor as having the necessary professional skills and independence to perform the work.	The selection process for external auditors for statutory and branch audit of banks is administered by RBI which ensures that only those having the necessary competence and experience would be entrusted with bank audit tasks.	
Additional Criteria: (i) The supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline.	The extent of disclosure in annual accounts has increased over the years. The BFS is considering moving to a system of half-yearly audited results. Listed banks are required to publish unaudited results quarterly in abridged form as per listing agreements. Recently, to ensure disclosure on par with international standards, banks are mandated to disclose certain additional information as part of annual financial statements: – Capital Adequacy Ratio; – Tier I capital ratio; – Tier II capital ratio; – Percentage of shareholding of the Government of India in nationalised	

	banks; – Net NPL ratio; – Amount of provision made towards NPLs and provisions for income-tax for the year; – Amount of Subordinated debt raised as Tier II capital (by way of explanatory notes / remarks in the balance sheet as well as in Schedule 5 relating to other liabilities and provision); – Gross value of investments, provision for depreciation on investments and net value of investments separately for within India and outside India; – Interest income as percentage to working funds; – Non-interest income as a percentage to working funds; – Operating profit as a percentage to working funds; – Return on assets; – Business (deposits and advances) per employee; – Profit per employee; – Maturity pattern of certain assets and liabilities;	

	– Movement in NPLs; – Foreign currency assets and liabilities; and – Lending to sensitive sectors as defined from time to time.	
(ii) The supervisor has guidelines covering the scope and conduct of audit programmes that ensure that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting.	Besides giving an audit report, the statutory auditors are also required to complete a quality assurance questionnaire (one for the bank as a whole and one for each branch), which covers aspects such as internal control, balances with other banks, investments, advances, premises, other assets and other liabilities, reserves and provisions, compliance with statutory reserve requirements, treasury operations and adherence to income recognition, asset classification and provisioning norms.	
(iii) Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.	Statutory auditors have the responsibility of highlighting matters of material significance in their report to the annual accounts as per Companies Act. However, under the existing laws, no legal responsibility devolves on the auditors to report directly to the supervisor matters of material significance observed by them in the audit of banks.	Such legal provisions will be helpful to RBI in its oversight of banks and will keep banks as well as their auditors more vigilant about the fairness and accuracy of banks' financial statements and their actual state of affairs. It will also enable the supervisors to place greater reliance on the role of external auditors in the audit of banks.
(iv) Auditors also have the legal duty to	The auditors are required to report matters, which	--Do--

<table>
<tr><td>report matters to the supervisor, in situations where they become aware of matters which, in the context of the available information, they believe is likely to be of material significance to the functions of the supervisor.</td><td>should be brought to the notice of shareholders (Section 30(3)(e) of BR Act).</td><td></td></tr>
<tr><td colspan="3">V. Formal Powers of Supervisors</td></tr>
<tr><td colspan="3">Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.</td></tr>
<tr><td>Essential Criteria:
(i) The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties upon, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal oral or written communication with bank management to actions that involve the revocation of the banking licence.</td><td>RBI is vested with powers to issue directions under the BR Act where necessary in the interest of banking policy, in public interest or where the affairs of the banking company are being conducted in a manner detrimental to the interest of the depositors. It has powers to initiate action against banks, which fail to fulfil prudential requirements. Such remedial actions are wide ranging and are taken depending upon the severity of the situation. They range from informal oral communication to restrictions on branch expansion, assets expansion and setting up of subsidiaries and can extend up to actions, which can lead to revocation of licence.</td><td></td></tr>
<tr><td>(ii) The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of</td><td>The BR Act also gives RBI wide powers to issue directions to banks on any aspect of their business (Section 35A), appoint nominees on their boards,</td><td>Imposition of conservatorship can enable a bank in difficulty to gain some time until it completes remedial</td></tr>
</table>

the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a take-over by or merger with a healthier institution, and imposing conservatorship.	cause change of management (Sections 36AA and 36AB), cancel their Licence (Section 22), take monetary and non-monetary penal measures (Sections 46 to 48), cause merger/ amalgamations, impose restrictions or even close a problem bank. RBI, however, does not have powers to impose conservatorship.	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.
(iii) The supervisor ensures that remedial actions are taken in a timely manner.	In any remedial action, timeliness is crucial. Timeliness of remedial actions is also being specified under the scheme of Prompt Corrective Actions (PCA).	It would also be desirable to extend the PCA concept further and define clear limits of forbearance it would show in any situation.
(iv) The supervisor applies penalties and sanctions not only to the bank, but, when and if necessary, also to management and/or the board of directors.	There are provisions for imposing monetary penalties against delinquent officials. In extreme cases, the top management of banks or the Directors on the board may be replaced. The sanctions applied by the supervisor depends upon its assessment of the severity of the situation. In deciding the course of its action, the supervisor takes into account the consequences of the default and violations observed in the functioning of banks and the impact its own actions will have on the individual bank, shareholders and the entire system. However, the public sector character of banks remains a limitation in the supervisor deciding upon and initiating remedial action in respect of 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.
Additional Criteria: (i) Laws and/or regulations mitigate against the supervisor unduly delaying appropriate	As of now, laws/ regulations do not have clear provisions which mitigate against undue delay on the part of supervisors. However, Prompt	The PCA regime should be kept under constant review so that it can be refined and made increasingly fail-safe.

corrective actions.	Corrective Actions are now being defined and triggers for specific remedial actions are being set. With a well-defined regime of Prompt Corrective Action in place, undue delays on the part of the supervisor in taking appropriate corrective action will be substantially mitigated.	Identification of new triggers should be a regular process and actions that will follow will have to be specified.
(ii) The supervisor addresses all significant remedial actions in a written document to the board of directors and requires that progress reports are submitted in writing as well.	Negative features and action called for as detected in on-site and off-site monitoring are addressed in a written communication to the chairmen of banks. Implementation of remedial actions is monitored periodically. Periodicity of such monitoring depends on seriousness of the problems faced by banks. Banks' balance sheets are analysed and supervisory concerns emanating therefrom are communicated to the Chief Executive Officers. Banks are also advised to place the communication before their boards and suggest action.	
Principle 23: Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.		
Essential Criteria: (i) The supervisor has the authority to supervise the overseas activities of locally incorporated banks.	The BR Act gives powers to RBI to inspect overseas activities of banks incorporated in India.	
(ii) The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies	RBI has prescribed periodic review of working of overseas branches to be put up to the board. RBI undertakes annual appraisal of banks' overseas activities based on records maintained at Head	While the position in regard to foreign branches of Indian banks is generally satisfactory, in the context of consolidated supervision, the position in

itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.	Office to ensure that prudential regulations are complied with and management has necessary expertise to manage these operations in a safe and sound manner.	regard to subsidiaries and particularly of joint ventures is not the same as that of branches. As we intend moving towards consolidated supervision, these areas will have to be addressed specifically.
(iii) The supervisor determines that bank management's oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified; b) assessing in an appropriate manner compliance with internal controls; and c) ensuring effective local oversight of foreign operations.	These are assessed during on-site inspection of head office and overseas branches of banks and through off-site reporting system specifically designed to cover overseas branches of Indian banks. The branches are also covered by independent internal audit function either by an in-house group or external professional accountant firm appointed in consultation with the host country regulator, where such approvals are necessary.	
(iv) The home country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.	RBI has the required authority for closing of overseas offices of Indian banks or imposing limitations on their activities.	
Additional Criteria: (i) The supervisor has a policy for assessing whether it needs to conduct on-site examinations or require additional reporting, and it has the legal authority and resources to take those steps as and when appropriate.	Sections 35 and 27 of BR Act give powers to RBI to conduct inspection of overseas branches of Indian banks and to call for any information from them. Overseas branches of locally incorporated banks are inspected depending on the feedback received during on-site inspection of the head office of banks and off-site monitoring. Additional information is called for whenever considered necessary.	

(ii) The supervisor determines that management's local oversight of foreign operations 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 principal locations at which the bank conducts comparable activities.	The extent and nature of oversight by the local management over the activities of individual operating units is left largely to the management.	RBI should move in this direction and look at the extent of oversight exercised by the local management over its specific units. While the business of the foreign unit has a special character, as supervisor, RBI should ensure that the oversight exercised by the management matches the requirement of the situation.
(iii) The supervisor arranges to visit the offshore locations periodically, the frequency determined by the size and risk profile of the overseas operation. The supervisor meets the local supervisors during these visits.	There are need based visits to overseas branches by RBI supervisors particularly to those clusters of branches functioning in important global money market centres. At the end of such visits, an exchange of information on important findings of the visit and concerns relating to the Indian branches of banks headquartered in the host country also takes place with the host country regulator.	The 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.
(iv) The home country supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.	Quality of supervision is one of the major factors considered before granting licence for opening a branch overseas.	The assessment of the host country's 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.
Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.		
Essential Criteria: (i) For significant overseas operations of its banks, the home country supervisor	RBI maintains contact/relations with overseas supervisors. However, such relations have not been put on a formal footing. In some cases there	Formal arrangements between home and host country supervisors for sharing of information and concerns would be

establishes informal or formal arrangements (such as memoranda of understanding) with host country supervision for appropriate information sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.	are also issues relating to reciprocity. Working Group on Home and Host country supervisory relationship recommended putting in place formal and/or informal arrangements for sharing information with overseas regulators. High level teams from RBI periodically visit overseas supervisors and share information.	preferable to having only informal arrangements. RBI should endeavour to get into formal relationship with host country supervisors on the basis of MOUs. It is only when there is good understanding between home and host country supervisors that the overall quality of supervision can come up to the desired level.
(ii) The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.	RBI has the powers to prohibit banks or their affiliates from establishing operations in countries where its supervisory reach will be limited in any manner.	
(iii) The home supervisor provides information to host country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and, to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.	RBI shares information with foreign supervisors on reciprocal basis.	The system of entering into formal relationship with host country supervisors on the basis of MOU suggested above (against item (i) above) will provide the necessary framework for exchange of this kind of information.
Additional Criteria: (i) A supervisor who takes consequential action on the basis of information received from another supervisor, consults with that supervisor, to the extent possible, beforehand.	This is done to the extent possible.	

(ii) Even for less than significant overseas operations of its banks, the home country supervisor exchanges appropriate information with host country supervisors.	Such information is shared on need based basis.	
Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.		
Essential Criteria: (i) Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.	The position obtains.	
(ii) For purposes of the licensing process as well as ongoing supervision, the host country supervisor assesses whether the home country supervisor practises consolidated global supervision.	While permitting opening of branches by foreign banks, RBI checks whether home country supervisor takes a consolidated view of the group operations. But no proposal is rejected merely on the grounds of non-existence of consolidated supervision at the home country level.	
(iii) The host supervisor, before issuing a licence, determines that approval (or no objection) from the home supervisor has been received.	No objection certificate from home country is required for permitting opening of a branch in India.	
(iv) The host country supervisor can share with home country supervisors information about the local operations of foreign banks provided its confidentiality is protected.	There is no formal framework for ‘Home country and Host country Supervisory Relationship’. However, RBI shares information with home country supervisors of foreign banks depending on need. Confidentiality is maintained by practice.	
(v) Home country supervisors are given on-	Home country supervisors have to obtain prior	

site access to local offices and subsidiaries for safety and soundness purposes.	permission for on-site access to branches of foreign banks operating in India, which is normally granted.	
(vi) The host country supervisor advises home country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.	Annual Financial Inspection reports of foreign banks are forwarded to their local head offices with an advice to put up the report before their Local Advisory Board and also to obtain comments of their parent bank. As of now there is no formal or set arrangement for RBI to share information with the home country regulator directly about any material remedial action it takes regarding the operations of a bank from that country. There is also no clear view as to what would constitute 'material remedial action'. The view so far has been one of reciprocity and subject to that RBI has shared such information with home country supervisors.	
Additional Criteria: The host country supervisor obtains from home country supervisors sufficient information on the banking group to allow it to put into proper perspective the activities conducted within its borders.	RBI has in the past focused more on individual operations than on the consolidated position.	

Annex 2
Enhancing Corporate Governance for Banking Organisations [3]

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

[3] "Enhancing Corporate Governance for Banking Organisations", Basel Committee on Banking Supervision, Bank for International Settlements, September 1999. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs56.pdf).

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

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

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

self-dealing and related party transactions.	hindrances in the way of achieving organisational goals tend to receive attention only at higher levels of management. Please also see comments at A(6) above.	Please also see remarks at A(6) above.
2. Board to set and enforce clear lines of responsibility and accountability for themselves as well as the senior management and throughout the organisation so that there is no unspecified or confusing and multiple accountability and lines of responsibility.	Boards of very few banks are known to enforce clear lines of responsibility and accountability for themselves. In quite a few cases there is not enough clarity about their roles. Much of it is because of the manner in which the boards are constituted. The lines for the responsibility and accountability for senior management and further down in the banks are, however, quite clearly defined leaving little room for unspecified or confusing and multiple accountability and lines of responsibility.	There is an urgent need to follow the best practices in banks in respect of constitution and functioning of the boards.
3. Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns:	Selection for nomination of individuals on banks' boards is on the basis of his/her qualification considered suitable for the position. There is, however, no practice of pre-induction meeting/briefing or any post-induction orientation. As such, often a proper appreciation of their role in the banks' corporate governance takes time to develop. Instances of undue influence from management or outside concerns are rare.	This practice can be put in place forthwith.

i. understand their oversight role and duty of loyalty to bank and shareholders.	Boards of Directors sometimes take longer time than expected to understand their role and obligation to the bank and the shareholders. New board members seldom go through any orientation programme.	There is a need to streamline the process of induction of directors into bank boards and their initial orientation. Suitable arrangement can be put in place forthwith.
ii. serve as a "check and balance" to the management.	The boards generally serve as a "check and balance" to the management. All members of the boards individually may not be said to be feeling and conducting themselves as ideally as envisaged.	The process can be self-sustaining once the responsibility and accountability are enforced.
iii. feel empowered to question the management and insist on explanation from the management.	Do	
iv. recommend sound practices gleaned from other situations.	Do	
v. provide dispassionate advice.	Do	
vi. are not over extended.	The system has till recently permitted board membership to an individual in up to 20 companies. This number is now sought to be reduced. Being on a number of boards does result in over-extension in some cases.	Members of Board of Directors are required to give their valuable time to the governance of banks. In this context, there is a need to have some ceiling on the number of boards and the number of committees a director can work at a time. Relative SEBI guidelines limit membership of board/

		Committees. Whereas in the case of listed companies this will hold good, the same principle may be adopted in the case of all banking companies.
vii. avoid conflict of interest in their activities with and commitments to other organisations.	The statutory provisions (Section 20 of the BR Act, 1949) prohibit loans and advances to directors or to any firm or company in which directors are interested or individuals in respect of whom any of its directors is a partner or guarantor. Disclosure of interest by directors is mandatory and in case there is any likelihood of conflict of interest arising, the concerned director is required to abstain from participating in the decision making process relating to that case.	
viii. meet regularly with senior management and internal audit to establish and approve policies, and monitor progress towards corporate objectives.	The board meets the senior management and internal audit regularly and establishes and approves policies and monitors progress towards corporate objectives.	
ix. abstain from decision making when incapable of providing objective advice.	Yes.	
x. do not participate in day-to-day management	Yes.	

of the bank.		
xi. Form committees for:		
a. Risk Management Committee	The regulatory guidelines for formation of Risk Management Committee are for a Committee of the Top Executives. Most banks are in a nascent stage of evolving risk management policies and practices.	Comprehensive risk management systems should be put in place in all banks at an early date. A timeframe of two to three years is considered adequate for the purpose.
b. Independent Audit Committee – comprising of external members, oversight of internal and external auditors, their appointment and dismissal, ensuring that management is taking appropriate action, etc.	The present system of constituting an audit committee of the board chaired by one of the non-executive directors is able to ensure performance in these tasks satisfactorily. Appointment and removal of auditors by the boards of banks has to be with the prior approval of RBI.	
c. Compensation Committee – oversight of remuneration of senior management, and other key personnel and ensuring compensation is consistent with bank's culture, objectives, strategy and control environment.	Public Sector Banks do not have Compensation Committees. The remuneration is fixed at the industry level uniformly for all banks at all levels of management with the approval of the Government of India. However, RBI approves the remuneration of CEOs of private sector banks.	There is a need to review the current practice and link remuneration with performance.
d. Nomination Committee – assessment of board effectiveness and directing the process of	As of now, there is no Nomination Committee of the Board of Directors for nominating	The desired change is possible after the ownership of the banks goes out of the

renewing and replacing board members	directors into the boards of banks, except in the case of some private sector banks. There is also no established system to assess the effectiveness of the functioning of the board members.	government's fold. The present system of nomination of directors on the boards of banks is expendable.
4. Ensuring that there is appropriate oversight by senior management ("four eyes principle") – senior managers not overly involved in business line decision making, are knowledgeable for their assigned area and willing to exercise control over successful and key employees without the fear of losing them.	The oversight is by Senior Managers who are not overly in the business and are knowledgeable. The oversight and checks and controls carried out by senior management may have no risk of losing an employee since the employment market is very tight. However, this may result in demotivation at the lower level.	
5. Effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide – recognising their importance and communicating this throughout the bank, enhance the independence and stature of auditors, utilising in a timely and effective manner their findings, ensuring their independence through the head auditor reporting to the board or board's audit committee, etc.	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 position may be deemed satisfactory.
6. Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment – do not overly depend on short-term performance.	There is no performance-related compensation in public sector banks and therefore, there is very little incentive or disincentive for good or bad performance. Some private sector banks have made efforts	See remarks against item A(7) above

	towards performance-related compensation. Such cases, which are not many, are recent. However, it is difficult to say at this stage with any degree of certainty that these are always consistent with the control environment and is not overly dependent on short-term performance.	
7. Conducting corporate governance in a transparent manner – Public disclosure is desirable in the following areas:		
i. Board structure (size, membership, qualifications and committees).	While the structure of the board is revealed in the Balance Sheet, details of Committees and qualifications of the directors are not always available publicly.	This practice may be introduced.
ii. Senior management structure (responsibilities, reporting lines, qualifications and experience).	This disclosure is not there.	Indian banks may be encouraged to make this disclosure.
iii. Basic organisational structure.	This disclosure is not there.	Indian banks may be encouraged to make this disclosure.
iv. Information about incentive structure (remuneration policies, executive compensation, bonuses, stock options).	This disclosure is not there.	Indian banks may be encouraged to make this disclosure.
v. Nature and extent of transactions with affiliated and related parties:		
1. Government – through laws.	Guidelines and norms for good corporate governance in banks and overall responsible corporate governance are still in formative	

	stages and healthy conventions are still to be built up. There are no laws as such which can be seen as supporting or facilitating corporate governance. It will be some time before tenets of good governance can be enacted in a piece of legislation. The RBI as supervisor and SEBI as capital market regulator are gradually introducing measures which lead to good corporate governance in banks and protection of depositors' and others' interests.	
2. Securities regulators, stock exchanges – through disclosures and listing requirements.	SEBI as the securities market regulator ensures healthy growth of capital markets and stands for the protection of the interest of shareholders. SEBI has stipulated disclosure and listing requirements and also reviews these on an on-going basis.	
3. Auditors – through audit standards on communications to boards of directors, senior management and supervisors.	The ICAI sets the accounting standards for banks in consultation with RBI. Standards on communication to Board of Directors, senior management and the Supervisors are, however, yet to be set and stabilise.	
4. Banking industry associations – through initiatives relating to voluntary industry principles and agreements on and publication of	Banks' industry level associations like the IBA, FEDAI, FIMMDA, etc., are active in taking initiatives relating to voluntary	

sound practices.	industry principles and agreements.	
E. Role of Supervisors		
1. Board of directors and senior management are ultimately responsible for the performance of the bank. Supervisors typically check that a bank is being properly governed and bring to management's attention any problem that they detect through their supervisory efforts.	The RBI as supervisor checks the governance practices at banks and brings to the management's attention the problems identified by them.	Because of RBI/government ownership of banks in the public sector, there is some overlap in the role of the RBI as owner/owner's representative and as the regulator/supervisor. This overlap needs to be corrected so that RBI can perform its regulatory/ supervisory role without any hindrance.
2. Attentive to any warning signs of deterioration in the management of the bank's activities.	The RBI as supervisor, through on- and off-site supervision mechanisms, is attentive to warning signs of deterioration in management of a bank's activities.	Government ownership of banks, however, stands in the way of any serious and urgent corrective action on the part of RBI as regulator. Laws of the land and the implied delay in the judicial system have also come in the way even where corrective action like removal of a management not found to be 'fit and proper' was contemplated.
3. Issue guidance to banks on sound corporate governance and pro-active practices.	The RBI as supervisor issues proactive and timely guidance to banks on sound corporate governance practices.	
4. Sound corporate governance considers interest of all stakeholders, including depositors, whose interests the supervisors should protect.	The basic spirit of banking supervision in India is to ensure that banks follow principles of sound banking and that the interests of all stakeholders, including depositors, are	

	protected.	
5. Should expect banks to implement organisational structure to ensure checks and balances.	The RBI as supervisor ensures that banks have organisational structure to ensure proper checks and balances.	
6. Emphasise accountability and transparency.	The RBI as supervisor emphasises accountability and transparency in banks.	The standards of transparency would need to be raised. A fair beginning has been made in this regard but the approach of the banks and the applicable accounting standards will have to be changed for achieving greater transparency in banking operations and accounting. The stress on accountability largely ends up with efforts to fix accountability for loans/advances that go bad. Accountability for non-performance, at any level including that of the Board of Directors, is nearly absent. This issue needs urgent attention.
7. Determine that board and senior management have in place processes that ensure they are fulfilling all of their duties and responsibilities.	Either on their own or under the guidance of the RBI as supervisor, most banks have put in place processes designed to monitor performance and fulfilment of duties and responsibilities at different levels.	The boards of banks, however, do not seem to subject themselves to any measure of accountability or performance either set by them voluntarily or made applicable to them externally. This leaves them as largely without any accountability either to the institution itself or to the supervisor.

		The situation calls for correction.

