CHAPTER 7

REGULATORY AND SUPERVISORY ISSUES IN BANKING

Banking System in the context of FCAC

7.1 Under a FCAC regime, the banking system will be exposed to greater market volatility. Hence, it is necessary to address the relevant issues in the banking system including the regulatory and supervisory aspects to enable the system to become more resilient to shocks and sustain their operations with greater stability. This chapter examines these issues and makes appropriate recommendations.

7.2 As the economy gets increasingly integrated with the global system, the Indian banking system too would progressively integrate with the rest of the world. Unless the banking system is strengthened and appropriate regulatory/supervisory norms are in place, the domestic banking sector could be vulnerable. Liberalisation of cross-border capital flows that deepen financial intermediation and capital markets, also brings in its wake increased risks. A system has two dimensions, *viz.*, markets and institutions. The competitiveness and efficiency in the functioning of financial markets depend upon the strength and soundness of banks which are the major players in the markets. Only a vibrant, resilient and competitive banking sector would be able to act as an effective facilitator and be well-equipped to handle new, emerging opportunities as also threats which would characterise a more open economy.

7.3 Scheduled Commercial banks, which account for over 75 per cent of the market share in the financial sector, play an important role in the Indian financial system. The other components of the Indian financial system are financial institutions and urban cooperative banks which account for about 7 per cent and 9 per cent, respectively, of the market share. In terms of systemic relevance the contribution of cooperative banks may not be significant but there are over 3,000 cooperative banks and all of them are not direct participants in the payment and settlement system. The Committee has focussed primarily on the commercial banking segment given their pivotal position in the payments system. As the banking system acts as an intermediary for allocation and transformation of economic resources, it becomes imperative that in a FCAC environment the capacity build-up of regulators and banks is so calibrated as to withstand and manage the risks associated with globalisation and to reap the maximum rewards.

7.4 The progress of financial sector reforms in India has been marked by growing market integration. Even as efforts are intensified for deepening and broadening financial market segments and developing a seamless and vibrant market continuum, the policy response in the transition would rely on multiple instruments and combination of instruments to ensure financial stability. The concomitants to liberalisation are a strong and resilient banking system, a robust banking regulation and supervision framework, an efficient clearing and settlement arrangement (in particular, for large transactions), appropriate accounting and public disclosure standards, auditing standards, codes of market conduct and institutional governance and conducive legal framework to deal with complex risks associated with increasingly diverse types of capital flows.

7.5 In a new environment, the commercial banks should be able to manage multi-dimensional operations in situations of both large inflows and outflows of capital. In particular, their own exposures to exchange rate risk, coupled with their exposures to corporates which are exposed to similar risks, panning across national jurisdictions add to the multiplicity of risks which need to be closely monitored and prudently managed. The RBI, therefore, needs to review the prudential standards applicable to commercial banks and should consider making the regulations activity-specific, instead of keeping them institution-specific. This approach will also help eliminating any regulatory arbitrage opportunities.

7.6 The risks to economic agents in a liberalised capital account environment also stem from the fact that as almost all economic agents and especially the larger and the more diversified ones get integrated in global fund/economic flows, they have to manage multi-currency balance sheets. This will place greater demands on the agents, especially banks, to manage risks related to assets and liabilities denominated in various currencies under a more dynamic environment. The skill and competency levels required to manage these risks are different and call for a very high level of technical proficiency which at present, is somewhat limited in the Indian context. Development of such skills across all agents and all the regulators present a formidable challenge.

7.7 As the economy gets more integrated with the rest of the world, there is an increased potential for spill-over effects in the markets, and this calls for a higher level of co-ordination among regulators, domestic as well as international, than at present. Adequate institutional frameworks need to be developed to foster such close co-ordination.

Dimensions of Risks

7.8 Going forward, opening up of the system is expected to result in larger two-way flows of capital in and out of the country; this underscores the need for enhancing the risk management capabilities in the banking system. In a FCAC regime, banks will be expected to undertake transactions in multiple currencies acting as channels for flow of funds in and out of the country when they are enabled to receive deposits and raise borrowing from both residents and non-residents and lend and invest in both domestic and foreign jurisdictions. Likewise, non-resident banks and financial institutions are expected to undertake similar transactions. Similarly, the non-financial entities having links with the banking system would also be transacting in multiple currencies by way of their borrowing, lending and investment operations. All these types of transactions add to the risks of the banking system that are not so evident in a less open domestic banking system. These factors would make the following risk elements more prominent than at present:

(i) Currency Risk - Fluctuations in the exchange rates may adversely affect economic agents with long and short positions in foreign currency, and cause mismatches between foreign currency denominated assets and liabilities.

(ii) Counterparty Credit Risk - Collecting and analysing credit information, including knowledge of the risks to which the counterparty is exposed and their capacity to efficiently manage those risks can pose significant challenges in cross-border transactions.

(iii) Transfer risk – Tracking of the financial position of various economies and their capacities to honour claims on the residents of those economies as and when they fall due on an ongoing basis will pose considerable challenges to banks.

(iv) Legal Risk – Enhanced cross-border transactions may give rise to legal rights and obligations which are different from those arising from domestic transactions. This makes adequate knowledge of the relevant statutes, rights, obligations and procedures for their enforcement necessary, if the banks are to manage legal risk.

(v) Risk of Regulatory Arbitrage – The differences in regulatory and supervisory regimes across countries may create incentives for capital to flow across borders to countries with inadequately regulated and supervised financial markets.

