REPORT OF THE WORKING GROUP TO REVIEW THE SYSTEM OF ON-SITE SUPERVISION OVER BANKS

RESERVE BANK OF INDIA

Department of Supervision

Mumbai

November 1995

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गवर्नर
GOVERNOR

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Foreword

In the recent period, bank supervision has assumed considerable importance in the context of maintaining the stability and soundness of a country's financial system. Instability in the banking system can lead to financial distress, banking failures and an overall loss of public confidence in general. In the broadest sense, the main objective of all bank supervision systems is depositor protection as also to ensure that the banking sector remains healthy so as to be able to enhance and promote economic growth. Another related objective of supervision is to examine systems and practices which promote improved efficiency in banking operations and ensure fairness in the allocation and use of credit. For supervision to be effective, the objectives must be clear and well understood both by the market participants as well as the supervisor.

The Reserve Bank of India has been vested with the statutory responsibility of exercising prudential supervision over banks under the Banking Regulation Act, 1949. The Bank has, therefore been conducting inspections of banks with the objective of assessing their financial and operating conditions and quality of management. The endeavour has been to ensure that the safety and soundness of the Indian banking system is not eroded. The Bank has also been reviewing periodically the techniques and methodology of its inspections so as to better respond to the new and rapidly changing environment. The last such review was carried out in 1991. With the setting up of the Board for Financial Supervision (BFS) in 1994, undivided and intensive focus is now being provided to prudential supervision. As one of its first tasks, the BFS reviewed and approved a revamp of the supervision strategy, putting in place additional instruments of supervision to supplement the periodical inspections.

Amongst the different instruments employed by bank supervisors, on-site inspections are the most widely used. Supervisory regimes which employ off-site monitoring as the predominant vehicle have in recent years begun to place greater emphasis on on-site examinations. There are areas like internal controls, compliance and management control, etc. which can only be assessed adequately through on-site inspections.

A five member Group headed by Shri S.Padmanabhan, former Chairman and Managing Director of Indian Overseas Bank and currently a member of the Advisory Council to the BFS was thus asked to review the existing system. The Group has recommended far reaching changes in the approach, thrust and style of inspections as well as follow-up. The major reforms suggested are:

i) Proposing targeted appraisals of major portfolios and control systems, in between periodical full-scope statutory inspections, operationalising a strategy shift to on-going supervision.

ii) Proposing discriminative approach to supervision and inspections by separating sound and problem banks, the latter receiving larger supervisory attention and resources.

iii) Proposing a rating methodology for banks on the lines of the widely adopted CAMEL model, in order to operationalise the "discriminative" approach.

iv) Proposing a focused approach to follow up on inspection reports and for supervisory interventions.

I expect the Group's report to make a significant contribution to our supervisory approach as it clarifies issues concerning scope and limits of prudential supervision, focuses on current concerns of supervisors all over the world, and, updates approaches to conform with the international supervisory practices and standards.

The report is being made available to a wider public, in the hope, that there will be a better appreciation on the part of the banks, other financial intermediaries as well as the depositors and other users of bank services as to what the BFS is doing. It would also help bring about greater convergence and congruity between the objectives of the supervisor and the expectations of the supervised.

(C.Rangarajan)
Governor

17-4-1996

S. PADMANABHAN
Member
Advisory Council
Board for Financial Supervision

Bombay

November 8,1995

The Governor
Reserve Bank of India
Bombay

Dear Sir

Please refer to the Bank's (Department of Supervision) letter of January 23, 1995 setting up the Working Group to review the system of on-site supervision of banks by Reserve Bank of India. I have great pleasure in submitting the report of the Group.

Yours faithfully

(S. Padmanabhan)
Chairman - Working Group

REPORT OF THE WORKING GROUP TO REVIEW THE SYSTEM OF ON-SITE SUPERVISION

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EXECUTIVE SUMMARY

A Retrospective

1. Reserve Bank of India (the Bank) has employed periodical inspections as the prime - almost exclusive - instrument of prudential supervision over banks. It reviewed and revamped its system of inspections twice in the last decade, based on the recommendations of expert groups headed by S /Shri Pendharkar (1985) and S. Padmanabhan (1991).

2. Pursuant to the major recommendations of Padmanabhan Group, which sought to address the major concern of the long periods entailed in the Bank's inspection and follow - up processes,

   * Annual financial inspections focusing essentially on financial appraisals of banks were introduced from 1992 - 93 (reference financial year) , replacing the earlier Annual Financial Reviews of public sector banks and full - scope inspections of all banks conducted at wide and varying intervals. The complementary biennial management audits recommended to cover non - financial assessments could not be brought on board due to the fact that examiner resources were fully tied up in financial inspections conducted on an annual cycle.

   * the authority for finalisation and issue of inspection reports, earlier requiring prior approval of the Central Office, was delegated to Regional Offices.

   * a beginning was made in using external auditors for looking into areas of supervisory interest in the statutory audits.

3. A fresh review of the Bank's inspection system was considered necessary, following closely on the last review i.e. within three years, because of far-reaching developments in the banking sector and significant changes in the regulatory approaches and organisation of the Bank, largely under the impetus of the financial sector reforms initiated since 1991-92. Notable among the regulatory developments are :

   - the enforcement of prudential norms for income recognition, asset classification and provisioning, valuation of investments, since 1992-93.

   - the introduction of Capital adequacy standard on the model of Basle framework (8% of weighted risk assets) to be attained by Indian Banks with a phase-in period through March 1995/96.

   - the setting up in November 1994, of the Board for Financial Supervision (BFS).

bifurcating the bank regulatory and supervisory function in the RBI and entrusting the supervisory function to a newly created Department of Supervision (DoS) which functions under the direction of BFS.

New Approach to Supervision

4. The Board for Financial Supervision (BFS) has approved a new approach to supervision of banks by DoS which has the following dimensions :

(a) the setting up of an off-site surveillance function in DoS as an additional tool of supervision; this is to be based essentially on a prudential reporting system which was introduced by the Department in March 1995 on a trial basis.

(b) restructuring inspections of banks for sharper focus as also to achieve complementarity with the off-site monitoring system.

(c) extending the role of auditors into areas of supervisory concerns - in other words, employ external audits as a supervisory resource.

(d) strengthening corporate governance and internal control and audit functions in banks as support systems for supervision.

Recommended Strategy

5. The Review Group considered the role and mechanics of on-site supervision over banks in the broad context of this new approach. Primarily, it considers a shift in supervisory strategy necessary in the emerging banking scenario in which the risk profile of banks, and as a corollary, their real capital positions can change rapidly. It recommends a shift from the current system of periodical inspections as the principal instrument of supervision to a strategy of continuous or on-going supervision and periodical inspections. The Group also recognises that off-site monitoring capability being set up in DoS is an important step in this direction.

6. The Group recommends that the strategy of continuous supervision should be operationalised and underpinned by the undernoted key elements :

(a) In tandem with the system of off-site monitoring, the on-site supervision should be made an on-going activity with linked appraisal exercises undertaken between periodical inspections. Such supplementary or bridge exercises should target specific /identified critical areas that are not explored in detail and depth in statutory inspections which focus on mandated core assessments. Such linkages and forward integration lead to the broader concept and approach of on-site supervision.

(b) Supervision, whether on or off-site, should be focused - for looking at specified areas of supervisory interest and concern. As a corollary, supervisory inspections should not

be employed as catch-all exercises leading to an overload of inputs and add-ons, as hitherto. They should focus on the core assessments as per the statutory mandate.

(c) Supervision should be discriminating as between banks, based on defined parameters of soundness - financial, managerial and operational, the last one related mainly to risk management and internal control systems. To this end, a rating system for banks should be set up to help calibrate the use of supervisory attention and resources such as frequency of inspections and coverage in networks and by appraisal "thresholds".

(d) Extending the role of auditors for supervisory purposes should not be by grafting "add-ons" to statutory audits but by commissioning special purpose 'agency' audits.

(e) Supervision should be oriented to enforcement and correction of deviations which are the raison d'etre of the supervisory process and the hall mark of its effectiveness.

7. The group opines that there is a role confusion between RBI inspections and the internal inspections and external audits in banks, especially the former - in public perception which tends to misinterpret the objectives and scope of prudential supervision; this has led to an 'expectations gap'. A facilitating factor in obviating such confusion would be designating the Bank's inspections as supervisory examinations in line with such usage in some major supervisory regimes.

REFOCUSING THE EXAMINATIONS

8. In terms of the statutory mandate - as laid down in sections 11 (minimum capital) and 22 (licensing criteria and conditionalities) of the Banking Regulation Act, 1949 and the related regulations, the supervisory examinations cannot be restricted only to financial assessments nor need they be conducted at annual intervals. The assessments have to necessarily cover solvency and capital adequacy, liquidity, operational soundness and managerial prudence. In other words, while the specified core assessments are mandatory, the periodicity at which such assessments are to be made is a matter of judgement for the Bank.

Periodicity

9 The group recommends that supervisory examinations may be conducted in two cyclical tracks by dividing banks into two categories, based on their reported or assessed financial and operational condition and compliance record, viz.

- those which need to be examined on annual cycle,

- those that can be examined on a wider time cycle - mostly, biennial.

The rating of the bank would be an important input in such categorisation.

The review of this categorisation is normally to be undertaken annually at the time of examination planning. Deviation from the programmed frequency is warranted with change in supervisory perception on an individual institution with availability of new information.

10. Major branches of our banks in international finance centres may be examined at intervals of three to four years - on a centre-wise basis. In respect of the overseas banking segment, by its very nature, supervisors have to rely more on management controls. To this end, the existing system of portfolio appraisals of International Divisions of Indian banks having overseas operations may be strengthened as part of the recommended strategy of Targetted appraisals at control - site ; these should be conducted on annual cycle and independent of regular examinations of the bank.

Examination Outputs

11. Supervisory examinations should be directed to assessment of key areas of supervisory interest that are linked to the statutory mandate viz. the core assessments. Accordingly, it is suggested that the examinations should focus on and produce outputs relating to assessments on three broad areas -

a) Financial Condition,

b) Operating Condition (Systems and Controls), and quality of Management

c) Regulatory Compliance.

12. **Financial Condition** assessments should cover asset quality, solvency and capital adequacy, liquidity and earnings performance.

* **Asset quality** appraisal consists in assessing the credit and market risk in the risk asset portfolios and the impairment in asset values; the appraisal is to be based on the prudential norms on income recognition and asset classification, and on whether adequate risk provisions / value adjustments have been made therefor.

* **Solvency** has to be assessed in terms of the estimated 'real or exchangable value' approach to the net assets position of the bank; **capital adequacy** on the other hand, is assessed on a broader concept of own funds in relation to its weighed risk assets.

* **Earnings performance** may be measured in terms of

  (a) Return on assets, both on pre-tax and post-tax basis, and

  (b) Accretion to equity (i.e. retained earnings of current year to equity at end of last year).

* **Liquidity assessment,** which is currently based on stock approach has to be

supplemented by appraisals on flow approach (gap analysis) and market access and backstops in relation to funding risk.

13. The **Operating Condition** of a bank has to be assessed in terms of its portfolio and risk management systems as well as internal controls in place. As most Indian banks are multi branch organisations, the assessment of Head Office controls over branches including the internal clearing system (i.e. the inter -branch adjustment account) and the internal inspection and audit function are very crucial in such assessment.

14. The Group emphasises that the **Quality of Management** is an important difference between sound and unsound banks; and this is essentially related to the corporate governance function. The evaluation of the role of the Board in providing policy direction and oversight of its implementation is accordingly stressed as a key area of examiner assessment. The assessment of bank management encompasses the adequacy of systems and controls put in place and their operational efficacy as well as its record in **regulatory compliance**.

REPORT STRUCTURE

15. The examination report has to be structured along the assessments as outlined above and rounded off with the identification of the supervisory concerns. It is suggested that the examiner's report may be in two parts, one of which is a closed or confidential section. The "closed" part will be an internal report to the top management in DoS and BFS and need not be provided to the bank. It should contain critical assessments on the bank's Board and management, some of which the examiner may not wish to discuss in the report to be provided to the bank, examiner's rating of the bank on different parameters and the recommended action plan related to the rectification of the serious concerns. It might also include suggestion/s on what portfolios and operating systems should be covered in supplementary assessments, referred later (in Para 21).

Related issues in examinations

16. The Group places a great deal of emphasis on pre -examination planning and strategy in which the outputs / reviews of the off - site reporting system will now become a major input. These in - house updates coupled with the system of targetted appraisals will help reduce significantly the time span of the examination process.

17. Branch coverage in inspection should essentially be decided as a part of the strategic planning of the examination at Regional Offices. Priority in branch selection should be accorded to special finance branches, very large (credit) branches and Trading, Treasury and Investment Management Centres.

18. The extent of detailed scrutiny of different portfolios of risk assets is to be

determined on a general assessment of the bank's condition and in particular, on the internal control and audit environment in the bank. Subject to this, the present norms of portfolio coverage (i.e. currently 30% to 60% of loans and near total coverage of investments) are considered reasonable.

19. Laying down standardised time frames for examination process is prone to be arbitrary. Indicative norms in this behalf for different banks based on size have been suggested for examination and report preparation phases.

20 The Group recognises that the Lead examiner or Principal Inspecting Officer (PIO) is the lynchpin of the on - site exercise and has to be a person with experience, insights and maturity. Grade seniority should not be the sole, or even main criterion for heading an examination team. The group also sees no virtue in the present practice of changing the leader of the bank examination teams or the Principal Inspecting Officer (PIO) in successive rounds. It recommends that the Lead examiner or the PIO can, and in fact, should be repeated for examination of a bank for upto three successive rounds.

SUPPLEMENTARY VEHICLES

21. The Group recommends four types of supplementary on-site assessments, in between the statutory examinations viz.,

a) Targetted appraisals

b) Targetted appraisals at the control site

c) Commissioned audits

d) Monitoring visits.

These will be regular and cyclical appraisals - as distinct from ad hoc scrutinies and investigations, which are re-active exercises responding to reports, complaints, industry-wide concerns, etc.

22. **Targetted Appraisals** will be detailed assessments focused on specific portfolios, operating and control systems, management and compliance aspects. These may be planned on cyclical basis to ensure coverage of all targetted areas over a period of three to four years.

23. **Targetted Appraisals at Control Site** are especially appropriate to areas such as overseas banking and subsidiaries in banking groups where a broad and general assessment of a number of units may be made at the Controlling Division in the Corporate or Group Office - without visiting the different group units (sites) for examination.

24. **Commissioned Audits** signify employing external auditors for investigating

specific and assigned areas of supervisory concern as the agent/s of supervisors. These are distinct from the system of Reporting Accountants in U. K. which is characterised by a continuous or tenurial engagement of auditors.

25. **Monitoring Visits** are short visits to banks undertaken for making quick reviews of selected areas of concern or interest. Such visits may be made to banks, for example:

— in start-up phase for assessing build up of risk asset portfolios, operating policies and control systems, and

— for investigating the concerns raised in off-site analysis.

FOLLOW-UP AND ENFORCEMENT

26. After the examination of a bank, the report prepared by the inspecting officer, which should be after full and frank discussions with the bank management, is approved and issued by the Regional Office. It is suggested that the examiner should furnish a draft action plan for the bank, based on identified concerns, in the confidential section of the report. It is also suggested that the discussion the top Management of DoS holds later with the bank's CEO and his team should lead to the **formulation of a monitorable action plan** agreed with the bank with a time frame. This should be monitored by the Regional Office until the next Action Plan for the bank is put in place.

The nature of follow-up action that needs to be taken after the targetted appraisals, commissioned audits and monitoring visits has also been indicated.

RATING OF BANKS

27. The Group considers the present system of inspector's ratings based only on the assessed solvency status of the bank as inadequate and unrealistic.It recommends adoption of the CAMEL rating model with modifications as necessary to our context. It recommends **for Indian banks**, six rating factors viz., Capital adequacy, Asset quality, Management, Earnings, Liquidity, Systems and controls (i.e. CAMELS), and **for foreign banks**, four rating factors viz., Capital adequacy, Asset quality, Compliance, Systems and Controls (i.e. CACS).

Each rating factor will be scored on a scale of 1 to 5. Based on these, **Composite Rating** of banks on a five-score scale of A to E are to be set up - indicating in descending order, the soundness and strength of the banks as under :

A - Basically sound in every respect.

B - Fundamentally sound but with moderate weaknesses.

C - Has financial, operational or compliance weaknesses that give cause for supervisory concern.

D - Has serious or immoderate financial, operational and managerial weaknesses that could impair future viability.

E - Has critical financial weaknesses that render the possibility of failure high in the near term.

28. The Group recommends that instead of accepting the rating given by examiners as definitive, an **Integrated Rating** may be set up at Central Office, based on a more comprehensive assessment of the information available on the bank/s; this will be the rating that should be conveyed to the bank as also the basis for in-house decision making for supervisory attention on banks.

EMERGING ISSUES FOR SUPERVISION

29. The Group has touched upon a number of emerging issues for the Indian supervision function. These relate to :

(i) Supervision of subsidiaries in banking groups and the issue of parental support.

(ii) Supervision of banks in financial and mixed conglomerates.

(iii) Consolidated supervision and the approaches.

(iv) Co-operation and co-ordination between different regulators in financial services industry.

(v) Market discipline as a support system to supervision, and

(vi) Coping with financial crime in the banking system, especially money laundering.

STRENGTHENING BACK-UP SYSTEMS

30. The Group suggests that adequate back-up systems, a streamlined organisation and a motivated and skilled cadre of bank examiners and analysts have to be developed for making supervision effective. The recommended measures include :-

(a) Preparing a new Manual for Examinations and Appraisals i.e. for on-site supervision of banks.

(b) Training of staff in techniques of bank examinations, financial and bank analysis, exposure to new technical areas such as risk management and control systems including in derivative products and EDP audits.

(c) Staff orientation to new technology, and especially for the examiners to be able to perform examinations in EDP environment and automated systems in banks.

(d) Setting up an EDP Audit Cell in DoS and its Regional Offices.

(e) Assured continuity of tenure for a reasonable period for the officers in the supervision function to justify the investment made in job training and skill formation, compatible with the Bank's plans for their career progression.

(f) Fresh look at the deployment of examiner resources positioned at various centres of the Department, some of which are underperforming by reason of absence of "core jurisdiction" i. e. with no banks headquartered in the area and having only branch networks.

