Report of The Working Group on Consolidated Accounting and Other Quantitative Methods to Facilitate Consolidated Supervision

December 2001

Recommendations

At present, in India the key components of consolidated supervision are annexing the financial statements of their subsidiaries along with their annual accounts. As banks diversify into different activities a need was felt to align the approach with that prevalent internationally, of which consolidated accounting is an integral part. Accordingly, a multi-disciplinary Working Group was set up in November 2000 to look into the introduction of consolidated accounting and other quantitative techniques of consolidated supervision and to make recommendations accordingly. The Working Group after detailed deliberations with the representatives of various banks and financial institutions as also with the officials of the Reserve Bank of India dealing with regulatory and supervisory aspects to ascertain the existing methodology, the supervisory concerns and the future requirements submitted the report in December 2001.

The report was placed before the Board for Financial Supervision at its meeting held on January 29, 2002 and it was decided to consider the views of interested parties while implementing the recommendations. Accordingly, the recommendations of the Working Group together with brief background and illustrative formats for submitting consolidated financial statements are placed on the website. The interested parties may offer their suggestions to the Chief General Manager-in-Charge, Department of Banking Operations and Development, Reserve Bank of India, World Trade Centre – 1, Mumbai 400 005 (email: cgmiicdbodco@rbi.org.in or email: anarian@rbi.org.in) before March 11, 2002.

1.1 Bank group structures in India are relatively simple structures and hence consolidated supervision has not emerged as a major area of concern for bank supervisors. The rigorous provisions of the banking law and licensing policy based thereon have ensured that bank group structures did not get complex so far. Generally, banks have only been parents and have formed subsidiaries mostly in the financial services sector. The concerned supervisor supervises the entities on a solo basis. In addition, in the course of their on-site inspection of banks, supervisors look at the functioning of the subsidiaries as reflected in the records of the bank to gauge the possible impact of the financial condition of the subsidiary on the financial condition of the parent.

1.2 In recent times, following the failure of large international banks triggered by the operations of their subsidiary ventures and by the concerns arising out of the entry of banks into other lines of business, there has been renewed focus on empowering supervisors to undertake consolidated supervision of bank groups. Nearer home the regulatory arbitrage between banks and their subsidiaries which was much in evidence in the stock market scam of 1992 also emphasized the need for consolidated supervision of banking groups in India. The Core Principles of Effective Banking Supervision issued by the Basel Committee of Banking Supervision (BCBS) have underscored this requirement as an independent principle, which requires that bank supervisors have the ability to supervise banking groups on a consolidated basis.

1.3 Consolidated Supervision is defined as "an overall evaluation (qualitative as well as quantitative) of the strength of a group to which a large bank belongs". The objective is to assess the potential impact of other group companies on the bank. Thus, it is a group-wide approach to supervision where all the risks run by a banking group are taken into account in totality, independent of wherever they are booked. A major element of this approach is the preparation of financial statements on a consolidated basis combining the assets and liabilities and off-balance sheet items of banks and their related entities, treating them in effect as if they were a single entity. On the basis of such reports, supervisors can then measure the financial risks faced by bank groups and apply supervisory standards such as large exposure and connected exposure limits and minimum capital adequacy ratios on a group basis.

The Board for Financial Supervision has evolved an approach to consolidated supervision as appropriate to the Indian context. The key components of this approach are a quarterly reporting by

banks on the key areas of their subsidiaries and a requirement that banks annnexe the financial statements of their subsidiaries with their annual accounts.

1.4 The liberalization of licensing policy in 1993, which allowed promotion of new banks by financial institutions and non-banking financial companies brought banks as subsidiaries in financial conglomerates. As banking structures expectedly grow increasingly complex in the future, and banks diversify into different activities and also as financial institutions now have both financial and non-financial subsidiaries, it has been now considered necessary to align the supervisory approach to consolidated supervision with that prevalent internationally, of which consolidated accounting is an integral part. Accordingly, a multi-disciplinary Working Group was set up in November 2000 by Reserve Bank of India (RBI) to look into the introduction of consolidated accounting and other related quantitative techniques of consolidated supervision and to make recommendations accordingly.
The composition of this Working Group is as follows:

1	Shri Vipin Malik, Director, Bharatia Reserve Bank Note Mudran Ltd. and Ex-Director, Central Board of RBI, Chartered Accountant, V Malik & Associates, 108/104 Golf Apartment, Sujan Singh Park, New Delhi 110 048.	Chairman
2	Shri K L Khetarpaul, Executive Director, Reserve Bank of India, Central Office, Mumbai.	Member
3	Shri P V Subba Rao. Chief General Manager, Reserve Bank of India, Department of Banking Supervision, Central Office, Mumbai.	Member
4	Shri B D Sumitra, Chief General Manager, State Bank of India, (Accounts & Compliance), National Banking Group, Central Office, Mumbai 400 021.	Member

5 Shri G Sitharaman/ Shri N D Gupta[1],
President, — Member
The Institute of Chartered Accountants of India,
Indraprastha Marg,
New Delhi 110 002.