(vi) Risk in Derivatives Transactions – Derivative prices respond to changes in market conditions for the underlying assets, and for many derivative products, their prices are more volatile than underlying prices.

(vii) Reputation risk due to non-adherence to Transaction Appropriateness Standards (TAS), Anti-money Laundering (AML)/Know Your Customer (KYC) requirements and the attendant risks.

7.9 All these call for strengthening the risk management systems in banks. These risk management systems should be suitably supported by appropriate stress test frameworks. As the flow of funds will ultimately be through the banking system, strengthening the banking system becomes paramount if the real sector is to reap the benefits of a FCAC regime. Capital will need to reflect economic risks and regulatory capital move closer to economic capital.

Focal points for Strengthening the Banking System

Prudential Regulation

7.10 Issues in prudential regulation related to FCAC would encompass broadly the following components:

(i) Regulation of the specific and inter-related risks that arise from international capital flows, notably liquidity risk, interest rate risk, foreign currency risk, credit risk, counter-party risk and country risk.

(ii) Improvements in financial institutions' liquidity management and disclosure practices as they are encouraged to diversify funding sources to contain maturity mismatches and improve debt-equity mix.

(iii) There is scope for considerable improvements in corporate governance in public sector banks with the aim of ensuring operational autonomy and equipping them to compete with other banks as equals.

(iv) The Banking Regulation (BR) Act, 1949 allows issue of only one type of banking licence, *viz*., whole banking licence, which permits all licensed banks to undertake all banking activities. There may be a need for the RBI to issue restricted banking licences to some banking institutions to enable them to exploit their core competencies.

(v) Level of computerisation and branch interconnectivity and computer security should meet the standards of well developed financial markets.

(vi) Capital adequacy standards should enhance the resilience of banks. The system should move forward to a differential capital regime. Consideration should be given to introducing a higher core capital ratio than at present. The risk weighting system should be modified to reflect the actual economic risk undertaken by banks. At present the directed lending exposures are unrated and are largely to persons who are financially weak which increases the inherent risk in these exposures. Coupled with this, the banking system is not able to price the risks efficiently. In the absence of a system of marking to market of these credit exposures, the extent of risks inherent in these exposures is not fully addressed. Hence, unrated or high risk sectors should be given much higher risk weights and/or the RBI should consider prescribing a higher level of minimum capital requirement than the present 9 per cent. Systems for ongoing scientific valuation of assets and available collateral should be established. Setting off losses against capital funds on an on-going basis should be considered without allowing banks to carry it as an intangible asset on its balance sheet.

(vii) The scope for undertaking enhanced activity particularly in new financial services should be linked to quality and adequacy of capital, risk management system and personnel.

(viii) On derivatives and related transactions, strengthening of risk management frameworks in banks and supervisory capacity, including oversight to limit excessive exposures, would be needed.

(ix) Uniform prudential limits prescribed by the RBI for interest rate risk (IRR) and capital market exposure (CME) need to be replaced with a differential limit regime which will factor-in the level and quality of risk management systems and capital in banks.

(x) Increased transparency and market discipline with quantitative and qualitative disclosures will be needed on risk exposures and risk management systems in banks.

(xi) Modifications to regulation to discourage or eliminate scope for regulatory arbitrage, focussing on activity-centric regulation rather that institution-centric regulation will be needed. This will require active involvement, coordination and cooperation among the financial sector regulators.

Differential Prudential Regime

7.11 While the move to a differential capital regime under Basel II is envisaged, it is recognised that there should be a differential treatment of *'complex'* banks, *viz*., those which are diversified into areas other than conventional banking; are parts of a large group/conglomerate; undertake significant cross-border transactions; act as market makers; and are counter-parties to complex transactions, since these banks would be exposed to the complexities of various risks. The RBI may consider prescribing a higher minimum capital ratio for these banks. The Committee further suggests that the RBI should review and revise its policy to allow banks to undertake market making; to deal with complex instruments such as derivatives; and to undertake large cross-border borrowing, lending and investment operations.

Supervisory Practices

7.12 Supervisory issues which need attention are as follows:

(i) Adaptations in supervisory practices would include global consolidated supervision of internationally active financial institutions and establishing contact and information exchange with various other supervisors, primarily host country supervisory authorities.

(ii) The existing supervisory reporting formats would need to be reviewed and revised in a post-FCAC scenario after studying the supervisory reporting formats operational in leading territories (e.g. UK, USA, Continental Europe)

(iii) Consideration needs to be given to introducing the concept of relationship managers in the RBI where a dedicated desk official would be tracking all developments in the allotted bank on a day-to-day basis.

(iv) Focus should be given on liquidity risks, interest rate risks, currency risks and currency mismatches, asset concentrations and exposure to price-sensitive assets – to entities and to countries – all at a global level – i.e., at whole bank level as well as bank group level.

(v) Adaptation of new technology will be required for putting in place an on-line connectivity with banks enabling a wide system aggregation of various critical parameters on near real time basis. Move toward a central point data centre in the RBI with appropriate analytical tools will be needed.

(vi) Significant upgradation of regulatory and supervisory skills in the RBI would be needed, which will also include building up a supervisory strategic strike force for dealing with issues expeditiously before they became major endemic problems. Scope for appointing specialists on short term/assignment basis, secondment of officials in regulation and supervision departments to select reputed regulatory/supervisory bodies in various countries, development of specialised skills in specific areas like technology – based supervision, modelling and model validation skills and regular exposure to new and evolving concepts in banking all will become necessary in the ensuing years. While adopting the international best practices and models, the RBI should ensure that the same are adapted to suit/reflect the Indian markets, after due empirical testing. Furthermore, the exchange of officials on deputation between the RBI and banks should be strengthened and serious attention given to redesigning this programme.