Annex 3
Framework for Internal Control Systems in Banking Organisations [ii]

Principle	Indian Position	Remarks
A. Management oversight and the control culture		
1.0 The board of directors should have responsibility for approving and periodically reviewing the overall business strategies and significant policies of the bank; understanding the major risks run by the bank, setting acceptable levels for these risks and ensuring that senior management takes the steps necessary to identify, measure, monitor and control these risks; approving the organisational structure; and ensuring that senior management is monitoring the effectiveness of the internal control system. The board of directors is ultimately responsible for ensuring that an adequate and effective system of internal controls is established and maintained.	The boards of banks in India do 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 the internal control system.	
1.01 The board of directors provides governance, guidance and oversight to senior management. It is responsible for approving and reviewing the overall business strategies and significant policies of the organisation as well as the organisational structure. The board of directors has the ultimate responsibility for ensuring that an adequate and effective system of internal controls is established and maintained. Board members should be objective, capable, and inquisitive, with a knowledge or expertise of the activities of and risks run by the bank. In those countries where it is an	Although the principle is unexceptionable, in practice, however, boards generally provide governance and general direction in regard to the setting of broad business strategies. The task of monitoring internal control and operational risk management systems is delegated to the audit committee of the board consisting of non-official directors who are independent from the daily management of the bank. A more focused attention to risks and their systematic identification and management, however, is	

option, the board should consist of some members who are independent from the daily management of the bank. A strong, active board, particularly when coupled with effective upward communication channels and capable financial, legal, and internal audit functions, provides an important mechanism to ensure the correction of problems that may diminish the effectiveness of the internal control system.	rather a recent concept. Managements and boards of banks are gearing themselves suitably to understand, measure and control risks.	
1.02 The board of directors should include in its activities (i) periodic discussions with management concerning the effectiveness of the internal control systems, (ii) a timely review of evaluations of internal controls made by management, internal auditors, and external auditors (iii) periodic efforts to ensure that management has promptly followed up on recommendations and concerns expressed by auditors and supervisory authorities on internal control weakness, and (iv) a periodic review of the appropriateness of the bank's strategy and risk limits.	The RBI has prescribed a set of mandatory reviews that need to be undertaken by the board of directors or specialised committees of the board. These include reviews of evaluations of internal and external audits as well as general and special recommendations and concerns expressed in the RBI inspection report, apart from those relating to risk management, credit management, investments, resources and profitability. The system of periodic discussions by the board with the management or follow-up of evaluation and review reports is not very well established.	The attention at the board level paid to evaluation and review reports on internal control systems in the banks is mostly routine and receives limited attention except when a bank has got into some trouble because of failure/ breakdown of the system. Such reviews and evaluation are generally not being 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 the banks. In depth discussions on periodic reports on internal control systems of the banks between the management and their boards should be institutionalised. RBI may consider advising all banks to take steps in this regard.

1.03. One option used by banks in many countries is the establishment of an independent audit committee to assist the board in carrying out its responsibilities. The establishment of an audit committee allows for detailed examination of information and reports without the need to take up the time of all directors. The audit committee is typically responsible for overseeing the financial reporting process and the internal control system. As part of this responsibility, the audit committee typically oversees the activities of, and serves as a direct contact for, the bank's internal audit department and engages and serves as the primary contact for the external auditors. In those countries where it is an option, the committee should be composed entirely of outside directors (i.e., members of the board that are not employed by the bank or any of its affiliates) who have knowledge of financial reporting and internal controls. It should be noted that in no case should the creation of an audit committee amount to a transfer of duties away from the full board, which alone is legally empowered to take decisions.	Banks in India establish an independent audit committee to oversee the internal control system. The audit committee is composed of non-executive members who normally have good knowledge of systems, audits and accounts.	
2.0 Senior management should have responsibility for implementing strategies approved by the board; developing processes that identify, measure, monitor and control risks incurred by the bank; maintaining an organisational structure that clearly assigns responsibility, authority and reporting relationships; ensuring that delegated responsibilities are effectively carried out; setting appropriate internal controls policies; and monitoring the adequacy and	Senior management have the responsibility for developing and implementing strategies, structures and processes for managing and controlling risks. They also have the responsibility for setting appropriate internal control policies and monitoring its effectiveness.	

effectiveness of the internal control system.		
2.1. Senior management is responsible for carrying out directives of the board of directors, including the implementation of strategies and policies and the establishment of an effective system of internal control. Members of senior management typically delegate the responsibility for establishing more specific internal control policies and procedures to those responsible for a particular business unit. Delegation is an essential part of management; however, it is important for senior management to oversee the managers to whom they have delegated these responsibilities to ensure that they develop and enforce appropriate policies and procedures.	Internal control strategies, policies and procedures are typically approved by the board and communicated to all levels of the hierarchy for implementation. This ensures consistency of internal control standards across the organisation. Senior management has the responsibility of ensuring implementation by the lower rungs of directives and policies of the board.	
2.2 Compliance with an established internal control system is heavily dependent on a well documented and communicated organisational structure that clearly shows lines of reporting responsibility and authority and provides for effective communication throughout the organisation. The allocation of duties and responsibilities should ensure that there are no gaps in reporting lines and that an effective level of management control is extended to all levels of the bank and its various activities.	This condition generally obtains.	
2.3 It is important that senior management takes steps to ensure that activities are conducted by qualified staff with the necessary experience and technical capabilities. Staff in control functions must be properly remunerated. Staff training and skills should be regularly. Senior management should institute compensation and promotion policies that reward	Banks generally have well articulated personnel policies providing for planned staff deployment, career path and training. A flat and performance-unrelated remuneration structure is prevalent in most banks, particularly in the public sector. Some private sector banks have made efforts towards performance related	

appropriate behaviours and minimise incentives for staff to ignore or over-ride internal control mechanisms.	compensation. Such cases, which are not many, are recent. However, it is difficult to say at this stage with a reasonable degree of certainty that these are always consistent with the control environment.	
3.0 The board of directors and senior management are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organisation that emphasises and demonstrates to all levels of personnel the importance of internal controls. All personnel at a banking organisation need to understand their role in the internal controls process and be fully engaged in the process.	Banks articulate corporate values, codes of conduct, standards of appropriate behaviour, etc., emphasising on importance of internal controls. Bank managements do endeavour to ensure that all levels of personnel understand their roles in the internal controls and are fully engaged in the process.	
3.1 An essential element of an effective system of internal control is a strong control culture. It is the responsibility of the board of directors and senior management to emphasise the importance of internal control through their actions and words. This includes the ethical values management displays in their business dealings, both inside and outside the organisation. The words, attitudes and actions of the board of directors and senior management affect the integrity, ethics and other aspects of the bank's control culture.	Importance of internal controls and a strong control culture is understood and stressed by the banks managements as well as their boards.	
3.2 In varying degrees, internal control is the responsibility of everyone in a bank. Almost all employees produce information used in the internal control system or take other actions needed to effect controls. An essential element of a strong internal control system is the recognition by all employees of the need to carry out their responsibilities effectively	All banks have comprehensive documentation in the form of operating manuals, checklists or guidelines in regard to operating procedures. These are also generally available with the controllers and to a lesser extent with the first line personnel.	Establishing a strong control culture requires the bank 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 to communicate to the appropriate level of management any problems in operations, instances of non-compliance with the code of conduct, or other policy violations or illegal actions that are noticed. This can best be achieved when operational procedures are contained in clearly written documentation that is made available to all relevant personnel. It is essential that all personnel within the bank understand the importance of internal control and are actively engaged in the process.		and sustaining a culture of control in the banks.
3.3 In reinforcing ethical values, banking organisations should avoid policies and practices that may inadvertently provide incentives or temptations for inappropriate activities. Examples of such policies and practices include undue emphasis on performance targets or other operational results, particularly short term ones that ignore longer term risks; compensation schemes that overly depend on short-term performance; ineffective segregation of duties or other controls that could allow the misuse of resources or conceal poor performance; and insignificant or overly onerous penalties for improper behaviours.	There is no performance-related compensation in public sector banks and, therefore, there is very little incentive or disincentive for good or bad performance. The remuneration is fixed at the industry level uniformly for all banks at all levels of management with the approval of the Government of India. However, RBI approves the remuneration of CEOs of private sector banks. The internal control guidelines issued by the RBI emphasises the need for segregation of duties, independent verification of transactions, joint custody of valuables and other operational risk management measures to be adopted and practised by banks. The RBI verifies satisfactory compliance during the on-site process.	
3.4 While having a strong internal control culture does not guarantee that an organisation will reach its goal, the lack of such a culture provides greater opportunities for errors to go undetected or for improprieties to occur.	This principle is accepted. RBI currently verifies the internal control system in banks during its on-site inspections. RBI's move towards a risk based supervision system is expected to help banks focus more attention on	

	internal controls and permeation of control culture.	
B. Risk Assessment		
4.0 An effective internal control system requires that the material risks that could affect the achievement of the bank's goals are being recognised and continually assessed. This assessment should cover all risks facing the bank and the consolidated banking organisation (that is, credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk). Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks.	The 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.	
4.1 Banks are in the business of risk-taking. Consequently, it is imperative that, as part of an internal control system, these risks are being recognised and continually assessed. From an internal control perspective, a risk assessment should identify and evaluate the internal and external factors that could adversely affect the achievement of the banking organisation's performance, information and compliance objectives. This process should cover all risks faced by the bank and operate at all levels within the bank.	-do-	
4.2 Effective risk assessment identifies and considers internal factors (such as the complexity of the organisation's structure, the nature of the bank's activities, the quality of personnel, organisational	-do-	With few exceptions risk management in most public sector and even private sector banks cannot be said to be effective. There is also not much

changes and employee turnover) as well as external factors (such as fluctuating economic conditions, changes in the industry and technological advances) that could adversely affect the achievement of the bank's goals. This risk assessment should be conducted at the level of individual businesses and across the wide spectrum of activities and subsidiaries of the consolidated banking organisation. This can be accomplished through various methods. Effective risk assessment addresses both measurable and non-measurable aspects of risks and weighs costs of controls against the benefits they provide.		conscious effort in these banks to measure different kinds of risk and decide the level of acceptability of such risks at the board level. While RBI has issued detailed guidelines to banks on risk management, it 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 board's supervision and guidance.
4.3 The risk assessment process also includes evaluating the risks to determine which are controllable by the banks and which are not. For those risks that are controllable, the bank must assess whether to accept those risks or the extent to which it wishes to mitigate the risks through control procedures. For those risks that cannot be controlled, the bank must decide whether to accept these risks or to withdraw from or reduce the level of business activity concerned.	-do-	
4.4 In order for risk assessment, and therefore the system of internal controls, to remain effective, senior management needs to continually evaluate the risks affecting the achievement of its goals and react to changing circumstances and conditions. Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks. For example, as financial innovation occurs, a bank needs to evaluate new financial instruments and market	-do-	Evaluation of risks affecting banks' strategies and objectives may need to be placed on a formal basis.

transactions and consider the risks associated with these activities. Often these risks can be best understood when considering how various scenarios (economic and otherwise) affect the cash flows and earnings of financial instruments and transactions. Thoughtful consideration of the full range of possible problems, from customer misunderstanding to operational failure, will point to important control considerations.		
C. Control Activities		
5.0 Control activities should be an integral part of the daily activities of a bank. An effective internal control structure requires that an appropriate control structure is set up, with control activities defined at every business level. These should include: top level reviews; appropriate activity controls for different departments or divisions; physical controls; checking for compliance with exposure limits and follow-up on non-compliance; a system of approvals and authorisations; and a system of verification and reconciliation.	Such checks and controls are in place. However, there is no uniformity in regard to the standards of compliance.	
5.1 Control activities are designed and implemented to address the risks that the bank identified through the risk assessment process described above. Control activities involve two steps: (i) establishment of policies and procedures; and (ii) verification that the control policies and procedures are being complied with. Control activities involve all levels of personnel in the bank, including senior management as well as front line personnel. Examples of control activities	Control activities in banks are more procedure driven than risk-management driven. Although the procedures established do manage some risk or the other, compliance with these procedures at the front line levels is not with the understanding and awareness that the objective behind the given procedures is risk management. The quality of compliance, therefore, very often suffers.	

include: (i) Top level reviews (ii) activity controls (iii) physical controls (iv) compliance with exposure limits (v) approvals and authorisations (vi) verification and reconciliation		
5.2 Control activities are most effective when they are viewed by management and all other personnel as an integral part of, rather than an addition to, the daily activities of the bank. When controls are viewed as an addition to the day-to-day operations, they are often seen as less important and may not be performed in situations where individuals feel pressured to complete activities in a limited amount of time. In addition, controls that are an integral part of daily activities enable quick responses to changing conditions and avoid unnecessary costs. As part of fostering the appropriate control culture within the bank, senior management should ensure that adequate control activities are an integral part of the daily functions of all relevant personnel.	-do-	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 RBI's on-site supervisory process for each bank.
5.3 It is not sufficient for senior management to simply establish appropriate policies and procedures for the various activities and divisions of the bank. They must regularly ensure that all areas of the bank are in compliance with such policies and procedures and also determine that existing policies and procedures remain adequate. This is usually a major role of the internal audit function.	-do- The adequacy and effectiveness of internal control systems, particularly the functioning of the internal audit departments forms a part of RBI's on-site inspections.	
6.0 An effective internal control system requires that there is appropriate segregation of duties and that personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest should be	This is normally done.	

identified, minimised, and subject to careful, independent monitoring.		
6.1 Segregation of duties is not limited to situations involving simultaneous back and front office control by one individual. It can also result in serious problems when there are not appropriate controls in those instances where an individual has the responsibility for: • Approval of the disbursement of funds and the actual disbursement; • Customer and proprietary accounts; • Transactions in both the ‘banking’ and ‘trading’ books; • Informally providing information to customers about their positions while marketing to the same customers; • Assessing the adequacy of loan documentation and monitoring the borrower after loan origination; and, • Any other areas where significant conflicts of interest emerge and are not mitigated by other factors.	Banks are generally aware of the importance of segregation of duties and such systems are normally in place.	
6.2 Areas of potential conflict should be identified, minimised, and subject to careful monitoring by an independent third party. There should also be periodic reviews of the responsibilities and functions of key individuals to ensure that they are not in a position to conceal inappropriate actions.	Most banks have a system of management audit during which responsibilities, functions and performance of key individuals are reviewed. Such exercise also helps to identify and minimise areas of potential conflict as well as chances of concealment of inappropriate	

	actions.	
D. Information and Communication		
7.0 An effective internal control system 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 would need to be identified as an area of potential risk both from the point of view of internal control and regulatory oversight.	
7.1 Adequate information and effective communication are essential to the proper functioning of a system of internal control. From the bank's perspective, in order for the information to be useful, it must be relevant, reliable, timely, accessible and provided in a consistent format. Information includes internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Internal information is a part of a record-keeping process that should include established procedures for record retention.	-do- The RBI has issued detailed guidelines to banks regarding the development and implementation of appropriate record management policies and processes. Banks have generally established policies and procedures in this regard. However, as most of the records continue to be in manuscript form, retrieval, presentation and analysis of data are invariably lagged.	
8.0 An effective internal control system requires that there are reliable information systems in place that cover all significant activities of the bank. These systems, including those that hold and use data in an electronic form must be secure, monitored independently and supported by adequate contingency arrangements.	The responsibility of ensuring appropriate information systems covering all activities and the integrity of such systems is enjoined on the senior management of the bank. However, more awareness needs to be promoted among senior management of banks in regard to security, risk and controls in computerised environment.	

8.1 A critical component of a bank's activities is the establishment and maintenance of management information systems that cover the full range of its activities. This information is usually provided through both electronic and non-electronic means. Banks must be particularly aware of the organisational and internal control requirements relating to processing information in an electronic form and the necessity to have an audit trail. Management decision-making could be adversely affected by unreliable or misleading information provided by systems that are poorly designed and controlled.	-do- The RBI has issued detailed guidance to banks on risks and controls in a computerised environment. The adequacy of controls is verified during the course of on-site inspections.	
8.2 Electronic information systems and the use of information technology have risks that must be effectively controlled by banks in order to avoid disruptions to business and potential losses. Since transaction processing and business applications have expanded beyond the use of mainframe computer environments to distributed systems for mission critical business functions, the magnitude of risks has also expanded. Controls over information systems and technology should include both general and application controls. General controls are the controls over the computer system (for example, mainframe, client/ server, and end-user workstations) and ensure their continued, proper operation. General controls include in-house back-up and recovery procedures, software development and acquisition policies, maintenance (change control) procedures, and physical/ logical access security controls. Application controls are computerised steps within software applications and other manual procedures that control	-do-	

the processing of transactions and business activities. Application controls include, for example, edit checks and specific logical access controls unique to a business system. Without adequate controls over information systems and technology, including systems that are under development, banks could experience the loss of data and programmes due to inadequate physical and electronic security arrangements, equipment or systems failures, and inadequate back-up and recovery procedures.		
8.3 In addition to the risks and controls above, inherent risks exist that are associated with the loss or extended disruption of services caused by factors beyond the bank's control. In extreme cases, since the delivery of corporate and customer services represent key transactional, strategic and reputational issues, such problems could cause serious difficulties for banks and even jeopardise their ability to conduct key business activities. This potential requires the bank to establish business resumption and contingency plans using an alternate off-site facility, including the recovery of critical systems supported by an external service provider. The potential for loss or extended disruption of critical business operations requires an institution-wide effort on contingency planning, involving business management, and not focused on centralised computer operations. Business resumption plans must be periodically tested to ensure the plan's functionality in the event of unexpected disaster.	-do-	
9.0 An effective internal control system requires effective channels of communication to ensure that all	Policies and procedures affecting duties and responsibilities of staff are communicated to all	

staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and that other relevant information is reaching the appropriate personnel.	concerned personnel.	
9.1 Without effective communication, information is useless. Senior management of banks need to establish effective paths of communication in order to ensure that the necessary information is reaching the appropriate people. This information relates both to the operational policies and procedures of the bank as well as information regarding the actual operational performance of the organisation.	-do-	
9.2 The organisational structure of the bank should facilitate an adequate flow of information-upward, downward and across the organisation. A structure that facilitates this flow ensures that information flows upward so that the board of directors and senior management are aware of the business risks and operating performance of the bank. Information flowing down through an organisation ensures that the bank's objectives, strategies, and expectations, as well as its established policies and procedures, are communicated to lower level management and operations personnel. This communication is essential to achieve a unified effort by all bank employees to meet the bank's objectives. Finally, communication across the organisation is necessary to ensure that information that one division or department knows can be shared with other affected divisions or departments.	The organisational structure of banks ensures appropriate multi-directional information flows across the organisation.	
E. Monitoring Activities and Correcting Deficiencies		

10.0 The overall effectiveness of the bank's internal controls should be monitored on an ongoing basis. Monitoring of key risks should be part of the daily activities of the bank as well as periodic evaluations by the business lines and internal audit.	Senior management continually monitors overall effectiveness of the bank's internal controls. However, monitoring of key risks is seldom done on a daily basis. Such monitoring is yet to be accepted in Indian banks as a part of the normal daily operations excepting in the case of market risks for treasury related transactions.	
10.1 Since banking is a dynamic, rapidly evolving industry, banks must continually monitor and evaluate their internal control systems in the light of changing internal and external conditions, and must enhance these systems as necessary to maintain their effectiveness. In complex multinational organisations, senior managements must ensure that the monitoring function is properly defined and structured within the organisation.	Periodical reviews of internal control systems in the light of changing internal and external conditions are undertaken by most banks.	
10.2 Monitoring the effectiveness of internal controls can be done by personnel from several different areas, including the business function itself, financial control and internal audit. For that reason, it is important that senior management makes clear which personnel are responsible for which monitoring functions. Monitoring should be part of the daily activities of the bank but also include separate periodic evaluations of the overall internal control process. The frequency of monitoring different activities of a bank should be determined by considering the risks involved and the frequency and nature of changes occurring in the operating environment.	Such review, monitoring and approval system prevails at the operating levels. Most banks have introduced the system of internal concurrent auditors who monitor the effectiveness of internal controls on a continuous basis. Internal control has thus been integrated into the operating environment.	

10.3 Ongoing monitoring activities can offer the advantage of quickly detecting and correcting deficiencies in the system of internal control. Such monitoring is most effective when the system of internal control is integrated into the operating environment and produces regular reports for reviews. Examples of ongoing monitoring include the review and approval of journal entries, and management review and approval of exception reports.	--Do--	
10.4 In contrast, separate evaluations typically detect problems only after the fact; however, separate evaluations allow an organisation to take a fresh, comprehensive look at the effectiveness of the internal control system and specifically at the effectiveness of the monitoring activities. These evaluations can be done by personnel from several different areas, including the business function itself, financial control and internal audit. Separate evaluations of the internal control system often take the form of self-assessments when persons responsible for a particular function determine the effectiveness of controls for their activities. The documentation and the results of the evaluations are then reviewed by senior management. All levels of review should be adequately documented and reported on a timely basis to the appropriate level of management.	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 efficient means of determining effectiveness of controls for both the operating level staff as well as the senior management responsible for the effectiveness of the internal control systems.	
11.0 There should be an effective and comprehensive internal audit of the internal control system carried out by operationally independent, appropriately trained and competent staff. The internal control function, as part of the monitoring of the system of internal	-Do-	

controls, should report directly to the board of directors or its audit committee, and to senior management.		
11.1 The internal audit function is an important part of the ongoing monitoring of the system of internal controls because it provides an independent assessment of the adequacy of, and compliance with, the established policies and procedures. It is critical that the internal audit function is independent from the day to day functioning of the bank and it has access to all activities conducted by the banking organisation, including at its branches and its subsidiaries.	Such a condition normally obtains in most banks. The frequency of internal audits is normally once a year or in many banks linked to the internal rating accorded to the bank's branch during the previous inspection. Frequency is also 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 the bank and has access to all activities conducted by the banking organisation.	
11.2 By reporting directly to the board of directors or its audit committee, and to the senior management, the internal auditors provide unbiased information about line activities. Due to the important nature of this function, internal audit must be staffed with competent, well-trained individuals who have a clear understanding of their role and responsibilities. The frequency and extent of internal audit review and testing of the internal controls within a bank should be consistent with the nature, complexity, and risk of the organisation's activities.	--Do--	
11.3 It is important that the internal audit function reports directly to the highest levels of the banking organisation, typically the board of directors or its audit committee, and to senior management. This allows for the proper functioning of corporate	The audit/ inspection reports are put up before the audit committee of the board/ the board unaltered in any way by the levels of management that the reports cover. The compensation of the officers conducting the	

governance by giving the board information that is not biased in any way by the levels of management that the reports cover. The board should also reinforce the independence of the internal auditors by having such matters as their compensation or budgeted resources determined by the board or the highest levels of management rather than by managers who are affected by the work of the internal auditors.	audit inspection or the budgeted resources are not determined by the managers who are affected by the work of the internal auditors.	
12.0 Internal control deficiencies, whether identified by business line, internal audit or other control personnel, should be reported in a timely manner to the appropriate management level and addressed promptly. Material internal control deficiencies should be reported to the senior management and the board of directors.	This position obtains.	
12.1 Internal control deficiencies, or ineffectively controlled risks, should be reported to the appropriate person(s) as soon as they are identified, with serious matters reported to senior management and board of directors. Once reported, it is important that management corrects the deficiencies on a timely basis. The internal auditors should conduct follow-up reviews or other appropriate forms of monitoring, and immediately inform senior management or the board of any uncorrected deficiencies. In order to ensure that all deficiencies are addressed in a timely manner, senior management should be responsible for establishing a system to track internal control weaknesses and actions taken to rectify them.	The internal audit department in banks monitors the corrective/ compliance action and submits status reviews to the board/ audit committee.	
12.2 The Board of Directors and senior management should periodically receive reports summarising all	This position obtains.	

control issues that have been identified. Issues that appear to be immaterial when individual control processes are looked at in isolation, may well point to trends that could, when linked, become a significant control deficiency if not addressed in a timely manner.		