CHAPTER I

INTRODUCTION

1.1 The system of inspection of banks by the Reserve Bank of India (the Bank) was last reviewed in 1991 by a Working Group chaired by Shri S. Padmanabhan, former Chairman of Indian Overseas Bank. Most of the recommendations of the Group were accepted by the Bank and some of the major ones have been implemented in the last three years. However, during this period, several far reaching developments and changes have taken place in the Indian banking system as well as in the regulatory approaches and norms, notably -

* the implementation of financial and banking sector reforms, following the recommendations of the (Narasimham) Committee on the Financial System (1991) - setting in train a progressive process of deregulation/liberalisation.

* the disclosures/uncovering of serious irregularities in the investment operations of many banks in the second quarter of 1992 which laid bare the deficiencies in the portfolio management systems and internal controls in the banks.

* the enforcement, since mid-1992, of new prudential norms on income recognition, asset classification and provisioning and valuation of investments which significantly changed the financials of banks, including perceptions of their solvency; and the re-capitalisation exercises that were undertaken in almost all banks with the concurrent introduction of the new capital adequacy standard (based on Basle framework).

* the phased equity infusion by Govt. Of India in the last two financial years (1993 -94 and 1994 -95) in the order of Rs. 11000 crores for re-capitalising the nationalised banks i. e. for funding portfolio losses disclosed by application of the prudential norms and for attaining the targetted minimum capital levels; and in order to underpin their financial and institutional re-structuring, Memoranda of Understanding (MOUs) were entered into by these banks with the Reserve Bank of India. In the case of the weakest of these banks, studies by management consultants on turn-around feasibility and strategy were also commissioned.

* the setting up by RBI in December 1993 of a separate Department of Supervision (DoS) followed by the establishment in November 1994 of the Board for Financial Supervision (BFS) for dedicated and integrated supervision over **all** credit institutions i.e. banks, development finance institutions and finance companies. BFS has put on the agenda a new approach to supervision for implementation by DoS.

1.2 Against this backdrop, the Bank considered it necessary to undertake a fresh look at its system of supervision by inspections and set up, in February 1995, a Working Group

to review its on-site supervision function in the new context. This review group, headed by Shri S. Padmanabhan- the Chairman of the 1991 Working Group - comprises the following members,

1.	Shri S.Padmanabhan (Chairman)	- Member of the Advisory Council to BFS and former Chairman of Indian Overseas Bank
2.	Shri P. R. Khanna	- Member of the Advisory Council to BFS and Chartered Accountant, New Delhi.
3.	Shri G. H. Deolalkar	- Director, National Institute of Bank Management, Pune.
4.	Shri Dipankar Chatterji	- Chartered Accountant, Calcutta.
5.	Shri A.M.M. Sarma (Member - Secretary)	- Chief General Manager, Department of Supervision, Reserve Bank of India.

1.3 The terms of reference of the Group are as under:

(i) Re-define the objectives, scope and focus of on-site supervision in the context of the new supervision strategy - adopting supplementary instruments such as off-site surveillance and supervisory use of external audits;

(ii) Suggest different modes or vehicles of on-site supervision i.e., in addition to full-scope, statutory examinations, what other forms of on-site assessments may be undertaken ;

(iii) Make recommendations on the periodicity of the examinations, coverage of networks i.e. selection of branches and screening criteria i.e. fixing "scrutiny thresholds.

(iv) Recommend on the content and outputs of the examinations and formatting of the reports ;

(v) Recommend a system for supervisory rating of banks and suggest whether and how it could be a basis for modulating supervisory attention and resources ;

(vi) Delineate areas for complementary use of other instruments for on-site examinations such as inter-face and compatibility with off-site monitoring, and suggest areas of work that could be entrusted to external auditors/Management Consultants ;

(vii) Make recommendations on the methodology for making inspections time and cost effective and on post examination follow-up procedures for making them more result and action oriented.

1.4 Inaugurating the deliberations of the Group on February 10, 1995, Shri S.P. Talwar, Deputy Governor and Vice - Chairman of BFS , explained the background and

context for setting up the Review Group, outlined the new strategy of supervision approved by BFS and also mentioned how the major elements of the new strategy are being sought to be operationalised after an in-depth study and guidance from different expert groups; he added that there were other groups looking into internal controls in banks and for developing a supervision framework for non-banking finance companies. He observed that the newly introduced off-site surveillance system was designed to pick up early warning signals which could be investigated in on-site examinations so that prompt and timely action could be taken by the supervisory authority.

1.5 Shri Padmanabhan in his response stated that Bank Supervision is but one of four support systems for a sound banking sector. The efficacy of banking supervision depends on ensuring the proper functioning of the other three systems viz. overall direction and supervision by the Board of Directors, internal audit and external audit functions in the supervised institutions. He observed that the thrust of the RBI supervision should be on strengthening and dovetailing these three functions with its own activity.

1.6 The Review Group held seven meetings at Bombay and one at Hyderabad. It met some inspecting officers of DOS for assessing the status and results of the Annual Financial Inspections (AFIs) introduced in 1993 in pursuance of a major recommendation of the last Working Group. The Group also met and obtained the views of the executives in charge of the Inspection and audit function in some banks on the effectiveness of this new (AFI) approach to Inspections. It also interacted with the Chairmen (CEOs) of a few banks on their perceptions on the content and thrust of RBI Inspections.

Acknowledgements

1.7 The Secretariat for the Group was provided by the Inspection (Follow - up) Division of the Department of Supervision. The Group wishes to place on record its special appreciation of the contribution made by Shri A.M.M. Sarma, Member - secretary, to the group deliberations and in the drafting of the report besides his research inputs. It also notes with appreciation the excellent support services provided by the members of the Secretariat - Shri A. Somasundaram (General Manager), Smt. C.M. Coutinho (Assistant General Manager) and Shri Sunil Kandalgaonkar (Manager) and of the secretarial services rendered by Ms. Lathika Menon, Ms.Rakhee Totlani and Shri R.N. Iyer. It thanks all those bankers and RBI Inspecting officials who gave their time and views in the inter-face with the Group.

CHAPTER II

A RETROSPECTIVE OF THE SUPERVISION FUNCTION

Legal Framework

2.1 Banking Regulation Act, 1949 which provides the legal framework for the prudential regulation and supervision of banks, vests in RBI extensive regulatory and supervisory powers to fulfill the mandate of promoting sound banks and protecting the interests of depositors. Section 35 of B.R. Act confers on the Bank the general authority to conduct inspections of books and accounts of banks. The Bank can also carry out inspections for certain specific purposes under different Sections viz. Section 22(3), 37(2), 38(4), 44(1), 44A, 44B and 45Q of the B.R. Act, but these special inspections have rarely been undertaken in recent years. The Bank has been given powers to call for various returns and information from banks under Section 27(2) of B.R. Act. The prudential supervisory reporting (PSR) framework recently set up by DoS (March 1995) for off-site monitoring of banks was in exercise of such authority.

2.2 The Bank has hitherto relied on periodical inspections of banks as the main instrument of supervision. These were supplemented by ad hoc scrutinies whenever any specific complaints or areas of concerns were brought to its attention. Reporting by banks was essentially employed for monitoring compliance with statutory and regulatory requirements, and for ensuring conformity with policy 'guidance' e.g. on directed and targetted lending and investments; it has not been used to any significant extent for prudential supervision purposes, except that

(a) a prudential reporting system was set up in 1985 in respect of overseas branches of Indian banks, and

(b) a health code reporting on loan portfolios by domestic banks was put in place in 1986.

2.3 Periodical inspections of banks under Section 35 of B.R. Act are, in a sense, undertaken as a follow-up of the bank licensing regulation and objectives as laid down in Section 22 of the Act. The substantive objective of the statutory inspections has been to verify whether the conditions subject to which the bank has been issued licence to undertake banking business [vide sub-section 3, and for foreign banks, - also 3A of Sec.22] continue to be fulfilled by it. The conditions include -

(a) the bank "is or will be in a position to pay its present or future depositors in full as their claims accrue". (i.e. it is solvent and has adequate liquidity);

(b) the bank "has adequate capital structure and earning prospects".

(c) "the affairs of the (banking) company are not being, or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors";

(d) "the general character of the management of the bank is not prejudicial to the public interest or the interest of its depositors". (i.e. it has sound operational systems and adequate controls operated by a prudent management).

Section 22(3)(4) authorises the Bank to cancel the banking licence "if at any time, any of the conditions referred to in Sub-section (3) is not fulfilled".

Reviews of the system of inspections

2.4 The systems and procedures relating to the statutory inspections have been reviewed by the Bank from time to time to meet emerging supervisory concerns. In the last decade, two such reviews were undertaken based on the recommendations of expert groups commissioned by it viz. of Pendharkar Working Group (1985) and Padmanabhan Working Group (1991). Pursuant to the recommendations of the former group, two types of inspections were being conducted by the Bank until 1992-93.

a) Financial Inspections (FI) - at intervals ranging from two (for private & foreign banks) to four years (for public sector banks); these included visits to Head Offices, Controlling Offices and a cross-section of branches for making detailed assessment of all aspects of a bank's operations;

b) Annual Financial Reviews (AFR) in respect of public sector banks (except SBI). These visits covered Head Office and a quarter of the Controlling Offices only and relied mostly on the Management Information System (MIS) in banks.

2.5 Padmanabhan Group (September 1991) recommended two major reforms in this system of inspections viz.

i) Replacement of AFR and the widely-spaced Financial Inspections of banks by

    (a) Annual Financial Inspections (AFI) with main accent on the assessment of the bank's financial position, and

    (b) biennial management audits by Senior Officials to look into the non-financial aspects i.e. **Management and Systems**.

ii) Utilisation of the services of audit profession for scrutiny of certain specified areas of bank operations.

The recommendation relating to the introduction of AFIs (replacing the FIs and AFR) was implemented in the last two years (reference financial years 1993 and 1994). Due to the abnormal diversion of the resources of the Department for special investigations in banks involved in the securities irregularities (since mid-1992), the regular inspection

programme/s went out of gear. No biennial management audits could be undertaken in a situation where the annual inspections programme itself could not be completed in time.

2.6 A beginning was also made towards implementation of the recommendation relating to the use of external auditors for scrutiny of specific operations / aspects but in an ad hoc manner and not as part of supervisory strategy. Since financial year 1994 (i.e. audit of accounts for 1993-1994) the Bank has required that statutory auditors verify and comment on certain areas of supervisory interest - mandated in the letters of appointment that banks issued to their statutory auditors . These include, for example, verification and reporting to the RBI, of the bank's compliance of SLR requirements under section 24 of the B.R. Act, 1949 on 12 odd dates spread over the year, and the correctness of the SLR and CRR returns submitted by the bank to RBI during the period under audit as also certifying to the RBI that-

* the regulatory norms for income recognition, asset classification and provisioning have been enforced as per the guidelines issued by it;

* the treasury operations of the bank are conducted in accordance with the instructions issued by it from time to time.

The use of auditors as a supervisory resource is now formally adopted as an integral element of the new approach to Supervision (by DoS). However, our Group considers that for operationalisation of this strategy, a more synergistic approach is called for than prescribing 'add-ons' to statutory audits. Such a strategy is recommended in Chapter VI.

2.7 Two important recommendations of the Padmanabhan Group on the inspection process have also been implemented. These are -

i) reducing the time span of the inspection, including preparation of reports, within a maximum period of 4 to 5 months ;

ii) delegation to Regional Offices of DoS, since October 1994, the authority to process, finalise and issue the inspection reports to banks.

The inspection process including issue of the reports is now entirely the function of the Regional Offices of DoS. Central Office is now concerned only with the follow-up phase i.e. issuing the supervisory letter to banks, highlighting the examination findings and after considering the responses from the bank/s, discussing the supervisory concerns on the bank's affairs with the bank management/s.

2.8 As compared to the previous system, the Annual Financial Inspections sharpened the focus of assessments and quickened the process of follow-up. The annual schedule has, however, imposed considerable strain on the department, leaving hardly any time for pre-inspection study and strategy formulation by the inspection teams. The rigorous time schedule - the concern for shortening time spans for examination and report preparation has also led to compromise in quality of assessments. Besides, the inspectors' task also

became more onerous during this period as the accounting policies and loan classification and provisioning policies in banks were in transition and in process of adjustment. The annual schedule of inspections has been seen to experience substantial time-overruns in the last two years. This was in part due to large diversion of inspection resources of the Department for ad hoc scrutinies and investigations; the increase in the number of banks by licensing of new private and foreign banks has also been a contributory factor.

2.9 The annual schedule of inspections has been lent further formal support recently by the commitments given by the Bank and the Govt. in the Action Taken Report in response to the concerns raised by the JPC Enquiry into the securities irregularities. This is a predictable response or corollary to a heightened concern for closer supervision of banks when periodic inspections is almost the sole instrument employed for supervision. Our group has considered this matter and expresses the view later in the report that the objective of closer supervision over banks can be secured - and more effectively - otherwise than by annual, full-scope inspections under a new, multi-channelled strategy of continuous supervision supported by a system of rating banks, based on key supervisory parameters.

CHAPTER III

REGULATION AND SUPERVISION - OVERVIEW

3.1 A major development in the banking regulation and supervision function of the Bank has been its restructuring in 1994 by separation of regulation and policy from prudential supervision in the context of setting up of the Board for Financial Supervision (BFS). The supervision function has been brought under the direction and oversight of BFS for bestowing undivided attention to it. This functional bifurcation has recently been extended to cover non-bank financial institutions (NBFIs) as well. The new Board now exercises integrated or umbrella supervision over a bulk of the credit system. In this context, our Group considers it pertinent to delineate the distinct objectives and content of regulatory and supervisory functions as also provide an overview of the scope and processes of supervision as a setting for its own task of advising on how to strengthen the process.

3.2 The group considers this necessary for another reason as well. A widening expectations gap concerning the bank supervision function seems to have emerged in the Indian System. The public perception of the role and ambit of supervision is powered by a significant rise in expectations and, as a result, there is a growing trend of public opinion that is ready to indict the supervisors for any and every aberration in the banking system including poor customer services and customer disputes with banks. For example, customer or employee fraud in some branch of a bank is seen as failure of the supervisory authorities to detect or even prevent it while prevention and detection of frauds is, clearly, a function of the internal audit and controls in the bank, and thus a management failure. Supervisors doubtless have a responsibility to assess and criticise poor internal controls, including laxity in enforcement of prescribed control mechanisms, and mismanagement - and arguably, to uncover Management fraud. This phenomenon of exaggerated expectations is possibly due to the Bank's substantial interventions and guidance over a wide range of affairs of banks in the post-nationalised era. It is, however, partly also due to inadequate understanding and misinformed perceptions of a bank's supervisor's role and role confusion with other control mechanisms in banks such as internal inspections and external audits. Our Group considers that a better appreciation of the objectives and scope of prudential supervision might help close in part this "expectations gap." Hence, an overview of this function is provided in this chapter.

3.3 In this context, our Group suggests that in order to obviate the confusion arising from the general perception of inspections and to distinguish from banks' own/internal control mechanisms, the Bank may consider re-designating its periodical on-site inspection exercises as "bank examinations" in line with such usage in some major supervisory regimes.An 'examination' would be more suggestive of an appraisal of the general health of a bank and of diagnosis of the malaise so as to be able to address the identified concerns. An inspection, on the other hand, evokes an image and expectation of a 'catch-all' of voucher audits, collateral verifications, document checking, compliance of internal

procedures and checks and balances, branch level audits, fraud detection - which are far from the focus of supervisory examinations.

RATIONALE OF BANKING REGULATION

3.4 The world over, there is greater regulation and official supervision of banks than of other business enterprises because they play a central role in the economy. They

* hold the savings of the public and provide means of payment.

* hold a large part of the money supply, create money and serve as the main conduit of the Central Bank for implementing monetary policy.

* administer the national payments and settlement system.

* intermediate between savings and investments, thus serving to allocate or channel funds to the economic sectors that can use them most efficiently and productively.

  In this intermediation function, banks assume risks - notably credit and liquidity risks, the latter stemming from maturity transformation. If the risks are controlled properly, the bank will create economic value by attracting savings to finance investment. In case of mismanagement, real resources will be misallocated and the banks may fail.

* As compared to other business enterprises, problems in one bank can be much more rapidly transferred through the entire financial system and the economy (contagion). Bank failures have monetary consequences, disrupt the payments system and lead to disintermediation. (systemic risk)

3.5 For all these reasons banks are also accorded a higher degree of official protection by providing certain safety nets. For example, the Central Banks usually act as lender of last resort to protect banks against temporary liquidity problems. Another safety net is the Deposit Insurance Scheme which helps maintain public confidence in the banking system.

3.6 Banking regulation has clearly defined purposes. Besides protection of depositor interests , these include :

* preserving a sound banking system and protecting the official safety net and thereby the tax payer (e.g. official bail-outs and recapitalisation exercises involving public funds).

* minimising the destabilising effects on the economy caused by any difficulties in the system, i.e. preventing troubles experienced by financial institutions from posing wider systemic risk.

* protecting consumers (i.e. users of bank services) from excessive prices and opportunistic behaviour by providers of financial services and other participants in the

financial market place i.e by curbing monopolistic trends and restrictive trade practices.

* ensuring that communities are adequately served by the banking system (broader social objectives)

3.7 All regulation has costs and regulators have to periodically assess whether the benifits of existing regulations are commensurate with the costs entailed.

PRUDENTIAL REGULATION - ROLE AND PROFILE

3.8 Banks exist because they are willing to take on and manage risk. Banks and banking business are typically highly geared - trading more with others' money than their own. More important, they hold the savings of the risk - averse sections of the community which are entrusted to them (as depository institutions) as deposits and not as credits after proper risk evaluation. The objective of bank regulation, therefore, is to dissuade banks from taking excessive risks owing to the moral hazard implicit in the highly - leveraged operation. While risk taking should be restrained, regulation and supervision should not seek to minimise it as that entails huge economic costs for the banks as well as the community.

3.9 Banking regulation is of two types - preventive and protective. Preventive regulation is designed to prevent

(a) wrong kind of business enterprises getting into the banking market and undertaking unrelated or speculative types of business (i.e. entry restrictions - geographic and product-wise), and

(b) to prevent those that are allowed entry, from getting into difficulties by non-prudential behaviour.