7.13 To conclude, as the country moves to an FCAC regime, it is necessary to improve relevant regulatory and supervisory standards across the banking system to enable them to become more resilient and sustain their operations with greater stability. The key requirements in this regard would be: robust and sophisticated risk management systems in banks supplemented by a regimen of appropriate stress testing framework; efficient and reliable IT systems providing on-line data to support the risk management systems in banks; robust accounting and auditing framework; adoption of economic capital framework and risk-based allocation of capital; upgradation of skills; upgradation of IT-based surveillance systems and manpower skills in the RBI; fuller compliance with Anti-money Laundering (AML)/Know Your Customer (KYC) and Financial Action Task Force (FATF) requirements; and a need for prescription of a limit on the off-balance sheet items with reference to balance sheet size. The tabular material attached to this chapter identifies specific measures for strengthening regulation and supervision in the banking sector.

MEASURES FOR STRENGTHENING REGULATION AND SUPERVISION

Present Position	Issues	Proposed Measures
1. **Liquidity Risk** At present banks are required to monitor their liquidity position with regard to their assets and liabilities (including off-balance sheet items) at the domestic branches. The prudential limits on the negative mismatches in the first two time buckets, *viz*., 1-14 days and 15-28 days has been fixed at 20 per cent of the cash outflows. At the foreign branches, banks are required to comply with the following prudential limits at each territory which focus on mismatches in the long term and medium term: (A) Long term liabilities should be at least 70 per cent of long term assets; and (B) Long and medium term liabilities should be at least 80 per cent of long and medium term assets.	Large, uneven flows of funds will expose the banks to greater fluctuations in their liquidity position and hence refinements in the management of liquidity risk by banks would be required.	(a) The liquidity position should be monitored at the head/ corporate office level on a global basis - including both at the domestic branches and at foreign branches. (b) The liquidity positions should be monitored for each currency – where the total liabilities in that currency exceed a stipulated percentage of the bank's total assets or total liabilities. (c) Banks should be required to monitor their liquidity position at a more granular level over the near term. Accordingly, they should monitor their liquidity positions on a daily basis for the next seven days. i.e., next day + six following days. (d) RBI should consider reviewing and reducing the regulatory limit on negative mismatches in the first bucket (1- 14 days) which is 20 per cent at present to say 10 per cent, to reduce the extent of mismatch in that bucket. (e) Banks should be required to fix internal limits on the positive mismatches in the medium term and long term time buckets – say from '3 to 5 years' and 'more than 5 years'. This will ensure that banks do not assume large mismatch positions whereby they depend heavily on short term resources for long term deployment. These mismatch limits should be monitored by the RBI – to look for outliers and initiate appropriate remedial measures. RBI may consider prescribing tolerance levels for mismatches in the medium term and long term.

Present Position	Issues	Proposed Measures
		(f) RBI may introduce capital requirements for banks with reference to the degree of their maturity mismatches. (g) Banks should continue to monitor the liquidity positions territory-wise where there are restrictions on free movement of funds to/from other territories. (h) RBI should examine the need for a limit on the short term borrowings (less than one year) of banks.
2. Interest Rate Risk (IRR) RBI had issued guidelines on Asset Liability Management vide Circular No. DBOD. BP. BC. 94/ 21.04.098/99 dated February 10, 1999, which, inter alia, covered interest rate risk measurement/ reporting frameworks. The immediate impact of changes in interest rates is on bank's earnings (i.e. reported profits) through changes in its Net Interest Income (NII). These guidelines approach interest rate risk measurement from the 'earnings perspective' using the Traditional Gap Analysis (TGA). To begin with, the TGA was considered as a suitable method to measure Interest Rate Risk. RBI had also indicated its intention to move over to modern techniques of Interest Rate Risk measurement, which included Duration Gap Analysis (DGA). A long-term impact of changes in interest rates is on bank's Market Value of Equity (MVE) or Net Worth through changes in the economic value of its assets, liabilities and off-balance sheet positions. The interest rate risk,	With interest rate movements becoming more frequent/dynamic and the potential for greater fluctuations in interest rates, it would be necessary for banks to improve their interest rate risk management systems.	(a) Banks are presently following the Traditional Gap Analysis which will enable them to capture the impact of Interest Rate Risk (IRR) on their earnings. Banks may upgrade their IRR management framework to assess the impact of the IRR assumed by them. With the opening of the capital account and the resultant flows, as also the ease with which such flows can materialise on either side, banks should adopt the duration gap analysis to measure interest rate risk in their balance sheet from the economic value perspective and manage the IRR. Furthermore, banks may be required to fix appropriate internal limits on their IRR exposures. Towards this end, the RBI has issued draft guidelines for upgrading the Asset Liability Management guidelines. In terms of the draft guidelines banks would be required to adopt the modified duration gap approach; compute the volatility of earnings (in terms of impact on Net Interest Income); compute the volatility of equity (in terms of impact on the book value of net worth) under various interest rate scenarios; fix internal limits under both earnings and economic value perspective. The RBI should