F. Evaluation of internal control systems by supervisory authorities		
13.0 Supervisors should require that all banks, regardless of size, have an effective system of internal controls that is consistent with the nature, complexity, and risk inherent in their on- and off- balance sheet activities and that responds to changes in the bank's environment and conditions. In those instances where supervisors determine that a bank's internal control system is not adequate or effective for the bank's specific risk profile (for example, does not cover all of the principles contained in this document), they should take appropriate action.	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 and takes necessary follow-up action to ensure that the banks concerned take appropriate corrective action.	
13.1 Although the board of directors and senior management bear ultimate responsibility for an effective system of internal controls, supervisors should assess the internal control system in place at individual banks as part of their ongoing supervisory activities. The supervisors should also determine whether individual bank management gives prompt attention to any problems that are detected through the internal control process.	The findings of the supervisory examinations are discussed by RBI with Chairmen and senior management team of banks. Banks are also required to place a copy of the inspection findings along with their strategy for corrective action before their boards/audit committees. RBI also monitors the compliance action taken by the bank.	
13.2 Supervisors should require the banks they supervise to have strong control cultures and should take a risk-focused approach in their supervisory activities. This includes a review of the adequacy of internal controls. It is important that supervisors not only assess the effectiveness of the overall system of internal controls, but also evaluate the controls over high-risk areas (e.g., areas with characteristics such as	RBI currently adopts a standardised approach for all banks irrespective of their risk profiles. The RBI has now decided to move over to a risk based approach to supervision, which would have an increased risk focus. A mandatory assessment of the control environment, apart from other areas of risk has been proposed as part of the new system. The	

unusual profitability, rapid growth, new business activity, or geographic remoteness from the head office). In those instances, where supervisors determine that a bank's internal control system is not adequate or effective for that bank's specific risk profile, they should take appropriate action. This would involve communicating their concerns to senior management and monitoring what actions the bank takes to improve its internal control system.	supervisor requires the banks to have written policies and procedures as a key communication mechanism.	
13.3 Supervisors, in evaluating the internal control systems of banks, may choose to direct special attention to activities or situations that historically have been associated with internal control breakdowns leading to substantial losses. Certain changes in a bank's environment should be the subject of special consideration to see whether accompanying revisions are needed in the internal control systems. These changes include: (i) a changed operating environment; (ii) new personnel; (iii) new or revamped information systems; (iv) areas/activities experiencing rapid growth; (v) new technology; (vi) new lines, products, activities (particularly complex ones); (vii) corporate restructuring, mergers and acquisitions; and (viii) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).	Supervisor directs special attention to activities or situations that historically have been associated with internal control breakdowns leading to substantial losses. Changes in bank's environment are subject to special considerations from the supervisor.	The supervisor's on-site inspection of banks is at present not fully tailored to specific bank's environment and is thus not quite individualised. The 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 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.
13.4 To evaluate the quality of internal controls, supervisors can take a number of approaches. Supervisors can evaluate the work of the internal audit department of the bank through review of its work papers, including the methodology used to identify,	This approach is generally followed in the on-site inspection of banks by the supervisor's (RBI) inspection teams.	

measure, monitor and control risk. If satisfied with the quality of the internal audit department's work, supervisors can use the reports of internal auditors as a primary mechanism for identifying control problems in the bank, or for identifying areas of potential risk that the auditors have not recently reviewed. Some supervisors may use a self-assessment process, in which management reviews the internal controls on a business-by-business basis and certifies to the supervisor that its controls are adequate for its business. Other supervisors may require periodic external audits of key areas, where the supervisor defines the scope. And finally, supervisors may combine one or more of the above techniques with their own on-site reviews or examination of internal controls.		
13.5 Supervisors in many countries conduct on-site examinations and a review of internal controls is an integral part of such examinations. An on-site review could include both a review of the business process and a reasonable level of transaction testing in order to obtain an independent verification of the bank's own internal control processes.	This position obtains.	
13.6 An appropriate level of transaction testing should be performed to verify: • the adequacy of, and adherence to, internal policies, procedures and limits; • the accuracy and completeness of management reports and financial records; and • the reliability (i.e., whether it functions as	The on-site assessments are based on the CAMELS model. The focus is on systems, controls and asset evaluation with a high level of transaction testing. However, with a move towards risk-based supervision, the level of transaction testing would be calibrated on the basis of the risk profile of individual banks focusing on areas of higher risks.	

management intends) of specific controls identified as key to the internal control element being assessed.		
13.7 In order to evaluate the effectiveness of the five internal control elements of a banking organisation (or a unit/activity thereof), supervisors should: • identify the internal control objectives that are relevant to the organisation, unit or activity under review (e.g., lending, investing, accounting); • evaluate the effectiveness of the internal control elements, not just by reviewing policies and procedures, but also by reviewing documentation, discussing operations with various levels of bank personnel, observing the operating environment, and testing transactions; • share supervisory concerns about internal controls and recommendations for their improvement with the Board of Directors and management on a timely basis, and; • determine that, where deficiencies are noted, corrective action is taken in a timely manner.	RBI evaluates the adequacy and effectiveness of internal control elements of banks during the on-site process. Apart from reviewing policies and procedures, the supervisory assessments are made by reviewing documentation, observing operating environment and also testing individual high value transactions on sample basis. The evaluation is factored in the risk assessment of the bank under the CAMELS framework where the component 'S' stands for systems and controls.	
13.8 Banking supervisory authorities that have the legal basis or other arrangements to direct the scope of and make use of the work of external auditors, often or always do so in lieu of on-site examinations. In those instances, the external auditors should be performing the review of the business process and the transaction testing described above under specific engagement	During the annual financial inspections conducted by the RBI of commercial banks, the findings of the external auditors are also reviewed in arriving at its evaluation. However, the findings of the auditors are invariably verified during the inspections.	It would be more efficient if RBI would leverage the findings of the external auditors of the bank. The RBI may also consider the practice of engaging external auditors for specific area audit/ inspection of banks and utilise their reports for supervisory oversight as is

arrangements. In turn, the supervisor should assess the quality of the auditor's work.		done by some other regulators.
13.9 In all instances, bank supervisor should take note of the external auditors' observations and recommendations regarding the effectiveness of internal controls and determine that bank management and the board of directors have satisfactorily addressed the concerns and recommendations expressed by the external auditors. The level and nature of control problems found by the auditors should be factored into the supervisors' evaluation of the effectiveness of a bank's internal controls.	This is done by the supervisor.	
13.10 Supervisors should also encourage bank external auditors to plan and conduct their audits in ways that appropriately consider the possibility of material misstatement of banks' financial statement due to fraud. Any fraud found by the external auditors, regardless of materiality, must be communicated to the appropriate level of management. Fraud involving senior management and fraud that is material to the entity should be reported by the external auditors to the board of directors and/or the audit committee. External auditors may be expected to disclose fraud to certain supervisory authorities or others outside the bank in certain circumstances (subject to national requirements).	External auditors report their audit findings directly to the board of directors of the bank. External auditors are not required to directly report their findings regarding frauds detected to the supervisors (RBI) or any other authority.	
13.11 In reviewing the adequacy of the internal control process at individual banking organisations, home country supervisors should also determine that the process is effective across business lines, subsidiaries and national boundaries. It is important that	RBI currently reviews the adequacy of internal control process in banking institutions on a stand-alone basis. In view of distinct supervisory jurisdictions for securities market, housing finance and insurance activities, RBI	

supervisors evaluate the internal control process not only at the level of individual businesses or legal entities, but also across the wide spectrum of activities and subsidiaries within the consolidated banking organisation. For this reason, supervisors should encourage banking groups to use common auditors and common accounting dates throughout the group, to the extent possible.	does not explicitly evaluate internal controls at subsidiaries engaged in these activities. At present, RBI also does not insist on the use of common auditors and common accounting dates throughout groups.	
G. Roles and responsibilities of External auditors		
14.0 While the primary purpose of the external audit function is to give an opinion on the annual accounts of a bank, the external auditor must choose whether to rely on the effectiveness of the bank's internal control system. For this reason, the external auditors have to obtain an understanding of the internal control system in order to assess the extent to which they can rely on the system in determining the nature, timing and scope of their own audit procedures.	The external auditors assess and comment on the adequacy and effectiveness of the internal control systems in banks.	
14.1 The exact role of external auditors and the processes they use vary from country to country. Professional auditing standards in many countries require that audits be planned and performed to obtain reasonable assurance that financial statements are free of material misstatement. Auditors also examine, on a test basis, underlying transactions and records supporting financial statement balances and disclosures. An auditor assesses the accounting principles and policies used and significant estimates made by management and evaluates the overall financial statement presentation. In some countries,	Professional auditing standards in India require audits to be performed in a way that reasonable assurance is obtained that the financial statements provide a true and fair view of the banks condition and that the statement is free of material misstatements. The auditors specifically comment on the consistency of accounting policies adopted by the bank and their conformance with generally accepted accounting principle.	

external auditors are required by the supervisory authorities to provide a specific assessment of the scope, adequacy and effectiveness of a bank's internal control system, including the internal audit system.		
14.2 One consistency among countries, however, is the expectation that external auditors will gain an understanding of a bank's internal control process to the extent that it relates to the accuracy of the bank's financial statements. The extent of attention given to the internal control system varies by auditor and by bank; however, it is generally accepted that material weaknesses identified by the auditors should be reported to management in confidential management letters and, in many countries, to the supervisory authorities. Furthermore, in many countries, external auditors may be subject to special supervisory requirements that specify the way that they evaluate and report on internal controls.	The auditing profession in India is governed by standards of professional conduct and ethics prescribed by the ICAI. While weaknesses in internal control are communicated either orally or in writing to the management, there is no practice of external auditors directly communicating their observations and concerns to the supervisors.	

Annex 4
Principles for the Management of Credit Risk [iii]

Principle	Indian Position	Remarks
A. Establishing an appropriate credit risk environment		
1. The board of directors should have responsibility for approving and periodically reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.	The board of directors of banks in India review and approve the loan policies of banks, which cover credit risk policy and strategy. However, as scientific risk management is in a nascent stage of development, Indian banks have not focused the credit risk strategy in their loan policies.	Banks will have to put in place a sound risk management system within as short a timeframe as possible, but in any case not exceeding two to three years. With stabilisation of risk management systems, banks will be required to revisit their loan policies and articulate credit risk management strategies in it.
2. Senior management should have responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank's activities and at both the individual credit and portfolio levels.	As stated above, Indian banks have not yet focused the credit risk strategy in their loan policies.	With stabilisation of risk management systems being put in place by banks, senior management of banks will be required to implement the credit risk strategy approved by the board.
3. Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being	Banks in India do identify the credit risk in most of the products and activities and take approval of the boards of directors. However, the management of credit risk is yet to be on scientific lines.	

introduced or undertaken, and approved in advance by the board of directors or its appropriate committee.		
B. Operating under a sound credit granting process		
4. Banks must operate under sound, well-defined credit granting criteria. These criteria should include a clear indication of bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of credit, and its source of repayment.	Banks in India do have a sound and well-defined credit granting system.	
5. Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in a comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.	Banks have set up maximum exposure limits to individual and group borrowers within the ceilings prescribed by the regulator, which is in line with international best practices.	
6. Banks should have a clearly established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.	Banks in India have clearly established processes for approving new credits and renewal of existing credits.	
7. All extension of credit must be made on an arm's length basis. In particular, credits to	Banks in India are statutorily prohibited to make connected lending to their directors	

related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.	or the parties in which the directors are interested. Lending to related companies, i.e., banks' own subsidiaries are at arm's length basis with no concessions.	
C. Maintaining an appropriate credit administration, measurement and monitoring process		
8. Banks should have in place a system for ongoing administration of their various credit risk-bearing portfolios.	Banks in India have in place a system for ongoing administration of their credit risk-bearing portfolios.	
9. Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.	Banks in India have system for monitoring individual credits. However, the determination of provisions for loan losses are formulae-based.	
10. Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with nature, size and complexity of a bank's activities.	Banks in India have developed internal risk rating systems in managing credit risk, which is consistent with their nature of activities.	
11. Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information	While banks in India have information systems to measure credit risk and concentration risk in all on-balance sheet exposures, the information system is not developed to capture off-balance sheet activities.	

on the composition of the credit portfolio, including identification of any concentrations of risk.		
12. Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.	Banks in India have systems in place for monitoring the overall composition and quality of credit portfolio.	
13. Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.	Though banks in India do generally take into consideration potential future changes in economic scenario while assessing individual credits, its impact on the credit portfolio under stressful conditions is not analysed in a sophisticated manner.	
D. Ensuring adequate controls over credit risk		
14. Banks must establish a system of independent, ongoing assessment of the bank's credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.	As stated earlier, Indian banks are yet to develop a risk focus in their credit risk management processes.	
15. Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and	This practice is there in Indian banks.	

enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.		
16. Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.	This practice is there in Indian banks.	
E. The role of supervisors		
17. Supervisors should require that banks have an effective system in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. Supervisors should conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio. Supervisors should consider setting prudential limits to restrict bank exposures to single borrowers or groups of connected counterparties.	RBI, the supervisor has issued comprehensive risk management guidelines in banks in October 1999. As stated earlier, scientific credit risk management systems are yet to stabilise in Indian banks. Through on- and off-site supervisory systems, RBI conducts independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio. RBI has also set up prudential limits to restrict bank exposures to single borrowers or groups of connected counterparties.	

Annex 5

Range of Practice in Banks' Internal Ratings Systems [iv]

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

reserves and provisions are expected to take care of the expected loss component, the unexpected loss is to be covered by Economic Capital.	that bank would experience over a chosen time horizon and unexpected loan losses.	
2. Banks have different approaches to rating system because of factors such as a) Differing emphasis on quantitative and qualitative risk factors; b) Importance of each institution's credit culture and historical experience; c) Differing judgements regarding complexity and opaqueness of risks associated with each transaction; d) Differing responses to inherent difficulties in quantifying loss characteristics; e) Different risk management and other uses to which rating information and risk measures are put.	a) Banks in India normally follow internal rating systems in which both qualitative and quantitative risks factors are measured and taken into account. These systems are, however, simple and not in a position to assess more opaque risks attached with complex transactions. b) Risk measurement techniques are yet to be used for quantifying loss characteristics as such.	With growing size and complexity of operations and increasing orientation of banks towards management of risks, there is a need for banks in India to restructure their rating systems enabling these to capture market dynamics.
B. Basic architecture of Internal Rating Based approach to capital		
Internal Rating Based approach to regulatory capital should have three basic elements : 1) To become eligible for IRB approach, a bank has to demonstrate that its Internal Rating system and processes are in accordance with minimum standards and sound practice guidelines which will be set up by Basel Committee. These	a) RBI, in their guidelines for Risk Management Systems in Banks, have stipulated that credit risk management process should be articulated in bank's loan policy, duly approved by the board. b) This process for banks in India can start only after Basel Committee sets	a) Any successful approach in this context would require familiarity of the functionaries with the rating process. b) A comprehensive risk rating system should serve as a single joint indicator of diverse risk factors. c) In the Indian context it would be

guidelines would ensure the quality, usefulness and integrity of the key statistics that would form the basis of the bank's capital requirements. 2) If the bank's internal system/ procedures meet these requirements, bank need to provide to supervisors exposure amounts and estimates of key loss statistics association with these exposures (such as PD) by internal rating grade. These exposures would include both outstanding balances as well as some percentage of committed but undrawn amounts. Banks would provide information based on their own rating systems, in accordance with minimum standards and sound practice guidelines that would be set forward by the Basel Committee. 3) Based on the banks' estimate of Probability of Default (PD) and estimates of Loss Given Default (LGD) and other potential asset characteristics, banks' exposure would be assigned to capital "buckets". Each bucket would have a risk weight that incorporates unexpected loss associated with estimates of PD, LGD and other losses. These risk weights would be developed by bank supervisors taking into account intrinsic risk of the asset and minimising incentives for banks to bias the assignment of Internal Rating, or to engage in capital arbitrage.	forward the minimum standards and sound practice guidelines for Internal Rating approach.	necessary to strengthen the MIS and data collection machinery in banks to ensure integrity and reliability of the data is beyond doubt. d) The ratings should facilitate the functionaries by informing them of the quality of loan at any moment of time.
C. Range of Practice in the Rating System Structure		
1. Range in Rating Systems		

a) Average number of grades reported by banks covering non-impaired corporate loan is 10. The range normally falls between 2 and 20. b) Average number of problem grades reported by banks is 3. c) The measure of ability of well-functioning rating system is the largest percentage of total rated exposures falling in a single grade. On an average, banks normally have 30 per cent of rated exposure within a single grade.	a) Banks in India have normally between 6-8 rating grades for non-impaired corporate loans. b) Banks in India have normally 3 rating grades for problem loans. c) This could be the position for banks in India also. However we need to get more data on this aspect of the present rating system of banks in India.	
D. A key element of rating system structure is the focus on characteristic of the borrower (obligor) as opposed to specific details of transaction/ facility		
a) Majority of banks have adopted an explicit obligor dimension, that is, they assign a rating which reflect the risk that borrower will default on any of its obligations. b) One third of the banks utilise a two dimensional rating, i.e., the ratings system includes both an obligor grade and a facility grade. Facility grades for different loans could differ based on collateral taken, seniority or other structural attributes of the loan. c) Among those banks with two-dimensional rating systems, a small number appears to assign an obligor rating and a second "LGD" rating that explicitly evaluates likely recovery rates for each transaction in the event that a default were to occur.	Internal Rating Systems in the Indian banking system is mostly with obligor dimension. This rating reflects the risk that the borrower will default in any of its obligations. Rating of individual facilities is yet uncommon although some banks, in recent years, have introduced differential pricing for term loans through an unique benchmark rate. However, despite the prevalence of 'only obligor' rating system, most banks in India do take into consideration, through analysis of quantitative and qualitative data, the riskiness of different facilities, profitability analysis of the various lines of business of the obligor, quality of the management, developments at the	

d) In practice, even banks which have only an obligor rating system in place, may implicitly take into consideration the riskiness of facilities for pricing, profitability analysis and in allocation of economic capital; in such cases, facility type LGD is mechanically derived based on the type of loan, the presence and type of collateral, and possibly other factors, in effect, outside of the rating system. e) In light of the above practices, it would appear that only a small minority of banks take no consideration of facility characteristics in their grading process.	industry/ business levels, etc., in arriving at the rating.	
E. Categories of Rating Process		
There are three main categories of rating processes under; a) <u>Statistical-based processes</u>: In this process, the credit rating models typically include both quantitative (financial rating etc.) and some qualitative but standardised (industry, payment history/ credit report) factors. Normally this approach has more prominent role in small corporate lending than for middle market or large corporates. b) <u>Constrained expert judgement processes:</u> In this, the raters base their rating on statistical models, but are permitted to adjust this rating to an explicitly limited degree based on judgement	Banks in India use a combination of both statistical based processes and constrained expert judgement processes. The expert judgement process is not in vogue especially for large corporates.	

factors. However the raters may adjust the final grade up or down by no more than two gradations based on judgement. Around 20 per cent of the banks use this approach for their large corporates, while a similar number used this approach for middle market and smaller corporates. c) <u>Expert judgement process:</u> In this process ratings are assigned using considerable judgemental elements. Over half the banks use this process for large corporates and a similar number noted its use for both middle and smaller corporates.		
F. Risk factors considered in assigning grades		
1. <u>Main considerations in assessing borrowers :</u> I. Financial statements such as balance sheets, income statements, cash flow statements, etc. Those banks relying heavily on the statistical default models use specific type of financial data (e.g., specific ratios that described leverage, debt service coverage, and the like), while those banks relying on more judgemental analysis may allow discretion to the rater on analysis of these data. II. Historical and trend data of the above financial statements. Some banks use three or more years of data. III. Industry and peer group analysis. In this case supporting industry analysis is provided by internal economic analysis units or outside	All these factors are taken into account by banks in India while assigning grades to the borrowers in most cases.	

vendors, so that the different raters within the same institution would tend to incorporate a common view of the industry's outlook across all borrowers. IV. Management experience and competence (especially in areas where constrained expert judgement is used) V. Ownership structure, reputation, quality of financial information provided, the purpose for which the loan is provided, environmental liabilities, etc. VI. Country risk in case of cross border lending. Country risk is universally considered using a "sovereign ceiling" rule (the rating of the counterparty cannot exceed the rating of the sovereign in which it is incorporated or has its principal place of business. 2. <u>Main considerations in assessing facilities</u> : i. Facility characteristics such as third party guarantee, collateral and seniority/ subordination of the obligations are taken into account taken into account while assigning a grade to an exposure and/or analysing internal profitability or capital allocations.	a) These factors are taken into account by banks in India while assessing facilities for the borrowers.	
ii. Most banks allow bank guarantees to affect the rating by effectively transferring the risk to the guarantor, or, alternatively, using the more favourable of the borrower or guarantor rating. iii. Banks providing facility grades generally did not	b) Some of the banks in India go by the principle that availability of collateral should not influence the risk rating as collaterals help in taking a business decision while credit rating facilitates a credit decision.	