6 Shri Nagesh Pinge,
General Manager, — Member
Internal Audit & Risk Department,
ICICI Limited. ICICI Towers,
Bandra Kurla Complex,
Mumbai 400 051.

7 Shri A M M Sarma,
General Manager, RBI (Retired), — Member
:ha", Plot No. 28,
Bank Colony,
No. 3, Banjara Hills,
abad 500 034. (AP).

8 Shri Aditya Narain,
General Manager, — Member-Secretary
Reserve Bank of India,
Department of Banking Supervision,
Central Office, Mumbai

The terms of reference of this Group were-

1. To examine the feasibility of introducing consolidated accounting for groups in which banks are either parents, subsidiaries or associates in line with international best practices.

2. To specify (i) the scope and (ii) the techniques to be used for consolidation of accounts and to recommend the introduction or adoption of any accounting standards for this purpose.

3. To recommend the introduction of any other quantitative methods such as group prudential norms to facilitate consolidated supervision.

4. To outline the sequencing of the introduction of consolidated accounting and other quantitative methods.

5. To specify the legislative amendments which would be required for the introduction of consolidated accounting and other quantitative methods.

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[1] Shri G Sitharaman was the President of ICAI when the Group was formed and contributed to the initial meetings. Shri N D Gupta substituted him as the member in the Group consequent on his election as the new President.

Subsequently, the Group was also requested to

6. Review the recommendations of the Informal Working Group on Subsidiaries of Banks set up by RBI for inclusion in the final report.

1.5 The Chairman of the Group held discussions with the officials of the Reserve Bank of India dealing with regulatory and supervisory aspects to ascertain the existing methodology, the supervisory concerns and the future requirements. After initial discussions within the Group, individual Members took up various areas for detailed study, which were then presented to the Group and deliberated upon till agreement was reached. The draft report was then finalized by the Group.

Scheme of the Report

1.7 The Group met a number of times besides the Chairman had interactions with a cross-section of experts including senior officers of RBI on each of the issues before finalizing the report. The Group has also taken the Securities Exchange Board of India (SEBI) disclosure requirement as recommended by their accounting standard committee to be incorporated, in the listing agreements with regard to consolidation of accounts by companies**.** The Group is grateful to the following officials from different organizations who made presentations on the subject and shared their views/experiences: Ms. Shalini Shah, GM, ICICI Ltd., Shri M Narendra, DGM, Corporation Bank, Shri M Kansal, Bank of America; Ms. Rama Srinivasan, SBI, Shri Srinivasan Rangan, HDFC Ltd., and Shri Nilesh Doshi, Chief Manager, ICICI Ltd. The Group also acknowledges the valuable contribution made by Ms. Bhavna Doshi, Chairperson, Accounting Standards Board and Dr. Avinash Chander, Technical Director of the ICAI, who attended some of the meetings of the Group and participated in the deliberations.

1.8 The Group also wishes to place on record its gratitude to the following officers of RBI: Shri Salim Gangadharan, GM, DBOD; Shri B Mahapatra, GM, DBOD and Shri B B Tiwari, Joint Legal Adviser, who have provided valuable technical assistance in the formulation and drafting of sections of the report, and Shri H S Shetty, DGM and Shri Ashok Narain, AGM of DBS who provided both technical and administrative assistance in the meetings of the Group. The Group also acknowledges the selfless support provided by Shri P B Uday, Clerk Gr I of DBS, in organizing the meetings and paperwork of the Group.

Issues in consolidated supervision

1.9 The issues identified by the Working Group for operationalising a system of consolidated supervision in the Indian context are as under:

(i) The Company Law in India does not mandate presentation of consolidated accounts by corporate groups. At the time the Working Group was constituted, the Institute of Chartered Accountants of India (ICAI) – the national accounting standard setter – had not notified standards on consolidated accounting. However, while the Group's deliberations were under way standards (besides exposure drafts for proposed standards) bearing on consolidated accounting, have been issued by ICAI. While this was a great help in its deliberations, the Group noted that consolidated financial statements (CFS) presented by corporate groups in terms of these standards would not fully meet the requirements of consolidated supervision which is essentially oriented to exposure quantification and risk evaluation; and as such a supplementary reporting system with prudential orientation would need to be put in place.