The latter part of regulation can be called prudential regulation . Prudential regulation is directed against excessive risk taking by banks (including through concentration of credit and other exposures) and detrimental management practices such as self-dealing (i.e. lending to owners, directors, etc).

3.10 Preventive regulation is concerned with issues relating to

(i) controlling entry into banking markets by a licensing procedure;

(ii) defining the scope of business that banks can or cannot undertake i.e. countermanding certain lines of business.

(iii) mandating minimum levels of capitalisation (including build-up of reserves by retention of earnings).

(iv) restricting investments in equities including for control of other corporates.

(v) regulating acquisitions and mergers of existing banks; and

(vi) intervening to curb monopolies and monopolistic trade practices (including cartelisation) to foster a competitive banking market.

Entry into banking markets entitles the licensed corporates to public deposit taking and participation in the national payments system. Licensing laws and regulations are designed mainly to prevent entry of under-capitalised corporates and dishonest or inexperienced persons from establishing or acquiring banks so that the key regulatory objective of preventing bank failures and depositor losses is not nullified. On the other hand, if licensing policies are too restrictive seriously limiting establishment of new banks, the system may become less competitive, tending to protect inefficient banks from more efficient banks that would enter the market.

Protective regulation is concerned with protecting depositors and the stability of the financial system when a bank encounters serious problems and market failure. It is aimed at handling bank failures and is linked to the Central Bank's role of the lender of last resort and the Deposit Insurance Scheme.

A collateral aspect of regulation is also promoting competitive and efficient banks. Competition ensures that the community - the users of bank services - get better services at lower cost. Efficient banks have a lower risk of failure, are competitive - operating with lower intermediation costs, and contribute to the efficiency of the economy. Poorly administered and managed banks have a higher chance of failure and are unable to adequately factor demand and supply, cost and risk factors into their decisions.

In some countries, self-regulation has been permitted for part of the financial services industry (e.g. U. K.). In a self-regulating regime, the industry sets most of its own rules and monitors the compliance by its constituent units.The underlying rationale is to encourage the participation of the banking community in the development of appropriate supervisory practices and to pay due regard to the market's judgements of those participating in it. In such a context, the supervisory authority has regard to the individual structure and circumstances of each supervised entity, not seeking a standard level of conformity through detailed ratio controls.

PRUDENTIAL SUPERVISION - PURPOSE AND SCOPE

Prudential supervision implies supervision over banks to ensure that banks recognise the importance of 'prudence' and accordingly conduct their business in a prudential manner. It also means that they ought to ensure the financial safety and soundness of their condition and business. It spans the entire period of a bank's total operational life i.e. from the time it is licensed until it is decided to put the bank into liquidation or is merged with another entity.

3.16 The central objective of prudential supervision is to promote the soundness of banks and maintain public confidence in the banking system. Depositor protection is a related goal which is ensured by fostering the development of strong and well-managed banks. Avoiding depositor "runs" on banks as a result of loss of public confidence in individual banks or in the system is the essence of the supervisory task.

3.17 While the core function of bank supervision is ensuring solvency and liquidity of individual banks, it is often overlaid with several 'add-ons' which vary in different supervisory regimes. In developing countries, these stem from macro-economic and social concerns and sometimes become so interventionist as to border on micro-management. Because of these "overlayers", bank supervision has come to mean many things to many people. It is, therefore, necessary to clarify what supervisors are expected to do and what they are not - and cannot be - expected to do.

(i) While the endeavours of bank supervisors are directed to safeguarding the bank's capital and thus the depositors' funds by limiting the risks assumed by them, it cannot mean that their task is to guarantee that no bank will ever fail. However, supervisory interventions should be directed towards minimising the possibility of such failures and when a bank does fail, minimise the consequences of such failure - not only in terms of reducing losses for the depositors but also in containing the contagion effects of such failure across the system. The aim of supervision is to intervene at an early stage in order to prevent problems from getting out of hand. For this reason, supervisors should be constantly aware of the developments in the banks and the banking system.

(ii) Supervisory examinations are often seen as parallel or analogous exercises to internal or external audits in banks. Yet, the objectives, scope and focus of these three exercises are totally divergent and distinct. External or statutory audits are conducted to express an opinion on the financial accounts finalised by the bank management i.e. Board of Directors. Internal audit is a control mechanism of the corporate management or Head Office to ensure and enforce compliance with laid down policies, procedures, authorisations, internal control and risk management systems. Reports on bank inspections by RBI clearly state that "an inspection is not an audit and it does not replace it". In the case of frauds, for example, supervisors assess the weaknesses in the control systems that facilitated the occurrence of fraud/s and the financial impact that the latter have on the bank's solvency. Detection or prevention of individual frauds, as earlier stated, is the task of the bank management through their internal audit and control function. The three exercises, however , are complimentary and mutually reinforcing.

(iii) Supervisors are not expected to make decisions on behalf of bank management nor are they expected to prevent banks from taking commercial decisions.

(iv) In some liberal and market-oriented economies, supervisors generally are not involved in the enforcement of monetary, credit and fiscal policies and refrain from doing anything that disturbs or distorts the competitiveness of markets.

3.18 Although supervisors focus mainly on individual institutions, they also need to take account of systemic weaknesses which affect these institutions. The interest and involvement of bank supervisors with respect to systemic risk derive from the broader concerns of the Central Banks, Governments and other public authorities which become pronounced in line with the market development and the maturity of the economy. Systemic risk derives from the fact that there are linkages between markets which can cause spillover effects. The risk of such chain reaction is greater

* when there is concentration of major market-making at a few very large participants;

* the lack of transparency impedes the markets' own assessment of the risks; and

* when there are many unregulated participants in the market.

As Basle Committee of Banking Supervision observes, "Two means of mitigating systemic risk are sound risk management systems and a strong capital cushion against the threat of potential losses. Supervisors should encourage banks to develop effective management of counterparty credit risks as well as liquidity plans to deal with periods of market or institutional stress".

Additional Concerns in advanced economies

3.19 As a result of the globalisation of banking systems and the resultant intensification of inter-sectoral and international financial relationships, disturbances in one or more financial markets are easily passed to the other markets or other countries. In this, context, preventing disturbances within the payments system becomes the joint concern of the supervisors of the payments system and the banking system where the supervision of both is not vested in the Central Bank.

3.20 The integrity of the managers and controllers of the financial system is another major concern.This used to be assessed earlier in a limited way by the reliability and expertise of the persons involved in banks' policy making and management- by the so-called "fit and proper" criterion. This now include imposition of

* stringent rules in respect of lending to bank management.

* a code of conduct on the private portfolio investment transactions of bank management and staff.

There are also obligations imposed on banks to disclose unusual transactions and for bank customers to identify themselves when making use of financial services within the framework of efforts seeking to counter money laundering.

3.21 Rapid growth and complexity of the financial markets and their inter-sectoral and international "interwovenness" and the involvement of banking systems in those markets

have significantly enlarged the range of risks which put the capital positions of banks at risk [e.g. the recent collapse of BARINGS PLC of U.K.]. As the complexity of the market has increased, so has the complexity of risk management . Technological advances breed increasing numbers of ways to take on risks as well as ways to measure and control risks. Consequently, supervision is seeking to delve deeper into such areas as risk analysis and assessment - in tandem with stringent enforcement by regulation of requirements of internal assessment systems of banks and other market parties.

STRATEGY OF SUPERVISION

3.22 Prudential supervision is largely institution-specific. It has two core objectives :

* to ensure that the supervised bank is conducting its affairs as a "prudent" entity i.e. not indulging in excessive risk taking and violating regulations in pursuit of profit or other owner-oriented goals jeopardising its solvency and liquidity;
* to force the bank to promptly address portfolio problems, should they develop.

Thus, supervision consists of two sequential phases viz. verification and enforcement.

Verification

3.23 Inadequate supervision fails to uncover mismanagement and speculative behaviour in banks. For want of timely and reliable financial information, the supervisors lack a clear picture of the health of the institutions under supervision and allow accumulation of problems and losses in bank portfolios. A key element in supervision, therefore, is credible information i.e. accurate, relevant and timely information - especially on asset quality of the bank, and if it is significantly into trading activity, its risk positions. Getting adequate and timely information on supervised institutions is the core of the supervisory task.Verification is a fact finding exercise or process: it seeks to find out whether, given the above objectives, the bank's operations engender any supervisory concerns. These concerns are related to the continued 'satisfaction ' of the supervisors with the conditions on which the bank was issued a licence; verification is, thus, directed towards assuring the supervisors, in essence, that the bank

* has adequate capital and liquidity;
* is being properly managed and has adequate systems and controls in place; and
* is in compliance with laws and regulations.

3.24 The verification process can be conducted by

(a) examining the books and accounts of the bank/s; "on-site" - i.e.. verification at site, or

(b) by off-site monitoring, based on source reporting.

The on-site verification may be performed by the Supervisory authority with its own staff (as in our system) or by agents appointed by it for the purpose - usually, Audit firms e.g. the practice of Reporting Accountants in the United Kingdom or "mandated audits" in Germany and other continental countries.

3.25 Surveillance is supervision operationalised otherwise than by on-site verification processes. It is employed in most regimes in combination with on-site supervisory examinations or auditor reporting systems. Surveillance is based on off-site monitoring

* of individual banks by a reporting system and / or

* of the markets in which banks operate, through a market intelligence or even a reporting system (for 'systemic risk').

Supervisory concern with systemic risk - so called macro-prudential supervision - has been increasing in recent years with the growing involvement of banks in market risk- related assets and products (services).

Enforcement

3.26 Enforcement is the supervisory follow-up for ensuring compliance with regulatory and supervisory requirements when deviations or violations are noticed in the verification process as also addressing the prudential concerns referred to above. The latter includes the set of actions taken to get the banks to restore capitalisation, liquidity and loss provisions to adequate levels as also to improve management. It covers imposition of such disciplines as issue of directions, nomination of observers/ additional directors on the bank boards, stoppage of dividends, impose discipline on banks through "Memorandum of Understanding" (MoUs), issue of "cease & desist'"orders or clamping moratoria.

CHAPTER - IV

NEW APPROACH TO SUPERVISION

4.1 The Board for Financial Supervision (BFS) was set up in November 1994, vested with the authority to exercise the statutory powers of RBI for supervision and inspection in respect of different categories of credit institutions - banks, financial institutions and non-banking finance companies. The Department of Supervision, established end-1993, functions as the operational arm of BFS and, under its direction undertakes integrated supervision of a major part of the credit system.

4.2 A new approach to supervision was approved by BFS in its first meeting in December 1994. The key elements of the new approach include -

(a) Setting up an off-site surveillance function in the Department;

The major components of this function include -

(i) establishing a system for in-house monitoring of banks (and in due course, other credit institutions) based on a prudential supervisory reporting framework.

(ii) building up a Memory on all supervised institutions, and

(iii) setting up a market intelligence unit (for the credit system) in the Department.

(b) Restructuring the system of bank inspections - the focus, process, reporting and follow-up.

(c) Strengthening the statutory audit of banks and enlarging the role of auditors in the supervisory process including using them as surrogates / agents.

(d) Strengthening the internal defences within the supervised institutions such as corporate governance, internal audit functions and the management information and risk control systems, as an extension of the task of supervision.

STRATEGY REVIEW

4.3 Our Group considers that the changes that took place in our banking system in the last four years i.e. since the last working group looked at the Inspection function in the Bank, are so fundamental and far-reaching that a fresh look at the total strategy of supervision is warranted. In a policy environment of progressive deregulation, new risks are emerging in bank portfolios which can significantly and rapidly impact their capital positions. Hence there is need to monitor the risk positions, especially the market risk in portfolios, and their impact on the financial condition of banks, on an on-going basis. The

Group is, therefore, of the view that this calls for a fundamental shift in the Bank's supervisory strategy - from the current system of periodic inspections to a strategy of "continuous supervision and periodic inspections". The rationale of continuous supervision is based on the need to pick up early warning signals of problems and signs of incipient distress in banks in order to be able to make timely supervisory interventions. Inspections conducted at periodic intervals, largely providing historic assessments, are seen to be inadequate for this task. The thrust of the new strategy should be to get feedback on banks that is more frequent, more current i.e. nearer to the present, integrated and from diversified sources. It requires supervision to be dynamic and more sensitive to the developments in the markets in which banks operate and are exposed to.

Our Group perceives in the new approach to supervision, elements of the strategy shift suggested - especially in the setting up of an off-site monitoring system. However, a strategy of continuous supervision requires, in addition to the off-site surveillance function, on-site supervision activity of a "bridge" nature with supplementary appraisals in between periodic inspections.

A multi-pronged supervision would also imply an inter-face between the different instruments of supervision; it implies a re-orientation of the existing instrument/s. The re-orientation of statutory examinations would obviously be warranted by reason of the updates of information on banks becoming available in the Department through the off-site monitoring system. The off-site analysis outputs provide an underpinning to the pre-inspection preparation and strategy planning by an updated awareness of the status of the concerns identified in the previous inspection.

Our Group re-emphasises the primacy of on-site supervision in the supervisory process. Some of the areas relating to the central concerns of supervisors such as quality of assets, quality of management and adequacy of internal controls cannot be effectively assessed and supervised by in-house monitoring. It also recognises that with a support system of off-site monitoring put in place, on-site supervision needs to be re-modelled to achieve complementarity.

We recommend a strategy of on-site supervision that has four key elements -

a) Switch over to a system of continuous / on-going supervision.

   It implies developing approaches for making on-site supervision an on-going activity with linked exercises in between statutory examinations. Such supplementary 'vehicles' are suggested in chapter VI.

b) Monitoring and examination processes should be focused.

   The focus should be on defined areas of supervisory concern and the supervisory processes should produce outputs that help to trigger early warning signals in those areas as well as in grading banks on well defined parameters of safety and soundness.

c) Supervision should be discriminating between sound and unsound banks.

This implies that supervisory attention should be modulated or calibrated to the financial soundness and operational condition of the bank and should not be purveyed in a uniform or routine manner across all banks. For such discriminating approach, a rating system of banks is necessary; it is recommended in Chapter VII.

d) Supervision should be oriented to enforcement and correction of deviations which are the raison d'etre of the supervisory process as also the hallmark of its effectiveness.

The criticality of enforcement in supervision i.e. following up with the banks to get identified concerns addressed promptly and effectively, can hardly be over-emphasised. The nature of follow-up on each on-site vehicle is indicated after the discussion of its rationale and content (Chapters V and VI).

4.8 Important supervisory concerns and issues that regulators in industrialised/ liberalised economies are currently grappling with and which are emerging in our system are outlined in Chapter VIII. The back-up systems and organisational review required for coping with the emerging challenges to supervision over a rapidly changing banking sector are briefly mentioned in Chapter IX.

CHAPTER V

REFOCUSING THE EXAMINATIONS

Redefining the Scope

5.1 Statutory examinations will continue to lie at the core of the supervisory process under the strategy recommended by our Group as well as in the new approach of BFS; the supplementary vehicles and off-site monitoring will be the support systems. A new area in the examinations would be reviewing and assessing the reliability of the information provided by banks in the supervisory reporting system for off-site surveillance. The statutory examinations as they were conducted until 1992, suffered from a cumulative overload of inputs due to the progressive add-ons of the preceding two decades. Any aberration noticed in the system or a new regulation or policy introduced was made an area of review in the inspections. These overlayers clogged the inspection process, which became unfocused and lost sight of the core objectives. This concern provided the rationale for the financial inspections suggested by Padmanabhan Working Group. Carrying forward the same rationale, we suggest that the approach to examinations should be to focus on the statutory mandate and concentrate on the core assessments, leaving collateral appraisals to supplementary exercises or vehicles. The core assessments under the statutory mandate viz. solvency, liquidity, sound operations and management, in fact, encompass the total and essential condition of the bank. By hiving off targetted or modular appraisals in exercises that are conducted independent of regular examinations, pressure on the full-scope examinations is reduced; examination and follow up processes can be conducted more efficiently.

Periodicity of examinations

5.2 The statutory examinations which are now conducted as Annual Financial Inspections can not evidently be only 'financial' nor need they be annual. The linked mandate under sections 11, 22 and 35 of the Banking Regulation Act requires RBI to 'satisfy' itself that the conditions prescribed in licensing a bank are continued to be complied with, i.e. by maintenance of minimum and adequate capital, adequate earnings and liquidity and prudent management and methods of operation.

5.3 The statute does not prescribe that this 'satisfaction' should be established at annual or any other prescribed frequency. It leaves the discretion to the Bank to implement the mandate in the manner it considers best. Clearly, the periodicity of assessment for such 'satisfaction' cannot be uniformly cyclical; it needs to be more frequent in case of weak banks and problem banks than in case of those known to be having strong financials / fundamentals and good compliance record. In the emerging scenario of broad spectrum banking, the supervisory concerns and needs have to be calibrated to the nature of business operations of the bank. For example, banks which have large trading operations with exposure to market risk in portfolios are more vulnerable than those with a predominantly

lending book. The liquidity risk is more pronounced for banks dependant on wholesale banking and relying on money market funding than those in retail banking. Our Group recognises that inspection programming is also, in actual practice, tailored to resources available with the supervisor for judicious deployment based on prioritisation of concerns. We are, therefore, of the view that it is illogical and wasteful to employ a uniformly routine approach to all banks - whether it is in terms of frequency or coverage of examinations. A discriminating approach would assist in rational deployment of the department's resources and in focusing attention on those banks that have problems.

5.4 Uniform frequency and annual cyclicality of examinations are not only of questionable logic and utility but they put the Department in a strait-jacket and constrain its options in resource deployment. Flexibility for DoS to calibrate supervisory attention and resources amongst the banks is necessary and desirable. In the context of an off-site monitoring system in place and the use of 'targetted appraisals' as supplementary vehicles of on-site supervision as later recommended, it will not be injudicious to relax the annual cycle and widen the interval between examinations in respect of banks without known or reported problems.

5.5 Our Group, therefore, suggests that statutory inspections may be conducted in two cyclical tracks, depending on the known or reported condition of the bank - in financial, operational and management and compliance terms. Banks may be placed in two categories for purpose of examination planning.

* those which need to be examined on an annual cycle; and

* those that may be examined on a wider time cycle - mostly biennial i.e. within two years from the date of last examination.