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

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

models and economic capital allocation process. v) Evaluating the accuracy and consistency of rating criteria (i.e., to determine whether different assets in the same grade have the same loss characteristics).	and sophistication, the objectives behind measuring loss characteristics by grade as stated here will not receive the desired focus.	levels of risk management to levels of greater sophistication more expeditiously. In this they may not be having in-house expertise and may therefore be encouraged to obtain external assistance, e.g., from consultants, etc.
I. Methods for estimating loss characteristics		
Rating systems rely on criteria that are expected to provide information about a borrower's/facility's perceived riskiness or loss characteristics. The process of inferring loss characteristics requires information about borrower and asset characteristics as well as information about historical loss experience that can be used to associate loss characteristics to grades. These requirements can be met in the following two ways. i) Banks can analyse its internal data on loss experience of various asset classes over a sufficiently long period. ii) If a bank has reconciled its grading with those of external credit assessment institution, then it can use the institution's published data on loss experience. A key consideration in relying on such external data is the comparability of such data to a bank's own portfolio. Comparability could become difficult due to reasons such as differences in the composition of the bank's own portfolio, the potential differences between the performance of publicly traded bonds and that of loans .	As above	As above

J. Survey Results on Probability of Default (PD)		
1) Many banks did not have sufficient data for specifying loss characteristic based on their own default history but a number relied on internal data for analysing the performance of borrower segments such as retail or middle market customers. Though many banks have initiated data gathering over the past five years, majority of banks rely on data provided by major rating agencies, public data banks or consulting company's data. 2) To use the data provided by external agencies, banks must assume correspondence between their rating grades and those of external agencies by 'mapping' to the grades of the latter. 3) This is more easily done in case of borrowers who have issued publicly rated bonds, as the ratings of various financial data by external agencies can be easily compared with grades given internally for the same borrower. 4) There are difference in banks' approach towards the conceptual definitions of defaults and loss in assigning ratings. The Models Task Force will continue to analyse the degree to which the use of such different definitions of default and loss at banks, and in the data sources used to quantify the loss characteristics of each internal grade, affect the comparability of PD estimates within the banks, as well as across banks and countries. 5) Many banks have started to track the migration of	a) Banks in India are yet to use their internal default data to arrive at PD, though some banks are attempting this process. b) In view of the wide network of branches and the fact that many of the branches in rural and semi-urban areas have not been computerised, many operational constraints are faced by banks in building up a reliable database.	a) MIS and data collection machinery in banks would need to be strengthened to see that integrity and reliability of data is beyond doubt. b)The probability of default could be derived from past behaviour of the loan portfolio, which is the function of loan loss provision/charge-offs for the last five years or so.

loans between rating grades. Some banks are relying on this data in checking the calibration of PD and LGD, and validating the internal consistency of the rating process. 6) Some banks are using statistical default models for calculating average PDs for each internal grades. Such models are in assigning and/or reviewing the assignment of internal grades.	Banks in India have yet to begin using statistical default models for calculating average PDs for each internal rating grade.	
K. Survey results on Loss Given Default (LGD)		
1) One third of banks apply facility-specific LGD estimates to their exposures for use in internal capital allocation and/or profitability analysis system. Among the remaining majority of banks, many indicated that they did not at present estimate LGD, possibly because they do not at present operate capital allocation or profitability analysis system that make use of LGD estimates. 2) General factors considered important for estimating LGD are as under : i) Borrower's attributes (such as borrower's grade, country of incorporation, size, industrial sector and other factors which may affect the unsecured value remaining in the defaulted borrower, whether it continues to operate after default or is in liquidation) ii) Facility characteristics(including the existence of credit mitigation techniques such as seniority of the structure, realisable value of the collateral taken, and the value of any other forms of credit risk mitigation such as third party guarantee)	Banks in India are yet to go in for LGD estimates though some banks are making efforts in this direction.	It is desirable that banks build historical data base on the portfolio quantity and provisioning/ charge off to equip themselves to price the risk.

iii) Bank specific characteristics (such as the internal policy towards recovery), and iv) Exogenous factors (such as the economic cycle) 3) With respect to secured facilities, banks use a variety of techniques and data sources to arrive at estimates of the value of both financial and physical forms of collateral. Some banks distinguish between “normal” and “forced sale” valuations. Some banks also request, based on the terms of the contract, additional collateral and /or other risk mitigants to maintain the expected recovery ratio. 4) As regards data used for measuring LGD, nearly all banks rely on data from their own historical records. 5) Like in the case of quantifying PDs, those banks seeking to quantify LGD also retain different definitions of what constitutes “default” as well as “loss”, and relied on different assumptions about direct and indirect costs, and the time taken to ultimate workout. N.B.: Models Task Force found survey responses insufficient to glean a consensus on a common framework or “right” LGD estimate for loans of various types. Hence it has urged banks to collect data on LGD as part of an overall approach to assessing and measuring more systematically the amount of credit risks to which they are exposed.		

L. Survey Results on Exposure at Default (EAD)		
a) It would appear that those banks that typically estimate EAD for facilities with uncertain drawdown, such as a standby line of commitment were those banks that were using some form of capital allocation model. In these cases, EAD is equated to the sum of (1) balances actually drawn and (2) committed but undrawn exposures multiplied by a factor of "x". Key variables having a bearing on the EAD estimate included current outstandings, committed funds, facility structure, and borrower ratings. In the calculation of conversion factor few banks made distinctions in terms of maturity. b) To an even greater degree than with LGD, banks rely heavily on internal data and studies based on their own historical experience while estimating EAD values. The banks that estimate a facility's EAD for use in capital allocation and profitability systems do so based only loosely on historical or statistical analysis, and incorporate substantial elements of business judgement and conservatism into these figures.	Banks in India are yet to go for estimation of EAD, though some banks are attempting on these lines.	
M. Applications of Rating systems		
The rating system is normally used in the following areas: 1) Management Reporting: Normally a summary reporting is made to senior management for the	1) The rating system is being put to similar use by some banks in India	The banks which are not following this practice as of now may be advised by RBI to do so.

purposes of monitoring the risk composition of the rated portfolios. In some cases the report can contain borrower specific information, such as shifts in rating classes for a single customer.	also.	
2) Pricing: The types of applications range from calculation of cost of funds to assigning grade specific risk premiums. At some more sophisticated institutions, the cost of capital is explicitly considered in pricing decisions.	2) Internal rating grades are used for pricing by some banks.	
3) Decisions on reserve levels: One third of the banks relate the level of reserves to the rating classes. Remaining banks also implicitly consider the rating information when determining reserves.	3) In the Indian system, reserves are created/provisions made on the rating of individual accounts and not in aggregate for a whole grade. Even though a uniform reserve is created for all standard assets, this reserve is the same across different grades as long as the relative advances are standard, i.e., performing.	
4) Economic capital allocation: About half the banks surveyed use rating information for attributing economic capital to product or business lines.	4) This is being attempted here	
5) Compensation for relationship managers: One third of the banks base compensation for relationship managers on ratings. A number of banks which calculate risk adjusted return on economic capital on rating information also noted that they base incentive-based compensation on this measure.	5) Neither the compensation package nor performance accountability is in any manner related to the rating categories.	
6) Setting of credit limits: More than half the banks indicated that limits are set based on rating categories. A few banks explicitly noted that loan	6) Internal rating grades are not being used for this purpose. The exposure limits to borrowers and sanctioning	

approval authority is tied to rating categories.	powers are mostly independent of the rating category in which a particular loan proposal may be falling.	
N. Oversight and Control of Internal Rating System		
1) Though primary responsibility for initially proposing rating for borrowers varied widely, ratings for large corporates must be approved by credit staff, although the rating may be initially proposed by relationship managers. 2) Most of the banks indicated that credit culture was very important in ensuring accuracy and consistency of rating assignments. 3) All the credit decisions are documented adequately. 4) There was little information provided on loan review units, although some banks indicated that loan review staff reviewed loans on a sampling basis, usually, from riskier loans or in growing areas of lending concentration. 5) All banks conduct a formal review of each risk rating at least once a year. The frequency of review depends on the riskiness of the loan and collateral. 6) In addition to formal review, many use credit scoring model as a monitoring tool to identify exposures whose riskiness may be increasing and thus potentially prompt further review.	1) Some banks follow this practice here as well whereby rating is initially recommended by the relationship manager and reviewed by the credit department. 2) Strong credit culture is in place in many of the banks in India. 3) All credit decisions are documented adequately. 4) Many banks in India conduct credit audits of large loans within three to six months of sanction and disbursal. 5) All banks conduct formal renewal of risk rating once a year. Periodical reviews are done on risky exposures. 6) Periodical review of ratings system is also undertaken.	

7) Normally all the rating systems are developed internally, sometimes in cooperation with outside consultants. 8) Many banks emphasised that their systems continue to undergo additional enhancements in a periodical manner. 9) All rating systems are extensively documented and the documentation is made available to relevant staff. 10) A third of the banks do backtesting of their internal rating process and use these results to modify either the rating process or the PDs associated with each grade.	7) The rating systems are mostly being developed internally. Some banks use scoring models to identify riskiness of exposures. 8) This is true of India as well. 9) The rating systems are well documented and the documentation is made available to the concerned staff. 10) The rating processes are reviewed periodically but backtesting is not yet in vogue.	
O. Future steps for supervisors		
1) Supervisors need to consider the following : i) More closely aligning regulatory capital charges to underlying risk. ii) Ensuring that the new supervisory standards provide incentives for banks to continue to refine risk measurement processes. iii) Ensuring that banks do not move away from established sound credit management policies, and iv) Addressing the degree of comparability of	Systematic risk management has only recently been introduced in Indian banks. Most banks are in the process of setting up a system which is simple. Sophistication will be introduced only with passage of time as the banks increase that affinity with the existing system and have improved their MIS substantially. Most of the concepts discussed here are yet to be introduced to the banks.	a) Allocation of economic capital on the basis of risk or variability of returns has gained international acceptance and supervisors are planning to evaluate the internal capital adequacy assessment of banks. b) Banks in India would have to formulate a medium term strategy to implement Risk Aggregation and Capital Allocation mechanism. c) RBI may consider guiding the banks to

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

Annex 6
Banks' Interactions with Highly Leveraged Institutions [v]

No.	Principle	Indian Position	Remarks
1.	**Banks' involvement with HLIs and their overall credit risk strategy** Before conducing business with HLIs, a bank should establish clear policies that govern its involvement with these institutions consistent with its overall credit risk strategy. Banks should ensure that an adequate level of risk management, consistent with their involvement with HLIs, is in place.	Indian banks do not generally have dealings with Highly Leveraged Institutions as defined in the BIS Paper. With increasing globalisation, the possibility of such interactions taking place, and on an increasing scale, cannot be ruled out. It is, therefore, felt necessary to have necessary guidelines in this regard in place.	
2.	**Information gathering, due diligence and credit analysis of HLIs** A bank that deals with HLIs should employ sound and well-defined credit standards which address the specific risks associated with HLIs.	-- do --	
3.	**Exposure measurement** A bank taking on OTC derivatives positions vis-à-vis HLIs should develop meaningful measures of credit exposure and incorporate these measures into its management decision-making process.	-- do --	
4.	**Limit setting** Effective limit setting depends on the	-- do --	

	availability of meaningful exposure measurement methodologies. In particular, banks should establish overall credit limits at the level of individual counterparties that aggregate different types of exposures in a comparable and meaningful manner.		
5.	**Collateral, early termination and other contractual provisions** A bank interacting with HLIs should align collateral, early termination and other contractual provisions with the credit quality of HLIs, taking into account the particular characteristics of these institutions such as their ability to rapidly change trading strategies, risk profiles and leverage. In doing so, banks may be able to control credit risk more pre-emptively than is the case when such provisions are driven solely by net asset values.	-- do --	

Annex 7

Sound Practices for Loan Accounting and Disclosure [vi]

Principle	Indian Position	Remarks
I. FOUNDATIONS FOR SOUND ACCOUNTING		
1. A bank should adopt a sound system for managing credit risk. Effective risk management and control policies are essentially related to sound and timely accounting and valuation of loans. To be able to prudently value loans and to determine appropriate allowances, it is particularly important that banks have a system in place to reliably classify all loans on the basis of risk. A credit risk classification system may include degrees of credit deterioration, borrowers' current financial position and paying capacity, the current value and realisability of collateral, and other factors that affect the prospect for collection of principal and interest. Accounting and valuation process must be complemented by effective internal control in bank's lending operations.	The regulatory requirement for banks in India is to classify loans on the basis of risk in a four-tiered asset classification system, viz., Standard, Sub-standard, Doubtful and Loss. The classification is primarily based on an objective criterion of record of recovery of interest and principal and an assessment of probability/chances of recovery in future. A Standard asset is one which does not indicate any problems and which does not carry more than normal risk attached to the business. An asset becomes non-performing (NPA) when it ceases to repay interest and/or instalment (principal) for a period of two quarters, i.e., 180 days (to be reduced to 90 days with effect from 31 March 2004) in a financial year. A Sub-standard asset is one which has been classified as NPA for a period not exceeding 18 months. A Doubtful asset is one which has remained NPA for a period exceeding 18 months.	The position of loan classification in India is objective, based on record of recovery of interest and principal coupled with an assessment about their realisability. Although internationally in most banking systems, an asset is classified into Sub-standard category after 90 days' of payment delinquency, Indian banks are expected to adopt this practice only from 31 March 2004. This is largely due to the current trade/business practices followed in the country, which permits a long payment cycle. Further, the Indian loan classification 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 collaterals is reckoned at a progressive discount up to 3 years only beyond which there is no further discounting of the value of collaterals. If the loan does not migrate to Loss category (for which 100 per cent

	A Loss asset is one where loss has been identified by the bank or its auditors, internal or external or by the RBI in its inspection report. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value. Advances need not go through the progression of Substandard to Doubtful to Loss; but, could be straightaway classified as Doubtful or Loss where there are potential threats to recovery. Loan loss allowances (provisions) are generally based on standardised formula as given below: Sub-standard assets – 10 per cent Doubtful assets – 100 per cent for the unsecured portion and 20 per cent, 30 per cent and 50 per cent on the secured portion if the loan remains in doubtful category up to 1 year, 1 to 3 years and more than 3 years respectively. Loss assets – 100 per cent Keeping in line with international best practices, a general allowance of 0.25 per cent is also created for Standard assets.	provision is required to be made), the accounts remains under-provided as after 3 years on a debt in Doubtful category a maximum of 50 per cent provision is created on the portion of the debt which is considered as secured. This loophole needs to be plugged in the context of limitations in the legal situation prevailing in the country in the realisation of collaterals. This should be gradually increased to international standards.

	The exercise of accounting/classification of loans into the four categories is carried out on an on-going basis and for the purpose of valuation, allowances (provisions) are created at the time of annual closing of balance sheet. Banks also have proper internal control systems approved by the Board of Directors for recording, documentation, loan review procedures, etc.	
2. Judgements by management relating to the recognition and measurement of impairment should be made in accordance with documented policies and procedures that reflect such principles as consistency and prudence. Recognition and measurement of loan impairment cannot be totally based on specific rules and involve a mix of formal rules and judgement by management. Judgements are necessary but should be prudently limited and documented and applied consistently over time.	Basic guidelines for risk classification of loans have been provided by the central bank, i.e., RBI. In addition, banks have their own documented policies of loan classifications which are formulated with the RBI guidelines as base. The policies are, therefore, 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.	
3. The selection and application of accounting policies and procedures should conform to fundamental accounting concepts, like true and fair view, reliability, prudence, materiality, consistency, accrual basis of accounting, etc.	The selection and application of accounting policies and procedures by Indian banks conform to fundamental accounting concepts.	

II. ACCOUNTING FOR LOANS		
Recognition, derecognition and measurement		
4. A bank should recognise a loan, whether originated or purchased, in its balance sheet when, and only when, the bank becomes a party to the contractual provisions of the loan.	The Indian banking system follows this practice.	
5. A bank should remove a loan (or a portion of a loan) from its balance sheet when, and only when, the bank loses control of the contractual rights that comprise the loan (or a portion of the loan). A bank loses such control if it realises the rights to benefits specified in the contract, the rights expire or the bank surrenders those rights.	The Indian banking system follows this practice.	
6. A bank should measure a loan, initially, at cost.	The Indian banking system follows this practice.	
Impairment – recognition and measurement		
7. A bank should identify and recognise impairment in a loan or a collectively assessed group of loans when it is probable that the bank will not be able to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the loan agreement. The impairment should be recognised by reducing the carrying amount of the loan(s) through an allowance or charge-off and charging the income statement in	Banks in India identify and recognise impairment in a loan on an ongoing basis primarily based on objective basis of record of recovery. Availability of collateral is not considered while recognising impairment of loans. However, banks have been given certain flexibilities in respect of loans which are restructured. In this context it may be added that the definition of a restructured loan and its treatment in the Indian banking system is more	There is a case for granting more flexibility to bank management in recognition and measurement of impaired loans than the extant rule based method allows. When legal system improves helping effective enforceability of the lenders rights, greater flexibility and reliance on availability security in considering

the period in which the impairment occurs. • Loan should be reviewed for impairment on a regular basis. • Based on all relevant factors – debtor's payment record, overall financial condition and resources, debt service capacity, financial performance, net worth and future prospects, prospect of support from guarantors, current and stabilised cash flows, value of underlying collateral, country risk, etc. • Collateral should be valued on a prudent basis. • Weaknesses in legal system and other obstacles that make it difficult to ensure rights should be taken into account. • Recognition of impairment should be considered whenever circumstances cause uncertainty about a borrower's ability to repay all amounts due according to the contractual terms of the loan agreement. • As an exception, loans need not be identified as impaired when the loan is fully secured, and there is reasonable assurance that collection efforts will result in repayment in a timely manner of principal and interest. • Loans which are not delinquent at all also need to be reviewed for deterioration in credit quality. • If the borrower is about to default and the bank advances additional funds to meet its	conservative than envisaged in the BIS paper, e.g., a loan in which even if only a reschedulement is permitted after the concerned unit has commenced production is considered as restructured. Also, a restructured loan is not treated as standard until 12 months after the restructuring and its satisfactory performance during the period. The legal system in India is at present not conducive for effective enforceability of the lenders' rights. It is uncertain and time-consuming. There is no certainty that the collaterals will be realisable within a definite and reasonable time frame. In this background, it is not considered prudent to rely on collaterals while recognising impairment in loans.	impairment of loans should be allowed.

current payment obligations, and there is a reasonable assurance that the borrower will be able to repay all principal and interest in full, or that the loan is fully secured and collection efforts will achieve the same result, the loan need not be classified as impaired. • A loan is a restructured loan when there is a modification in the terms of loan, e.g., reduction in interest from that originally agreed or a reduction in principal amount. A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt of similar risk is not a restructured troubled loan.		
8. A bank should measure an impaired loan at its estimated recoverable amount. Acceptable methods for calculating estimated recoverable amount are: • The present value of expected future cash flows discounted at an appropriate interest rate. • The fair value of the collateral to the extent the loan is collateral dependent. • The observable market price. A bank should measure the estimated recoverable amount of a restructured troubled	Banks in India measure impaired loans net of the provisions created for the impairments. The provisions created are formulae based. Indian banks are presently not following this method. Indian banks do not take into account the value of collateral in estimating recoverable amount There are still no secondary markets for loans to determine observable market price. Banks determine impairment for each account separately and not on portfolio basis.	The extant rule based provisioning requirements need to be tightened and gradually brought at par with the internationally accepted standards in this regard. 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.

loan taking into account the cost of all concessions at the date of restructuring. For a group of small homogeneous loans, the extent of impairment should be determined on a portfolio basis by applying formulae. When latent losses are known to exist, but they cannot be ascribed to individual loans, general allowances (provisions) should be established. General allowances (provisions) should be replaced by specific allowances or charge-offs immediately when the impairment in loan becomes apparent. Past experience and current economic and other relevant conditions, etc., should be taken into account in determining general allowances. General allowances should be determined by using one or several of a number of methodologies including: • Applying a formulae based on analysis of arrears, ageing of balances, past loss experience, etc. • Migration analysis • Various statistical methodologies. • Estimating impairment in the group based on the bank's judgement of the impact of recent events and changes in economic conditions, etc.	This is being followed. As of now, general provisions are created on a formulae basis. RBI has issued Risk Management Guidelines to banks in October 1999 wherein banks have been advised to set up loan review mechanism for determining, inter alia, the adequacy of loan loss provisioning.	Banks should be asked to adopt this approach and determine impairment on portfolio basis also. In such cases a higher provisioning on standard loans in particular portfolio should be considered. While at present a formulae based system for provisioning on impaired loans is being followed, the extent of provisioning is not being determined

Bank should review the assumptions used against actual experience at regular intervals. An impaired loan should only be restored to unimpaired status when the contractual amount of principal and interest is deemed to be fully collectible in accordance with the terms of loan agreement. This should take place when the loan has become regular and has remained so for a reasonable period, or the loan becomes well secured and is in the process of collection.		scientifically based on any analysis of arrears, ageing of balances, migration analysis or the 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 specific guidelines given by RBI. The banks should be asked and encouraged to place their system of provisioning on more scientific lines, closer to 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. RBI 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 RBI should attempt to lead the banks towards that.
Adequacy of the overall allowance		
9. The aggregate amount of specific and general allowances should be adequate to absorb estimated credit losses associated with the loan portfolio. A bank should maintain an overall allowance at a	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.	Please see remarks at paragraph 8 above.

level that is adequate to absorb credit losses. The adequacy of specific and general allowances should be reviewed in preparation of annual or more frequent interim reports, if warranted, to ensure adequacy of allowances with current information about the collectibility of loan portfolio. A bank should not understate or overstate loan losses in order to achieve a desired level of earning in current or future reporting periods. Assessment of appropriate level of allowances necessarily includes a degree of subjectivity. However, exercise of management discretion should be subject to established policies and procedures, in a consistent manner over time, in conformity with objective criteria and be supported by adequate documentation. The method of determining overall allowance should ensure the timely recognition of loan losses, based not only on historical loss experience but also current factors that are likely to cause losses associated with the bank's portfolio. There must be proper documentation. Ratio analysis as to the relationship between overall allowances to past due and impaired loans, and to total loans, over time and across institutions, can be useful as a supplemental check or tool for evaluating the overall reasonableness of allowances.	RBI has issued Risk Management Guidelines to banks in October 1999 wherein banks have been advised to set up loan review mechanism for determining, inter alia, the adequacy of loan loss provisioning.	In preparing its future guidelines on provisioning, RBI may undertake this ratio analysis for the system as a whole. It may also, while asking banks to report to it their respective relative figures, instruct them to undertake such an analysis on their own and make it a part of their mandatory disclosures.