(ii) Different statutes have prescribed varying formats of financial statements for their regulated entities, viz. Companies Act, Banking Regulation Act, Insurance Regulatory and Development Act, etc. Consequently, preparing consolidated financial statements using "line by line method" would not be feasible in all cases. Separate and ad-hoc formatting for consolidation would therefore be needed for supervisory purposes.

(iii) The Accounting Standards issued by ICAI require consolidation and presentation of group accounts by the corporate parent, consolidating all its subsidiaries. For supervisory purposes, the scope and ambit of consolidation need to be different, given their pre-dominant focus on risk assessment. Clearly, the types of risks faced by group companies carrying on businesses as dissimilar as manufacturing, trading and insurance are not similar to or compatible with those carried by banks and other financial entities. It becomes therefore necessary to define the scope of consolidation – in other words, "the exclusions", in respect of supervised institutions in corporate groups.

(iv) A key issue in consolidated supervision is to determine the "target group" – that is to say, which banks and other entities should be supervised on a group-wide basis, and which therefore, should be required to furnish consolidated prudential reports (CPRs). In other words, the crucial

issue is to determine whether consolidated supervision should cover only banking groups, i.e. where a bank is the parent, or whether it should also be extended to groups where a bank is a subsidiary as in a financial conglomerate or a mixed (activity) conglomerate. In the case of latter, what should be the approach for consolidated supervision? Which institution should consolidate and file prudential reports and for how much of the group?

(v) A related issue is whether consolidated supervision should also extend to "proxy" banks, i.e. large corporates not holding a banking licence providing credit and other para-banking and financial services, through a network of subsidiaries/affiliates.

(vi) Since consolidation of financial accounts in supervisory reporting may leave out some group companies with non-compatible businesses, the impact of non-consolidated entities on the "supervised" group has to be assessed in qualitative terms, e.g., quality of management, internal controls. The approaches for such qualitative assessments have to be indicated.

Summary of recommendations

Framework for consolidated supervision

1.10 The components of consolidated supervision generally are:

(i) Consolidated financial statements [CFS] (which are intended for public disclosure for market discipline).

(ii) Consolidated prudential reports [CPR] for supervisory assessment of risks which may be transmitted to banks (or other supervised entities) by other group members.

(iii) Application of prudential regulations like capital adequacy and large exposures / risk concentration on group basis.

Among the instruments normally available to supervisors to facilitate consolidated supervision are the (i) ability to ring fence the supervised institution from the rest of the group in case the latter threatens the solvency of the former (ii) ability to call for information from/about the group including unregulated entities / parents in the group or those regulated by other agencies, in the manner and format as considered relevant, and (iii) ability to share supervisory information with other domestic and foreign regulators.

1.11 **Consolidated Financial Statements (CFS)**

(i) Coming into effect of AS 21 on CFS from the financial year beginning April 1, 2001 has considerably facilitated the supervisory task of the financial regulators. The Group recommends that all banks - whether listed or unlisted – should prepare and disclose CFS from the financial year commencing from April 1, 2002 in addition to solo financial statements as present.

(ii) A parent presenting CFS should ***consolidate all subsidiaries*** – domestic as well as foreign, except those specifically permitted to be excluded under AS 21. A subsidiary is an entity that is controlled by another entity – known as `Parent’. 'Control' has been defined in Accounting Standard 21 issued by the Institute of Chartered Accountants of India. The reasons for not consolidating a subsidiary should be disclosed in CFS.

(iii) The investments in associates (other than those specifically excluded under AS 23) should be accounted for under the "Equity Method" of accounting in accordance with Accounting Standard 23 issued by the Institute of Chartered Accountants of India.

(iv) The investments in subsidiaries and associates (which are excluded) should be accounted for as per Accounting Standard 13 issued by the Institute of Chartered Accountants of India unless excluded by AS 13 in which case the relevant valuation principle will apply.

(v) The investments in joint ventures should be accounted for under the 'proportionate consolidation' method as prescribed by the Exposure Draft on Accounting Standard on "investments in Joint ventures" issued by the Institute of Chartered Accountants of India.