5.6 Such categorisation has to be made by the Central office of DoS at the time of drawing up the Annual Plan for examinations of banks based on various considerations, notably the supervisory rating of the bank. An approach to the setting up of a rating framework for banks is outlined in Chapter VII. Other than bank rating, considerations influencing the two-track categorisation of banks for examination frequency may include

* extant commitments of the Bank (RBI) such as in respect of public sector banks;

* short term supervisory perceptions and need for closer monitoring of certain categories of banks; and

* gradual strengthening and reliability of other instruments of supervision, especially stabilisation of the supervisory reporting system underpinning the new off-site monitoring function in DoS.

This categorisation evidently needs to be reviewed periodically; a review could normally be undertaken, as referred above, at the time of the next following Annual examination

programming but reported developments of major set backs in a bank could warrant an earlier review.

5.7 While the general approach to periodicity of bank examinations is suggested above, there could be special considerations warranting deviance. Banks with identified weaknesses of critical nature warrant examination at intervals of even less than a year. By the same token, banks with demonstrated strength and soundness could be examined at intervals longer than two years, the off-site monitoring system and targetted appraisals providing required level of comfort to the supervisors during the interregnum.In short, deployment of supervisory resources should be responsive to or in correspondence with the identified or perceived supervisory needs of the individual institution.

5.8 In regard to overseas branches of Indian banks, the Group is not in favour of recommending any cyclical periodicity or programmed frequency for on-site examinations. This is an area where the supervised bank's own operational and control systems, especially its internal inspection and audit functions, have to be largely relied upon. Targetted appraisals of overseas banking operations - at control site - on an annual cycle are considered appropriate and have been recommended as the "base level" of on-site supervision.

5.9 Generally speaking, the practice of bank regulators going into other supervisory regimes for on-site examinations of the overseas branches of their banks is restrained and **less frequent.** Some regulatory regimes such as Singapore do not even permit it. When considered necessary, there are protocols to be observed, such as pre-advising and making pre-examination calls on the host country supervisors and holding end-of-task discussions with them. For example, instances of home country supervisors of foreign banks operating in India, coming for on-site examinations of the latter's Indian branches, have not been many. However, following the recent revisions in the Basle Concordat and in the banking regulatory approaches in the European community, specially in pursuit of the need for consolidated supervision, parent country supervisors now assume greater responsibilities for their banks' overseas branches and subsidiaries and have stepped up the frequency of on-site visits and reviews in relation to the latter. In our particular context, having regard to the perceived weaknesses in Head Office/management controls over foreign branches and subsidiaries in some of our banks and the fact that losses in overseas banking have been large for some of them in recent years, a case exists for conducting on-site examinations on a selective basis. Branches in international finance centres such as London, Hongkong and New York which carry on their books a bulk of the risk assets of our internationally operating banks may be examined at the intervals of, say, three to four years. Such examinations may be conducted on a centre-wise approach i.e. of all major bank branches at the centre. However, having regard to the nature of business operations in international finance centres and the high risk profile, sporadic supervisory reviews can hardly be a substitute for the bank's own management control systems nor can they be a fail-safe instrument against its inadequate or poor management.

5.10 The objectives of on-site examinations of banks are to

* evaluate a bank's safety and soundness,
* appraise the quality of Board and management,
* ensure compliance with banking laws and regulations, and
* identify the areas where corrective action is required to strengthen the institution and improve the quality of its performance.

5.11 These objectives require the examination process to

* provide an appraisal of the soundness of the bank's assets,
* analyse key financial factors such as capital, earnings, and liquidity - generally, determine the bank's solvency,
* assess the quality of its management team and evaluate the institution's policies, systems of management, internal operations and controls, and
* review compliance with banking laws and regulations as well as supervisory guidance conveyed on specific policies.

Having regard to the general examination objectives as above and the mandate under the banking law, it would be necessary that the statutory examination should make core assessments and produce reviews in respect of three broad areas, viz.

A. Financial Condition and performance

B. Management, Systems and Controls (Operating condition)

C. Regulatory and guidance Compliance

5.12 Our Group recommends that these assessments in the examinations may be restructured to fall in line with the internationally adopted CAMEL rating model. Under this paradigm, critical evaluations are made and reported in modules that are rated. Such component ratings will help in a composite rating of the bank. This is recommended also to tie in with our other recommendation for introducing a system of rating banks (Chapter VII). Accordingly, we suggest that evaluations may be made and presented in the undernoted modules.

Sr. No. Area of evaluation (module)

A. Financial condition and performance

* Asset quality
* Solvency and capital adequacy
* Earnings Performance
* Liquidity

B. Management and Operating Condition

* Management (Board of Directors and Management team)
* Management Systems including (Risk Management Strategies)
* Internal Controls

C. Compliance

* Regulatory Compliance (including integrity of reporting)
* Guidance Compliance

D. Summary assessment

* Identification of concerns and areas for corrective action.

A. FINANCIAL ASSESSMENT

5.13 The key element of supervision is to make sure that banks have sufficient capital at all times. Assessment of solvency and capital adequacy is thus central to the process of statutory examinations. This assessment covers other financial appraisals; it is based on and is the end-product of assessment of asset quality, required provisions and earnings performance. Asset quality and earnings determine the Internal capital generation which strengthens or impairs a bank's capital and solvency.

Asset Quality

5.14 Appraisal of asset quality is the area that receives major part of attention and time of examiners. Examiners' approach to this appraisal currently needs to confirm to the prudential norms brought in force in 1992 on :

* Income recognition on interest earning assets (which are to be categorised as accrual and non-accrual loans, based on debt service record).

* Classification of assets based on risk perceptions and parameters. The high-risk assets are to be reckoned value impaired and graded for purpose of loss provisioning into sub-standard, doubtful and loss categories. Impaired assets are those for which provisions are made and are stated at netted value in financial reports.

5.15 The following ratios are generally used in asset quality appraisal :

a) Non accrual loans / Total loans

b) Impaired credits / Total credits

c) Loan loss provisions / Impaired credits (loan loss ratio)

d) Impaired assets / Total assets

e) Impaired assets / Shareholder equity

Notes :

i) **Non-accrual Loans** - are loans on which interest payment is overdue for two quarters and more and are put on cash basis (i.e. excluded from accrual basis)

Ratio (a) is to be computed on "gross loan" basis.

ii) **Impaired Credits** - are loans and advances (including bills) **plus** credit contingents such as financial guarantees and irrecoverable credit commitments which have been adversely classified on the basis of risk parameters (non-servicing of debt being one of them) and in respect of which, valuation reserve has been set up i.e. loss provisions are made.

Ratio (b) : Impaired credits (gross) to Total credits (gross)

CARE - The current practice in Indian banks is to use a composite classification of non-performing assets (NPA) covering both non-accrual and value impaired credits which is incorrect. The regulatory norms indicate that certain categories of loans put on cash basis can be classified standard assets.

iii) **Loan Loss ratio**

Ratio (c) : Provisions for possible credit losses / Total credits (gross)

iv) **Impaired assets** - include impaired credits as well as other value impaired assets such as those in inter-bank assets, securities and other assets.

Ratio (d) : Impaired assets (gross) / Total assets (gross)

v) **Shareholder equity** (or owned funds) capital and reserves (including surplus) and netting off deficit on P & L a/c. (i.e. accumulated losses),if any; and **excluding** all loss reserves or provisions.

Ratio (e) : Impaired assets (net of provisions) / Average equity

5.16 A related aspect of asset quality appraisal is concerned with concentrations of credit risk which could be in relation to borrowers/counterparties, industries, and regions and countries (country risk). A bank's vulnerability is especially enhanced by too much of credit outstanding to a single borrower or related group of borrowers. The regulatory norm(in force since 1989) on single borrower and borrower group lending limits is 25% and 50% respectively of a bank's Capital and Reserves. In examinations, there can be additional "large exposure" tests, to assess the vulnerability of the bank's equity - which may be detailed in the Examinations Manual.

Solvency and Capital adequacy

5.17 A bank is solvent if the value of its assets is greater than the amounts of its liabilities to depositors and other creditors; "net worth" is the amount by which assets exceed liabilities. The larger a bank's net worth, the larger its cushion against insolvency - that is, the larger will be its ability to sustain the fall in asset values and yet be solvent. Evidently, protection of interests of depositors can be ensured by bank supervisors only by ensuring that banks have adequate capital. This they do by prescribing levels of minimum capitalisation - also called solvency margin. The adequacy of capital or required "solvency margin" used to be related for long to the size of the total assets or total liabilities (gearing ratio). Under the Basle framework, it is considered more relevant to relate the solvency margin to the possibility of losses incidental to a bank's operations i.e. the size of its risk assets and positions - to be more precise, the 'riskiness' of those assets and positions. Hence, the shift of focus in measurement of capital adequacy from the former "gearing" to weighted risk assets approach.

5.18 Current regulations stipulate two levels of minimum capitalisation for banks operating in the country :

a) Minimum capital requirement under the section 11 of B.R. Act.

b) Adequate capital requirement under the Capital adequacy standard laid down in April 1992.

The former relates to the start-up capital requirement for authorising a new bank to commence business. This amount of initial capital needs to be maintained by the bank at all times as minimum solvency margin entitling it to hold the banking licence.

5.19 Since a minimum amount of capital usually becomes inadequate once a bank begins to grow rapidly, an on-going capital ratio is prescribed as minimum operating capital or capital adquacy requirement. Since 1992, a risk-based capital ratio on Basle model has been set as the regulatory standard, with a phase-in period of three years for

internationally operating Indian banks and four years for other Indian banks i.e. through March 1995 and 1996.

The following approaches are re-focussed for assessment of solvency and capital adequacy in the supervisory/statutory examinations.

a) Solvency appraisal

5.20 Provisions of Section 22 (3) (a) i.e. the licensing conditionality of 'ability to pay its depositors in full' read with Section 11 ("the aggregate value of the bank's paid up capital and reserves shall not be less than ....) stipulate the base level of solvency margin required. Section 11(5) (b) lays down that compliance with the minimum capitalisation requirement is to be assessed in terms of "real or exchangeable value" of capital and reserves and not at book values ("not the nominal value which may be shown in the books of the bank"). This entails the major exercise of determining the estimated real value (ERV) of the shareholder equity - more precisely, of the net assets position of the bank; it is the most critical assessment in the supervisory examinations. The 'exchangeable value' is generally explained as the economic or market value of the firm (the bank) and involves more rigorous appraisals than the standards or policies of financial accounting and reporting. The approaches to assessment of ERV of a bank's equity or net assets position - representing the surplus of net realisable value (NRV) of assets over outside liabilities, are detailed in the Bank Examinations Manual/s.

5.21 An important assessment in the examinations is to monitor the change in the shareholder equity (net worth) of the bank since date of last review. This assessment may be structured as under :

			(Rs.lakhs/crore) Per bank books	Per examiner assessment
Shareholder equity at date of last examination				
(Add)	**Retained Earnings**			
(Deduct)	**Loss**			
Add	(i)	New equity		
	(ii)	Revaluation reserves * (created)		
Equity at date of current examination				

*netted for depreciation on revaluation component

(b) **Capital adequacy appraisal**

5.22 This appraisal is made in terms of capital adequacy standard directive issued in April 1992 (as amended) and is different from the assessment for minimum capitalisation requirement in important respects, notably

* 'capital' is defined differently - it is more broadbased, tiered (with two tiers) and involves netting of some assets.
* 'capital' is related to weighted risk assets and not to outside liabilities.
* the relationship of the two quantities is assessed as multiplier (ratio) and not a level (surplus or deficit in amount)

5.23 As in the case of minimum (initial) capital appraisal, there is need to review the bank reported capital to risk asset ratios in the examinations, involving adjustments to bank valuations of assets. The major adjustment is effected through the item of impairment of capital by losses not provided for i.e. by factoring the additional provisions for risks assessed by the examiners into the capital as shown in bank books. The review will be structured somewhat as under :

	Tier one Capital	As per bank	As per examiner
i)	**Unimpaired capital**	capital (less) accumulated losses	- Capital (less) - accumulated losses - Deficit in provisions for risk assets / losses - short provisioning for liabilities
ii)	**Reserves (excl. revaluation reserves)**		- Reserves (less) inflation in retained earnings as assessed e.g. unrealised interest on NPAs accrued as income.

In other words, examiner evaluations on asset quality and other adjustments made to shareholder equity in determining its estimated realisable value - especially, aditional provisions required - are deducted to arrive at **Adjusted** Tier one Capital.

5.24 The international supervisory practice recognises core (Tier one) capital to Risk assets as indicator of the real capital strength of a bank although total capital ratio of 8% is set as the bench mark. With the recent growth of Tier two capital components in the capitalisation of our banks, it is important that the bench mark ratio of 4% for Tier one capital is emphasised along with the CRAR ratio of 8% in capital adequacy assessments.

5.25 Foreign banks which operate with branches in the country, are also now subject to capital adequacy regulation as in case of domestic banks. The approved components of the 'assigned or local capital' for testing adeqacy vis-a-vis risk weighted assets are laid down in the 1992 regulation. What is of greater relevance in case of these banks, however, is the "Strength of Support" of the Parent. Gaps in local capitalisation or local liquidity will not be a matter of much concern to the Bank (host country supervisor) if the overseas parent bank is

* financially strong and can support the (Indian) branch capitalisation and liquidity, and

* located in a credible supervisory jurisdiction such as to assure adequate home country supervision over the bank's global solvency.

Earnings appraisal

5.26 Banks need to be profitable in order to add to their capital and support business or asset growth. Prior to the enforcement of Capital adequacy standard (in India, since 1992), the main objective of banks and financial institutions was growth and, consequently, the size of the balance sheet (in India, mainly through deposit growth). This objective has been - or needs to be - replaced by profitability, with the imposition of mandatory ratio requirements on the capital position of banks. Under the discipline of capital adequacy standard, growth has to be matched, and is constrained by increase of capital.

5.27 Most new capital comes from internal capital generation i.e. retained earnings added to Reserves. Capital can come also from outside sources i.e. fresh capital injections (usually) raised by issues on the capital market. Capital of all kinds must be serviced, in the form of either dividends or interest and the cost of capital affects the pricing of bank services, thus helping to determine competitiveness with (a) other banks and (b) the capital markets. Profitability is thus a sine qua non for adding to reserves and keeping the cost of capital as low as possible.

5.28 Two key ratios are employed as measures of profitability, viz.

(a) Return on Assets (ROA)

(b) Return on Equity (ROE)

Two different approaches are in vogue in defining Return - i.e. either as pre-tax or post-tax earnings/income. In a system like ours where corporate income taxes are high, the tax element makes a significant difference to the way the Return (numerator) is defined. It is desirable to indicate the measures both on pre-tax and after tax basis.

5.29 Earnings build capital only if they are retained. A bank does little to increase its capital if it pays out almost all its profits as dividends. The bottom-line in Earnings appraisal is, therefore, the Internal Capital generation; it indicates how much is added to the Tier one or Core capital by business operations to support further business growth.

Thus, one other measure recommended in earnings appraisal is "Accretion to Equity". It is 'Retained earnings' divided by last year's shareholders' equity.

(Retained earnings are net income less distributions i.e. dividend, etc.)

5.30 An illustrative approach to earnings analysis and appraisal in examinations is furnished in Annexure A.

Liquidity appraisal

5.31 A core assessment relating to the financial condition of the bank is its liquidity. Liquidity is assessed firstly in terms of compliance with statutory requirements - the SLR compliance. Secondly, it is assessed on the basis of the structure of the bank's assets and liabilities, concentration of deposits, stability of the funds, maturities of assets and liabilities and the extent of mismatch between them. Special attention has to be bestowed if the bank relies heavily on potentially volatile money market funds and other interest rate-sensitive short term funds and these are used to support relatively long term assets. Consideration is also given to the availability of standby lines of credit. In other words, liquidity is generally assessed on three parameters :

* level of liquid assets (stock approach)
* Maturity mismatches or gaps (Flowapproach)
* Access to funding and standby facilities

5.32 Only the 'stock approach' is used in current inspection practice of DoS. The tests recommended for liquidity appraisal on this approach are :

i) Net loans to deposits (%)
Net loans are total advances less provisions for loan losses and interest suspense.

ii) Time deposits to Total deposits (%)
(to measure the stability of the deposit base).

iii) Liquid assets to short term liabilities (%)

[**Notes** : Liquid assets are defined for this purpose as cash and balances with the Central Bank, Due from banks (in current accounts), Money at call & short notice, and tradeable Govt. securities.

Short term liabilities may be defined to include balances in current accounts, 25% of savings deposits and due to banks (in current a/cs) and by borrowings in inter-bank market].

5.33 Liquidity appraisal by a "flow approach" compares the expected funds inflows and outflows by analysis of the assets and liabilities in terms of specified time-bands, from

time to time, and identifies the maturity gaps. An assessment is then made to assure that these gaps in liquidity are sustainable in terms of

(a) the 'tolerance limits' set up by the Management for each time band, for liquidity management.

(b) the funding sources available or accessible to cover them.

In other words, this review is to assure that the bank can manage and control its funding risk. The flow approach may be adopted with the development of relevant, adequate data base or MIS in banks, generating data on maturing assets and liabilities in specified time bands.

B. APPRAISAL OF MANAGEMENT AND OPERATING CONDITION

5.34 The quality of management is an important difference between sound and unsound banks. The single most important reason for bank failures or crises is often weak or perverse (i.e. bad) management. The evaluation of bank management is an important task of supervision and is a key area in examinations. Examiners have to assess

* the adequacy and quality of management which includes /Board level management,

* the decision making process, and

* management control procedures in the bank.

Supervision to be effective should be able to enforce recommendations to improve management - if necessary, by removing inadequate managers as well as Board members.

Quality of management

5.35 Banking is a business of controlled risk taking. The mangement of diverse risks in banking requires a clear perception of a bank's own strengths & weaknesses, ability to assess risk and assume risk commensurate with its own capacity and seek reward appropriate to risk.

5.36 Management assessment covers appraisals of

* **the Management functionaries** i.e. those who are performing the Management function at various levels viz. Board of Directors as well as whole-time management comprising CEO, Executive management (i.e. Heads of functions), Supervisory Management (at Head Office and Zonal Offices) and Operating (i.e. branch level) Management, and

* **the Management Function** such as Portfolio Management Treasury and ALM Systems, MIS, Risk management and operational controls and such others as Business planning, HRD, Vigilance, Customer Service, etc.