Income recognition		
10. A bank should recognise interest income on an unimpaired loan on an accrual basis using the effective interest rate method.	Banks in India recognise interest on unimpaired loans on accrual basis. Effective interest rate method is however not being used.	
11. When a loan is identified as impaired, a bank should cease accruing interest in accordance with the terms of the contract. • Interest on impaired loan should not contribute to net income if doubt exists concerning the collectibility of loan principal or interest. • Uncollected interest that has been previously accrued should be reversed or included in the loan balance with an adequate specific allowance established against it. • When an impaired loan is carried at the present value of expected future cash flows, interest may be accrued and reported in net income. • If present value method is applied, but interest is not accrued to reflect updated present values, bank may adjust the allowances. • If allowed by law or regulators, cash interest payments received on an impaired loan for which accrual of interest has ceased may be reported as interest income on cash basis as	Banks do not charge and take into income statement interest income on loans which have been identified as non-performing (impaired). Banks follow this practice. Banks in India do not carry impaired loans on present value method and therefore do not accrue interest and report in net income. Not applicable since banks do not use present value method. The practice in India is to treat any cash interest payment received on an impaired loan for which accrual of interest has ceased, as interest income. This is done notwithstanding the fact that the recorded amount of the loan may not be	This practice should be modified so that interest received is treated as such, only if the loan is deemed fully collectible on a timely basis.

long as the recorded investment in loan less any specific allowance is deemed fully collectible in a timely manner. • A loan on which a bank has ceased to accrue interest should only be restored to accrual status when the loan has returned to unimpaired status unless the loan has been restructured or the loan has been acquired at a discount that relates to its credit quality. An impaired loan that has been restructured so as to be reasonably assured of repayment and performance according to its modified terms, may be returned to accrual status.	deemed collectible in a timely manner. This practice is being followed by banks in India. The position in India is more conservative. A restructured loan remains in sub-standard category for one year (non-accrual) before being returned to accrual status.	
III. PUBLIC DISCLOSURE		
12. Disclosures in a bank's annual financial reports should be adapted to the size and nature of the bank's operations in accordance with the materiality concept. As a minimum, banks should disclose their accounting policies and practices, credit risk management, credit exposures to different types of loans and credit quality (including past due and impaired loans, changes in credit quality and changes in allowances).	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.	At present, all banks irrespective of their size, scope and complexity of operations, are required to make the same disclosures. RBI may take urgent steps to introduce the concept of materiality in the matter of disclosures.
Accounting policies and practices		
13. A bank should disclose information about the accounting policies, practices and methods it	This practice is being followed.	

uses to account for loans.		
14. A bank should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses.	Banks in India, as mentioned against principle 9 above, disclose information on the accounting polices and methods they use to determine specific and general allowances, which is totally rule-based as set out by RBI, the regulator/supervisor. In the circumstances, there is no explanation regarding the assumptions used in making the allowances.	
Credit risk management		
15. A bank should disclose qualitative information on its credit risk management and control policies and practices.	Although most banks are not making these disclosures, they are gradually moving in that direction.	Banks should be asked to make these disclosures in their management's Note to the Balance Sheet.
Credit exposures		
16. A bank should disclose information about loans by major categories of borrowers.	Business segment-wise disclosure of loans is available in the Balance Sheet. Exposures to sensitive sectors are also disclosed.	
17. A bank should disclose information about loans by geographic areas.	Indian banks do not make such disclosure. Their exposures are mostly within the domestic boundaries.	
18. A bank should disclose information about significant concentrations of credit risk.	Indian banks do not make this disclosure.	This should be introduced urgently.

19. A bank should disclose summary information about its contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.	An estimate of losses under recourse arrangement does not at present form part of normal disclosures in banks' balance sheets.	This practice needs to be introduced in the Indian banking system at the earliest. RBI may advise banks suitably and guide them to adopt this practice within next two years.
Credit quality		
20. A bank should disclose impaired and past due loans by major categories of borrowers and the amounts of specific and general allowances established against each category.	Indian banks do not make this disclosure.	Business segment-wise general and specific provisions should be disclosed. RBI may advise banks suitably and guide them to adopt this practice within next two years.
21. A bank should disclose geographic information about impaired and past due loans including, if practical, the related amounts of specific and general allowances.	Indian banks do not make this disclosure. However, their exposures are mostly within the domestic boundaries.	
22. A bank should disclose a reconciliation of changes in the allowances for loan impairment.	Movements in provisions do not yet form a part of disclosure by Indian banks.	These disclosures should be introduced urgently.
23. A bank should disclose balances of loans on which the accrual of interest – in accordance with the terms of the original loan agreement – has ceased because of deterioration in credit quality.	Banks are now required to disclose in their published annual accounts under notes on accounts, information in respect of total loan and also standard and sub-standard assets subjected to restructuring, etc., undertaken during the year.	
24. A bank should disclose summary information about troubled loans that have been restructured during the year.	Do	

IV. ROLE OF SUPERVISORS		
25. Banking supervisors should evaluate the effectiveness of a bank's policies and practices for assessment of loan quality.	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.	
26. Banking supervisors should be satisfied that the methods employed by a bank to calculate allowances produce a reasonable and appropriately prudent measurement, on a timely basis, in accordance with appropriate policies and procedures.	Through on-site inspection and off-site returns, RBI satisfies that the methods employed by the bank to calculate allowances are as per its guidelines. The position in this regard is deemed satisfactory.	

Annex 8
Enhancing Bank Transparency [vii]

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

of measurement will however depend on applicable accounting standard.		
1.3 In countries with less developed financial markets, supervisors may need to establish a more comprehensive supervisory reporting system covering these six broad categories of information to compensate for inadequacies in publicly disclosed information.	This principle is acceptable. The level of compliance in respect of each of the six broad categories is assessed in detail under item 2.0.	
2.0 Details in disclosure		
2.1 Financial Performance		
2.1.1 Information about the performance of a bank, in particular about its profitability, and the variability of those profits over time, is necessary to assess potential changes in financial position and future potential to repay deposits and liabilities, to make distributions to owners, and to contribute to capital growth. Information about profits and losses and their components over recent and earlier periods, helps form assessments of future financial performance and cash flows. It also helps assess the effectiveness with which a bank has employed its resources. Useful information includes basic quantitative indicators of financial performance, breakdowns of income and expenses, and management's discussion and analysis of financial performance.	RBI is committed to enhance and improve the levels of transparency and disclosure in the annual accounts of banks. The formats for preparation of financial statements are prescribed under Section 29 of the Banking Regulation Act. Banks are mandated to disclose additional information as part of annual financial statements: • Capital Adequacy Ratio; • Tier I ratio; • Tier II ratio; • Percentage of shareholding of the Government of India in nationalised banks; • Net NPL ratio; • Amount of provision made towards NPLs and provisions for income-tax for the year; • Amount of subordinated debt raised as Tier	However, we would have to go beyond these disclosures to provide for more disaggregated information including data on variability of profits over time. Further areas of disclosure of information relating to financial performance could include: • Contribution of different activities and regions • Impact of non accrual and impaired assets on financial performance • Effect of hedging activities on income and expenses • Income effect of securitisation

	II capital; • Gross value of investments, provision for depreciation on investments and net value of investments separately for within India and outside India; • Interest income as percentage to working funds; • Non-interest income as a percentage to working funds; • Operating profit as a percentage to working funds; • Return on assets; business (deposits and advances) per employee • Profit per employee; • Maturity pattern of certain assets and liabilities; • Movement in NPLs; • Foreign currency assets and liabilities; • Lending to sensitive sectors as defined from time to time.	
2.1.2 To assess the financial performance of a bank, it is essential to have a breakdown of income and expenses incurred. This information is necessary to assess the quality of earnings, to identify the reasons for changes in a given bank's profitability from year to year and to compare the financial performance of different banks. Information on financial performance typically includes an income statement that groups income and expenses by nature or function within the	The income statement usually includes items for interest income and expense, fees and commissions, other non-interest income, operating expenses, charge for credit losses, any extraordinary items, tax expenses and net income. However, complete breakdown of income is not furnished in banks' financial reporting making a meaningful assessment of the quality of income and inter-bank comparison difficult. Such break-up should be standardised and mandated	

bank. The income statement usually includes items for interest income and expense, fees and commissions, other non-interest income, operating expenses, charge for credit losses, any extraordinary items, tax expenses and net income.	for disclosure.	
2.1.3 The notes to the income statement provide additional detail on important income and expense categories.	Notes containing details, wherever necessary, are being given.	
2.1.4 For the purpose of assessing sustainability of profits, it is essential that the impact of acquisitions and lines of business discontinued during the year be disclosed.	Mergers and acquisition as also discontinuance of a line of business are new for the Indian banking industry. In the few cases in which these have occurred so far, only general assessments of their impact is given in the balance sheet.	Banks should be asked to make more quantitative assessment of their impact on profitability and disclose it in their balance sheet.
2.1.5 Key figures and ratios should include the return on average equity, return on average assets, net interest margin (net interest income divided by average interest earning assets), and cost-to-income ratio.	All these ratios are disclosed as per the regulatory requirements in this regard.	
2.1.6 Business and geographical segment information aids in the analysis of past performance and assists in assessing future prospects. The user of financial information can achieve a better understanding of a bank's overall financial performance if the bank discloses the contribution of different activities and regions to overall financial performance. In particular, this information helps the user assess the extent of	A break-up of contribution of different activities to assess the diversification in banks' business and contribution of different business lines is necessary. Banks should be asked to make these disclosures in their balance sheet. A timeframe of two or three years may be stipulated for this purpose.	

diversification in the bank's business and the contribution of specific business segments and regions that may be considered to be of a higher risk. It also facilitates awareness of the impact of significant changes, e.g., due to regional disturbances, on the bank as a whole.		
2.1.7 Management has a detailed knowledge of the business that outsiders cannot have. Therefore, management can greatly assist both the market and supervisors by discussing the main factors that influenced a bank's financial performance for the year, by explaining differences in performance between the current year and previous years and by discussing factors they believe will have a significant influence on the bank's future financial performance.	This type of information is usually provided in management or director's report to the market or supervisors to arrive at meaningful inferences.	Factors that impact current and next year's profitability should necessarily be discussed explicitly as part of the Management Discussions and Analysis.
2.1.8 In many countries, comprehensive accounting guidance is available on the presentation and disclosure of information about financial performance. Authoritative guidance has been issued by legislators, regulators, and national and international accounting standard-setters, and should be referenced to identify appropriate disclosures and to gain an understanding of why they are useful.	In India, the ICAI guidelines on bank audit, which covers aspects of presentation and disclosure of financial information, is being followed. RBI has stipulated standards of disclosure from time to time based on international best practices.	The levels of disclosure in the balance sheets of Indian banks can be improved further. Areas of disclosure have been indicated above. Efforts have to be made to come close to internationally followed standards of disclosure within the next two years.
2.2 Financial Position (including capital, solvency and liquidity)		
2.2.1 Market participants and supervisors need information about the financial position	Information about the nature and amount of assets, liabilities, commitments, contingent	Information detailing maturity and repricing structure of all assets and liabilities should

of an institution. Information about the financial position of a bank is useful in predicting the ability of the enterprise to meet its liabilities and financial commitments as they fall due. Information about the nature and amount of assets, liabilities, commitments, contingent liabilities, and shareholders' funds, both at points in time and averages over periods, including their maturity and repricing structure, is useful for assessing a bank's liquidity and solvency, and ultimately its financial strength, and the trends therein.	liabilities and shareholders' funds are furnished in the financial statements and in notes to the accounts.	form part of the mandatory disclosure.
2.2.2 Information about institutions' provisions and allowances for losses and how these provisions and allowances are determined is important in assessing an institution's ability to withstand losses.	Charge of loan loss provisions made during the year and the basis of provisioning are now being disclosed. However, as yet cumulative provisions held against loan losses and movement in provisions are not being disclosed.	These disclosures should be made mandatory.
2.2.3 To assess an institution's financial position, it is essential to have a breakdown of assets and liabilities, and equity capital by type. Information on financial position typically includes a balance sheet that distinguishes different types of assets, liabilities and sources of equity capital. The balance sheet usually includes separate items for loans, trading securities, investment securities, tangible fixed assets (e.g., real estate), intangible fixed assets (e.g., goodwill), short-term debt and long-term debt.	Breakdown of assets and liabilities and equity capital by type and their distribution is given in the balance sheet. Information on securities held as investments and for the purposes of trading is also given separately. The format of balance sheet of banks provides for adequate breakdowns on both assets and liabilities sides.	
2.2.4 Disclosure of off-balance sheet items	Commitments and contingent liabilities are	Full disclosures with notional values and fair

may include information about notional amounts and fair values or replacement values of off-balance sheet transactions, and about commitments and contingent liabilities.	being disclosed in the balance sheet.	value of off-balance sheet transactions, commitments and contingent liabilities should be disclosed.
2.2.5 In notes to the balance sheet, additional information about the items in the balance sheet which is relevant to the needs of users may also be provided, e.g., fair value (trading account, loans, deposits, others).	Notes to consolidated balance sheet and income statements contain additional information relevant to users.	
2.2.6 Information about regulatory capital and its components is important in analysing the financial position of a bank (Tier 1, Tier 2, Tier 3 – if applicable, risk-weighted assets, risk-based capital ratio), as well as information about equity capital (e.g., debt-to-equity ratio, restrictions on distributions). Information about the changes in the amount and types of capital, including the impact of earnings, dividends and capital issuances, is important in assessing the cushion available to absorb future potential losses and for the bank's ability to sustain growth over the near term. Management's discussion and analysis of a bank's financial position and changes therein, help the market better understand and form expectations based on them.	In India information is being furnished on regulatory capital (Tier-I & Tier-II) but details of risk weighted assets, leverage ratio, restrictions on distributions, including the impact on earnings, etc., are not being furnished uniformly.	Disclosures relating to management of risks by banks such as calculation of capital requirements for credit risk, capital requirement for market risk and data relating to broad values at risk, stress/ back testing information will have to be broadly introduced in banks' balance sheets. Alongside disclosures on capital allocation, future capital plans will also have to be disclosed. It should be possible for banks to begin providing these disclosures in two to three years time by when it can be made mandatory.
2.2.7 Information about the nature and amount of assets pledged as collateral, e.g., to support deposits, other liabilities and commitments, and the amount of secured liabilities is useful in assessing the financial position of a bank	Banks in India do not accept collateralised deposits or any other such liabilities or commitments.	Where there are occasions of the bank having availed of collateralised lines for managing their liquidity, the details should be provided.

and, in particular, the collectibility of claims on the bank in case of its liquidation.		
2.2.8 As with guidance on presentation and disclosure of financial performance, comprehensive accounting guidance on the presentation and disclosure of information about financial position is available in many countries. Authoritative guidance has been issued by legislators, regulators, and national and international accounting standard-setters.	Guidance on presentation of statement representing financial position (balance sheet) is prescribed by Section 29 of the Banking Regulation Act. Disclosure requirements are also being prescribed by the regulator from time to time.	RBI may consider issuing comprehensive guidelines on necessary disclosures in a banks balance sheet. Since disclosures in India are still in an evolutionary stage and additional disclosures are being added to the disclosure requirements, it would also be desirable to update these guidelines from time to time until the Indian disclosures fully match international standards in this regard. Initially, updating of these guidelines may be undertaken at shorter, say, annual intervals. A coordinated approach between the ICAI and the RBI may be adopted for this purpose.
2.3 Risk Management strategies and practices		
2.3.1 Market participants and supervisors need information about a bank's management strategies and policies for managing and controlling risks. Risk management is a key factor in assessing the future performance and condition of a bank and the effectiveness of management.	Directors' report or management report forming part of the annual report contain information on bank's management strategies.	
2.3.2 Disclosures may include discussions of overall risk management philosophy, overall policy and methodologies, how risks arise, how risks are managed and controlled, and whether and how derivatives are used to manage risks. It may also be useful to discuss the risk management structure and risk	Although risk management is a rather recent concept, bank managements are gearing themselves suitably to be in a position to furnish in their annual reports details of their risk management philosophy, strategies and methodologies.	More disclosures on risk management are essential. Banks will have to take steps so that even before they start making detailed analytical disclosures about their risk management arrangements, they begin disclosing details about risk mitigating tools being used by them, limits, exposure to banks,

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

	operational, banks in India will be in a position to measure and quantify various risks in addition to furnishing qualitative aspects of various risk exposures.	
2.4.2 A bank's risk profile, i.e., the risks inherent in its on- and off-balance- sheet activities at a point in time and its appetite for taking risk, provides information about the stability of an institution's financial position and the sensitivity of its earnings potential to changes in market conditions. Moreover, an understanding of the nature and extent of an institution's risk exposures helps assess whether a bank's returns are appropriate for the level of risk it has assumed.		
2.4.3 Disclosures of risk information assist in assessing the amount, timing and certainty of future cash flows. Given the dynamic financial markets in which banks operate, and the influences of increased global competition and technological innovation, a bank's risk profile can change very quickly. Therefore, users of financial information need measures of risk exposures that remain meaningful over time and which accurately reflect sensitivities to changes in underlying market conditions.		Measures such as VaR and/or EaR, which sufficiently capture a bank's risk exposure, should also be disclosed at least on a quarterly basis along with quarterly operating results. Banks should also be encouraged to develop their own risk models, which appropriately capture their risk profile. Details of the model as well as the assumptions constraining it and the process employed for validating the model should also constitute part of the disclosure framework.
2.4.4 Traditionally, banks have focused on disclosing information about credit risk and market risk, including interest rate and foreign exchange risk, and, to a lesser extent, liquidity	Banks in India have already begun providing both qualitative (e.g., management strategies) and quantitative information (position data) in the balance sheet. Concept of comparative	Banks' annual reports do provide these information.

risk. In discussing each of these risk areas, an institution should present sufficient qualitative (e.g., management strategies) and quantitative information (e.g., position data) to help users understand the nature and magnitude of these risk exposures. Further, comparative information of previous years' data should be provided to give the financial statement user a perspective on trends in the underlying exposures.	information of previous years has also been introduced.	
2.4.5 Other risk exposures such as operational, legal and strategic risk are less easy to quantify, but may be highly relevant. Qualitative information should be given about the nature of the risks and how they are managed.	Notes on account on the balance sheet contain details on legal risk. Other risks have so far not been forming part of the disclosures in the balance sheet.	A discussion on legal, operational and strategic risks may be made mandatory in the Management letter/ Director's report to the share holders.
2.4.6 Credit risk		
2.4.6.1 Disclosures should help the reader understand the magnitude of an institution's credit exposure on an aggregate basis as well as its significant components. Further, the user of financial information should be able to understand how an institution manages credit risk and whether or not those strategies have been effective.	Credit related disclosures in the bank's balance sheet are presumably limited to details of NPAs, provisions for loan losses and lending to some sectors which are considered sensitive.	At item 2.3.2, it was suggested that risk mitigating tools, limits, concentrations and exposures be disclosed. RBI may consider issuing some guidelines in this regard. It should be possible for some banks to make these disclosures about credit risk management in their balance sheet without much difficulty.
2.4.6.2 To achieve transparency, an institution should provide descriptive information about the business activities that create credit risk, its strategies regarding those business lines,	Business activities that create credit risks are not being separately identified. Quantitative information regarding gross positions, e.g., loans, investments and off-balance sheet	We should follow a gradual process of disclosure on risk so that key elements remain in focus. Suggestions in this regard have been given while examining earlier items. The

and the nature and composition of the exposures that arise. Examples of useful disclosures include a discussion about business strategies, risk management processes and internal controls relating to activities that generate credit risk.	exposures are given. We need to ensure that we begin with disclosures, which are of greater relevance in our context including those which are sophisticated and have relevance in more complex situations.	proposed guidelines to be issued by RBI will be able to take care of this phasing.
2.4.6.3 In addition, quantitative information should be provided regarding gross positions (e.g., loans, investments, trading and off-balance-sheet exposures), information about the types of counterparties (e.g., exposure to banks, commercial, and government entities; domestic and international exposures; subordinate assets, and secured and unsecured exposures), and significant concentrations of credit exposure. Further, information on potential credit risk exposure arising from existing derivative contracts is useful, since that exposure may change rapidly and substantially.		
2.4.6.4 Disclosures about the quality of the current loan and investment portfolios and other significant counterparty exposures provide important information about an institution's future earnings potential. Quantitative disclosures should include the amount of problem loans and other assets, an ageing schedule of past due loans and other assets, concentrations of credit, and aggregate exposures by counterparty credit quality.	While aggregate amount of problem loans (NPAs) is given in the management report, details as to ageing schedule of past due loans and other assets, concentrations of credit, aggregate exposures by counter party credit quality, etc., are not given.	These disclosures will be helpful and may be made mandatory. In the phased increase of disclosures, these can be prioritised higher.