1.12 **Scope of consolidation**

(i) The key issue in operationalising consolidated supervision is defining the 'Target Group' – in other words, which institutions in the supervisory jurisdiction should be supervised on **Group-wide** basis. Banks and a large number of non-bank credit institutions are presently under RBI's supervisory jurisdiction. Banks having a network of subsidiaries constitute banking groups and are clear candidates for consolidated supervision. The issue for supervisory policy decision should apply to -

? Banks, which are subsidiaries in group structures, with non-banks as parents or holding companies as in financial conglomerates or mixed conglomerates,

? Non-bank deposit taking credit institutions, which have networks of subsidiaries providing Para banking or other financial services.

(ii) The Working Group is of the view that initially, consolidated supervision may be mandated for all groups where the parent company – in the sense of controlling entity – is a supervised institution. This would cover-

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

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

(c) all registered non-banking deposit taking financial companies which have networks of subsidiaries and are in control of the group.

(iii) In respect of non-banking financial companies covered in item (c) above, consolidated supervision may be applied on selective basis, based on pre-determined parameters such as the size of the group (in terms of assets and/or income) vis-à-vis that of the parent and the strength of linkages and controls between them. The selective approach is recommended also because of the large number of non-banking financial companies (NBFCs) and the relatively modest financial size and operations of some of the NBFC groups. In due course, the net may be cast wider to bring under consolidated supervision, banks and non-banking financial companies in mixed conglomerates where

(a) the parents may be non-financial entities, or

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

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

The consolidated supervision in cases `a' & `c' may have to be largely of a qualitative type. In the case of `b' category, it may also include some quantitative assessments, by entering into MOUs with the counterpart regulators.

iv) In all the cases, the consolidation may not extend to group companies which are engaged in

? insurance business, and

? businesses which do not pertain to financial services.

It may also be pertinent to mention that the supervisor's purpose in consolidated supervision is not to supervise all the companies in a group containing a bank but to supervise the bank (or supervised institution) as part of the group.

1.13 **Consolidated Prudential Reports (CPRs)**

(a) The key element of consolidated supervision is the setting up, and more often, the extension of a prudential reporting system under which supervised institutions in banking and other corporate

groups prepare and provide to the supervisory authority, financial reports on a consolidated basis. These reports combine (i.e. `consolidate') the assets, liabilities and off balance sheet positions of supervised institutions and their related financial entities and furnish the consolidated financials as of a single business entity. The consolidated prudential reports help supervisors

? assess the financial risk profile of the group, of which the supervised financial institution (SFI) is a part, and

? apply the supervisory standards such as minimum capital (adequacy) ratios, large exposures, connected exposures, market risks and liquidity

at the level of the whole group or sub-group, as the case may be.

(b) While designing and introducing the consolidated prudential reports), the supervisory authority should provide guidance to the reporting institutions on

i) the scope of consolidation (This involves specifying the type of companies or related entities which should be included in consolidated reporting i.e. consolidated for consolidated prudential report purposes), and

ii) the methods of consolidation (This concerns the accounting methods which reporting institutions should use while preparing consolidated prudential reports).

(c) The consolidated prudential reports should normally have the following components.

(i) CFS at the frequency and in the manner prescribed by the regulator.

(ii) Computation of key prudential ratios on consolidated basis as well as financial ratios for the group.

(iii) Information on intra-group transactions and exposures and maturity profile of assets and liabilities.

(iv) Information on shareholding and structure of other members of the group.

(d) The Group recommends that consolidated prudential reports be initially introduced on half-yearly basis from April 1, 2002 as part of the Off-site Monitoring System and then increased subsequently to higher frequency as appropriate.

Banking Group

Banking group typically comprises "a licensed bank with subsidiary companies engaged in a range of specialized financial activities and possibly one or more subsidiary banks and other companies established in foreign countries".

(e) Consolidated prudential reports (other than consolidated financial statements) for Banking Groups should include information and accounts of related entities which carry on activities of banking or financial nature. Related entities would include all such subsidiaries and associates of a bank, together with `parallel' or `sister' banks and financial institutions which are *controlled by the same shareholders* as the bank itself. The test applied for identifying related entities is `common control' and not only the size of the ownership stake or shareholding in the controlled entity. For consolidation in the supervision context, the "related entity/common control approach" replaces the subsidiary approach of AS 21.

(f) Related entities engaged in insurance business may be excluded as the risks of insurance companies are different from those of banks; a position statement that combined the assets and liabilities of an insurance company with those of a bank would not provide a suitable basis for measuring banking risks and applying capital adequacy ratios prescribed for banks.