Present Position	Issues	Proposed Measures
when viewed from this perspective, is known as 'economic value' perspective.		finalise the guidelines and require banks to fully implement the above revised requirements by March 2008. (b) RBI should introduce capital requirements for banks with reference to the extent of IRR assumed by it and the likely impact of such risks on the bank's net worth during stress situations.
3. Forex Open Position At present banks are required to fix their open foreign exchange position limits and approach the RBI for approval. While approving the open position limits RBI relates the proposed limits to the bank's capital funds.	Under a more liberalised environment, banks would expect greater freedom to fix their own open foreign exchange position limits without prior approval of the RBI, since the open forex position limits attract capital requirements.	While the fact that banks' open position limits attract capital requirements may give some comfort, RBI should consider reviewing the process for approving open position limits and consider issuing prudential limits for open position limits, which will be linked to the banks' capacity to manage the foreign currency risks and their unimpaired Tier 1 capital funds. The RBI should undertake the review before March 2007 and implement the revised procedure by March 2008.
4. Asset Concentration The following limits have been prescribed for credit exposures to : (a) Individual exposure : • 15 per cent of the capital funds • 20 per cent, if exposure is on infrastructure sector	With the greater inflows into the Indian banking system, proper deployment is crucial. Hence it is necessary to address the issue of asset concentrations in banks more comprehensively.	Following prudential limits may be laid down to identify and manage concentrations within the portfolio: (a) Banks were advised to fix internal limits for substantial exposures vide RBI guidelines issued in October 1999. Since these were not mandatory, many banks may not be adopting these limits. Banks should be directed to monitor their 'large exposures' (i.e., exposures in excess of 10 per cent of capital funds) and ensure that the aggregate of these large exposures do not exceed the *substantial exposure*

Present Position	Issues	Proposed Measures
(b) Group of borrowers : • 40 per cent of the capital funds • 50 per cent, if exposure is on infrastructure sector In addition to the above, in exceptional circumstances, banks may assume an additional exposure up to 5 per cent of capital funds with the approval of Board.		*limit*, i.e., sum total of all large exposures not to exceed a specified multiple of capital funds say 600 per cent to 800 per cent. This should be done immediately. (b) With a view to ensure diversification/ avoid concentration, banks may be required to fix internal limits on exposure to the following: i) a particular sector/industry; ii) a particular counterparty category; iii) a particular country, region or state. (c) RBI may fix a regulatory umbrella limit on sensitive sector exposures with relation to the bank's net worth/capital funds. The umbrella limit can be in addition to the sector/exposure specific limits like the capital market exposure limits. This will help in limiting banks' capacity to deploy the likely inflows into sensitive sectors which may prove difficult to exit without a considerable loss of value during times of crisis. For this purpose, the RBI should identify the sensitive sectors and review periodically the need for fresh inclusion or exclusion of certain sectors.
5. Income Recognition Asset Classification and Provisioning (IRAC) Norms Banks are required to follow strict prudential norms with regard to identification of NPAs and making provisions therefor. These are largely in alignment with the international best practices. (a) The current provisioning norms for Non Performing Assets (NPAs) require banks to	With the prospect of greater inflows under a fuller CAC regime, it may be necessary for tightening the provisioning requirements, so as to enhance the shock	(a) RBI should require banks to make provisions for their non fund based commitments in NPA accounts with reference to

Present Position	Issues	Proposed Measures
make provisions for funded exposures. The non-fund based exposures to entities whose fund based exposures are classified as NPAs do not attract a provisioning requirement as per the present RBI regulations. In terms of AS-29: Provisions, contingent liabilities and contingent assets; banks will be required to subject their contingent liabilities to an impairment test and if there is a likelihood of the bank incurring a loss in settlement of the obligations, they are required to make a provision therefor.	absorbing capacity of banks and thus enhance their resilience.	the credit equivalent amounts. RBI should consider prescribing explicit conditions/ situations when the banks should make a higher level of provisions for the contingent liabilities.
(b) At present the asset classification status of an account is based on the record of recovery in each bank. As a result, this gives rise to scope for a borrower to keep the non performing portion of his exposures in one particular bank and keep the other exposures as performing. Though the exposure to the banking system - when viewed at an aggregated level - might have become NPA.		(b) RBI should re-introduce the concept of uniform asset classification across the banking system such that if an exposure to a counterparty becomes NPA in any bank, all banks having an exposure to that counterparty should classify the exposure as NPA.
(c) The provisioning requirements for NPAs on the secured portion are as under:		(c) RBI should review the schedule of provisioning requirements for NPAs and consider tightening the provisioning requirements as under: • The provisioning requirements on substandard assets may be increased to 20 per cent for secured advances and 30 per cent for unsecured advances.

Present Position	Issues	Proposed Measures
Category **Age of delinquency** **Provi-sioning (per cent)** Substandard 90 days to 15 months Secured advances - 10 per cent of total outstanding. Unsecured advances – 20 per cent of total outstanding. Doubtful Over 15 months to 27 months 20 per cent Doubtful Over 27 months to 51 months 30 per cent Doubtful Over 51 months 100 per cent		• The age of delinquency may also be reviewed to ensure that all working capital exposures beyond a delinquency of 36 months are fully provided. • The proposed schedule for provisioning should be as under: **Category** **Age of delinquency** **Provisioning (per cent)** **Secured portion** **Unsecured portion** Substandard a) secured advances b) unsecured advances 90 days to 15 months 20 per cent 30 per cent