In addition, information should be provided about the allowances for credit losses and how those allowances have changed from period to period.		
2.4.6.5 An understanding of an institution's credit risk position is facilitated through disclosure of risk management strategies. For example, disclosures about the use of collateral and guarantees, the use of credit scoring and portfolio risk measurement models and the organisation of the credit risk function and similar discussions about activities undertaken to manage credit exposures provide background information useful in assessing the significance of risk exposures. Information about the use of credit limits and internal credit ratings is also useful.	Disclosures in detail about risk management strategies are not currently being furnished, except brief description of the organisation of the credit risk management function. But disclosures on these are expected to improve in the ensuing years.	
2.4.7 Market risk		
2.4.7.1 As with credit risk, an institution should provide both quantitative and qualitative information regarding its market risk exposures. Market risk arises from the potential for changes in market rates and prices, including interest rates, foreign exchange rates, and equity and commodity prices. An institution's disclosures about each of these types of risk should be commensurate with the degree of exposure.	At present, except for depreciation in the value of investments arising out of interest rate risk, and equity price risk, the impact of interest rate risk on bank's NIM or impact of foreign exchange risk on unhedged exposures are not disclosed.	Disclosures in these areas may be prescribed.
2.4.7.2 Since interest rate risk is especially relevant to banks, management should provide	Such detailed information on interest rate risk and the extent of interest rate – sensitive assets	A beginning can be made by presenting of quantitative information about the nature and

detailed quantitative information about the nature and extent of interest rate-sensitive assets and liabilities and off-balance sheet exposures. Examples of useful disclosures for the banking book include breakdowns of fixed and floating rate items and the net interest margin earned. Other useful disclosures include the duration and effective interest rates of assets and liabilities. These disclosures should also identify assets and liabilities, and related gains and losses.	and liabilities and off-balance sheet exposures are not furnished since ALM and other Bank Risk Management tools are just in their infancy in India.	extent of interest rate sensitive assets and liabilities.
2.4.7.3 Disclosures should also provide information about the interest rate sensitivity of an institution's assets and liabilities. For example, disclosures about the effect on the value of assets, liabilities and economic equity given a specific change (increase or decrease) in interest rates can provide a useful summary measure of the institution's risk exposure.	Do	Do
2.4.7.4 To facilitate understanding of foreign exchange risk exposures, institutions should provide summarised data for significant concentrations of foreign exchange exposure by currency, broken down by hedged and unhedged exposures.	Summarised data for significant concentrations of foreign exchange exposure by currency, broken down by hedged and unhedged exposures are not provided now.	This should be prescribed.
2.4.7.5 It is also helpful to disclose information about investments in foreign subsidiaries (foreign currency translation risk). This quantitative information should be supplemented with discussion about the nature of the currency exposure, how that	Detailed information on investments in foreign subsidiaries (Translation Risk) or foreign exchange transactions risk, the earnings impact of foreign exchange transactions and effectiveness of hedging strategies are not furnished.	

exposure has changed from year to year, foreign exchange translation effects, the earnings impact of foreign exchange transactions and the effectiveness of risk management (hedging) strategies.		
2.4.7.6 For larger institutions, “ value-at-risk” (VAR) or “earnings-at-risk” (EAR) disclosures can provide summarised data about a market risk exposure. Typically, VAR and EAR disclosures are provided for interest rate and foreign exchange risk, but these models could also be used to summarise equity and commodity risk exposures.	Disclosures on “Value at Risk” (VAR) and “Earnings at Risk” (EAR) are currently not provided. Banks should be encouraged to disclose this information on a voluntary basis to start with.	While these disclosures will have to be finally prescribed, in most cases banks have yet to gain experience in risk measurement. To be able to use models for this purpose efficiently they will need at least two years in case of larger banks and even more in case of smaller ones. RBI may consider a time frame of 3-4 years for prescribing these disclosures in the balance sheet. To begin with VaR and Ear may be prescribed in selected areas of activity, e.g., foreign exchange, treasury activities and investments.
2.4.7.7 Specific disclosures relating to these models include the magnitude of the exposure on a daily, weekly or monthly basis, maximum and minimum values, and end-of-period values. To help the user understand such model-generated information, the assumptions used in calculations (e.g., confidence level, holding period, etc.) should also be disclosed. In addition, a histogram of the daily profits or exposures over the reporting period may facilitate an understanding of the volatility of risk exposures.		

2.4.8 Liquidity risk		
2.4.8.1 Liquidity is the ability to have funds available to meet the commitments of the bank. To enable market participants to understand an institution's liquidity risk exposure, an institution should provide information about its available liquid assets, as well as its sources and uses of funds. For example, disclosures about short-term assets (e.g., cash and cash equivalents, repurchase agreements and interbank loans) and short-term liabilities (e.g., reverse repurchase agreements, commercial paper) provide basic information about an institution's liquidity profile. A cash flow statement shows the sources and uses of funds and provides an indication of an institution's ability to generate liquid assets internally. Information about concentrations of depositors and other fund providers, maturity information about deposits and other liabilities, and the amount of securitised assets, are useful in assessing an institution's liquidity.	Except for cash flow statement, detailed information on liquidity risk exposure is currently not being furnished. However, with the concept of ALM expected to stabilise in Indian banking in the ensuing years, detailed disclosures on liquidity risk exposure will be possible.	Being largely owned by the Government, Indian banks so far have had so serious concerns about liquidity. With the changing scenario, liquidity will become an issue. As more detailed statement of cash flow than at present (this statement is presently given in the balance sheet to meet the listing requirements of the stock exchange) showing sources and uses of funds should be prescribed for disclosures.
2.4.8.2 Descriptive discussion about the diversity of funding options and contingency plans provides additional perspective on the potential impact of liquidity risk to the institution.	Details about the diversity of funding options and contingency plan are also not provided.	This should form part of the management's letter/ Director's report on managing liquidity risks.
2.4.9 Operational and legal risks		

2.4.9.1 Institutions should also provide disclosures about operational and legal risks. Operational risk disclosures should include information about the main types of such risk and should identify any specific problem (e.g., Year 2000) considered to be individually significant.	No such disclosures on operational and legal risks are made at present.	The ability of the accounting as well as internal control and management systems to support the growing size and diversity of the business is the main operational risk faced by banks. Increasing frauds and deficiencies in follow up are manifestation of this risk intensifying. A discussion in the management letter/ Director's report on this issue along with a discussion on the sufficiency of technology used by the bank and fall back positions in the event of their failure may be prescribed. Details of transactions in nominal accounts pending reconciliation should also de disclosed.
2.4.9.2 Legal risk disclosures include legal contingencies (including pending legal actions) and a discussion and estimate of the potential liabilities. Qualitative information about how the bank manages and controls these risks should be given.	Note to the accounts in the disclosure on contingent liabilities carry details on pending legal action and estimate of potential liabilities.	
2.5 Accounting policies		
2.5.1 Market participants and supervisors need information about the accounting policies that have been employed in the preparation of financial reports. Accounting policies, practices and procedures differ not only between countries, but also between banks in the same country. Accordingly, users of accounting information need to understand how items are being measured to properly interpret the information. Disclosure of	Significant accounting policies are being disclosed.	

significant accounting policies on which financial reporting is based enables users to make reliable assessments of the bank's reported position and performance.		
2.5.2 Disclosure of accounting policies may be appropriate with respect to general accounting principles, changes in accounting policies/practices, principles of consolidation, policies and methods for determining when assets are impaired, recognising income on impaired assets and losses on non-performing credits, policies to establish specific and general loan loss allowances, income recognition, valuation policies (trading securities, investment securities, loans, tangible fixed assets, intangible fixed assets, liabilities, etc.), recognition/derecognition policies, securitisations, foreign currency translations, loan fees, premiums and discounts, repurchase agreements, securities lending, premises/fixed assets, income taxes, and derivatives (hedging, non-hedging, losses on derivatives).	Do	
2.6 Basic business, management and corporate governance information		
2.6.1 To accurately evaluate a bank's disclosures about its financial position and financial performance and its risks and risk management strategies, market participants and supervisors need fundamental information	Directors' or top management report in the annual report contain detailed information about the bank's business management, its different activities, strategies and plans for the future. Discussion on corporate governance is	

about the bank's business, management and corporate governance. Such information can help provide the appropriate perspective and context to understand a bank's activities. For example, management's discussion about the bank's position in the markets in which it competes, its strategy and its progress towards achieving its strategic objectives is important for assessing the bank's future prospects.	also now forming part of these reports.	
2.6.2 The organisation of a bank, in terms of both its legal and management structure, provides information about an institution's key activities and its ability to respond to changes in the marketplace. Further, such information may provide an indication of the institution's efficiency and overall strength. Accordingly, it is appropriate to disclose information about the board structure (e.g., the size of the board, board committees, and membership), senior management structure (responsibilities, reporting lines), and the basic organisational structure (line of business structure, legal entity structure).	Recently, a beginning has been made by some banks in disclosing information about the broad structure with regard to Board Committees and membership, Senior Management structure with responsibilities and reporting lines and the basic organisational structure.	These disclosures should be prescribed for all banks uniformly.
2.6.3 In addition, information should be provided about the qualifications and experience of the board and senior executives. This information may be helpful in assessing how an institution may perform in times of stress or how it may react to changes in the economic or competitive environment.	Information on qualifications and experience of the board and senior executives are being furnished.	Do
2.6.4 Information about the incentive structure	Information on incentive structure within a	Do

within a bank, including its remuneration policies, such as the amount of executive compensation and the use of performance bonuses and stock options, helps evaluate the incentives management and staff have to take excessive risks.	bank, remuneration policies, the use of performance bonuses and stock options are not given.	
2.6.5 Useful information may include a summary discussion of the philosophy and policy for executive and staff compensation, the role of the board of directors in setting compensation, and compensation amounts.	Summary discussion of the philosophy and policy of executive and staff compensation, the role of the board in setting compensation are not provided.	Do
2.6.6 In addition, banks should provide information on the nature and extent of transactions with affiliates and related parties. Such information is useful in identifying relationships that may have a positive or negative impact on a bank's financial position and performance. Further, it can help assess its susceptibility to the effects of affiliates on the bank's financial performance (contagion risk).	Nature and extent of transactions with affiliates and related parties are not disclosed.	Do
2.6.7 Finally, institutions should consider providing general information that would help market participants and supervisors gain a broad understanding of the institution's culture. As indicated previously, banks should be innovative in identifying the types of information they provide and the methods by which they provide such data.	General information on the institution's culture is provided by some banks in the annual report as part of management discussion/ report.	Do
2.6.8 Supervisors and public policy makers	RBI and government are very focussed in their	The progress shall have to be gradual but

should focus their efforts on promoting high-quality disclosure standards, taking into consideration the recommendations presented in this paper, and on developing mechanisms that ensure compliance with those standards.	efforts on promoting high quality disclosure standards.	sustained. While there will be some key disclosures which must find place in balance sheet of all banks as prescribed by RBI, individual banks should be encouraged to make additional disclosures which they consider relevant to their business and balance sheet.

Annex 9
Best Practices for Credit Risk Disclosure [viii]

	Principle	Indian Position	Remarks
1.	Disclosures in a bank's annual financial reports should be adapted to the size and nature of the bank's operations in accordance with the materiality concept.	As of now, the disclosure requirements are uniform irrespective of the size of banks' operations.	
2.	A bank should disclose information about the accounting policies, practices and methods it uses to account for its credit risk exposures.	Banks disclose information regarding the level of non-performing assets. These are required to be in compliance with the guidelines set out by the RBI. Banks are, however, free to adopt a more prudent approach, in which case, these do find mention in the balance sheets.	
3.	A bank should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses.	This is generally mandated by the regulator. The banks are, however, free to adopt a stricter policy in regard to methods it uses for determining allowances. A policy which deviates from the guideline given by the regulator is generally made public.	
4.	A bank should disclose qualitative information about the nature of credit risk in its activities and describe how credit risk arises in those activities.	This is not being provided as of now.	
5.	A bank should disclose information on the management, structure and organisation of its credit risk management function.	--do--	

6.	A bank should disclose qualitative information on its credit risk management and control policies and practices.	--do--	
7.	A bank should disclose information on its techniques and methods for managing past due and impaired assets.	--do--	
8.	A bank should provide information on its use of credit scoring and portfolio credit risk measurement models	--do--	
9.	A bank should disclose balances of credit exposures, including current exposure and, where applicable, future potential exposure, by major categories.	--do--	
10.	A bank should disclose information about credit exposure by business line.	Business line-wise exposure is not being disclosed. However, 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.	
11.	A bank should disclose information about credit exposures by major categories of counterparties.	--do--	
12.	A bank should disclose information about credit exposures by geographic areas.	--do--	
13.	A bank should disclose information about significant concentrations of credit risk.	--do--	
14.	A bank should disclose the effect of credit risk mitigation techniques, including	--do--	

	collateral, guarantees, credit insurance and legally enforceable netting arrangements.		
15.	A bank should disclose quantitative and qualitative information about its use of credit derivatives and other instruments that reallocate credit risk.	Credit derivatives are yet to be introduced in the country. Information in respect of other credit mitigating instruments, such as securitisation, factoring and forfaiting, etc., are not disclosed in the balance sheets.	
16.	A bank should disclose quantitative and qualitative information about its securitisation activities	This is not being provided as of now. However, securitisation is yet to pick up in the country in a big way and, as such, its effect is negligible as of now.	
17.	A bank should disclose summary information about its contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.	This is not being done as of now.	
18.	A bank should provide summary of information about its internal rating process and the internal credit ratings of its credit exposures.	--do--	
19.	A bank should disclose total credit exposures by major asset category showing impaired and past due amounts relating to each category.	Banks disclose information in regard to their gross and net NPA position and changes in NPAs and provisions made during the year in the notes on account to the balance sheet.	
20.	A bank should disclose the amounts of specific, general and other allowances. Where applicable, these allowances	While provisions made during the year are disclosed, these are not being classified by asset category. Cumulative provisions are	

	should be disclosed by major asset category.	not being disclosed.	
21.	A bank should disclose a reconciliation of changes in the allowances for credit impairment.	Banks disclose information in regard to their gross NPA position and changes in NPAs during the year and the amount of provisions held against the NPAs.	
22.	A bank should disclose credit exposures on which the accrual of interest or other contractual cash flows – in accordance with the terms of the original agreement – has ceased because of deterioration in credit quality.	As per current instructions, interest cannot be accrued in respect of NPAs.	
23.	A bank should disclose summary information about credit exposures that have been restructured during the year.	This is being disclosed.	
24.	A bank should provide information on revenues, net earnings and return on assets.	This information is being disclosed.	

Annex 10
Supervision of Financial Conglomerates [ix]

No.	**Principle**	**Indian Position**	**Remarks**
A.	**Capital Adequacy Principles Paper – Guiding Principles**		
	Acceptable capital adequacy measurement techniques should be designed to		
I.	detect and provide for situations of double gearing, i.e., where the same capital is used simultaneously as a buffer against risk in two or more legal entities; proceeds in the form of equity, which can result in excess leverage;	The capital invested in subsidiaries (where banks' holding is more than 50 per cent) is deducted from the Tier-I capital of the bank to avoid double gearing. However, other investments which are below 50 per cent are not deducted from the investing bank's capital.	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. 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.
II.	Detect and provide for situations where a parent issues debt and downstream the proceeds in the form of equity, which can result in excessive leverage;	Such deduction would normally be possible by adopting group-wide capital adequacy measurement. In the absence of consolidated accounts, however, the effective leverage of a subsidiary	

		(dependent) unit gets computed on solo basis only. Protection against the risk of excessive leverage is available on account of deduction of the parent body's investment at face value from its regulatory capital.	
III.	include a mechanism to detect and provide for the effects of double, multiple or excessive gearing through unregulated intermediate holding companies which have participation in dependants or affiliates engaged in financial activities.	At present there is no case of an unregulated entity (of a financial conglomerate) acting as the holding company of a bank or other regulated entities.	
IV.	include a mechanism to address the risks being accepted by unregulated entities within a financial conglomerate that are carrying out activities similar to the activities of entities regulated for solvency purposes (e.g., leasing, factoring, reinsurance)	-do-	
V.	address the issue of participations in regulated dependants (and in unregulated dependants covered by principle IV.) and to ensure the treatment of minority and majority interests is prudentially sound.	-do-	
B. Fit and Proper Principles Paper – Guiding Principles			
1.	In order to assist in ensuring that the regulated entities within financial conglomerates are operated prudently	Regulations take care to ensure that unregulated entities do not normally exercise material or controlling	In the absence of any clear guidelines or established practices on this issue, the approach adopted in this regard is not

	and soundly, fitness and propriety or other qualification tests should be applied to managers and directors of other entities in a conglomerate if they exercise a material or controlling influence on the operations of regulated entities.	influence on operations of regulated entities. Where it is perceived that managers and directors of other entities in a conglomerate can exercise a material or controlling influence on the operations of a regulated entity, fitness or propriety or other qualification tests are applied.	uniform. RBI may consider issuing suitable guidelines on the subject considering the emergence of conglomerates on the financial scene.
2.	Shareholders whose holdings are above specified thresholds and/or who exert a material influence on regulated entities within that conglomerate should meet the fitness, propriety or other qualification tests of supervisors.	Fitness, propriety and other qualification tests are at present not applied to shareholders.	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 the RBI clearly in this regard.
3.	Fitness, propriety or other qualification tests should be applied at the authorisation stage and thereafter, on the occurrence of specified events.	Fitness, propriety and other qualification tests are normally applied at the authorisation stage. Thereafter, however, there are no specified events excepting changes in the top position,	

		on the occurrence of which the tests will be applied.	
4.	Supervisors' expectations are that the entities will take the measures necessary to ensure that fitness, propriety or other qualification tests are met on a continuous basis.	We are in agreement with this view.	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.
5.	Where a manager or director deemed to exercise a material influence on the operations of a regulated entity is or has been a manager or director of another regulated entity within the conglomerate, the supervisor should endeavour to consult the supervisor of the other regulated entity as part of the assessment procedure.	Exchange of information between two supervisors about a manager or a director of a regulated entity who is deemed to exercise material influence on the operations of another regulated entity is only on case to case basis. The practice is as yet neither formalised nor universal.	-do-
6.	Where a manager or director deemed to exercise a material influence on the operations of a regulated entity is or has been a manager or director of an unregulated entity within the conglomerate, the supervisor should endeavour to consult with the supervisors of other regulated entities that have dealing with the unregulated entity as part of the assessment procedure.	We are in agreement with this view.	-do-

7.	Supervisors should 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.	-do-	RBI may consider issuing specific and clear instructions in this regard. With most banks going for insurance business such exchange of information between regulators regarding directors/managers would be essential.
C.	**Principles for Supervisory Information Sharing Paper – Guiding Principles**		
1.	Sufficient information should be available to each supervisor, reflecting the legal and regulatory regime and the supervisor's objectives and approaches, to effectively supervise the regulated entities residing within the conglomerate.	Supervisors are armed with sufficient legal powers to call for any information that it may require in the exercise of their supervisory functions.	Arrangements should be formalised for exchange of information between all regulators involved in regulation of different entities in a conglomerate.
2.	Supervisors should be proactive in raising material issues and concerns with other supervisors. Supervisors should respond in a timely and satisfactory manner when such issues and concerns are raised with them.	We are in agreement with the view.	-do-
3.	Supervisors should communicate emerging issues and developments of a material and potentially adverse nature, including supervisory actions and potential supervisory actions, to the primary supervisor in a timely manner.	The concept of primary supervisors has not yet been introduced in India.	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.
4.	The primary supervisor should share with other relevant supervisors information affecting the regulated entity for which the latter have responsibility, including supervisory actions and potential supervisory actions, except in unusual circumstances when supervisory considerations dictate otherwise.	We are in agreement with this view.	
5.	Supervisors should purposefully take measures to establish and maintain contact with other supervisors and to establish a climate of cooperation and trust amongst themselves.	-do-	
D.	**Ten Key Principles on Information Sharing** [x]		
1.	**Authorisation to share and gather information:** Each Supervisor[xi] should have general statutory authority to share its own supervisory information with foreign supervisors, in response to requests, or when the supervisor itself believes it would be beneficial to do so. The decisions about whether to exchange information should be taken by the Provider[xii], who would not have to seek permission from anyone else. A provider should also possess adequate powers (with appropriate safeguards) to	In India, supervisors, as providers of information have both the ability to collect information and the freedom and powers to share the same with other supervisors, within the country and abroad.	

	gather information sought by a Requestor[4].		
2.	**Cross-sector information sharing:** Supervisors from different sectors of financial services should be able to share supervisory related information with each other both internationally (e.g., a securities supervisor in one jurisdiction and a banking supervisor in another) and domestically.	There is no legal or any other bar to such sharing of information between supervisors of different financial sectors even if they are in different jurisdictions.	
3.	**Information about systems and controls:** Supervisors should cooperate in identifying and monitoring the use of management and information systems, and controls, by internationally active firms.	There is no formal system as yet for such cooperation, but, there is no bar for putting in place such a system.	
4.	**Information about individuals:** Supervisors should have the authority to share objective information of supervisory interest about individuals such as owners, shareholders, directors, managers or employees of supervised firms.	There is no disability with regard to sharing of such information about individuals.	The 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 suitable enacting these powers needs to be considered.
5.	**Information sharing between exchanges:** Exchanges in one jurisdiction should be able to share	Exchanges in India do not have supervisory functions.	