(g) Since non-financial companies in the group are not to be consolidated, risks inherent in their business are to be assessed qualitatively. The group's investments in related non-financial entities appear as a single asset item in the consolidated prudential reports. Non-financial companies include companies such as Asset Management Companies, Web Portals, Venture Funds and other companies, as may be defined by RBI under this exclusion from time to time. The risks in case of entities where the holding is above 20% consequent to conversion of debt to equity on case to case basis may also be assessed similarly for such periods as may be permitted from time to time.

(h) A related financial entity established in a country which prevents repatriation of capital the risks should be assessed qualitatively and investments should not be included in the asset.

(i) In case a banking group is controlled by a parent which does not itself carry on any financial activity, the consolidated financial statements of the parent often helps the group companies for raising and providing capital and other funds besides exercising control over their policies. RBI

should obtain the legal right to call for such information in future from any parent company of the supervised entities.

Financial Conglomerates

Financial Conglomerates are corporate groups that include multiple financial institutions often regulated by different agencies.

(j) If a non-bank credit institution is the parent company of the group, the parent company, which is subject to RBI supervision, should consolidate and submit the consolidated prudential report at its level, in addition to such reports being submitted at the level of the supervised entities. If the parent company of a non-bank credit institution is not regulated by RBI, consolidated prudential report need not be submitted. However, RBI should obtain the legal right to call for such information in future from any parent company of the supervised entities.

(k) Insurance companies should not be consolidated regardless of their status in the group/s as a parent company or as a related entity. The non-financial entities, related financial entities, etc. referred to in paragraphs 4.22 and 4.23 are also not consolidated.

(l) If a securities trading company is the parent, the bank in the group may be asked to consolidate and provide the consolidated prudential report since market risks of the parent could decisively impact the bank (the related entity). When there is a non- banking financial subsidiary in the group and it has no banking company, the NBFC or FI under the supervision of RBI is responsible for submitting consolidated prudential reports.

Mixed Activity Groups

Mixed activity group *is one, which controls commercial and industrial companies as well as banks. Mixed activity groups may often contain a sub-group of banks and other financial companies, which operate as a single entity.*

(m) Banking / Financial sub-group of the larger mixed group may be required to consolidate the financials for the purposes of consolidated prudential report. For the parent company the 'balance of business test' may be applied for determining whether the non-bank parent company may be consolidated with the sub-group to which the supervised bank belongs.

The exclusions in consolidation for banking groups would apply mutatis mutandis to financial conglomerates and mixed activity groups.

1.14 **Methods of Accounting for consolidated prudential report**

(a) The Working Group is of the view that as a starting point the consolidated financial statements prepared on the basis of the Accounting Standards 21 and 23 issued by the Institute of Chartered Accountants of India and as modified by the Reserve Bank of India may be used for the purpose of consolidated supervision. Information, other than that available from the financial statements prepared on the basis of the said accounting standards but relevant for the purpose of consolidated supervision, may be obtained by the supervisor separately for the purpose of consolidated supervision.

(b) Consolidated financial statements should normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements including cash flow statement and explanatory material that form an integral part thereof. The consolidated financial statements should be presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements.

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

(d) If different entities in a group are governed by different accounting norms laid down by a regulator for different businesses then where banking is the dominant activity like transactions and other events in similar circumstances, accounting norms applicable to a bank should be used for consolidation purposes. In situations where no accounting norms have been prescribed by the regulatory authority and different accounting policies are followed by different entities of the group, balance of business may be used as a deciding factor for application of accounting norms. For dissimilar items and circumstances, different accounting policies would have to be followed. Illustrative format of consolidated financial statements for banks and its subsidiaries

engaged in financial is given in **Annexure A** and the format of consolidated financial statements of non-banking financial entities and its subsidiaries engaged in financial activities is given in **Annexure- A1**.

Elimination of Intra-group Holdings

(e) In preparing consolidated financial statements, the cost to the parent of its investments in each subsidiary and the parent's portion of equity of each subsidiary, should be eliminated. This and other steps specified in the consolidation procedures as per AS 21, give rise to a capital reserve/goodwill at the time parent-subsidiary relationship comes into existence.