Present Position	Issues	Proposed Measures
		20 per cent 30 per cent Doubtful Over 15 months to 27 months 20 per cent 100 per cent Doubtful Over 27 months to 51 months 30 per cent** 100 per cent Doubtful Over 51 months 100 per cent 100 per cent **Note: The working capital exposures in NPA accounts will attract a 100 per cent provisioning requirement on both secured and unsecured portions when the delinquency exceeds 36 months. (d) These measures should be implemented in a phased manner over the period 2007-08 to 2010-11.
6. Capital Adequacy Banks in India are at present adopting the capital adequacy framework as required under Basel I.	Migration to a fuller CAC is likely to throw up numerous	(a) It will not be adequate to have a uniform 9 per cent norm for all banks. The system should move forward to a differential

Present Position	Issues	Proposed Measures
Banks are maintaining capital for both credit risk and market risk exposures. The minimum CRAR required to be maintained by the banks in India is 9 per cent as against the 8 per cent norm prescribed by the Basel Committee on Banking Supervision. As of March 2005, 86 banks were maintaining capital in excess of the regulatory minimum and 2 banks were falling short of the regulatory requirement. Reserve Bank has advised banks in India to implement the revised capital adequacy framework (popularly known as Basel II) with effect from March 31, 2007. Banks will be maintaining capital for operational risks under Basel II in addition to credit risks and market risks. The Indian banking system will be adopting the standardised approach for credit risk, standardised duration method for market risk and the basic indicator approach for operational risk. On a quick broad assessment, it is expected that the impact of Basel II on banks' CRAR will be adverse to the extent of 150 to 250 basis points.	challenges to banks' risk management systems. Migration to Basel II at the minimum approaches, would be making the banks' capital adequacy framework more risk sensitive than under Basel I. The capital adequacy framework, even under Basel II, will need to be strengthened even beyond the Basel II requirements with a view to ensure that it enhances banks' capacity to sustain unexpected losses/ shocks.	capital regime. The '*complex'* banks (as defined in Paragraph 7.11 of the Report) should be moved over to this regime in the next 3 years and all other banks may be moved over to this regime over the next 5 years. (b) Banks should be encouraged to migrate to an economic capital model for allocation of capital and measuring efficiency of capital. This may be dovetailed to the Pillar II requirement under Basel II which requires banks to have in place an internal capital adequacy assessment process (ICAAP). (c) Consider introducing a higher core capital ratio (than the default 50 per cent of total capital funds) at present. It may be raised to at least 66 per cent. (d) At present the banks are generally not adopting risk based pricing. Further almost 90 per cent of banks' credit portfolio is unrated. The risk weight structure under Basel II provides a perverse incentive for high risk borrowers to remain unrated. In view of this and since the system may not be able to rank risk objectively, the risk weighting system should be modified to reflect the actual economic risk undertaken by banks. Hence, unrated or high risk sectors should be subject to a 150 per cent or higher risk weights. (e) The 75 per cent risk weight considered for retail exposures under Basel II is low. Considering the fact that retail exposures include a much wider weaker segment, the risks to which banks are actually exposed to under retail exposures is not low. Hence, the risk weight for this sector

Present Position	Issues	Proposed Measures
		should also be appropriately increased. (f) Systems for ongoing scientific valuation of assets and available collateral should be established since in many banks these systems are conspicuous by their absence. (g) Framework linking branch authorisations, undertaking new financial services etc. to quality of capital and adequacy of capital should be established. (h) Banks should not be allowed to carry accumulated losses in their books. They should be required to set off losses against capital funds, including certain capital instruments other than equity shares, on an on-going basis. RBI should decide on the methodology for setting off the losses against capital funds. (i) These measures may be made operational over a period by 2009-10.

Present Position	Issues	Proposed Measures
7. Risk Mitigants Banks are having the benefit of the following hedging tools for managing their risk exposures: Credit – collateral, guarantees, insurance Interest – Interest Rate Swaps (IRS), Forward Rate Agreement (FRA), Interest Rate Futures (IRF) Equity – None Forex – forwards, currency swaps, options	In view of the potential for greater fluctuations and uncertainties, banks may assume a greater degree of risks and, therefore, would need to have access to greater array of risk mitigants.	Banks may feel the need for the following risk mitigants to hedge or manage their risk exposures in a situation where there is FCAC. These are at present not effectively available to the banks and hence will need to be made available: (a) Interest rate futures and options (b) Credit derivatives (c) Commodity derivatives (d) Equity derivatives However, it is essential for the RBI to put in place the appropriate infrastructure to enable banks to conduct their operations in the above products in a stable and efficient manner. Some of these essential pre-requisites are: (a) a robust accounting framework; (b) a robust independent risk management framework in banks, including an appropriate internal control mechanism, before it is allowed to undertake these activities; (c) appropriate senior management oversight and understanding of the risks involved; (d) Comprehensive guidelines from the RBI on derivatives, including prudential limits wherever necessary; (e) Appropriate and adequate disclosures.