[4] "Requestor" means the Supervisor that has asked for information.

	supervisory information with exchanges in other jurisdictions, including information about the positions of their members.		
6.	**Confidentiality:** A Provider should be expected to provide information to a Requestor that is able to maintain its confidentiality. The Requestor should be free to use such information for supervisory purposes across the range of its duties, subject to minimum confidentiality standards.	Confidentiality is insisted upon for information shared but, at the same time, the use of the information is not restricted for genuine supervisory uses. For information received as a receiver of such information also, confidentiality is ensured.	
7.	**Formal agreements and written requests:** The Requestor should not have to enter into a strict formal agreement in order to obtain information from a Provider. Nor should a written request be prerequisite to the sharing of information, particularly in an emergency.	Information is usually shared even in the absence of formal written agreements to that effect.	
8.	**Reciprocity of requirements:** These, too, should not be a strict precondition for the exchange of information, but the principle of reciprocity may be a consideration.	Reciprocity is a consideration for sharing of information.	
9.	**Cases which further supervisory purposes:** In order to ensure the integrity of firms and markets, the Provider should permit the Requestor to pass on information for supervisory or	There is no bar on passing on received information to other supervisors or law enforcement agencies for the purpose of supervision or law enforcement.	

	law enforcement purposes to other supervisory and low enforcement agencies in its jurisdiction that are charged with enforcing relevant laws, in cases which further supervisory purposes.		
10.	**Removal of laws preventing supervisory information exchange:** To facilitate cooperation between the supervisors of internationally-active groups, each jurisdiction should take steps to remove or modify those laws and procedures that prevent or impede the exchange of necessary supervisory information.	There are no laws or procedures which prevent or impede the exchange of necessary supervisory information.	
E.	**Coordinator Paper – Guiding Principles**		
1.	Arrangements between supervisors relating to the coordination process should provide for certain information to be available in emergency and non-emergency situations.	RBI has as yet not entered into any formal arrangement with other supervisors for coordination on information sharing and/or any such other specific purpose.	
2.	The decision to appoint a coordinator and the identification of a coordinator should be at the discretion of the supervisors involved with the conglomerate.	There is no system as of now for appointment of a coordinator to facilitate information sharing between the supervisors involved with a conglomerate.	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.
3.	Supervisors should have the discretion to agree amongst themselves the role and responsibilities of a coordinator in emergency and non-emergency situations.	-do-	-do-
4.	Arrangements for information flows between the coordinator and other supervisors and for any other form of coordination in emergency and non-emergency situations should be clarified in advance where possible.	-do-	- do -
5.	Supervisors' ability to carry out their supervisory responsibilities should not be constrained by reason of a coordinator being identified and a coordinator assuming certain responsibilities.	-do-	-do-
6.	The identification of a coordinator and the determination of responsibilities for	-do-	-do-

	a coordinator should be predicated on the expectation that those responsibilities would enable supervisors to better carry out the supervision of regulated entities within financial conglomerates.		
7.	The identification and assumption of responsibilities by a coordinator should not create a perception that responsibility has shifted to the coordinator.	-do-	-do-

Annex 11
Risk Concentrations Principles [5]

Principle	Indian Position	Remarks
1.0 Supervisory strategy with respect to risk concentration in a conglomerate necessarily reflects the powers that the supervisors have to induce financial institutions to reduce excessive concentrations and other dangerous exposures. Supervisors should have sufficient authority to gather and safeguard information to be able to monitor material risk concentrations across sectors and to understand how such risks are managed. Supervisors at the sector level should review whether they have sufficient powers to protect the regulated entity from problematic risk concentrations, for example, through requiring reduction in exposures or higher capital in the regulated entity. Where supervisors lack sufficient powers, they should seek the additional authority they need.	Conglomerate structures in India are relatively uncomplicated and simple. The Banking Regulation Act, 1949, empowers the RBI to gather all material information from commercial banks. Although there is no explicit legal provision empowering the RBI to call for information directly from subsidiaries or joint ventures of banks, in practice there has been no constraint in RBI receiving financial and structured information on risk concentrations and exposures in respect of these down stream and upstream entities. RBI has the necessary powers to direct the banks in a manner that can remedy problems relating to risk concentration. For example RBI has powers to require reduction in exposures of a bank and/ or a higher capital.	
1.1 Supervisors should take steps, directly or through regulated entities, to provide that conglomerates have adequate risk management processes in place to manage group-wide risk concentrations. Where	RBI has issued general guidelines to banks in regard to management of various types of risks. Further prudential guidelines are also in place in regard to banks' exposures to counterparty/	RBI should consider issuing appropriate guidelines requiring banks to ensure that they and their subsidiaries and joint ventures put in

[5] The Joint Forum on Financial Conglomerates, "Risk Concentrations Principles", Documents jointly released by the Basel Committee on Banking Supervision, International Organisation of Securities Commissions, and the International Association of Insurance Supervisors, Papers prepared by the Joint Forum on Financial Conglomerates, Basel Committee on Banking Supervision, Bank for International Settlements, December 1999. The paper is available on the BIS website (http://www.bis.org/publ/bcbs63.pdf).

necessary the supervisors should consider appropriate measures, such as reinforcing these processes with supervisory limits.	single borrower, borrower groups, and sensitive sectors particularly to stock market, real estate and commodities. There are currently no prudential requirements in regard to group-wide risk concentration.	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 a solo and consolidated basis.
1.2 Supervisory concerns emerging from risk concentrations can be mitigated by good risk management and internal control policies, and supplemented by the holding of adequate capital. Risk concentrations need to be monitored both in the legal entity and across the different sectors of the conglomerate to provide for the protection of the regulated entities. Supervisors should take steps directly or through regulated entities to provide that financial conglomerates have controls in place to manage their risk concentrations. For example, where the supervisor does not consider the controls adequate, supervisors should consider imposing supervisory limits.	Assessment of risk concentration in banks is normally made during the on-site inspection of banks on a stand-alone basis. Group-wide assessment of risk concentration is not normally done. Credit risk concentrations in individual banks are, however, monitored regularly through the off-site monitoring systems.	In order to more fully comply with best practices in this regard, it is necessary for RBI to issue instructions to banks to ensure that their up-stream and down-stream units have appropriate controls in place to manage their risk concentrations. To be effective it is preferable to prescribe limits linked to the unimpaired regulatory capital of the bank.
1.3 A sound risk management process begins with policies and procedures approved by the board of directors or other appropriate body and active oversight by both the board and senior management. The process should include clearly assigned responsibilities for the measurement and monitoring of risks and risk concentrations at the conglomerate level. The conglomerate should have in place a process to identify the conglomerate's principal risks, a comprehensive measurement system, a system of	Banks in India are yet to develop and implement sound risk management policies and procedures including sophisticated measurement techniques. The RBI has been proactive in providing guidance to banks in regard to the principles, measurement and management of risks and risk concentrations covering quantifiable and non-quantifiable risks. RBI has also been proactive in urging and motivating the Board of Directors and senior	Comprehensive management information and reporting system at the conglomerate level would have to be insisted upon by the RBI.

limits to manage large exposures and other risk concentrations and processes of stress testing and scenario and correlation analysis. Comprehensive management information and reporting systems are essential to sound risk management approach. Finally, sufficient attention should be given to non-quantifiable, as well as quantifiable, risks.	management of banks to exercise oversight on risk management practices and procedures in the banks. However, these are not extended to the conglomerate level. Sound and reliable management information systems, which are essential for an effective risk management approach, are largely lacking due to the low level of technology application and networking within and across individual units.	
1.4 As financial institutions from different sectors merge and financial conglomerates evolve, the potential for new types of concentrations arise. When evaluating proposed mergers and expansions, supervisors should take into account management plans to manage material risk concentrations at a group-wide level.	Assessments of the risk profiles of amalgamating entities on a solo and combined basis is done while evaluating mergers and acquisitions. However, the assessment is not normally extended to cover its impact on the evolving risk profile at the conglomerate level.	
2.0 Supervisors should monitor material risk concentrations on a timely basis, as needed, through regular reporting or by other means to help form a clear understanding of the risk concentrations of the financial conglomerate.	Refer to item 1.1 to 1.4. Material risk concentrations, including country risk exposures, are monitored on a quarterly basis in respect of the foreign branches, subsidiaries and joint ventures of Indian banks.	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.
2.1 Supervisors should have access to information or should be informed on a regular basis of the nature and size of material risk concentrations. To facilitate the process, supervisors may find it useful to set limits or thresholds that serve as reporting or supervisory benchmarks. Given the dynamic nature of the conglomerate organisations and the ease with which risk profiles can change, monitoring should be frequent. Risk concentrations or stress scenarios that	There are currently no major impediments to the RBI having access to such information on a consolidated as well as disaggregated unit-wise basis, apart from data management standards obtaining in individual banks.	-do-

generate large losses should be acted upon promptly through follow-up questions of the conglomerate's management.		
3.0 Supervisors should encourage public disclosure of risk concentrations.	We are in agreement with this view.	These disclosures will be helpful and may be made mandatory.
3.1 Public disclosure of risk concentrations at the group-wide level can promote market discipline. Effective public disclosures allow market participants to reward conglomerates that manage risks effectively and to penalise those that do not, thus reinforcing messages provided by the supervisor. For market discipline to be effective, disclosures need to be timely, reliable, relevant and sufficient. Given the complexity and variety of possible risk concentrations in a financial conglomerate, enhancing disclosure includes expanding the range of the most important risk concentrations in periodical financial statements, especially in the annual reports, while making timely and reliable disclosures of exposures outside normal reporting cycle as necessary to provide greater detail in response to market concerns. A description of the conglomerate's risk management approach to concentrations would be a useful supplement to quantitative information. In addition public disclosure can facilitate supervisory monitoring and risk assessment and lead supervisors to explore further material issues.	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.	We should follow a gradual process of disclosure on risk so that key elements remain in focus. Suggestions in this regard have been given while examining issues involved in enhancing bank transparency (Chapter 6). RBI may also consider requiring banks to make public the management's assessment of risk-concentration across sectors on a group-wide basis.
4.0 Supervisors should liase closely with one another to ascertain each other's concerns and coordinate as deemed appropriate any supervisory action relative to risk concentrations within the group.	Arrangements for information sharing between domestic regulatory bodies exist. However, notwithstanding mechanisms for coordination having been established, the level of actual	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

	coordination is not very high and seldom provides the regulators opportunities to take coordinated supervisory actions.	action, particularly in the area of risk management by the different entities of a conglomerate.
4.1 Risk concentrations may arise from exposures in many parts of a financial conglomerate. The effective assessment, monitoring and control of such concentrations by supervisors is likely to require sectoral expertise as well as a good understanding of the techniques used by other supervisors. Supervisors need to communicate on risk concentrations found within sectors or jurisdictions, as supervision at the sector level may not detect instances of arbitrage. In addition supervisors may need to coordinate across sectors and jurisdictions.	We are in agreement with this view.	-do- 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.
5.0 Supervisors should deal effectively and appropriately with material risk concentrations that are considered to have a detrimental effect on the regulated entities, either directly or through an overall detrimental effect on the group.	At present RBI has not articulated a general approach on how to deal with risk concentration 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 the prompt corrective action framework, which is being developed.
5.1 If a financial conglomerate is exposed to risk concentrations that may affect its financial stability, supervisors should take appropriate measures with respect to regulated entities. In some cases, supervisors may elect to take preventive measures. For example supervisors with necessary powers may consider establishing cross-sectoral limits for risk concentrations. Exceeding these limits could trigger supervisory intervention directed at controlling situations affecting the viability of the regulated entities of the conglomerate. While supervisors may generally feel they have the powers to seek corrective	Please refer to items 4.0 and 5.0. RBI has adequate powers to seek corrective action in respect of the banks under its supervision.	

action by the entity they regulate, actions elsewhere in the conglomerate may be necessary to effectively reduce or mitigate the concentration. Where risk concentrations cut across the regulated entities of the firm, cooperation among the relevant supervisors (as well as with the primary supervisor) is important.		

Annex 12
Intra-Group Transactions and Exposures Principles [6]

Principle	Indian Position	Remarks
1.0 Supervisory strategy with respect to Intra-Group Transactions and Exposures (ITE) in a conglomerate necessarily reflects the powers that the supervisors have to induce financial institutions to control problematic or excessive ITEs and non-arms length transactions. Supervisors should have sufficient authority to gather and safeguard information to enable them to monitor material ITEs across sectors and to observe how ITE-related risks are managed. Supervisors also should have the power to deal with ITEs that are manipulative or abusive, through preventive regulation, such as limits, or remedial action, as necessary. Where supervisors lack sufficient powers, they should seek the additional authority they need.	As indicated in the assessments of compliance with risk concentration principles, the RBI has requisite powers to gather all material information from commercial banks. Although there is no explicit legal provision empowering the RBI to call for information directly from subsidiaries or joint ventures of banks, in practice there has been no constraint in RBI receiving financial and/ or other structured information in respect of any of the transactions between the commercial bank and its down stream and upstream entities. RBI has the necessary powers to direct banks in regard to their ITEs. RBI also has powers to prohibit banks from engaging in ITEs that are manipulative or abusive.	Risk management systems that are being put in place need to take into account the special requirements of ITEs.
1.1 Supervisors should take steps, directly or through regulated entities, to provide that conglomerates have adequate risk management processes in place, including those pertaining to ITEs. Where necessary the supervisors should consider appropriate measures,	Conglomerate structures in India are relatively uncomplicated and simple. RBI has issued general guidelines to banks that all transactions with their subsidiaries/ joint ventures and associates should be on an arms length basis	RBI should consider issuing appropriate guidelines requiring banks to ensure that they and their subsidiaries and joint ventures put in place adequate risk management

[6] The Joint Forum on Financial Conglomerates, "Intra-Group Transactions and Exposures Principles", Documents jointly released by the Basel Committee on Banking Supervision, International Organisation of Securities Commissions, and the International Association of Insurance Supervisors, Papers prepared by the Joint Forum on Financial Conglomerates, Basel Committee on Banking Supervision, Bank for International Settlements, December 1999. The paper is available on the BIS website (http://www.bis.org/publ/bcbs62.pdf).

such as reinforcing these processes with supervisory limits.	and at market determined rates. The extant risk management guidelines issued by the RBI also addresses exposures to counterparties. There are currently no prudential limits in regard to intra-group transactions excepting prudential exposure limits.	processes covering intra-group exposures as well. It would also be useful to stipulate limits for ITEs on a solo and consolidated basis.
1.2 Supervisory concerns emerging from ITEs, in particular contagion effects, can be mitigated by good internal control policies within the conglomerate. Supervisors should expect that regulated entities will monitor and control ITEs in such a manner that the financial integrity of each regulated entity is protected. Supervisors should take steps directly or through regulated entities to provide that financial conglomerates have controls in place to manage their ITEs. For example, where the supervisor does not consider the controls adequate, or there is evidence of abusive or manipulative activity, supervisors should consider imposing supervisory limits or other measures.	Internal control policies as applicable to normal transactions are also applicable to intra-group transactions. There is no system whereby intra-group transactions in a financial/ banking conglomerate are monitored by supervisors in India. . However, market intelligence is being developed as a source of supervisory information.	In order to more fully comply with best practices in this regard, it is necessary for RBI to issue instructions to banks to ensure that their up-stream and down-stream units have appropriate controls in place in regard to intra-group transactions. To be effective it is preferable to prescribe norms as to permissible types of ITEs and also limits linked to the unimpaired regulatory capital of the bank.
1.3 A sound risk management process for ITEs begins with policies and procedures approved by the board of directors or other appropriate body and active oversight by both the board and senior management. The process should include a unified framework for the measurement and monitoring of material ITEs, so that both sides of bilateral transactions can be analysed at the individual regulated entity level, as well as at the conglomerate level. Comprehensive management information and reporting systems are essential to sound risk management approach. Finally, sufficient	This principle is acceptable. The RBI has been proactive in providing guidance to banks in regard to the principles, measurement and management of risks and risk concentrations covering quantifiable and non-quantifiable risks. RBI has also been proactive in urging and motivating the Board of Directors and senior management of banks to exercise oversight on risk management practices and procedures in the bank. However, these do not adequately cover ITEs.	RBI may consider issuing detailed guidelines to banks urging them to formulate and put in place clearly defined policies and procedures, including a unified framework for measurement, monitoring and management of risks associated with ITEs.

attention should be given to non-quantifiable, as well as quantifiable, risks.		
1.4 As financial institutions from different sectors merge and financial conglomerates evolve, the potential size, volume and complexity of ITEs increase. When evaluating proposed mergers and expansions, supervisors should take into account management plans to manage material ITEs at a group-wide level.	Assessments of the risk profiles of amalgamating entities on a solo and combined basis is done while evaluating mergers and acquisitions. However, the assessment is not normally extended to explicitly cover plans to manage ITEs at a group-wide level.	
2.0 Supervisors should 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.	Refer to item 1.1 to 1.4. Material ITEs are not captured in the supervisory off-site reporting system. These are however, looked into during the on-site inspection process if there frequency and concentration is large enough to attract supervisory concern.	Adequate reporting systems need to be put in place.
2.1 Supervisors should be able to tailor their monitoring of material ITEs based on the nature and scope of the conglomerate’s corporate governance and internal control mechanisms. Supervisors should have access to information or be informed on a regular basis on ITEs, on both a solo and consolidated basis that exceed a set standard rule. This implies that supervisors need to refer to both consolidated and unconsolidated financial statements to properly detect ITEs.	Refer to item 2.0. There are currently no major impediments to the RBI having access to such information on a consolidated as well as disaggregated unit-wise basis, apart from data management standards obtaining in individual banks.	
2.2 In instances where the conglomerate contains significant unregulated entities or has an organisational structure very different from its legal entity structure, sound management of ITEs by the regulated entities of the financial conglomerate, and	This principle is acceptable. RBI should ensure that material ITEs are effectively monitored through the principle entity falling within its jurisdiction.	

possibly by the financial conglomerate as a whole will be an important concern.		
2.3 Different approaches to capital regulation and accounting rules in different financial sectors may increase the opportunities for regulatory arbitrage. Supervisors should be especially vigilant in identifying ITEs throughout the financial conglomerate that facilitate such arbitrage.	This principle is acceptable.	
2.4 As ITEs evolve, reporting of these transactions must also evolve and take into account new benefits and risks that may be associated with these new structures.	Refer to comments at 2.1.	
3.0 Supervisors should encourage public disclosure of ITEs.	ITEs are at present not subject of 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.
3.1 Public disclosure of ITEs at the group-wide level can promote market discipline by providing insight into the relationship among the various entities in the conglomerate. Effective public disclosures allow market participants to reward conglomerates that manage risks associated with ITEs effectively and to penalise those that do not, thus reinforcing messages provided by the supervisor. For market discipline to be effective, disclosures need to be timely, reliable,	While the type of information usually provided in the annual report and management or director’s report to the market or supervisors generally allow these users to arrive at meaningful inferences in regard to financial condition, solvency, earnings performance and brief risk profile, disclosures relating to ITEs are currently not mandatory. RBI currently requires banks to append the financial	

relevant and sufficient. Given the variety of possible ITEs in a financial conglomerate, public disclosure should not simply highlight the volume of ITEs but help the reader of financial statements to gain a greater understanding of the operations of the conglomerate. This no doubt means enhancing disclosures by expanding both the qualitative information, such as scope, significance and management of the conglomerate's major ITEs, as well as quantitative information. In addition, public disclosure can facilitate supervisory monitoring and risk assessment and lead supervisors to explore further material issues.	statements in respect of subsidiaries/ joint ventures along with the financials of the parent unit. RBI may consider requiring banks to also make public not only the variety and volume of ITEs, but also the management's statement of the purpose and implications of ITEs on a group-wide basis.	
4.0 Supervisors should liase closely with one another to ascertain each other's concerns and coordinate as deemed appropriate any supervisory action relative to ITEs within the group.	We are in agreement with this view. Information sharing between domestic regulatory bodies like Securities and Exchange Board of India (SEBI), National Bank for Agricultural and Rural Development (NABARD), National Housing Bank (NHB), etc, are attended to on mutual understanding. The RBI is also represented on the boards of these bodies. A High level Committee on Capital Markets comprising of Governor of RBI, Chairman of SEBI and Finance Secretary of the Central Government serves as a forum for discussing key regulatory issues of common interest. Cooperation established should also extend to sharing information on material ITEs across jurisdictions.	Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate. Close coordination and liaion 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.
4.1 A better understanding of supervisory methods dealing with ITEs and their rationale will facilitate a group-wide assessment of the difficulties that may be	The range and scope of information exchange among sectoral supervisors as well as the contact levels needs to be made broader and	

encountered by conglomerates as a result of ITEs. Supervisory concerns associated with cross-jurisdiction and cross-sector ITEs may be mitigated by communication among supervisors.	multi-point. It would also be useful to have a structured agenda so that all material issues with cross-sectoral implications receive appropriate attention.	
4.2 One of the key considerations influencing the supervisory approach to the regulation of ITEs is the legal structure of the conglomerate in each jurisdiction and country in which the conglomerate has operations. In deteriorating financial scenarios, the liquidation and bankruptcy regimes of each separate legal entity will determine at what point the regulated entity is endangered and will be moved into liquidation or resolution. Supervisors need to be aware that the differences in the bankruptcy/ liquidation regimes exist so that they can anticipate the impact of such regimes on the regulated entities within a troubled conglomerate and coordinate as necessary and where possible with other supervisors.	Bankruptcy and liquidation regimes for commercial entities are uniform across India. However, there are serious implications for cross- border conglomerates.	
5.0 Supervisors should deal effectively and appropriately with material ITEs that are considered to have a detrimental effect on the regulated entities, either directly or through an overall detrimental effect on the group.	We are in agreement with this view. At present RBI has not articulated a general approach on how to deal with material ITEs at the group level apart from issuing guidelines to banks to have arms length relationship in their commercial transactions with subsidiaries.	
5.1 Most supervisory regimes are designed to prohibit detrimental ITEs. If prohibited transactions occur or if a financial conglomerate is exposed to ITEs that may affect its financial stability, supervisors should take appropriate measures with respect to regulated entities. Examples of supervisory actions include requiring that prohibited transactions be nullified or cease to	Please refer to items 4.0 and 5.0. RBI has adequate powers to seek corrective action in respect of the banks under its supervision.	

continue, that the use of ITEs be modified going forward or that they be subject to prudential measures. Supervisors may have to use moral suasion in instances where their powers are lacking to deal with ITEs. Where ITEs cut across the regulated entities of the firm, cooperation among the relevant supervisors (as well as with the primary supervisor) is important.		

Annex 13

Principles for the Supervision of Banks' Foreign Establishments (The Basel Concordat) [7]

No.	Principle	Indian Position	Remarks
I. General principles governing the supervision of banks' foreign establishments			
i.	Effective supervision between host and parent authorities is a central prerequisite for the supervision of banks' international operations. In relation to the supervision of banks' foreign establishments there are two basic principles which are fundamental to such cooperation and which call for consultation and contacts between respective host and parent authorities;		
	Firstly, that no foreign banking establishment should escape supervision; and	All foreign banking establishments in the country are subject to supervision.	
	Secondly, that the supervision should be adequate.	Systems are in place and have so far proved to be adequate. In the changing worldwide scenario of banking particularly the integration of markets, there is now a need to strengthen the system further. The first step would be a greater interaction with controlling office (not only the immediately superior office) and the home office regulator. A full understanding of the overall operations of the bank involved is considered necessary.	