5.37 Those who manage a bank (Board of Directors and executive Management) may be inadequate, leading to weak or underperforming management of the bank; they may be even perverse resorting to dubious practices for cover up of their and bank's poor/real performance. A weak management is one which is unable to properly assess and control the risks, makes the wrong decisions and incurs losses. It also would have failed to put in place adequate internal supervision and control procedures. It is important for the examiners to develop insights to distinguish between good and bad management. A diagnostic profile of bad management comprising inadequate as well as perverse management is furnished in Annexure B.

Board-level management

5.38 Assessment of the **Board of Directors** and its Committees is made with reference to overall supervision and guidance which includes policy formulation and oversight. The Board is ultimately responsible for achieving the bank's mission\objectives and ensuring prudent and efficient management down the line. Consequently, the Board is also accountable for failure. In this respect, the Board of Directors of a bank is no different from the Board of any other business enterprise. The assessment should address the following questions :

* Is the Board passive or taking active interest in the bank's affairs ?

* Is it providing direction to management or is led by the latter ?

* Is its direction right and adequate (including oversight of execution) ?

* Is the Board unduly influenced by the owner - controllers?

* Are the directors knowledgeable and do they understand that they have overall responsibility for proper functioning of the bank, besides a commitment to their special interests, if any, e.g. small industries or agriculture ?

5.39 Other elements used as a basis to rate a bank's management include

* the quality of management team and potential succession, and

* the risk of "self dealing".

5.40 Management Team

(a) Chief Executive Officer

Chief Executive Officer is the critical level in Management and should be assessed in terms of "fit and proper" criterion. This can be considered as including professional competence, integrity and leadership. Important aspects in assessing the performance of the Chief executive include his strategic planning ability, quality of policies formulated and the ability to ensure that they are implemented, and the rapport and extent of inter-face with the board.

(b) Executive and operating management

The Senior Management (CEO's executive team) should be assessed to ascertain whether it is professionally competent, prudential (not speculative), conforming (to Board direction) and compliant (to regulation).

Assessment of the operating or branch management should address the questions - Is it pro-active, customer friendly ?

5.41 In private banks, the influence of the owners (controlling/significant shareholders) on the decisions of the Board and CEO, especially in financing of connected firms is a critical area of assessment. The concentration of ownership in the bank makes it possible for the dominant shareholder or group to dictate policy and promote special interests while protecting executive management from supervision and control. In the case of foreign banks, the strategic corporate objectives of the bank (Overseas Parent Office) in international banking and, in particular, the Indian operations are to be understood and assessed as to whether their business strategy is in tune with or runs counter to local laws or interests.

Management Performance

5.42 Management performance is appraised with reference to not only financial results but also the operating condition of the bank - as largely evidenced by the management systems and internal controls in place and their effectiveness. The management systems cover portfolio management as well as operational systems such as Treasury & investment management, credit management, asset/liability management, business planning and, most importantly, Management information systems (MIS), which runs through all systems. Inadequate MIS - a notable weakness in public sector banks - affects internal decision making and controls. Sound managerial decisions require accurate and timely information about the bank's state of affairs. When such information is not available or available only after long delays, problems develop which would increase costs, cause the bank to lose competitiveness and increase losses. With modern accounting and data processing techniques, updated information should be available on all essential operational areas in a well-managed bank.

Internal Controls

5.43 In multi-branch organisations, as most of our banks are, branch controls should be a major area of attention. The capacity of Indian banks to control branches, it has been observed, has not kept pace with the rapid branching undertaken under bank expansion programmes which, for most banks, were, until recently, mandated programmes. Inefficient or insufficient services and often fraud in poorly controlled branches cause losses to banks, besides causing public to lose confidence in the banking system. Another fall-out has been the distortions and cumulative build-up of backlog in the internal clearing system - better known as Inter-branch adjustment accounts - which has been a major concern in the public sector banks. Banks have been taking up mechanisation and computerisation of their operations increasingly in the drive for improving services and efficiency. The risks inherent in EDP operating systems are many; these have to be identified and efforts made by bank managements to control such risks. Examinations should include a review of the effectiveness of the EDP audit function in the banks. It is recognised that an in-depth review of the systems and controls may not be feasible in examinations which are conducted under tight time schedules and have, therefore, to draw on targetted appraisals. Targetted appraisals are especially appropriate vehicles for reviews of systems and controls.

5.44 Management is appraised also by the efficiency or productivity levels achieved by the bank. Efficiency or productive tests commonly used in the banking sector are :

(i) Cost-income ratio (%). Operating expenses as a % of Net Total income (i.e.Total income minus interest expense).

(ii) Profit per employee ratio (%). Profit to be defined as Pre-tax profit (i.e. PBT)

(iii) Business per employee ratio (%) Business defined as Total of deposits and advances of the bank.

C. COMPLIANCE REVIEW

5.45 Assessment of regulatory compliance should uncover or focus on deviations from/ violations of

* Legal and regulatory directives (general to all banks).

* Regulatory or supervisory directions (specific to a bank).

* Policy guidance (e.g. Targets for Priority Sector lending and export credit, food credit).

The regulations may relate to monetary and credit control such as required cash and liquidity reserves, selective credit control directives, interest rates on deposits and lending or to prudential supervision; the latter pertain to rules, standards and norms such as on Capital adequacy, single and group borrowing limits, norms on income recognition, asset classification and provisioning.

5.46 An important aspect of compliance review relates to verification of the integrity of the supervisory and regulatory reporting by the banks; that is, the correctness and reliability of the data provided in Regulatory and supervisory returns. The review should distinguish between wrong, distorted and manipulated reporting and poor management information and data collection systems that make the data provided unreliable or deficient in credibility. While the former would be a cause for serious concern as reflective of a devious management, the latter deficiency is no less a matter of concern in that it closes a channel of regulatory oversight, warranting larger measure of on-site supervision.

REPORT STRUCTURE AND REVIEW FORMAT

5.47 There is a statutory obligation on RBI to furnish a copy of the report on the inspection to the examined bank, under Section 35. A complaint often voiced by the bank managements in regard to RBI Inspection reports is that the reports are accessible to the staff in most banks - (in large Indian banks, the report is parcelled out in segments to various departments for processing, commenting and for follow up action) and some of the critical comments, especially reflecting on the Management and the Board, tend to cause them a lot of embarrassment. On occasions, these also become 'tools' in the hands of various interests to embarass the bank managements. The Group considers that the grievance is not without substance and there is a need to be sensitive to it. Besides, there would also be some adverse perceptions and critical evaluations on management which the examiners may hesitate to put in an "open" report i.e. the report that goes to the bank. It is, therefore, suggested that the Examination report might be prepared by the examiners in two parts - "open" and "confidential".

5.48 The "open" part of the report would contain factual findings and objective evaluations, assessments and observations that are meant to be conveyed to the bank in fulfilment of the communication requirement. The "open" Report could have the following structure.

I. **A summary review** or an overview of the bank's affairs in the period covered by the examination (i.e. since date of last inspection) such as changes in ownership and control, Board and management (CEO) changes, equity injection, Dividend payout, new investments in subsidiaries or disinvestments and organisational re-vamp effected during the period.

II. **Financial Assessments**

A. Asset quality Evaluation (including evaluation of nonfunded exposures).

B. Determination of liabilities and networth (Solvency).

C. Capital adequacy assessment

D. Earnings appraisal

E. Liquidity appraisal

III. **Appraisal of Management and operating condition** (covering areas and tests spelt out for management function (systems and controls) and functionaries. (Refer paras 5.34 to 5.44 above)

IV. **Compliance Review** (Refer Paras 5.45 and 5.46 above)

V. **Supervisory concerns and suggestions.**

Highlighting the financial and systems weaknesses and focusing on the issues to be addressed by the Management of the bank.

5.49 Providing a full-scope format of an Examination Report falls within the ambit of an Examinations Manual of the Department. However, in order to respond to the terms of reference, an illustrative profile of a structure is furnished in Annexure C which gives an indicative outline of the **Review of the examination report** which is prepared in the Central Office of DoS, for conducting discussions with the bank's management on the examination findings.

5.50 The 'closed' or 'confidential' part of the examination report may include the following :

* Examination 'rating' of the bank on the parameters of CAMELS (Indian Banks) or CACS (Foreign Banks). (Refer to Chapter VII).

* Critical perceptions and comments on the functioning of the Board and its direction; on the competence and integrity of the CEO and any of his executive team (Heads of Functions)

* Major supervisory concerns that should be urgently addressed by the bank.

* Identification of areas for Targetted appraisals that may be undertaken in the following year/s.

* Identified areas for corrective action and Suggested Action Plan.

COVERAGE PARAMETERS

5.51 The Group considers it inadvisable to lay down any minimum norms for coverage of branch networks, or the screening thresholds (cut-off points for detailed scrutiny) in portfolios or operational segments. There cannot be prescriptions of uniform applicability to all banks. These are variable between banks depending on their size and networks, business levels and configuration and, importantly, the quality of risk management systems

and internal control environment. Such norms/thresholds should be decided as part of the strategic planning for the examination of each bank. Some indicative guidelines may, however, be suggested.

5.52 In the branch coverage, priority should be accorded to specialised branches such as for commercial credit i.e. Industrial Finance or Small Scale Industry branches, Overseas business/International Finance as also very large branches, from the view point of credit business. All offices where treasury and investment management is undertaken and forex and securities dealing is conducted should be examined. While the above coverage has business appraisal objectives, selected branch examinations and visits to controlling offices may be undertaken for the purpose of testing how the systems are operating at the ground level and how operating management is aiding or defeating the management decisions and disciplines. Examinations of branches and controlling offices need not be programmed for a total coverage over a target period as in case of internal inspections in banks. (Please see remarks at Para 9.7 in Chapter IX)

5.53 The present norm of a 30% floor for coverage of loans portfolio for public sector banks and 60% for other banks is reasonable. All large NPAs need to be reviewed for proper classification and adequacy of provisions. Examination of Investments portfolio would be near total. Likewise, treasury and trading operations should be largely covered.

EXAMINATION PLANNING AND STRATEGY

5.54 The examination programme schedules have to be settled by the Regional Offices of DoS in consultation with Central Office as part of the Annual Plan of Examinations and Appraisals, which is later broken down by each Regional Office into its Quarterly examination programme. It is recommended that examination strategy for each bank should be settled by a "Senior Officers Group" to be set up at the Regional Offices, chaired by the Officer-in-Charge, with the Principal Inspecting Officer (PIO) or examination-in-charge participating. The strategy should decide on

(a) coverage of branches and controlling offices, besides the Corporate or Head Office, where on-site examinations should be conducted,

(b) the coverage of the proportion of portfolios (Loans, investments, other assets) in value and operations that should be subjected to detailed scrutiny with reference to primary sources of information,

(c) the cut-off points for assets to be examined in detail (Screening thresholds).

(d) the size and composition of the examination team, in terms of required skills and expertise, given the configuration of the portfolios and operations of the bank, and

(e) the time schedule for the conduct of examination and preparation of the report.

The Group considers that strategy planning of an examination is of critical importance for

ensuring cost and time effectiveness and output quality and has to be given due attention. Considering its importance, the Group has raised the responsibility for the strategy planning to Committee level. Examinations Planning and Control cell at the Central office of DoS should monitor the implementation of the programme.

TIME FRAME

5.55 Turning over detailed appraisals of major portfolios and operations from the statutory examinations to targetted appraisals and the availability of such appraisals to the examiners, a well-designed examination strategy and the outputs of off-site analysis in the bank - all go to help the examiner zero in on core assessments. This focusing as well as the collateral supports should considerably help shorten the time span for examination exercises. The current norms prescribe a cap of four to five months for any bank inspection, including preparation of the report. While setting time-tables for examination exercises is bound to be somewhat arbitrary, they are also necessary for planning and implementing an examination programme which is prepared on a cyclical basis. Indicative norms could be as under :

Banks	Time for Exam	Time for preparation of report
State Bank of India	3 months	1 month
Other Large banks	2 months	1 month
Medium sized banks	6 weeks	2 weeks
Small banks	3 to 4 weeks	1 week

LEAD EXAMINER

5.56 The examination team should be headed by an examiner of sufficient experience and insights responding to the expertise demands of the bank to be examined. The team leader is the lynch-pin of the examination process, as he plans, co-ordinates and optimises the team effort. There is a case for breaking the "grade barrier" in nominating the examiner-in-charge or Principal Inspecting Officer. Until a cadre of bank examination specialists is built in DoS when there will be correspondence between grade (position) and experience, the inexperienced or less skilled senior (grade) officer should be in the team on "attachment basis" and not head the team.

5.57 An issue that arises in setting up a bank examination team is whether the Principal Inspecting Officer (PIO) or lead examiner can be fielded for the same bank in the next round/successive rounds. Current DoS practice does not normally allow repeat inspections by the same PIO - perhaps on apprehension of developing "vested interests". Our Group is of the view that there is a strong case for deploying an examination team, or at least the Principal examiner and some members of his team, in successive rounds of examinations of a bank. This is an approved practice in on-site supervision in many countries, notably U.S.A., and is the adopted pattern in external audits. The team gets to

know the bank, understands its organisational climate, dynamics and culture, and its accounting and information systems. Each successive round of inspection builds up a cumulative knowledge base and expertise on the bank, which affords better insights to the examiner beside saving a lot of time usually spent in understanding the bank's systems. Continuing the same examiners, at least the Principal one, for the same bank upto three rounds of inspections is strongly recommended.

FOLLOW-UP AND REMEDIAL ACTIONS (Supervisory enforcement)

5.58 The need for effectively following up the concerns raised by the findings of the inspections can hardly be overemphasised. To put the follow-up function in perspective, a sequence profile of the examination and follow-up processes as they are - or should be - conducted is furnished in Annexure D. A clear trend of responsibility - sharing is evident with Regional Offices conducting inspections and issuing the reports and Central Office taking over thereafter and being involved in the follow-up phase.

5.59 The first step in follow-up is issue of Supervisory letter by Central Office, highlighting the regulatory concerns in respect of the bank and calling for its responses on the findings of inspections. Discussions with the Management should normally be scheduled after receiving and processing the responses of the bank. In order to put some 'muscle' into the follow-up process, a definitive, agreed and time-bound monitorable action plan has to be set up by DoS; this has to emerge after the discussions with the Management. It should clearly spell out the actions that DoS requires the bank management to take and the time frame or schedule for completion of each of the actions as also the reporting or other requirements for monitoring. The action plan represents the commitments of the bank management analogous to MOUs with RBI currently now in vogue in respect of the nationalised banks.

5.60 The Action plan of the bank should be communicated to the concerned Regional Office for monitoring on an on-going basis until a new Action Plan is put in place, following the next round of examination of the bank. It is evident that the Regional Offices would have an enhanced role in the on-site examinations and supervision process. They will decide on the strategy of examination, conduct the examination, issue the report, suggest an action plan for the bank for the Central office to finalise it after discussions with bank management and oversee the implementation of the Monitorable Action plan set up for the bank by the Central office.

CHAPTER VI

SUPPLEMENTARY VEHICLES

6.1 In order to operationalise a strategy of continuous supervision, as already mentioned, periodical examinations need to be supplemented by additional instruments of supervision including other 'on-site' review procedures. The latter help not only in updating information on the bank but also provide depth to the examination process. Our Group, therefore, suggests that collateral to and in between statutory, full-scope examinations, DoS may undertake the following types of supplementary on-site assessments and review exercises.

A. Targetted Appraisals

AA. Targetted Appraisals at Control site

B. Commissioned Audits

C. Monitoring Visits

These will be in addition to ad hoc scrutinies and investigations which are undertaken as reactive exercises even now in response to complaints, regulatory violations referred for verification, reported industry-wide concerns.

A. TARGETTED APPRAISALS

6.2 Statutory examinations are directed towards core assessments covering a wide gamut of bank operations leading to an overall view on the condition and conduct of affairs of bank/s. In these examinations which need to be put on a tight time-schedule in order that follow-up action is initiated promptly and in proper time, in-depth assessments of sensitive operational areas or major portfolios cannot be undertaken. It would enhance the quality of oversight if detailed appraisals of major portfolios, specific business segments and systems are undertaken between the examinations on a "modular approach" and these focused assessments are fed into the next following examination of the bank. Such focused appraisals may target

* Portfolios such as credit, investments, international business, leasing, factoring, consumer banking, merchant banking.

* Operating systems such as Treasury and investment management,asset-liability management, forex and securities trading (Trading book), regulatory and supervisory reporting.

* Control systems such as branch control including internal clearing i.e. inter-branch

adjustment accounts (in multi branch banks), accounting and EDP controls, risk control systems, computer audit.

* Management (Board level, executive and operating).

* Compliance (regulatory and guidance).

6.3 The targetted appraisals may be planned on a cyclical basis i.e. undertaken in successive years such that over a time span of three to four years, all important portfolios and major areas of systems and controls can be covered. Which portfolio/s or operational and control system/s should be taken up in a particular year for in-depth appraisal in each bank has to be decided in advance as part of the Annual Examination Planning or Programme of the Department. This would be based on the identification of vulnerable or sensitive areas and, bank-specific supervisory needs in the recent examination report or in the off-site analysis and review.

AA. TARGETTED APPRAISALS AT CONTROL SITE

6.4 In respect of certain areas of operations of a bank or a banking group, it may not be expedient or cost effective for the supervisors to undertake these focused assessments at site of operations. We suggest that such targetted appraisal may be conducted at the "site of control", that is, the controlling department in the supervised bank. Typical areas appropriate for reviews at control site include overseas banking operations and operations of subsidiaries and affiliates. These appraisals obviously can only capture financials and to some extent, assess Head Office controls; they cannot admittedly comprehend the quality of field level operations. It has, therefore, to be ensured that such aspects as cannot be assessed in the supervisory review process are adequately taken care of by the Internal audit and inspection systems of the banks. These control-site appraisals will be analogous to the Annual Financial Reviews (AFRs) which were conducted in respect of public sector banks until 1992.