(f) Intra-group balances and intra-group transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intra-group transactions and exposures should also be eliminated unless cost cannot be recovered. However, for consolidated supervision purposes, the details of the intra-group transactions and exposures may be useful. For this purpose, disclosures made pursuant to the requirements of AS 18, Related Party Disclosures, issued by the Institute of Chartered Accountants of India, in the individual financial statements of parents and subsidiaries, should be presented separately along with the consolidated financial statements. The definition of 'related party' should be wider than that of AS 18 and should be on the lines as laid down for connected lending and also include all significant shareholders.

Minority Interest

(g) Minority interest in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent. Minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. For the purposes of assessment of group capital adequacy minority interest should be excluded from the group capital.

Accounting for Associates

(h) *Equity method* for preparation and presentation of the consolidated financial statements should be followed, both from the accounting as well as from the consolidated supervision points of view. If an investor does not have a subsidiary (but has associates) and therefore does not

prepare consolidated financial statements, the Working Group even in such a situation, recommends that, for consolidated supervision purposes, equity method should be followed.

Accounting for Joint Ventures

(i) Proportionate consolidation method should be followed for consolidation of joint venturers, where two or more banks/ entities are joint ventures in a jointly controlled entity.

Intra-Group Transactions and Exposures (ITEs)

(j) Assessment of group capital should exclude intra-group holdings.

(k) The existing liquidity requirements applicable to banks on a solo basis need to be extended to the consolidated position of the groups. If the Group is a homogenous group of Banks, liquidity compliance of banks, i.e., CRR and SLR could be evaluated on a consolidated basis after netting out intra-group transactions and exposures. If the Group is a heterogeneous Group, comprising non-banking, non-financial entities, suitable modalities are required to be prescribed by the regulator.

(l) Maturity-wise assets/ liabilities should be disclosed on a consolidated basis. Short-term deficits/mismatches should be within tolerance limits prescribed by the regulator.

(m) The regulator should set limits on connected lending transactions, particularly, on those that are not conducted on an arms-length basis. These limits should be less than the Group Exposure limits stipulated by the regulator.

(n) For consolidated supervision purposes, the details of the intra-group transactions and exposures may be useful. For this purpose, disclosures made pursuant to the requirements of AS 18, Related Party Disclosures, issued by the Institute of Chartered Accountants of India, in the individual financial statements of parents and subsidiaries, should be presented separately along with the consolidated financial statements.

(o) Such transactions could prove to be of supervisory concern, particularly if, the risk transfer is to unregulated entities in the group. In such cases assessment of group capital adequacy could be done by using “Risk-Based Aggregation” or “Risk-Based Deduction” approach, wherein the risks of unregulated entities in the Group need to be assessed on a notional basis and capital requirements computed and aggregated with those of the Group.

(p) Supervisors should take steps directly or through regulated entities to ensure that financial conglomerates have limits and controls in place to manage their intra-group transactions and exposures. To this end, a responsibility be cast on every individual regulated entity (Bank) as also the parent (whether regulated or unregulated) of the banking group or non-banking group with a banking subsidiary, to confirm to the regulator that such a system to monitor and control intra-group transactions and exposures is in place. a description of the supervised entities' policy on intra-group transactions and exposures should also be submitted to the regulator. This reporting framework should be extended to include reporting of all intra-group transactions and exposures beyond specified limits under an 'exception reporting system'.

(q) AS 18 on Related Party Disclosures (mentioned above) requires intra-group transactions and exposures to be omitted from the purview of such disclosures in the consolidated financial statements. However, the supervisory policy should specify that transactions should also be reported on an 'exception reporting basis' at quarterly/ half yearly intervals. In addition, the parent (whether **regulated or not**) should provide information to RBI on intra-group transactions and exposures during the quarter, for transactions conducted on other than arms length basis and the impact of non-arms length transactions especially on its revenues.

(r) Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate any supervisory action relative to intra-group transactions and exposures within the group.

(s) In the Indian context, as the supervisor does not have the legal authority to prohibit detrimental intra-group transactions and exposures, such authority needs to be specifically sought and obtained, as a part of the evolution of the consolidated supervisory policy. Initially, the group recommends that all intra-group transaction related disclosure be only on consolidated prudential report and moved to the public domain after April 1, 2003.

1.15 **Quantitative Consolidated Supervision**

(i) Currently, prudential supervision of banks and other credit institutions is conducted individually or institution-wise i.e. on 'solo' basis, by RBI with reference to certain key parameters or standards, embodied in what is known as CAMELS rating methodology. Four of these

parameters relate to assessments based on numbers or quantitative data and are therefore referred as quantitative assessments; essentially, they purport to appraise the financial condition of the supervised institution. These quantitative parameters are adequacy of capital, asset quality, earnings and liquidity – known as CAEL factors.