Present Position	Issues	Proposed Measures
8. Stress Testing Framework		
At present banks are not required to undertake any specific mandated stress tests on their portfolios. In the Annual Policy Statement in April 2006, Reserve Bank has mentioned that stress tests would enable banks to assess risks more accurately and, thereby, facilitate planning for appropriate capital requirements. This stress testing would also form a part of preparedness for Pillar 2 of the Basel II framework. Against this backdrop, RBI is in the process of advising banks to undertake sound stress testing practices.	With a view to sustain the impact of lumpy and unpredictable inflows and outflows in the new environment which will be routed through the banking system it is necessary not only to strengthen the risk management systems in banks, but should also be suitably supported by appropriate stress test frameworks.	While the stress testing framework proposed to be introduced by the RBI now will be addressed at the entire banking system, the focus under a FCAC regime would be: (a) to assess the robustness of the frameworks put in place by banks to ensure that they meet the minimum requirements prescribed for the entire system; (b) to ensure that banks are using the findings of their stress tests as an active ingredient of their risk management systems; (c) to consider encouraging banks, which are exposed to greater risks or greater complexities of risk, to have a more scientific stress testing framework in place.
9. Level of Computerisation and Branch Interconnectivity		
At present the new private sector banks and the foreign banks are largely computerised and networked. This equips them to address MIS and risk management issues effectively. Due to the lack of equally efficient systems, many of the public sector banks and the old private sector banks are lagging in adoption of real time (or near real time) MIS for business decisions and risk management.	Going forward, level of computerisation and branch interconnectivity will be of significant importance to banks. The quality of MIS will make a significant difference to banks' capabilities.	Banks should have the following IT infrastructure : A few banks are attempting to achieve this through their core banking solutions. Whatever be the mode banks should strive to achieve: (a) On-line connectivity to all major branches (75 per cent of business within 3 years and 90 per cent within 5 years and 100 per cent within 7 years).

Present Position	Issues	Proposed Measures
Some of these banks are attempting to achieve this through the core banking solutions model which will be adapted to meet the other MIS/ risk management requirements.		(b) MIS content should support the risk management requirements and supervisory reporting requirements. With a view to reduce the time lag, the supervisory reports should be system generated with appropriate authentication and submitted to the RBI using the IT medium.
10. Need for Prudential Limits on Off-Balance Sheet (OBS) items Banks' activities are distributed between on-balance sheet business and off-balance sheet business. Though there are no specific norms in terms of the size of these two broad business categories, it is observed that in some banks the size of off-balance sheet business is becoming disproportionate to the on-balance sheet business.	With the increasing use of off-balance sheet products for meeting customer requirements, the pace at which banks use these instruments and the customer demand for these are expected to grow at an increasing pace under an open regime. In the absence of advanced risk management systems in banks, the risks that are assumed by them through the derivatives book can be cause for worry.	RBI should study the composition of the off-balance sheet business of banks and consider issuing prudential norms establishing a linkage between the off-balance sheet business of banks and their risk management systems. They may also take into account the international practices in this regard.
11. Off-balance sheet Exposures – comfort letters		

Present Position	Issues	Proposed Measures
While assessing the risks to which banks are exposed the focus should be on balance sheet items, off-balance sheet items and also other items through which resident entities might have assumed risks – in the form of comfort letters issued to non residents. This will also include the comfort letters issued by head offices of banks to the host regulators while establishing some of their foreign operations and comfort letters issued to other banks on behalf of their clients.	While the capital outflows may be triggered due to various reasons, the commitments undertaken through off-balance sheet items in the form of comfort letters are not reckoned at times. This might pose an additional threat.	Banks issue comfort letters in two situations: (i) covering operations of their subsidiaries to the Regulators in the host country; and (ii) comfort letters on behalf of their customers. Banks should reckon exposures assumed through such comfort letters also and have appropriate strategies in place to - (a) ensure that such contingencies do not arise – by ensuring that the operations for which comfort letters have been issued are always well managed and solvent. (b) have contingency plans in place to ensure that they are able to meet the demands as and when made without any serious disruption of the overall operations. (c) banks should be required to make appropriate disclosures with regard to the nature and extent of comfort letters issued by them.
12. Accounting Standards (a) The Institute of Chartered Accountants of India (ICAI) has issued an Accounting Standard, *viz*., AS -11: The Effects of changes in foreign exchange rates. The RBI has issued guidelines to banks requiring them to comply with the AS but with the use of certain approximations, *viz*., weekly or quarterly average rate instead of daily rate. (b) At present India does not have any accounting standards which specifically	(a) Banks will be undertaking a significantly larger number of foreign exchange transactions with growing integration with international markets. Hence, the accounting framework may need to be made more robust.	(a) Banks should be encouraged to move towards full compliance with AS–11 without any approximations over a 5 year period. The *'complex'* banks should be required to comply with the AS within the next three years and the other banks within the next five years. (b) The ICAI has initiated a move in this regard for issuing corresponding Indian Standards assimilating the principles of IAS 39 on Financial Instruments: Recognition and Measurement, IAS 32 : Financial Instruments : Disclosure and Presentation and IAS 30 : Disclosures in financial statements of banks and similar financial institutions. This