6.5 The suggested approach is briefly explained below.

(a) **Overseas Banking**

In respect of banks having overseas branches and subsidiaries, these operations are generally far flung, being located in several countries and have highly varying business levels. It may not be feasible or cost effective to conduct on-site examinations at all or major branches - even at elongated intervals. Some countries like Singapore do not even permit on-site examinations of foreign bank branches in that country by home country supervisors.

(b) **Subsidiaries in the Bank Group**

Banks have been advised to deal with subsidiaries at arm's length which implies countermanding the essentially inter-unit flows of funds (setting up firewalls). In

actual practice, especially where there are problem units in the Group, there are slippages in the observance of this direction and the risk of cross-infection becomes real. With the principle of consolidated supervision gaining urgency in the aftermath of Barings collapse, the supervisors have to be sensitive to the financial performance and condition of the constituent units of the group, especially subsidiaries. If a bank has several subsidiaries, it may not be viable or operationally feasible (owing to absence of the requisite skills across all categories of business) - or even possible (for want of regulatory authority) - to conduct full scope examinations of all or even some of the subsidiary institutions.

6.6 In such cases, a pragmatic approach would be to look at the cross-border operational segments of the bank and its subsidiaries from the "site of control" at the parent bank on the basis of information available with it. Our Group suggests that focused reviews of these modules viz. operations of "overseas branches" and "bank subsidiaries" should be conducted at the 'International Divisions' and at the 'Subsidiary Control Divisions' respectively - of the concerned banks.

6.7 This type of control site review exercises were being conducted as portfolio appraisals of International Divisions in respect of the nine Indian banks which have overseas networks, since 1986. But with the inspections of these banks being undertaken on an annual cycle, the appraisals of overseas banking portfolio have practically lost their discrete identity and are being conducted as linked and subordinate exercise to inspections. The attenuation of these appraisals has to be reversed; it is also necessary that these reviews are conducted with the intensity of clustered branch examinations. In other words, focused appraisals of subsidiaries and of overseas banking operations need to be put formally on an annual cycle and their assessments fed into the next regular examinations.

B. COMMISSIONED AUDITS

6.8 A key element of the new supervisory strategy is to make increasing use of external audit function and auditors as supervisory resource and support system. In some countries (e.g. Germany), auditors are mandated by the authorities to carry out surrogate examinations. In some others (e.g. Belgium), they are employed as supplementary resource in the conduct of examinations by the supervisors. A system of surrogate supervision is in vogue in U.K. in the system of Reporting Accountants, who report to the supervision authority on areas of interest agreed upon. The Working Group is in favour of identifying specific areas of bank's affairs or operations which can be examined by auditors as agents of the Department of Supervision.

6.9 Most of the areas that can be subject of targetted appraisals such as Portfolio reviews, Reviews of operational segments and / or systems can be entrusted to external agents e.g. audit firms or management consulting firms. These may be called Commissioned Audits. Areas that may be inexpedient to auditors as commissioned audits may be appraisals of Management functionaries (Board & CEO). Areas that are particularly appropriate for commissioned audits are those areas which require specialist

expertise such as may not be immediately available with officers of the Department e.g. Computer Audits, Risk Management System Audits, Audits of the derivatives book.

Follow-up

6.10 The reports on targetted appraisals (including control site appraisals) and commissioned audits may be sent to the bank; or alternatively, the major findings need only be communicated to it for necessary corrective action, there being no statutory obligation to furnish the full report to the bank as in respect of examinations under section 35. In the supervisory communication, the corrective action taken by the bank may be required to be reported; what is important is that the corrective action taken should be verified in the next /following examination. In the meantime, discussions can be held with the bank management - i.e. with the senior officials in charge of the function such as the head of the International Division or the Subsidiaries Division, as the case may be. The pattern suggested is the supervisory practice of "Review and interview" in vogue in some countries e.g. U.K., Singapore. The prudential discussions may be held at the level in the Supervision Department considered appropriate for the bank and the size of operations under review. This would include delegation of prudential discussion to the Regional Offices.

C. MONITORING VISITS

6.11 Short visits to the banks may be undertaken by supervisors for making quick reviews of selected areas of interest or verification of identified concerns. The Group understands that DoS has been deputing officers on such monitoring visits on a quarterly basis to the newly licensed private banks during their first year of operation i.e. before they are put on the annual cycle of regular examinations; these visits have the object of assessing the build-up of risk portfolios and operational and control systems appropriate in a start-up situation. Clearly, the scope of such visits and review exercises can be extended to explore many other areas of supervisory concerns in other banks as well, as an underpinning to a system of continuous supervision. Such snap visits may be warranted, for instance, for clarifying the concerns aroused by off-site analysis of the prudential returns or reports from the market intelligence function (i.e. off-site surveillance outputs). These visits would be mostly reactive and as such must largely fall outside the annual programme.

6.12 Based on the above proposals, the approach to operational supervision by DoS in terms of the new strategy becomes clearer. A schematic presentation of the profile of operational supervision as emerging from our group's recommendations is furnished in Annexure 'D'.

CHAPTER VII

RATING OF BANKS

Objective

7.1 Even as banks have in-house systems of rating borrowers and/or grading loan assets for purpose of credit management, regulators in several countries employ a system of rating supervised institutions as a tool of supervision. The regulatory ratings are intended to help identify institutions whose condition warrants special supervisory attention, to focus attention on real and potential problems and to permit effective allocation of supervisory resources among the banks. Padmanabhan Working Group (1991) had recommended that "it would be worthwhile to introduce a system of rating of banks, as is prevalent in the United States, with appropriate weightage for different components". Carrying forward the recommendation, our group suggests a profile of a rating framework appropriate to our system in the following paragraphs, for use by the Department of Supervision in replacement of the rating system currently employed by it. The rating system will help the Department to

* generate memory on banks,
* enable year-to-year comparisons of examiner evaluations,
* put select bank(s) on watch or under closer surveillance,
* evaluate components of risk facilitating better macro level controls and counselling to upgrade management in banks.

7.2 Presently, DoS gives a rating to banks after inspections but on a very narrow basis viz. on the sole factor of assessed "solvency" relative to the impairment of the components of reported own funds. Depending on the status of the book value of bank's capital and reserves in terms of examiner assessment of "real value", a bank's condition is rated on a four- level scale as under -

(a) Good - where book equity (capital and reserves) is unimpaired.

(b) Satisfactory - where reserves are only impaired but capital is intact.

(c) Not satisfactory - where reserves are lost and capital is also impaired, and

(d) Unsatisfactory - where shareholder funds are totally lost and there is erosion of deposits.

This rating system is clearly inadequate and is also misleading; inadequate because it does not capture evaluations of even all financials such as capital adequacy, liquidity and profitability. It is misleading because, besides the above exclusions, a bank may be solvent but may have serious management, operational and compliance problems. Furthermore, these ratings oriented to segmentation of shareholder equity give an especially distorted picture when there is injection of Capital (direct into the top segment of equity) and asset losses erode reserves (second layer). There is thus a need for substituting it with a more comprehensive and realistic rating system.

Rating factors and models

7.3 The rating models employed by the supervisory authorities in U.S.A. offer a good basis for developing a rating framework which may be suitably adapted to our context. After an examination, the U.S. regulatory agencies assign to the examined bank a rating that summarises its total Condition and Performance. They currently employ two rating models; rating on CAMEL factors for local or domestic banks (parameters evaluated and rated being Capital Adequacy, Asset Quality, Management, Earnings and Liquidity), and ROCA factors for Foreign Banking Organisations (FBO) - (parameters rated being Risk Management Systems, Operational controls, Compliance and Asset Quality). It is pertinent to note that Capitalisation, Management and Earnings factors are de-emphasised in assessments of FBOs for obvious reasons.

7.4 Our Group suggests, on the same analogy, two rating models separately for Indian banks and Foreign banks based on a differential mix of the rating factors or parameters. For domestic (i.e. Indian) banks, it recommends six key parameters for evaluation and rating viz. Capital adequacy, Asset quality, Management, Earnings performance, Liquidity, and Systems (CAMELS - acronym). Addition of systems parameter is considered necessary in view of the growing supervisory concerns on the need for adequate systems of risk management and operational controls in banks, especially with the increase of market risk in bank portfolios.

7.5 Despite the fact that foreign banks are operating in India through dependent branches, a distinction between domestic banks and foreign banks appears to be less relevant in the Indian context since capital adequacy regulation is applicable to the latter as well. However, one recognises that some parameters are clearly of lesser concern in regard to branch operations. Management for instance, is a factor that does not need much supervisory focus. Likewise, earnings performance, or even liquidity of a foreign bank's local operation may not be of equal concern as in case of domestic banks from the viewpoint of a host country supervisor, provided strength of support from parent is reassuring. On the other hand, regulatory compliance - which is factored with the "Management" parameter for domestic banks - needs to be evaluated in respect of foreign bank operations on a stand-alone basis, given the serious aberrations that recently surfaced in the operations of some foreign banks. Thus, a rating model with differential focus - evaluating four factors viz. Capital Adequacy, Asset Quality, Compliance and Systems (acronym - CACS) is suggested for foreign banks.

Component ratings

7.6 On the lines of the supervisory practice in U.S.A., each of the six components in CAMELS or four components in CACS - may be assigned a rating on a scale of 1 to 5 in descending order of performance.

1. **Strong** performance

2. **Satisfactory** performance

3. **Fair** performance that is flawed to some degree

4. **Marginal** performance that is significantly below average

5. **Unsatisfactory** performance that is critically deficient and in need of immediate remedial action.

While the six - or four, as the case may be - performance factors are inter-dependent somewhat, each is to be rated separately.

Composite rating

7.7 Once the component ratings have been determined, a **COMPOSITE** (CAMELS or CACS) rating may be assigned as a summary measure and may be used by the supervisors as the prime indicator of bank condition. It is important to emphasise that the composite rating is not to be determined by calculating an average of the separate components but rather based on an independent judgement of the overall condition of the bank.

7.8 Composite ratings may be assigned on a scale of A to E. Composite rating of A indicates that an institution is of least supervisory concern while composite rating of E indicates an institution to be of most supervisory concern. The five composite rating levels, as set out below, may be adopted.

Rating A - an institution that is basically sound in every respect.

Rating B - an institution that is fundamentally sound, but with moderate weaknesses.

Rating C - an institution with financial, operational or compliance weaknesses that give cause for supervisory concern.

Rating D - an institution with serious or immoderate financial, operational and managerial weaknesses that could impair future viability.

Rating E - an institution with critical financial weaknesses that render the probability of failure high in the near term.

Integrated rating

7.9 Unlike in the U.S. system where the banks are rated on examinations (the exercise is called "examination and rating") - and also departing from the current practice of DoS - it is recommended that final "Supervisory rating" on banks is set up at the central office; it is considered necessary to establish a more realistic rating than the one limited to examination process. Such rating will be based on **all** inputs and information flows available in the Department, although the major input will doubtless be the examiner rating. The organisation in Central Office with "nodal point" approach under which all information flows on each bank are directed to the "bank desk" is considered especially suitable. The examiners' rating on the new CAMELS or CACS parameters which will be furnished in the confidential or 'closed' part of the examination report will be the base input for integrated supervisory ratings - component and composite - that should be communicated to the bank's Board and Chief Executive in a confidential communication by the Central Office at the appropriate time - separate from the Management letter which issues to convey examination findings.

CHAPTER VIII

EMERGING ISSUES IN SUPERVISION

The process of financial sector de-regulation, initiated in mid-1991, has brought in its trail major changes and new trends on the Indian banking scene. Those of particular interest for prudential supervision are outlined below.

* The borders of banking are significantly changing. A trend of progressive de-specialisation of financial institutions is evident; the spectrum of permissible lending and funding activities for them has been extended.

* The range of activities that banks can engage in, either directly or through ownership stakes in other enterprises, has widened. Notably, the ability of banks to engage in securities business has been considerably broadened. Banks are in investment or merchant banking either directly or through subsidiaries in a substantial measure.

* Banks have set up subsidiaries for undertaking para-banking and other financial services such as leasing, factoring, venture capital funds, mutual funds, housing finance companies - even promoting infrastructure.

* Restrictions on ownership of banks by non-banking groups have been relaxed. Promotion of new banks and bank affiliations i.e. acquisition of significant holdings and controlling interest in banks by non-financial groups in the wake of the liberalised bank licensing policy of 1993 have begun to alter the contours of banking structures in the system.

The above developments have led to the emergence of banking groups and banks in Conglomerates.

The blurring of distinctions between commercial and investment banking poses challenges to the supervision function which has traditionally organised its prudential framework along institutional lines. Supervision of banks in banking groups and conglomerates throws up unfamiliar issues and new concerns not previously addressed in Indian supervisory practice. The issues relating to adjustments needed for supervision of banking groups and Conglomerates are outlined below :

A. BANK SUBSIDIARIES AND SUPERVISION

Recent experience where bank subsidiaries got into difficulties or became insolvent have brought into focus the issues of -

(a) responsibility of banks in relation to their subsidiaries - in other words, the issue of parental support of their solvency and, as a corollary.

(b) Prudential supervision of bank subsidiaries.

Issue of Parental Support

8.4 Currently, the regulatory instructions of RBI require the parent bank/s to maintain an "arm's length relationship" with the subsidiaries and ensuring that the Boards of the latter put in place adequate internal controls in the subsidiaries. There is a view held currently by a section of bankers in our system that this regulatory instruction definitively delineates the responsibility of parent banks towards their subsidiaries, that the Boards of the subsidiaries should be held fully accountable for their functioning including their solvency and the liability of the parent is governed by the doctrine of corporate separateness which rules out parental support or bail-out of subsidiaries if they slide into distress or insolvency. This view does not distinguish between a relationship based merely on ownership stake not accompanied by Management control and one where management control clearly exists. Management control can be deemed to exist where beside appointing a Board and the Chief executives, the parent also influences the Management policies and processes in the organisation through the Board or the Senior Management deputed to man the subsidiaries.

It is perhaps not realistic to expect the public - especially the small depositors and small investors - to appreciate such subtle distinctions before taking up a relationship with a bank subsidiary; hence, the extra-dimensions to parental responsibility in a banking context.

8.5 Quite apart from the legal position which refers to, the limited liability of corporates, purporting to limit potential liability or exposure of parent companies to the extent of actual exposures by way of funded investments (equity and loans) and guarantees - under the plea of corporate separateness, there are market perceptions and dynamics that build up contrary pressures in actuality.

8.6 Pemberton Committee of U.K. (June 1985) opined that banks were in a special category and had a special responsibility to the community regardless of what the legal position was; to quote, "a bank should stand behind its subsidiaries and other related companies, especially if those companies themselves take deposits. .... Owners of banks have an additional responsibility not present in the ownership of most of other commercial or industrial undertakings, because of the special fiduciary responsibilities on those who run businesses which take deposits from the public. ...."

8.7 The Pemberton Committee also recognised the moral responsibility of the parent to stand behind the subsidiaries, should the need arise, also on the reasoning that the Group failure to rescue a subsidiary which got into difficulties would quickly cause a loss of confidence in the parent bank itself. In this context, it is noteworthy that the regulators who require "arm's length" relationship with subsidiaries in normal times may expect or compel the Parent bank to provide support when the latter are in difficulties. In U.S.A., under the "source of strength" doctrine, the Federal Reserve demands that holding companies help their bank subsidiaries in distress.

Integrated View of bank groups

8.8 The view on parental support of bank subsidiaries which recognises group inter-dependencies and market pressures - the "thinness" of the "Corporate veil" - leads, as a corollary, to the issue of the need for supervision of bank subsidiaries. The recent collapse of the Barings Singapore subsidiary which led to the collapse of the parent bank i.e. Barings Plc, U.K. ended the regulatory prevarication on whether or not to supervise subsidiaries in banking groups. It is now known that there was enormous financial interlocking of the parent with the subsidiary in the Barings situation. The Investigation Report by the Board of Banking Supervision of U.K. into the Barings collapse has emphasised the need for strengthening consolidated supervision of financial groups around which international supervisory concensus has been emerging for some time.

8.9 Our Group suggests that DOS should monitor, during on-site supervision exercises and otherwise, the fall-out effects on the parent bank of the financial distress or market failure of any of the subsidiaries. In case such subsidiaries or affiliates are under the partial jurisdiction of another regulatory authority, close co-operation with the other regulator/s is to be forged and legal barriers, if any, on exchange of information have to be overcome. It should be assessed which of the subsidiaries are carrying on businesses and business volumes and are undertaking risk positions that can create problems for the parent in the event of forced bail-outs. Such vulnerable constituents in the banking group need to be identified and earmarked for closer supervisory attention. Where the operations of any of the subsidiaries are of sizable magnitude and the 'contagion' effects of their collapse are likely to be significant on the parent bank, the Department should seek to put in place, on-site supervision strategies directly where possible, and indirectly where not; that is, in the latter case, by "Targetted appraisals at control site" of subsidiaries.

B. BANKS IN CONGLOMERATES AND SUPERVISION

8.10 The emergence of banks in corporate conglomerates, as mentioned above, has been a recent phenomenon in our system. In a banking group, the bank is the parent and it has subsidiaries or affiliates undertaking para-banking or non-banking financial services (down stream linkage). A conglomerate, on the other hand, is a business group containing a bank or banks and, therefore, attracts the interest and attention of the bank regulatory authorities. Such conglomerates are, from a regulatory viewpoint, of two types (as defined by the Tripartite Group of regulators of Basle Committee on Banking Supervision) :

* "Financial Conglomerate" refers to any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors viz. banking, securities, insurance.

* "Mixed Conglomerate" is a group of companies under common control that offers non - financial or commercial services as well as financial services which is predominantly industrially or commercially oriented but contain at least one regulated financial entity.

8.11 As a result of the emergence of financial conglomerates covering hitherto separate activities, existing highly compartmentalised prudential supervisory systems have come under pressure. A BIS study (Working paper No. 43 of 1994) poses this issue as under: "Is it still possible for supervision to be effective if it is performed by considering exclusively individual components of a group (on a so called 'solo' basis) ? The answer depends on whether independent capitalisation of units, possibly combined with operational restrictions on the transfer of information and above all, of financial capital between them, can be relied upon to isolate those units from the rest of the group in times of stress..............At a minimum, supervisors should be in a position to **access information** about the various group units including the unregulated ones. This also raises the need for exchange of information between the regulatory authorities responsible for different parts of the group, if any."