(ii) Consolidated supervision of banking groups or financial conglomerates containing banks/ supervised institution(s) requires that the assessments with reference to these prudential parameters be made on a group wide/ consolidated basis. A variety of issues arise in group-wide consolidation and measurement for such assessments; the techniques or approaches to be used in this context are referred as quantitative techniques.

(iii) Quantitative techniques for consolidated supervision (QTCS) essentially deal with issues arising from

(a) Intra-group transactions and exposures (ITEs)

(b) Disparate or uneven regulatory requirements (including absence of regulation) of constituent entities in the group, facilitating regulatory arbitrage, that is, diverting exposures/ transactions from entities subject to higher regulation to those under less/ lighter or no regulation.

(iv) the approaches generally used and recommended for adoption in quantitative consolidated supervision (QCS) are dealt with in the following paragraphs.

(a) While assessing asset quality, besides determining the level of non-performing exposures and the adequacy of provisions therefor, the supervisor makes also an assessment of the risk concentration and insider lending practices which are tested with reference to prudential norms on large exposures and connected and related lending respectively.

(b) Assessment of "earnings" parameter comprehends the impairments that could result from market risk and currency risk (i.e. foreign exchange exposure) carried in the portfolios and books of the constituent units in the group.

v) **The Group's recommendations on quantitative techniques are as under:**

(A) Assessment of capital adequacy

(a) Assessment of group capital should exclude intra-group holdings. Capital adequacy standards in the context of group wide consolidation should be designed to detect and provide for situations of double or multiple gearing; that is, the same capital is used simultaneously as buffer against risk in two or more legal entities. Under such situations, assessments of group capital that are based on measures of solo capital are likely to overstate the external capital of the group. Assessment of group capital should, therefore, exclude intra-group holdings of regulatory capital.

(b) Current supervisory regime in India mandates deduction of investment made by parent bank towards equity capital of the subsidiary from the bank's Tier I (one) capital. This practice should be changed in line with the international best practice of deduction of investments in deconsolidated entities in equal proportion from Tier 1 and Tier 2 capital.

(c) In order to conform to the international best practice -

(i) any long term diminution in the value of the investments in subsidiaries should be duly recognized and provided for in the books of the parent (s).

(ii) the bank's investments exceeding 20% of its paid up equity capital in any entity should be considered significant and such investments should be deducted equally from the Tier 1 and Tier 2 capital.

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

(e) If, in case of related party or intra-group exposures, risk is seen to be transferred to unregulated entities in the group, assessment of group capital adequacy could be done by using "risk-based aggregation" or "risk-based deduction" approach wherein the risks of unregulated entities in the group need to be assessed on a notional basis and capital requirements computed and aggregated with those of the group.

(f) In the case of an unregulated parent company, for an assessment of group-wide capital adequacy by supervisors, it is essential to obtain information about the unregulated parent company through regulated entities or public domain information and make an assessment of its ability to service all external debt. For unregulated entities, supervisors have a number of analytical alternatives including substitution of a capital proxy for the relevant sector for unregulated financial entities (e.g. leasing, factoring, reinsurance, etc.), a comparable or notional capital proxy may be estimated by applying to the unregulated industry the capital standards of the most important regulated entities. Unregulated non-financial entities should normally be excluded from the assessment of the group. Where risk has been transferred from regulated to unregulated entities within the group, the supervisors of the regulated entities should evaluate the overall quantum and quality of assets in the unregulated entities, especially where a notional capital proxy has not been used.

(g) Where the group participation in a regulated dependant give significant influence and exposure to risk, but falling short of control, only the pro-rata share of surplus regulatory capital should be regarded as available to support risk in the parent company or other entities in the group. Participations, which confer effective control and / or meet company law definitions of subsidiaries is usually consolidated in full and minority interest shown separately from the group shareholders' funds. For prudential purposes, pro-rata share of regulatory capital in excess of the subsidiary's own regulatory capital requirements, and which could be regarded as in principle available to support risk in the parent company or in other entities in the group should a shortfall arise, can be recognised in the group-wide capital adequacy assessment. However, the parent should provide for the entire deficit in the regulatory capital. This treatment can be applied to group participant in excess of 50% including 100% participation.

(h) A group-wide assessment should ensure adequate distribution of capital within the group. Any solo deficits in dependants' capital should be attributed in full in the group capital assessment if it appears to the supervisor that the parent is likely to have to support the dependant without assistance from other external participants.