[7] "Principles for the Supervision of Banks' Foreign Establishments (The Basel Concordat)", Basel Committee on Banking Supervision, Bank for International Settlements, May 1983. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs2.pdf).

ii.	In giving effect to these principles, host authorities should ensure that parent authorities are informed immediately of any serious problems which arise in a parent bank's foreign establishment. Similarly, parent authorities should inform host authorities when problems arise in a parent bank which are likely to affect the bank's foreign establishment.	This principle has as yet not received universal acceptance amongst regulators in regard to their cross border regulatory obligations. Host authorities in a large majority of cases remain inadequately informed about the parent bank's current and impending difficulties. A more comprehensive system of information sharing based on mutuality and reciprocity need to be established.	
II. Aspects of the supervision of banks' foreign establishments			
1. Solvency[8]			
	The allocation of responsibilities for the supervision of the solvency of banks' foreign establishments between parent and host authorities will depend upon the type of establishment concerned.	Supervision of banks in India mainly aims at ensuring the solvency of the banks and their ability to meet their liabilities as and when they arise.	
	For branches, their solvency is indistinguishable from that of the parent bank as a whole. So, while there is a general responsibility on the host authority to monitor the financial soundness of foreign branches, supervision of solvency is primarily a matter for the parent authority.	While supervising the branches of foreign banks operating in India, RBI looks mainly at the solvency of the branch. The solvency of the parent bank needs to receive a more pointed attention even if the responsibility to monitor is only general.	
	For subsidiaries, the supervision is a joint responsibility of both host and parent authorities.	For supervision of subsidiaries of foreign banks which have branches in India as also for subsidiaries of Indian banks abroad, RBI would need to develop a more focussed policy. At	

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

		present, the supervision of the subsidiary does not seem to attract enough attention of the regulator.	
	For joint ventures, the supervision should normally, for practical reasons, be primarily the responsibility of the authorities in the country of incorporation.	This is our position as well.	
2. Liquidity [9]			
	Allocation of responsibilities for the supervision of the liquidity of banks' foreign establishments will depend upon the type of establishment concerned.	Liquidity of branches of banks incorporated abroad and functioning in the country as well as those of Indian bank branches abroad are monitored.	
	For branches, host authorities will often be best equipped to supervise liquidity as it relates to local practices and regulations and the functioning of their domestic money markets. At the same time, the liquidity of all foreign branches will always be a matter of concern to the parent authorities, since a branch's liquidity is frequently controlled directly by the parent bank and cannot be viewed in isolation from that of the whole bank of which it is a part. Parent authorities need to be aware of parent banks' control systems and need to take account of calls that may be made on the resources of parent banks by their foreign branches. Host and parent authorities should always consult each other if there are any doubts in particular cases about where responsibilities for supervising the	Foreign banks operating in the country are required to bring in capital funds and minimum CAR is also stipulated for such branches. Systems are also in place whereby RBI can take into account calls that may have to be made by them on their parent banks. This is also periodically monitored. In the case of Indian banks with branches abroad, systems are in place for monitoring liquidity by means of periodical returns.	

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

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

		concordat is taken to mean responsibility in respect of the foreign exchange operations of the branches of foreign banks operating in India.	

Annex 14
Information Flows Between Banking Supervisory Authorities [10]

No.	Principle	Indian Position	Remarks
I. Authorisation			
i.	Host authorities should as a matter of routine check that the parent authority has no objection before granting a banking licence.	Before granting permission to a foreign bank for opening a branch in India, prior consent of the parent authority is ensured.	
ii.	Where a host authority is unable to obtain a positive response from the parent authority, it should consider either refusing the application, increasing the intensity of supervision or imposing conditions on the grant of authorisation. In the latter case, it is recommended that the conditions (and any subsequent changes in the conditions) should be communicated to the parent authority.	RBI considers it essential to obtain the parent authorities' consent before allowing any foreign bank to open a branch in India.	
iii.	Host authorities should exercise particular caution in approving applications for banking licenses from foreign entities which are not subject to prudential supervision in the parent country of joint ventures for which there is no clear parental responsibility. In such circumstances, any authorisation should be contingent on the host authority's capacity to exercise a parental role.	The principle is accepted. However, as yet there has been no occasion for RBI to permit opening of a bank in India where due to its joint venture character there is lack of clarity about the parent authority and its supervision over its foreign branches.	
iv.	If the host authority follows the procedure outlined	Indian banks are not permitted to open any	

[10] "Information Flows Between Banking Supervisory Authorities", Basel Committee on Banking Supervision, Bank for International Settlements, April 1990. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs7.pdf).

	in sub-section (i), a parent authority which disapproves of its bank's plans to establish abroad can recommend the host authority to refuse a licence. Parent authorities nonetheless should ensure that they have taken adequate steps to prevent their banks establishing in unsuitable locations or making inappropriate acquisitions. Where the parent supervisor imposes conditions on a foreign establishment, such conditions should be communicated to the host authority.	branch abroad without permission of the Reserve Bank. Opening branches or making any acquisition abroad is subject to a thorough appraisal. Conditions imposed on a foreign establishment are communicated to the host authority.	
II. Information needs of parent authorities			
i.	Host and parent authorities should seek to satisfy themselves that banks' internal controls should include comprehensive and regular reporting between a bank's foreign establishments and its head office.	While RBI ensures that the branches of Indian banks abroad are controlled properly by banks' head offices and that suitable control mechanisms for the purpose are in place, in regard to the quality of control exercised by Head office of foreign banks, whose branches are operating in India, the position is not as unambiguous.	The information flow between the branches (of foreign banks) and the quality of internal control is taken more as a matter between the branch and its HO. The approach is that such internal control is primarily the responsibility of the head office and also on the assumption that any deficiency will be brought to its notice by the bank's head office as well as the parent supervisor. It is suggested that RBI may increase its reliance on the parent country supervisor and convey to them its expectation about being informed about the extent and quality of control maintained by the head office on its branches operating in India.

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

	parent supervisor.		
iv.	If serious problems arise in a foreign establishment, the host authority should consult with the head office or parent bank and also with the parent authority in order to seek possible remedies. If the host authority decides to withdraw banking authorisation from a foreign establishment or take similar action, the parent authority should, where possible, be given prior warning.	Systems are in place for consulting with head office / parent bank and also with the parent authority whenever serious problems arise in a foreign bank branch operating in the country.	
III. Information needs of host authorities			
i.	Parent authorities should inform host authorities of changes in supervisory measures which have a significant bearing on the operations of their banks' foreign establishments. Parent authorities should respond positively to approaches from host authorities for factual information covering, for example, the scope of the activities of a local establishment, its role within the banking group and the application of internal controls and information relevant for effective supervision by host authorities.	Exchanges of such information between parent and host supervisors *suo moto* is not quite common. Reserve Bank has, however, been providing the host authorities with all such information that they have sought.	In its own turn, RBI has so far not been seeking much information from the parent authorities of banks operating in India. In certain areas of their operations, particularly about the internal about the internal controls exercised by the concerned head offices of banks, more information is desirable. RBI may consider taking steps in that direction.
ii.	Where a parent authority has doubts about the standard of host supervision in a particular country and, as a consequence, is envisaging action which will affect foreign establishments in the territory	The quality of host supervision differs from country to country. System of advance consultation with the host/parent supervisors is in vogue.	A periodic review would need to be made of the supervisory systems and standards of host supervision where Indian banks have a presence.[11]

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

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

iii.	The confidentiality of information transmitted should be legally protected, except in the event of criminal prosecution. All banking supervisors should, of course, be subject to professional secrecy constraints in respect of information obtained in the course of their activities.	Confidentiality of supervisory information is ensured.	There is perhaps a case for incorporating strict legal provisions in this regard so that supervisory information should not be shared with any agency, including central or state level vigilance/investigative agencies, but only when specifically called for by a court of law. As a related BIS document states, it needs to emphasised, even in the event of a court demanding supervisory information, that making such information public may result in the drying up of such information and thus adversely affect the quality of supervision in the long run.
iv.	The recipient should undertake, where possible, to consult with the supervisor providing the information if he proposes to take action on the evidence of the information received.	The actual position may vary from case to case. Usually, such consultation with supervisor, after the information has been parted with, does not take place.	Consultation with the supervisor providing the information should be stipulated by law in order to safeguard the integrity and credibility of supervisory system and has relationship of trust between parent and host supervisors.
V. External audit			
i.	The existence of adequate provision for external audit should be a normal condition of authorisation for new establishments. It would be advantageous for the audit firm to be one that audits the parent bank, provided the firm in question has the	Foreign establishments of Indian banks are usually submitted to an external audit in the host country. Similarly, foreign bank branches in India are submitted to external audit. Audit reports of Indian bank branches are	

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

Annex 15
Minimum Standards for the Supervision of
International Banking Groups and their Cross-Border Establishments [12]

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

[12] "Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments", Basel Committee on Banking Supervision, Bank for International Settlements, July 1992. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs10.pdf).

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

Annex 16

The Supervision of Cross-Border Banking [13]

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

No.	Principle	Indian Position	Remarks
i.	In order to exercise comprehensive consolidated supervision of the global activities of their banking organisations, home supervisors must be able to make an assessment of all significant aspects of their banks' operations that bear on safety and soundness, wherever those operations are conducted and using whatever evaluative techniques are central to their supervisory process.	RBI's supervisory stance is aimed at exercising comprehensive and consolidated supervision of the global activities of the Indian banks. However, in this regard it faces constraints in countries where the local laws do not permit the home supervisor to conduct on-site inspection/examination of records. There is no legal or other hindrance to parent supervisors from other countries conducting such inspections of Indian branches of banks under their supervisory jurisdiction.	A country-wise analysis will have to be made and suitable action taken to address the constraints.
ii.	Home supervisors need to be able to verify that quantitative information received from banking organisations in respect of subsidiaries and branches in other jurisdictions is accurate and to reassure themselves that there are no supervisory gaps	In regard to the quantitative information received from banks in respect of their branches abroad, RBI depends upon the banks providing this information for their accuracy. Such cross checks as are there are also based on the information available from the banks themselves as RBI does not consider it necessary to collect any independent information for reassuring itself that there are no supervisory gaps. At present, the	

[13] "The Supervision of Cross-Border Banking", Basel Committee on Banking Supervision, Bank for International Settlements, July 1992. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs27.pdf).

		foreign operations of all Indian banks constitute a small part of their total operations, say, less than 20 per cent and therefore the current methodology is considered acceptable.	
iii	While recognising that there are legitimate reasons for protecting customer privacy, the working group believes that secrecy laws should not impede the ability of supervisors to ensure safety and soundness in the international banking system	We are in agreement with the view. Where safety and soundness in the international banking system is likely to come in question, customer privacy should have to lose priority.	
iv.	If the home supervisor needs information about non-deposit operations, host supervisors are encouraged to assist in providing the requisite information to home supervisors if this is not provided through other supervisory means. The working group believes it is essential that national legislation that in any way obstructs the passage of non-deposit supervisory information be amended.	We are in agreement with the view. In India there is no legislation at present obstructing passage of non-deposit supervisory information either to the parent office or to the home supervisor of the branches of foreign banks.	
v.	Where the liabilities side of the balance sheet is concerned, home supervisors do not routinely need to know the identity of individual depositors. However, in certain well-defined circumstances, home supervisors would need access to individual depositors' names and to deposit account information.	We are in agreement with this view subject to a prior mutual agreement as regards what are "well-defined circumstances" in which the home supervisor would need access to individual depositor names and account information. Customer privacy cannot be easily and routinely compromised as it can have serious implication on the banking system. For this arrangement to work it will have to be the basis of mutuality between home and host supervisors and all supervisors would need to agree to it.	
vi.	It should not normally be necessary for the home supervisor to know the identity of investors for	Our views on the issue are the same as in the case of item (v).	

	whom a bank in a host country is managing investments at the customer's risk. However, in certain exceptional circumstances, home supervisors would need access to individual investors' names and to investment account information subject to the safeguards in paragraph 10.		
vii.	The working group recommends that host supervisors whose legislation does not allow a home supervisor to have access to depositor information use their best endeavours to have their legislation reviewed and if necessary amended to provide for a mechanism whereby in exceptional cases a home supervisor, with the consent of the host supervisor, will gain access to depositor information subject to the same conditions as outlined in (viii) below.	No such restrictions exist in the country. Laws in India at present do not debar the sharing of depositor information by a branch of foreign bank with its parent office or the home supervisor.	
viii.	In order to provide legitimate protection for bank customers, it is important that the information obtained by home supervisors especially that relating to depositors' or investors' names, is subject to strict confidentiality. The working group recommends that those host jurisdictions whose legislation allows foreign supervisors to have access to banks' depositor or investor information should subject such access (at the host country's discretion) to the following conditions - the purpose for which the information is sought should be specific and supervisory in nature; - information received should be restricted solely	We are in agreement.	RBI is at present not specifying such conditions. It may consider stipulating these conditions whenever foreign supervisors are to be given access to bank's depositor or investor information.

	to officials engaged in prudential supervision and not be passed to third parties without the host supervisor's prior consent; - there is assurance that all possible steps will be taken to preserve the confidentiality of information received by a home supervisor in the absence of the explicit consent of the customer;		
	- there should be a two-way flow of information between the host and home supervisors, though perfect reciprocity should not be demanded.	We do not see any reason why perfect reciprocity should not be demanded. In fact, it is felt that without an understanding of perfect reciprocity it would be difficult to put such an arrangement in place.	
	- Before taking consequential action, those receiving information will undertake to consult with those supplying it.	Such consequential action shall only be supervisory and prudential.	
ix.	If a host supervisor has good cause to doubt a home supervisor's ability to limit the use of information obtained in confidence solely for supervisory purposes, the host would retain the right not to provide such information.	It is not quite clear how this provision can coexist with the provision suggested earlier that secrecy laws should not impede the ability of the supervisors to ensure safety and soundness in the international banking system. (Item (iii) above). Also, without objective reciprocity on the issue of sharing information between supervisors, information flow may become very uneven making cross-border supervision difficult.	
x.	Subject to appropriate protection for the identity of customers, home supervisors should be able at their discretion, and following consultation with the host supervisor, to carry out on-site inspections in other	The Group is in agreement with this view.	

	jurisdictions for the purposes of carrying out effective comprehensive consolidated supervision. This ability should include, with the consent of the host supervisor and within the laws of the host country, the right to look at individual depositors' names and relevant deposit account information if the home supervisor suspects serious crime as defined in section (d). If a host supervisor has reason to believe that the visit is for non-supervisory purposes, it should have the right to prevent the visit taking place or to terminate the inspection.		
xi.	It would avoid potential misunderstandings if a standard routine were laid down for conducting cross-border inspections along the lines recommended.	Standard routine is not implemented as of now. Nor is it demanded of parent supervisors inspecting branches in India. A standard routine for conducting cross-border inspection as proposed would be difficult.	
xii.	In those countries where laws do not allow for on-site inspections use their best endeavours to have their legislation amended. In the meantime, host supervisors should, within the limits of their laws, be willing to co-operate with any home supervisor that wishes to make an inspection. The working group believes that the host supervisor should have the option to accompany the home supervisor throughout the inspection.	We agree. Inspections by the home supervisors are not impeded in any way in India.	
xii.	It is important that the confidentiality of information obtained during the course of an inspection be maintained. Home supervisors should use their best endeavours to have their legislation modified if it does not offer sufficient	We agree. However, the present legal provisions in India in respect of confidentiality of information available with the home supervisor (RBI) do not seem to be providing sufficient protection of information. More clearly defined	

	protection that information obtained for the purposes of effective consolidated supervision is limited to that use.	laws would be needed for this purpose.	
xiv	In the event that a home supervisor, during an on-site inspection in a host country detects a serious criminal violation of home country law, the home supervisor may be under a strict legal obligation to pass the information immediately to the appropriate law enforcement authorities in its home country. In these circumstances, the home supervisor should inform the host supervisor of the action he intends to take.	We agree.	
xv.	In order to carry out effective comprehensive consolidated supervision, home supervisors also need information on certain qualitative aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are the home supervisor. All members of the working group agree that it is essential for effective consolidated supervision that there are no impediments to the passing of such qualitative information to the home supervisor.	There is no restriction in India for passing on such information to other country supervisors regarding the branches of banks under their jurisdiction.	A country-wise analysis will have to be made to ensure reciprocity in this arrangement.

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

i.	In the case of information which is specific to the local entity, an early sharing of information may be important in enabling a potential problem to be resolved before it becomes serious. The home supervisor should therefore	We are in agreement with this view. This arrangement is likely to improve supervisory efficiency.	

	consult the host supervisor in such cases and the latter should report back on its findings. In particular, it is essential that the home supervisor inform the host supervisor immediately if the former has reason to suspect the integrity of the local operation, the quality of its management or the quality of internal controls being exercised by the parent bank.		
ii.	A home supervisor should have on its regular mailing list for relevant material all foreign supervisors which act as hosts to its banks.	This may not be necessary as it could lead to much flow of sparingly needed information between the supervisors. Any information, wherever required is likely to be available on demand or already made public by the concerned supervisor, e.g., on their web sites.	
iii.	While the working group agrees that home supervisors should endeavour to keep host supervisors apprised of material adverse changes in the global condition of banking groups, the Group recognises that this typically be a highly sensitive issue and that decisions on information-sharing necessarily will have to be made on a case-by-case basis.	There cannot be a settled principle on this since it has to be decided on a case-by-case basis.	

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

i.	The working group has formulated a set of principles of effective consolidated supervision which could be used by host supervisors as a checklist to assist in determining whether a home supervisor is meeting the Minimum	The checklist provided by the working group can act as a good tool for assessing the capabilities of any supervisor to exercise consolidated supervision. However, any assessment of this nature can become arbitrary and lead to	The principle of consolidated supervision is unexceptionable. Reserve Bank needs to move in that direction. The accounting standards as well as the regulatory

	Standards.	considerable difference of opinion between the host and home supervisors. Unless, therefore, there is a general consensus amongst all supervisors on the scope and methodologies of exercising consolidated supervision and until there is an agreement between most supervisors on its acceptance as the common mode of supervision, this approach if insisted upon could become counterproductive.	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 found.
ii.	Regional group procedures might be used to support the implementation of the Minimum Standards, as the Offshore Group is now doing.	Our views are as expressed in regard to item xix.	
iii.	The working group recommends that other regional groups consider the possibility of using a checklist similar to the one used by Offshore Group as a means of establishing which of their members might be certified as meeting certain general criteria.	Our views are as expressed in regard to item xix.	
iv.	The Basel Committee encourages its member countries to assist the Offshore Group or another regional group in the fact-finding verification process, but any decision-making regarding membership of a regional group should be left to the group alone. The Committee has asked its Secretariat to maintain a list of competent persons (for example, retired supervisors) who are available to undertake exercises of this nature.	No comments.	
v.	The supervisor that licenses a so-called shell branch has responsibility for ensuring that there	RBI's position on these issues is the same as stated in the BIS document. It does not permit	

	is effective supervision of that shell branch. No banking operation should be permitted without a licence, and no shell office should be licensed without ascertaining that it will be subject to effective supervision. In the event that any host supervisor receives an application to license a new shell branch that will be managed in another jurisdiction, that supervisor should take steps to notify both the home supervisor and the appropriate host supervisor in the other jurisdiction in order to establish that there will be appropriate supervision of the branch before approving the application.	any banking operations without a licence. It also does not allow opening of any kind of branch of an Indian bank, unless it is satisfied that the branch will be subject to effective supervision.	
vi.	Home supervisors should not authorise their banks to establish or acquire offices in any host jurisdiction without satisfying themselves in advance that such offices will be subject to appropriate supervision.	This is being ensured while granting permission for opening of branches abroad.	
vii.	Where the home authority wishes to inspect on-site, they should be permitted to examine the books of the shell branch wherever they are kept. The working group believes that in no case should access to these books be protected by secrecy requirements in the country that licenses the shell branch.	We are agreeable to this suggestion.	
viii.	The working group recommends that home or host supervisors be vigilant to ensure that parallel-owned banks (where a bank in one jurisdiction has the same ownership as a bank in another jurisdiction, where one is not a subsidiary of the other) become subject to	We are in agreement with this suggestion.	

	consolidated supervision, if necessary by enforcing a change in group structure as indicated by the Minimum Standards.		
ix.	Any home supervisor that licenses a banking entity has a responsibility to monitor its operations on a worldwide basis.	This is being ensured.	
x.	No entity should be allowed to use the word “bank” in its name if it is not conducting banking activities and being supervised as a bank.	This is provided for in law.	
xi.	The working group believes the Basel Committee should advise all host countries to be extremely cautious about approving the establishment of cross-border operations by banks incorporated in under-regulated financial centres, and even more cautious about accepting other financial institutions conducting banking activities from those centres.	RBI's approach on these issues is in line with the thinking of the working group.	

1. “Core Principles for Effective Banking Supervision”, Basel Committee on Banking Supervision, Bank for International Settlements, September 1997. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs30.pdf). The assessment has been made using the harmonised assessment methodology given in “Core Principles Methodology”, Basel Committee on Banking Supervision, October 1999. (http://www.bis.org/publ/bcbs61.pdf)
2. “Framework for Internal Control Systems in Banking Organisations”, Basel Committee on Banking Supervision, Bank for International Settlements, September 1998. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs33.pdf).
3. “Principles for the Management of Credit Risk”, Basel Committee on Banking Supervision, Bank for International Settlements, September 2000. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs75.pdf).
4. “Range of Practice in Banks’ Internal Rating Systems”, Basel Committee on Banking Supervision, Bank for International Settlements, January 2000. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs66.pdf).
5. “Banks’ Interactions with Highly Leveraged Institutions”, Basel Committee on Banking Supervision, Bank for International Settlements, January 1999. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs46.pdf).

6. “Sound Practices for Loan Accounting and Disclosure”, Basel Committee on Banking Supervision, Bank for International Settlements, July 1999. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs55.pdf).
7. “Enhancing Bank Transparency”, Basel Committee on Banking Supervision, Bank for International Settlements, September 1998. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs41.pdf).

8. “Best Practices for Credit Risk Disclosure”, Basel Committee on Banking Supervision, Bank for International Settlements, September 2000. The BCBS paper is available on the BIS website (http://www.bis.org/publ/bcbs74.pdf).
9. The Joint Forum on Financial Conglomerates, “Supervision of Financial Conglomerates”, Documents jointly released by the Basel Committee on Banking Supervision, International Organisation of Securities Commissions, and the International Association of Insurance Supervisors, Papers prepared by the Joint Forum on Financial Conglomerates, February 1999. The paper is available on the BIS website (http://www.bis.org/publ/bcbs47.pdf).

10. Issued by the G-7 Finance Ministers in May 1998. The principles were published in a report of the Ministers entitled Financial Stability – Supervision of Global Financial Institutions. It has been reproduced as Annex 1 to the Chapter on “Principles for Supervisory Information Sharing Paper” in the documents on “Supervision of Financial Conglomerates”.
11. “Supervisor” means the entity or entities with statutory, supervisory or regulatory powers over financial firms and/markets within their jurisdiction.
12. “Provider” means the Supervisor to which a request for information has been made.