8.12 The Tripartite Group of Basle Committee recently (July 1995) expressed the unanimous view that supervision cannot be effective if individual components of a group are supervised on a purely "solo" (stand - alone) basis and there is a need for an assessment of risk from a group perspective. This can be achieved by the adoption of

* **"Solo-plus"** approach to supervision which focuses on individual group entities and in which the solo supervision of individual entities is complemented by a group - wide risk assessment and group - wide availability of capital. In the execution of solo - plus supervision, some form of consolidation can take place in order to assess the risks on a group basis.

* **"Consolidated Supervision"** which focuses on the parent or holding company and involves application of the capital requirements of the parent company to consolidated group assets and liabilities.

C. CONSOLIDATED SUPERVISION

8.13 Pointing the way forward, Basle Committee in its latest Annual report on International Developments in Banking Supervision (Report No.9 - Sept. 1994) observes that "For banking regulators, consolidation is, or is to become, an important element of supervision. Some of these regulators may place greater emphasis on consolidated supervision than on any solo supervision they undertake. Some of them may undertake no solo supervision at all".

8.14 In this context, it is pertinent to mention that one of the "Minimum standards of supervision" (vide Basle Committee Paper of 1992) relates to consolidated supervision systems and capabilities being in place with the banking regulators of internationally operating banks. In order to meet this standard, the said supervisory authority should

> receive consolidated financial and prudential information on a bank's or banking group's global operations, have the reliability of this information confirmed to its own satisfaction through on-site examination or other means, and assess the information as it may bear on the safety and soundness of the bank or banking group.

* have the capability to prevent corporate affiliations or structures that either undermine efforts to maintain consolidated financial information or otherwise hinder effective supervision of the bank or banking group; and

* have the capability to prevent the bank or banking group from creating foreign banking establishments in particular jurisdictions.

It is suggested that DoS may consider initiating steps to re-orient its reporting and supervisory systems to consolidated supervision in respect of operations of the supervised institutions on a global as also group-wide basis.

D. REGULATORY CO-OPERATION & CO-ORDINATION (DOMESTIC)

8.15 Conglomeration and the blurring of distinctions between financial services and activities also raise the question of appropriate allocation of responsibilities between different regulators/supervisors. Typically, when securities business has been performed by banks either in-house or through subsidiaries, it has fallen under the jurisdiction of banking supervisors. On the other hand, stand-alone securities firms have often been covered by securities authorities - be these stock exchanges, securities commissions or self-regulatory organisations. In the U.K., which has a functional supervision regime, a "lead supervisor" chosen on the basis of the dominant activity of the group, has been responsible for co-ordinating overall efforts, when two regulators have a shared responsibility - for example, for the securities business carried out in-house by a bank. At the far end, Denmark (in 1988) and Sweden (in 1991) followed the de-specialisation trend by merging the supervisory authorities for banking, securities and insurance business. Our group is of the view that RBI should develop a continuing dialogue with SEBI and any other regulatory authority having jurisdiction over certain operations of the financial institutions which are supervised by DoS, for co-operation and co-ordination.

E. MARKET DISCIPLINE VS. SUPERVISION

8.16 The balance between official involvement/intervention and market discipline is a fundamental issue in the design of the framework of Prudential regulation and supervision. An experiment to "substitute the market for official supervision" is being tried in New Zealand. While this is an extreme and almost a solitary case of relinquishment, a case for bringing in the 'market' as a disciplining force for financial institutions is increasingly gaining acceptance in most countries. The RBI, in our view, could also consider increasing the role of the market discipline and progressively enlarge it as a support system to its own supervision function. Critical to this strategy re-orientation is enhancement of transparency and standards of disclosure by banks in respect of their financial as well as prudential information. Present structures of financial reporting and levels of disclosure by our banks are significantly non-transparent relative to those in industrially advanced countries.

F. MONEY LAUNDERING

8.17 There is growing recognition of the dangers of allowing economies to become infested with criminal or tainted money. Govt. measures to combat money laundering that are related to the financial sector spill over into and draw support from the bank supervision function in the regulatory regimes of several industrial economies. These impact the banking system in several ways but notably in

* requiring improvement or restructuring of the reporting systems of financial institutions to **detect** suspect transactions.

* ensuring that an appropriate balance is struck between the desire to preserve banking confidentiality, the need to preserve civil liberties and professional ethics and the aim of facilitating investigations into money laundering.

* setting up mechanisms for international co-operation including eliminating the scope for laundering arbitrage between different regulatory regimes.

8.18 Currently, there are global initiatives to pressure Govts. of major economies to put in place anti-money laundering regulations in their countries. This 'regulatory gap' may need to be urgently covered and the required support systems set up in our banks. Our Group understands that there is a Working Group appointed by the Indian Banking Association looking into the issues of money laundering in India.

CHAPTER IX

STRENGTHENING THE BACK-UP SYSTEMS AND ORGANISATION

9.1 The financial system is undergoing rapid change both in size and character, under the impetus of financial sector reforms initiated in 1991. Banks are entering new areas of business, dealing in new products and are operating in new markets that are increasingly becoming de-regulated as well as complex. Information technology that has skirted a large part of the banking sector until recently due to unionised employee resistance is rapidly permeating the system and is slated to bring about a sea-change in the work culture operating systems and procedures of banks. Supervisors have to re-position themselves to cope with the new challenges and growing complexity of their task. Change of strategy responding to a changing environment calls for adjustments in attitudes, skills and work systems. The directions in which the Department has to equip itself and its staff in the adjustment process, at the minimum, are briefly mentioned in the following paragraphs.

A. BACK-UP SYSTEMS

"Manualisation" of the new approach

9.2 Bank inspections are currently conducted by officers of DoS based on the Inspection Manual of 1987. The new regulatory norms set up in 1992 have totally changed the way of looking at and evaluating the loan and investment portfolios and risk exposures and capital adequacy in banks. The Inspection Manual is to an Inspector what a compass is to a sailor, navigating in uncharted seas; a sailor with a compass that has stopped showing proper direction drifts and gets tossed around, away from the goal. With the new strategy of supervision on the agenda of DoS, preparation of a new Inspection Manual covering the new approaches to bank examinations - or to be more precise, 'on-site' supervision - should be accorded top priority by the Department.

Staff Training

9.3 The Department should build up a cadre of bank examiners and bank analysts (for off-site monitoring) on a systematic basis. Bank supervision is increasingly becoming a complex task requiring a good deal of specialisation and technical expertise. Examiners need to be trained through structured and linked programmes tailored to individual officers' potential and organisational needs; the major part of the examination skills, and insights have to be acquired on the job i.e. in conducting examinations. Examiners need to be provided intensive exposure to the new and emerging areas of risk assessment and control systems in banks. Financial analysis and financial risk appraisal are the key areas for training bank analysts. Supervision of NBFIs - a new responsibility devolved on the Department - also underscores the need for re-orientation training for bank examiners to inspect NBFIs. Personnel placement policies of the Bank should take note of the investment

that goes into the building up of supervisory skills and expertise and assure continuity of tenure in the Department, compatible with the career advancement and prospects planned for them.

Orientation to new technology

9.4 The technological switch-over and upgradation programmes in supervised banks and financial institutions, especially by introducing automation, have been referred to in Para 5.43. The number of banks which use computerised record-keeping and accounting systems is increasing. DoS examiners should be able to interpret and move fluently around computerised books and undertake examination exercises in a computerised environment in banks, for which they should be equipped. Besides, they should be able to assess whether the managements of supervised institutions have identified the risks inherent in EDP operations and systems and taken measures to contain them - in other words, assess the security of any given bank's computer system against unauthorised entry, disaster and attempted fraud. In regard to the in-house data processing function, the scope of the assessment includes a review of the management systems and programming, computer operations, data integrity, ATM services and a review of the teleprocessing work. The examinations should also include a review of the EDP audit function in the bank. Trained examiners who can conduct reviews if not audits of EDP systems in banks and financial institutions should be posted - and preferably, EDP audit cells set up in major Regional Offices of DoS at Bombay, Calcutta, New Delhi, Madras and Bangalore.

9.5 The examination work itself should be technologically upgraded by the examiners using personal computers and note books. The Department may use computerised approaches for building up Central data file or Memory on large borrower and borrower group exposures, large classified loans and all other data which would help in monitoring trends in the banking system.

B. ORGANISATION

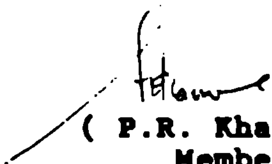
9.6 DoS has currently 16 Regional Offices, located in State capitals. The rationale for the Bank setting up its offices in all states for performing conventional central banking functions - through its Issue and Banking Departments - is quite evident, but that in setting up parallel networks at all these centres for bank supervision is not so clear. Bulk of the bank supervision activity of the Department is centered at five Regional Offices with Bombay Regional Office (B.R.O.) leading the pack, carrying the largest load and becoming the highest pressure point. One half of the regional offices of the Department have either one or two banks, headquartered in their jurisdiction, (e.g. Ahmedabad, Bhopal, Chandigarh, Jaipur, Jammu and Hyderabad) or none at all (e.g. Bhubaneswar, Patna, Gauhati). It is understood that these offices, which account for a quarter of the Department's examiner resources deploy the examiners round the year on branch (and controlling office) examinations, without even correspondence to the reference dates of the examination of the concerned bank/s, in most cases. Often, the examination exercises of these Regional Offices reportedly produce outputs which are peripheral to the mainstream supervision; deployment of officers in some examination activity round the year seems to

be their prime justification. It is possible that some of the experienced and skilled examiners are wasted at these centres while the large number of location options facilitate less competent examiners being posted at the Department's pressure points.

9.7 Supervision is essentially geared to institution level assessments and not so much to those of its diverse operational networks. All core supervisory assessments are bank-wide viz. solvency, capital position, earnings, liquidity and management. Bank Supervisor's approach is more akin to that of a statutory auditor's - who provide assessment on total bank's reported financial condition - rather than to that of the internal inspectors who have to produce reports on each branch/office for corporate management control. Visits to large branches are undertaken in the supervisory examinations in the context of asset quality assessment and other branches are visited for testing controls and compliance and, to some extent, for constraining moral hazard. In supervisory regimes like United Kingdom, where off-site monitoring system is the main instrument, bank branches do not figure at all in supervisory focus - although U.K. banks are also multi-branch organisations like ours. In U.S.A., supervisory examinations are so extensive because of the extensive unit banking system. In our system, branch examinations are undertaken by the RBI, to some extent, to 'double up' for weak internal inspection systems in the supervised institutions.

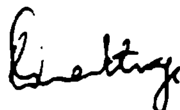
9.8 Given the above, there is a case for a fresh look at the deployment of examiner resources of the Department positioned at various centres on a more need-oriented basis. With the assumption of supervisory responsibility for non-bank financial institutions (NBFIs), new jurisdictions, however, would have accrued to some of the offices hitherto under performing on bank examination criteria. This new factor has also to be taken into account while considering re-locating the examiner resources across the different Regional Offices with a view to optimising them.

(S. Padmanabhan)
Chairman



(P.R. Khanna)
Member

(G.H. Deolalkar)
Member



(Dipankar Chatterjee)
Member

(A.M.M. Sarma)
Member-Secretary

Bombay
November 8, 1995.

ANNEXURE A

APPRAISAL OF EARNINGS PERFORMANCE

(AN ILLUSTRATIVE APPROACH)

Appraisal of the bank's earnings performance or profitability for the period under review, seeks to address two types of questions. viz.,

* Has it earned acceptable returns ?

* How do they compare with prior period performance and returns of Peer Group or the industry ?

"Acceptable return" has wide ramifications, raising issues such as market/investor perceptions, dividend payment record and inter-industry (sectoral) or intra-industry investment flows. For the purpose of analysis in supervisory examinations, it may be considered in the limited context of industry level or Peer Group performance.

Earnings analysis will thus have two facets viz. to assess -

(a) the improvement/deterioration in the results or return in comparison with previous year/s.

(b) earning levels of the bank in comparison with those of peer group banks or the industry.

MEASURES OF RETURN

The comparative assessments are made in terms of two key measures of profitability. viz.

* Return on Assets (ROA)

* Return on Equity (ROE)

Return is alternately defined as

- Profit before tax (pre-tax return), or

- Net income (after tax return),

and thus the "return" is measured on **both** pre-tax and post-tax basis.

The convention in our system has, however, been to define 'return' as Net profit or net income. Thus,

* ROA indicates the **net income/profit** generated on total assets or working funds employed in business.

  Also known as ROIF (return on Invested funds i.e. working funds).

* ROE relates the **net profit** to shareholder equity or owner funds.

It is recommended that ROA should be indicated also on Pre-tax return basis (PBT or Pre-tax earnings/Average Total assets). It is a more 'critical' measure in supervisory assessments.

It is pertinent to appreciate the inter-relationship of the two measures. Since the numerator (viz. net income or pre-tax earnings) is common, the inter-relationship is linked through the denominators (Assets and Equity).

ROE is net income divided by total capital or equity. It is a product of ROA and the leverage multiplier (Total assets divided by equity).

ROE is an important measure of profitability because it is influenced by how well the bank has performed on **all other return categories** (including capital structuring). It also indicates whether a bank can access the market for Capital.

ROE being an extension of ROA, modified by debt-equity mix (leverage) in capital structure, ROA is the key test of profitability. Profitability appraisal, therefore, gets focused primarily on analysis of ROA.

RETURN ON ASSETS

Two approaches are available for analysis of ROA.

a) **Direct** - by relating major components of net income to total assets (or working funds).

b) **Indirect** (or two phased approach), through linked analysis of net margin and asset productivity.

The direct approach (i.e. net income analysis) is the preferred and more commonly used one and is commended for use in bank examinations.

The indirect approach (i.e. analysis of "net margin") is, however, profiled in Part B for affording the examiners a better insight into the inter-linkages in the analysis of ROA - if only as an academic exercise.

For both approaches, the following definitions and notes are relevant.

a) **Gross income** is Total income from operations plus capital gains from sale of assets and before netting interest expense.

   Total income from operations comprises interest income, fee (or commission) income and trading profits (forex or securities dealing).

b) **Net Total income** is Total income from operations net of interest expense. "Net Total income", for analysis, is seen to be made up of (i) Net interest income and (ii) other operating income.

c) **Net income** is after tax profit or net profit.

d) **Total assets** and total working funds are equal.

e) **Total equity** includes capital, reserves and surplus (less deficit on P & L A/c), but not provisions for loan and other asset losses.

While relating items of income or expense (i.e. of Net Income Statement) to total assets or total equity (Balance sheet items), the latter are always averaged (whether it is on half yearly or quarterly or monthly basis).

PART A

NET INCOME ANALYSIS

Net Income Analysis (by margins) is undertaken to figure out the contribution of the diverse components of net income to ROA (for trend or Peer Group analysis).

Analysis of net income (i.e. income and expenses) for, say, two periods (last two financial years) may be made in the following format.

(Amounts Rs. crore/lakh)

(SYMBOLS : CFY / PFY : Current/Previous Financial Year)
PTA = Percentage to total assets

Item	(Ref. for details, -item in schedule)	Amount			(PTA-%)	
		CFY	PFY	Change	CFY	PFY
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. Interest income (net of intt. tax)	A					
2. Other operating income	B					
3. INCOME FROM OPERATIONS (1+2)						
4. Interest expense	C					
5. TOTAL INCOME (net) (3 - 4)						
6. Staff costs						
7. Other operating costs	D					
8. OPERATING PROFIT BEFORE PROVISIONS (OPBP) (5 - 6 - 7)						
9. Write-offs and risk provisions	E					
10. NET OPERATING PROFIT (NOP) (8 - 9)						
11. Realised gains / (losses) on sale of assets						
12. PRETAX EARNINGS OR PROFIT BEFORE TAX (PBT) (10 ± 11)						
13. Provision for income tax						
14. NET INCOME (PAT) (12 - 13)						
15. Dividends paid / proposed						
16. RETAINED EARNINGS (14 - 15)						

Note : Give in the schedule (to this format) break up or components of each item earmarked to E.

Building blocks in Net Income analysis

Total assets (or working funds) are made up of (a) earning assets and (b) Non-earning assets.

Bulk of earning assets are deployed in the bank's core operation viz earning interest (including discount) from lending and investment. The interest earning assets comprise loans and advances (including bills and commercial paper), investments (mainly fixed income securities) as also inter-bank placements.

Other earning assets such as those that are deployed in operations other than for earning interest e.g. dividends, are peripheral to bank income analysis.

A key ratio is earning assets as % of total assets.

Core Income Analysis

Core income analysis refers to revenues and costs related to interest oriented operations of the bank. Margins at items (i) to (iii) below relate to this analysis.

(i) **Interest Spread** is the **differential** between

  (a) interest income as a percentage of average interest earning assets, and

  (b) interest expense as a % of average interest bearing liabilities (deposits and borrowings).

(ii) **Net Interest Margin** represents net interest income (i.e. interest income less interest expense - items 1-4 above) as a percentage of Total assets (i.e. working funds). Net Interest Margin (NIM) is an important analytical tool in net income analysis as it represents the outcome of the core operations of the bank. It is the combined result of the Interest spread and the level of earning assets in total assets (or working funds).

(iii) **Risk Adjusted Net Interest Margin**

A refinement of net interest margin as a measurement tool is Risk adjusted net interest margin (R.A.N.I.M) which factors into net interest margin the erosion by reason of credit risk. the real return from the core operations of the bank (i.e. lending) is seen as the surplus interest generated **after netting** for the possible loss on credit or default risk entailed in producing such surplus.

Risk adjusted net interest margin thus represents Net interest income minus provision for possible credit losses for the period as a % of total assets. Direct write-off of bad debts is excluded on the reasoning that most write-offs relate to credits of prior periods.

A bank's net margin, which is the focal point of Net income analysis (Part B) largely depends, therefore, on the level of Risk adjusted net interest margin. (Together with Non-interest margin - vide item (iv) below, it determines pre-tax ROA).

(iv) Non-Interest Margin

Non-interest Margin is alternatively defined as

* Non-interest income as a % of average commitments (i.e. as counterpart of "interest spread") or

* the differential (surplus or deficit) between non-interest income and non-interest expense as a % of total assets (i.e. as counterpart of Non-Interest Margin)

The second approach may be adopted for analysis - as relating revenue - cost generating activities other than in the core operations (interest related).