(i) The application of capital requirements on a consolidated basis should be done on a sub-consolidated basis to all internationally active banks at every tier to eliminate double gearing in

the banking group. Consolidation of insurance subsidiaries is not mandated. As such, the Working Group suggests deducting bank's investments in insurance subsidiaries. Supervisors may be given discretion to assess the appropriateness of recognising in consolidated capital the minority interest that arises from the consolidation of less than wholly owned banking, security or other financial entities. If capital shortfall exists which is not corrected quickly, say within three months, the amount of shortfall should be deducted from the parent bank's capital. Significant minority owned equity investments in non-insurance financial entities where control does not exist, should also be excluded from the banking group's capital by deduction of the equity and other regulatory investments. Alternatively such investments might be under certain conditions consolidated on a pro-rata basis where the supervisor is satisfied that the parent is legally or de facto expected to support the entity on a proportionate basis. Significant minority and majority investments in commercial entities, which exceed certain materiality level i.e. 15% and 60% of the bank's capital for individual significant investments and aggregate of such investments, respectively should also be deducted from bank's capital.

Market Risk

Aggregation plus method is recommended wherein capital requirements for a subsidiary is added to the capital requirements for the remainder of the group. The total capital requirements calculated in this way is then compared with the consolidated group capital in order to assess capital adequacy on a consolidated basis. Where the supervisors have not prescribed any explicit capital charge for market risk, the norms as applicable to the banks may proxy the unregulated entities capital requirements for market risk.

(B) Assessment of liquidity

(j) The existing liquidity requirements applicable to banks on a solo basis need to be extended to the consolidated position of the groups. If the group is homogenous, liquidity compliance i.e., CRR and SLR should be evaluated on a consolidated basis after netting out intra-group transactions and exposures. If the group is heterogeneous comprising non-banking, non-financial entities, suitable norms or prudential standards are to be prescribed on a consolidated basis.

(k) Maturity wise distribution/ analysis of assets and liabilities should be disclosed on a consolidated basis in the designed consolidated prudential reports. Tolerance limits for near-term and short-term deficits/ mismatches should be prescribed by the regulator. Intra-group transactions and exposures should be excluded from this consolidation.

(C) Large Exposures

(l) Prudential limits should be set on individual / group exposures on a group-wide basis. It should also be mandated on a group as a whole to report all large exposures at a lower threshold than permitted level to monitor concentration of risk at the conglomerate level. Similarly, prudential limit should also be set on country exposures and currency exposures on a worldwide - consolidated basis.

(D) Connected Lending

(m) Exposures assumed by the banks against the connected persons such as influential shareholders, directors and their close relatives and legal entities controlled by them should also be brought under the purview of supervisory focus at solo, sub-consolidated and at a consolidated level.

(E) Foreign Exchange Exposures

(n) It is very important to monitor and regulate foreign currency exposures on a consolidated basis. It is quite often the experience in other jurisdictions that banks / subsidiaries pass their open positions among related entities in different time zones, causing supervisory concern.

1.16 The Group is of the view that the appropriate enabling provisions would be required to be included to the existing Acts by way of amendments for the facilitation of Consolidated Accounting and quantitative methods in the Indian context and with regard to the issues raised in Para 1.10. The text of such amendments to the respective Acts may be finalized in consultation with respective Institutions/ government pursuant to final policy decision, as may be taken, with respect to implementation of the recommendations of the Group, and keeping in view the objectives to be achieved in this regard i.e. introduction of Consolidated Accounting and other quantitative methods (as recommended by the Group) and consequentially for vesting requisite powers in the respective supervisory/regulatory authorities under the Acts, so as to empower them to (i) specify from time to time methods of accounting and forms, and to issue directions for adoption and compliance thereof; (ii) ring fence the supervised institution from the rest of the group and prohibit detrimental Inter-group Transactions and Exposures; (iii) call for information from/about the group including unregulated

entities / parents in the group or those regulated by other agencies, in the manner and format as considered relevant and appropriate; and (iv) share supervisory information with other domestic and foreign regulators.

Sd./-	Sd./-
Vipin Malik	K L Khetarpaul
(Chairman)	(Member)

Sd./-	Sd./-	Sd./-
N D Gupta	B D Sumitra	A M M Sarma
(Member)	(Member)	(Member)
Sd./-	Sd./-	Sd./-
P V Subba Rao	Nagesh Pinge	Aditya Narain
(Member)	(Member)	(Member- Secretary)

Mumbai
Date: December 11, 2001