Present Position	Issues	Proposed Measures
address accounting of derivatives. (c) In terms of AS 25 – Interim Financial Reporting, banks are required to make interim financial disclosures at a periodicity as they may choose. RBI has advised banks to make half-yearly disclosures on the quantitative aspects in a summary form as per disclosure format approved by RBI in consultation with SEBI. The listed companies are also required to make quarterly disclosures as per the listing agreements with the various stock exchanges. These disclosures are also on quantitative parameters.	(b) It is imperative to align the Indian accounting standards with the international best practices. Adequate public disclosures by both banks and non-banks are essential to assess the extent of risks, especially un-hedged foreign currency exposures and derivative exposures assumed by non banks. This becomes necessary in view of the likelihood of the risks assumed by the non banks becoming indirectly risks of the banks through their exposures to the non banks.	would ensure accounting of financial instruments, including derivatives, in a uniform and consistent manner. This would also foster a better understanding of the risk exposures of various entities through the disclosures mandated under the accounting standards. Pending issue of the relevant accounting standards, RBI should issue derivative accounting guidelines to banks adopting the broad principles of the above international standards. It would not be adequate if these accounting standards/ principles are mandated on the banks. These should also be made applicable to non bank market participants (corporates) also. Hence, issue of these accounting standards (corresponding to IAS 32 and IAS 39) by the ICAI would be necessary. RBI should pursue this with the ICAI. (c) It would be useful to enhance the scope of disclosures under AS 25 to include qualitative aspects which will bring out the level and direction of risks assumed by the various entities, including non-banks, in consultation with the ICAI. In the absence of the ICAI making such disclosures an integral part of the AS, RBI should coordinate with the other regulators (SEBI – for corporates and securities firms; and IRDA - for insurance firms)
13. Disclosures Over a period the RBI has enhanced the disclosure requirements of banks by prescribing additional disclosures in the Notes on accounts to Balance sheets. These disclosures are largely quantitative in nature with a focus on capital adequacy, NPAs,	For greater transparency and market confidence in the system and to activate the market discipline process, it will be necessary to place more information in the	The disclosures to be made by banks in future should include the following, in addition to the disclosures required by the Basel II guidelines: (a) Concentration of deposit base.

Present Position	Issues	Proposed Measures
investments, provisions, productivity ratios, maturity pattern of assets and liabilities, risk exposures on account of derivatives, etc. The Basel II framework recognises the importance of public disclosures and the role of market discipline by requiring banks to make greater disclosures. Accordingly, banks in India will be required to make additional disclosures with regard to the following: (a) capital and capital structure; (b) capital requirements for each major risk (credit, market and operational) and the capital adequacy; (c) Qualitative disclosure requirement regarding banks' risk management policies for the three major risks and credit risk mitigation. (d) Geographical and industrial concentrations of credit risk exposures.	public domain.	(b) Concentration of borrowings. (c) Extent of dependence on models for risk management and pricing purposes. (d) Framework in place for building and validating models. (e) Disclosure should shift from the position as on the date of balance sheet to the average during the year. (f) Currency-wise maturity pattern of deposits and liabilities where the position exceed a certain percentage of total assets or liabilities. (g) Disclosures on managed assets basis for securitised and assigned assets. (h) Disclosure of top 20 shareholders. (i) Make segment disclosures in greater detail – to include 'corporate', 'retail' and 'priority' sectors, including disclosures pertaining to movement of NPAs in these segments. (j) Greater disclosures on contingent liabilities, including comfort letters. (k) Bank's holding out policy towards their subsidiaries/joint ventures/ associates.
14. Type of Supervision At present the RBI supervises the commercial banking system primarily through two modes, *viz*., off-site and on-site. While the banks' domestic branches are subjected to a periodical on-site inspection (normally annual), the foreign branches	The risks that may emerge under FCAC regime are likely to test the strengths of the supervisory mechanism and may expose its	(a) RBI should consider strengthening its supervisory framework, both off-site and on-site, to effectively capture the revised elements proposed above. The scope and focus of the revised supervisory framework may apply equally to

Present Position	Issues	Proposed Measures
are subjected to on-site examinations at a lesser frequency. The present regulatory and supervisory practices of the RBI are largely conventional in nature and approach.	weakness. It will be necessary for the supervisor to adopt refined and improved supervisory techniques and fix appropriate priorities. The traditional approach may not be adequate in an environment which is likely to be more dynamic.	both domestic branches and foreign branches. (b) Supervision should be geared to assess the adequacy and effectiveness of the risk management systems in place in banks. The risk management systems in banks may be required to explicitly address all material risks and at the minimum should address the following risks: credit risk; market risks; operational risk; liquidity risk and country/ transfer risks. RBI may monitor the risk profile of banks on an ongoing basis. Towards this, the Capital Adequacy, Asset Quality, Management, Earnings and Liquidity System (CAMELS) approach should be adjusted to accommodate the proposed focus and become Capital Adequacy, Asset Quality, Risk Management, Earnings and Liquidity System (CARMELS) approach. Additionally, RBI may undertake targeted appraisals of 'risk management systems' and 'corporate governance' in all banks at periodical intervals. (c) Supervision should also focus on the vulnerability of the bank due to developments in group entities. RBI may review its supervisory mechanism for the consolidated bank/conglomerates and initiate necessary measures/ mechanisms which will enable all the regulators to undertake coordinated off-site and on-site exercises. (d) RBI should put in place appropriate framework to ensure full adherence by banks with the Anti Money Laundering (AML)/Know Your Customer (KYC) and Financial Action Task Force (FATF) requirements to foster the integrity of the banking system. (e) With a view to contain the forex settlement risks in the

Present Position	Issues	Proposed Measures
		system, RBI should ensure that forex transactions in all currencies that are material are settled on a PVP basis. (f) RBI should consider strengthening the Prompt Corrective Action (PCA) framework making it non-discretionary to a larger extent to reduce the scope for regulatory forbearance. At the minimum, the identified banks may be placed under strict watch and RBI should also consider placing certain restrictions on the activities of these banks. (g) Putting in place an on-line connectivity with banks to support submission of timely system generated supervisory reports to the RBI. This connectivity should also provide for supervisory (read only) access to banks' database. RBI should be able to use this access and generate technology driven system wide aggregation of various critical parameters on near real time basis. Co-ordination between departments in sharing information and rationalisation of returns – move toward a central point data centre in the RBI with appropriate analytical tools and necessary redundancies. The existing supervisory reporting formats should be reviewed and revised in the light of the post fuller CAC scenario after studying the supervisory reporting formats operational in leading territories (UK, USA, continental Europe) (h) Consider introducing the concept of Central Point of Contact (CPOC) in RBI where a dedicated desk official would be tracking all developments in the allotted bank on a day-to-day basis. This should be supported by appropriate structures for triggering appropriate remedial/ supervisory response.

Present Position	Issues	Proposed Measures
		(i) Off-site focus on liquidity risks, interest rate risks, currency risks and currency mismatches, asset concentrations and exposure to price sensitive assets – to entities and to countries - all at a global level – i.e., at whole bank level as well as bank group level. (j) Derivatives and related transactions – Strengthen supervision capacity, including oversight to monitor excessive exposures, to assess the risks associated with derivatives - Strengthen accounting rules to properly measure the risks - Strengthen reporting by financial institutions on derivatives risks, and disclosure of counterparty exposures. (k) At present certain prudential limits prescribed by RBI (for IRR, Capital Market Exposure (CME), etc.) are uniform across the banking system irrespective of the quality of the risk management systems in place. This may be replaced with a differential limit regime which will factor-in the level and quality of risk management systems in banks. (l) Human Resources aspects: Significant upgradation of regulatory and supervisory skills in the RBI; Scope for appointing specialists on short term/assignment basis; Secondment of officials in regulation and supervision departments to select reputed regulatory/supervisory bodies in various countries; Development of specialised skills in specific areas like technology based supervision, modeling and model validation skills; Regular exposure to new and evolving concepts in banking.

Present Position	Issues	Proposed Measures
		(m) Global consolidated supervision of internationally active financial organisations, with adequate monitoring of prudential norms for all aspects of the business conducted by these banking organisations worldwide, including their foreign branches, joint ventures and subsidiaries. (n) Establishing contact and information exchange with various other supervisors, primarily host country supervisory authorities.
15. Licencing Methodology At present Reserve Bank of India issues a full bank licence to all applicants who are found suitable.	Under FCAC, it may be necessary to discriminate among different players on the role that they may play or the freedom they may have to undertake various types of business. This discrimination should be based on the relevance of the entity to the Indian economy and its risk management and risk bearing capacity.	The B R Act, 1949, allows issue of only one type of banking licence, *viz.,* whole banking licence, which permits all licensed banks to undertake all banking activities. However, there may be a need for RBI to issue restricted banking licences to some banking institutions which may not warrant granting of a full banking licence. RBI should have a methodology for issuing restricted licences to entities which the RBI does not deem eligible for a full bank licence. For example, this will be relevant to decide on entities that may undertake cross border transactions and those that may not. Until the statutory amendments are carried out RBI should consider allowing banks to undertake only those activities which the banks may declare at the time of application for a banking licence. They should be required to seek the prior approval of the RBI in case they desired to undertake a fresh activity, other than those declared initially.
16. Regulatory Arbitrage Under the current financial regulatory structure, a	This can lead to regulatory	In this context, as a first step, RBI may focus on activity–centric

Present Position	Issues	Proposed Measures
single financial institution is often supervised by multiple regulators, whose regulatory prescriptions may not be well aligned.	overlaps, the diffusion of regulatory power, and the lack of proper accountability, all of which can weaken supervision and increase risks. In this context, the emergence of financial conglomerates poses a new and complex challenge for regulators. The variances in the regulatory approaches may provide an adverse incentive for regulatory arbitrage. This will have serious implications for financial sector efficiency and stability.	regulation instead of entity-centric regulation to reduce or eliminate the regulatory arbitrage.
17. Inter-agency Cooperation/Coordination and Home - Host Supervisory Cooperation At present there are no formal methodologies for inter agency cooperation/coordination in regulation/supervision of the regulated entities especially where there may be a chance for overlapping of jurisdiction i.e., where the regulated entity performs an activity which may come under the purview of another regulator. With regard to cooperation with host/home supervisors (i.e., foreign regulators/ supervisors) the RBI ensures that the essential requirements for	In view of greater complexities of banking business under a FCAC regime the RBI should be establishing a strong formal mechanism for cooperation/ coordination with other regulatory/supervisory agencies in India and also with foreign regulators/ supervisors. This is essential	The RBI should consider placing the cooperation and coordination with other regulators within the country and with the host regulators/ supervisors in other territories on a more structured and formal platform to enhance the effectiveness of the regulation/supervision of the bank (on a global basis) as well as the banking group (on a consolidated basis).

Present Position	Issues	Proposed Measures
cooperation/ coordination are achieved through a healthy mix of informal and formal approaches.	for activating appropriate regulatory and supervisory responses to significant developments which may be relevant from the perspective of systemic stability.	
18. Financial Soundness Indicators (FSI) The Reserve Bank compiles a set of Financial Soundness Indicators at half-yearly intervals. The Financial Soundness Indicators (FSIs) are placed in the public domain through the Bank's publication – Trend & Progress of Banking in India.	There would be a need for improved monitoring.	The utility of FSIs would be enhanced if the information is put in public domain at half yearly intervals. Furthermore, the time lag in preparing the FSIs may also be reduced, in stages, to say two months from the end of the half year.
19. Legislation The current Indian laws do not explicitly recognise bilateral netting and multilateral netting.	Legislative reforms may be necessary for achieving effective financial sector regulation.	Some of the legislative changes which would be required include legalising bilateral netting and multilateral netting which will secure the netting arrangements under an insolvency situation

Source : Reserve Bank of India, Foreign Exchange Department