Non-Interest Margin is often negative in most commercial banks where non-interest income does not normally cover non-interest operating costs or overheads. In other words, the cost-income ratio (operating costs as % of total income) is higher than the "other operating income to Total income" ratio.

In earnings analysis, two other important ratios are also used - besides ROA and ROE.

(a) Cost-income ratio (or efficiency ratio)

represents operating costs (i.e. non- interest expenses) as a % of Net Total income. A high CIR - normally exceeding 60% indicates the need for cost control.

(b) Internal Capital Generation

Internal Capital Generation is retained earnings (of current year) as % of last year's equity and shows how much contribution - addition or depletion - the net result of the current year's operations (including dividend payout) have made to the bank's equity.

Internal Capital Generation is the additive (or depletive) to the capital strength of the bank, providing the base for its future business growth.

PART B

RETURN ON ASSETS (ROA) BY NET MARGIN ANALYSIS

While total income (net of interest expense) is the reference point in the Net income analysis (Part A), gross total income is the base parameter in analysis of 'net margin'.

Financial data for the (two) years under review may be marshalled as under :-

	(Amount Rs. crore/lakhs)		
	Current fin year	**Previous fin year**	**Change (%)**
	....	....	....
1. Gross Total income			
2. Net income			
3. Total assets (average)			
(Return measurements - %)			
i) Net Margin (Net income/Total income)			
ii) Asset Productivity (Total income/Assets)			
iii) Return on Assets (Net income/Assets)			

ROA is a product of Net Margin and Asset productivity (or efficiency) [Measures (i) x (ii) = (iii)].

It follows, therefore, that a change in ROA - improvement or decline - can be explained in terms of an increase or decrease in one or both of the two variables.

ASSET EFFICIENCY (or utilisation) depends on the mix of earning assets and non-earning (incl. infrastructure) assets, on the one hand, and the earning power of the earning assets, on the other. The earning power of the assets depends on their distribution across portfolios and the risk - return profile of the portfolios.

NET MARGIN represents the relationship between the size of total income and the "residuary" of Total income after meeting various costs (viz. Interest, overhead, risk provisions and tax).

Structural Analysis of Net Margin

The change in Net margin can be explained in terms of variations in the five variables. In other words, **net margin** is dependent on the levels of Total income, interest and overhead costs as also the level of provisions required (for risk and tax) and can be analysed as under.

(Analysis of "net margin")	**For financial year**	
	Current	**Previous**
Gross Total income (Rs. lakhs/crore)		
(As % of total income)		
- Interest expense		
- Staff Costs		
- Other overheads		
- Risk provisions/losses		
- Tax		
- Net income		

Increase in income - or more correctly, on core income - can result from expansion of loan book or an increased net interest margin. While income growth is usually a positive development, it can also mask the increased level of risk which might accompany it but is recognised only in subsequent years.

ANNEXURE B

DIAGNOSTIC PROFILE OF BAD MANAGEMENT IN BANKS

1. The primary responsibility for the conduct of the business of a bank is vested in the board of directors and management appointed by it. This responsibility includes ensuring,

   * that those entrusted with banking tasks are professionally competent and that there are sufficiently experienced staff in key positions;

   * that proper control systems exist and are functioning;

   * that the operations of the bank are conducted with due regard to prudence including the assurance that adequate provisions are maintained for losses;

   * that statutory and regulatory directives, including directives regarding solvency and liquidity, are observed; and

   * that the interests not only of the shareholders but also of the depositors and other creditors are adequately protected.

2. A World Bank working paper (by A. De juan, 1991) stresses the role of bank management as a major element in all banking crises, as a potential originator or multiplier of losses and economic distortions; it adds that good bankers, when in trouble, often become bad bankers through a sequence of deteriorating attitudes. It alerts against bad management which manifests in various forms such as

   * **Technical mismanagement** - which is more like poor or weak management - involving a whole variety of inadequate policies and practices such as poor lending, over-extension of credit, risk concentration, connected lending, inadequate credit review procedures and ineffective recovery, lack of internal controls, poor business planning and poor management information systems.

   * **Cosmetic management** - consisting of recourse to diverse ruses and stratagems for hiding past and current losses so as to buy time and remain in control while looking and/or waiting for solutions.

* **Desperate management** - trapped in a situation of having to declare 'capital loss' or not being able to pay any or adequate dividend, looks for (speculative) types of businesses that permit them time in the hope of making up for previous deterioration. Typical practices include speculation, paying above-market rates for deposits and charging unduly high rates on lending.

* **Fraudulent management** - essentially engaged in promoting personal as distinct from institutional interests by means such as self lending, building up private portfolios including through swinging ownership, siphoning off bank funds through loans to phantom clients, paper companies, related parties - all these entailing systematic attempts at hiding the truth or the real position from the public and the supervisors.

3. To all this can be added what seems to be a phenomenon unique to many Indian public sector banks - non-management at the Board level, where directors are not known to have contributed significantly to the efficient running of the bank.

ANNEXURE C

REVIEW OF BANK EXAMINATION REPORT

(Illustrative format / outline)

A. INTRODUCTION AND OVERVIEW

An examination of ___________ bank was conducted by our (name) Regional Office with reference to its position as on (date) between .... and .... The bank was last examined with (date) as the reference date; the developments in the bank's affairs since then have been reviewed in the examination report.

2. During the period under review -

* There has been no significant change in the ownership pattern and control of the bank. **(Name of person or corporate)/(corporate)** group continues to be the Principal/major/controlling shareholder; [or] The shareholding is widely dispersed, no single shareholder or group controlling 10% or more of the equity.

* Major changes have/have not taken place in the composition of the Board of Directors.

* Shri (name) has continued to be Chief Executive of the bank./ There was a change of guard with (name) taking over as C.E.O. of the bank from (name) since (date).

* The bank's subsidiaries have remained at ________/ ; it set up subsidiaries since last inspection. New financial investments in subsidiaries/associates/affiliates have/ have not been made.

* Its branch network has gone up/down by ___________ to _______.

  (There is no change in the overseas branches network, if any).

* The bank has a market share of _____% and _____% in commercial bank deposits and bank credit, (date) as against _____% and _____% respectively at last review(date).

* In the financial acccounts for _______(financial year), it reported an operaing profit before provisions(OPBP) of Rs._______ and net profit(i.e. profit after provisions and taxes) of Rs.______.

* The bank's risk based capital ratio stood at _____% (__________%).

B. FINANCIAL ASSESSMENTS

(a) SOLVENCY APPRAISAL

(i) SHAREHOLDER EQUITY/NET WORTH

3.1 The shareholder equity (at book value) stood at Rs. _______ crores/lakhs on date of present examination, posting an increase/decrease of Rs. _______ crores (%) since the date of last examination. This increase/decrease in **book equity** resulted from the following changes -

		(Rs. Crores)
Equity as at date of last examination		....
Add	Retained earnings added to reserves (REAR)	
(Deduct)	(Loss)	
Add	New equity (of which share premium)	
Add	Revaluation reserves (net)	
		__________
Equity at date of present examination		
		__________

3.2 The examiners assessed the real value of own funds/shareholder equity i.e. bank's assessed net worth (ANW) at Rs. _____ crore i.e. Rs. _____ crore less/more than book value.

Examiner's analysis of the impairment of book equity is furnished in Schedule I. It is based **primarily** on the assessment that Rs. _____ crores (%) of the bank's loan and other assets were impaired in value (as against Rs. _____ crores reckoned by the bank) and required further Rs. _____ crores in loss provisions on top of Rs. _____ crores held by the bank.

There has been an increase/decrease of Rs. _____ crores in the assessed networth (ANW) since date of last examination (dole) when it was placed at Rs. _____ crores.

(Minimum Capital)

3.3 With ANW at Rs. _____ crores, the bank is considered to have adequate assets to meet its liabilities, as required under Section 22(3) (a) of B.R. Act. It also continues

to maintain, in "real value" the minimum capital required or prescribed for it for holding banking licence (Rs. _____ crores) and thus complies with the provisions of Section 11 of the B.R. Act.

3.4 The assessed networth further shows that with reference to the reported or book value.

* the shareholder equity is intact (Scenario One)

or

* the shareholder equity is impaired to the extent of Rs. _____ crores, indicating erosion of reserves ( ) and capital (Rs. ____ crores) (Scenario Two)

or

* the shareholder equity is totally lost and deposits have also been eroded to the extent of Rs. _____ crores or % (Scenario Three)

(Equity cover)

3.5 ANW covers __% of outside liabilities as compared to __% at last review.

(ii) CAPITAL ADEQUACY

3.6 The bank reported Capital to weighted Risk Assets Ratio (CRAR) of _____% and a primary capital ratio of ___ % on date of examination.

The examiner assessed the bank's CRAR at ___% and primary CRAR at ____ % The divergence between the reported and assessed capital ratios is analysed as under :

	Reported by bank	**Assessed by examiners**	**(Rs. Crores) At date of last examination [assessed]**
(i) Total assets			
(ii) Total weighted risk assets			
(iii) Total capital			
(iv) Primary or Tier one Capital			
(CAPITAL RATIOS)			
(a) CRAR (%)			
(b) Primary CRAR (%)			

3.7 The bank has adequate/inadequate capital in terms of the regulatory capital standard i.e. CRAR of 8% and core CRAR of 4% . The capital position of the bank has improved/weakened/deteriorated since last examination.

(b) ASSET QUALITY APPRAISAL

4.1 The bank's total assets stood at Rs. _____ crore, posting an expansion of Rs. _____ crore or _____ % since date of last examination. Asset composition by major portfolios was as under : -

	Amount	% to Total assets (TA)	% to TA on date of last exam.
(a) Loans & advances (net)			
(b) Investments - SLR			
(c) Investments - Other			
(d) Other (current) assets			

(i) LOAN ASSETS

4.2 The bank's advances, **net** of loan loss provisions of Rs. _____ crores, were stated at Rs._______ crores. The growth in the portfolio since date of last examination was as under, per books :

(Rs. Crore / lakhs)

	On date of Present exam	On date of Last exam	Increase (+) /Decrease (-)
Loans & advances (gross)			
(Provisions for losses)			
Loans & advances (net)			

(a) Non-performing loans and unrealised interest

4.3 The bank classified Rs._____ crores or % of the gross loans and advances as non-performing and not booked/suspended Rs._____ crores in unrealised interest on these loans. The examiner assessment was that Rs._____ crores (or %)

of gross loans were non-performing and interest amounting to Rs. ______ crores was wrongly recognised or accrued as income.

The proportion of loans on non-accrual basis in total loans was ____ % (assessed) on date of last examination.

(b) Impaired loans and loss provisions

4.4 Value impaired loans and advances aggregated Rs.____ crores and formed % of the Portfolio (% on dole), as per bank's classification. On this basis, the asset quality was **reported** as under :

Impaired credits (gross)	____ %
to Total loans & advances	____ %
- do - (net) to shareholder equity	____ %
- do - (net) to Total assets	____ %

4.5 The risk profile (and value impairment) of the advances portfolio as assessed by the examiners is given below in juxtaposition to the bank's classification :

	As per Bank's classification	**(Amount Rs. Crore/lakhs) As per Examiner classification**
A. STANDARD	.... (%)	.... (%)
B. IMPAIRED comprising	.... (%)	.... (%)
- Sub-Standard	.... (%)	.... (%)
- Doubtful	.... (%)	.... (%)
- Loss	.... (%)	.... (%)
TOTAL ADVERSELY CLASSIFIED (OR VALUE IMPAIRED)	(%)	(%)

(% shown in brackets are on gross loans and advances)

The examiners assessed % of the portfolio to be impaired as compared to % of portfolio impairment assessed at date of last inspection. Thus, there has been an improvement/further deterioration in loan portfolio quality.

The peer group ratio for impaired loan portfolio was _____. (......... year).

4.6 By reason of revision of loan classification, examiners estimated that additional loan loss provisions (on top of Rs._____ crores held by the bank) are necessary as shown below. (Vide **Schedule 2** for itemised statement of large classified loans)

			(Rs. crores)
	Provisions held	**Provisions assessed**	**Addl. Provisions required**
Sub-standard			
Doubtful			
Loss			

With the additional provisions required, the loss ratio (i.e. stock of loan loss provisions to gross loans and advances) in the loan portfolio is assessed at ____% (____% at last examination).

The impaired credits (net of assessed provisions) formed ___% of net advances i.e. as per **examiner classification** - as shown below

	(Amount Rs. Crores)	
	Date of present exam	**Date of last exam**
i) Gross loans and advances		
ii) Loan loss provisions (assessed)		
iii) Net loans and advances (i - ii)		
iv) Impaired loans (net of provisions)		
% of Impaired loans (iv) to net loans (iii)	%	%

(ii) INVESTMENTS

4.7 Investments of the bank (other than participations) amounted to Rs.____ crores; the portfolio grew/shrank by Rs._____ crores (%) since date of last examination. The reasons for significant expansion or contraction of the portfolio included ....

4.8 The composition of the portfolio was as under :

	Book value	(% of total)	(Rs. Crores) Market value
A. SLR/APPROVED SECURITIES			
(a) In **current** category			
(i) Treasury bills			
(ii) Govt. dated securities			
(b) In **permanent** category			
(i) Dated Sec - Central			
(ii) Dated Sec - State Govts.			
(Iii) Other approved Sec.			
(Sub-total)	( )	( )	( )
B. NON-SLR SECURITIES			
(a) **Bonds**			
(i) GOI Capitalisation Bonds			
(ii) PSU Bonds			
(iii) Other corporate bonds and debentures			
(b) **Equities** (other than participations)			
(i) Quoted			
(ii) Unquoted			
(c) Other securities			
C. OTHER INVESTMENTS (i.e. OTHER THAN IN SECURITIES)			
TOTAL			

4.9 Investments held in SLR securities (i.e. eligible/qualifying for statutory requirements) amounted to Rs.______ crores or % of the total portfolio; they exceeded the minimum statutory requirements by Rs.__________Crores (%).

4.10 Current category investments - required to be valued at market rates - account for _____% of total SLR securities; this is ____% less/ more than the "divide" (level) prescribed to be held in "current book". On date of examination, their market value is lower/higher by Rs.___ crores than shown in bank books.

4.11 Approved securities held in permanent category, which are permitted to be carried in books at costs by valuation norms, entailed a depreciation of Rs._____ crores on valuation at market rates. The bank did not hold any provision/held provision for depreciation in respect of these securities to the extent of Rs._____crore.

4.12 In Non-SLR category of securities, which account for ____% of the portfolio, the bank holds in provision for depreciation Rs.____ crores. This is lower by Rs.____ crores than the requirement as assessed by examiners.

4.13 Other investments (not being securities) comprise the following;

(i)
(ii)

These are fully realisable/the bank has adequately provided for them (Rs.____ crores)/ there is a short provision of Rs.____ crores for problem/illiquid/unrealisable investments.

4.14 Depreciation in portfolio as stated by bank and as assessed by examiners is summarised as under;

	As per Bank books	**Examiner assessed**
SLR		
Non-SLR		
Other investments		

4.15 Comments on the Liquidity level/status of the Investment Portfolio, especially the non-SLR category. (as per books).

4.16 Comments on maturity and yield pattern/analysis (as per books).

(iii) PARTICIPATION (INVESTMENTS)

4.17 The bank's investments by way of participations (long term/financial investments) stood at Rs.____ crores, categorised as under and accounted for % of total assets.

(Rs. Crores)

	Book Value	Market Value	Book value at last examination
(i) In subsidiaries			
(ii) In associates/affiliates			
(iii) Other companies			

4.18 Comments on value impairment.

(iv) OTHER ASSETS

4.19 The bank's "other (current) assets" totalled Rs.______ crores (% of total assets) and comprised the following **major** items.

	Amount (Rs. Crores)	% in total assets
i)		
ii)		
iii)		
iv) etc.		

4.20 Comments on collectibility/potential losses in these assets - provisions held by bank and assessed by examiners.

Note : **(Comments on systems of control that impair/jeopardise the realisability are to be made in "Management Section - Systems & Controls").**

(v) OFF-BALANCE SHEET EXPOSURES

4.21 Break-up into major categories,

(a) credit contingents such as Letters of Credit, Guarantees, Underwriting/Standby facilities, undrawn amounts under Committed Credit Lines.

(b) Other exposures (contracts/derivatives)

4.22 Evaluation of loss exposures in category of credit contingents.

4.23 Examine derivatives books - outstanding Forward contracts, Forex options, FRAs. Identify market risk, open positions and loss exposures as on the books, if any. (Control systems to be commented in Management - systems & Controls).

LIABILITIES EXAMINATION

4.24 The examination should focus on those liabilities which have impact on networth assessment including contingent liabilities. These will be by way of identification of -

(a) Liabilities not brought on books

(b) Provisions or additional provisions required for liabilities, i. e. Including on and off balance sheet for contingent liabilities.

Comments on both categories.

(C) EARNINGS APPRAISAL

5.1 The earnings of the bank improved/deteriorated in the year ended ______ as compared to the preceding year as shown below.
(Earnings analysis of the two years is provided in Schedule 3).

(Amount Rs. Lakhs)

	For the year ended March			
	199 - 9		199 - 9	
	Amount	**% to TA**	**Amount**	**% to TA**
(i) Total income				
(ii) Net interest income				
(iii) Operating profit before provisions				
(iv) Risk provisions				
(v) Profit before tax				
(vi) Net income/profit				
(vii) Internal Capital generated (Retained earnings)				

5.2 The bank's Pre-tax ROA improved/deteriorated from ____% to ___% during the period. The reasons include

* change (improved/reduced) in net interest margin;

* change (higher/lower) in loan loss provisions;

* lower/higher operating costs (cost-income ratio);

* higher income by one time transactions last year / this year.

The bank's net margin (net income/Total income) was ____ % as compared to ____ % in previous year.

The bank's ROA (at ___%) compares favourably/unfavourably with peer banks (____ %).

5.3 The bank's Return on equity (ROE) at ____% was higher/lower than ____% in last year. (Comments, if any on the reasons).

The bank's ROE compares favourably/unfavourably with the ROE of Peer banks which was around ______ % and _____% in years ____ and _____.

(d) LIQUIDITY APPRAISAL

6.1 The liquidity of the bank has been assessed as under :

	* **Status classification**
(In terms of)	
i) holding of liquid assets (stock approach)	
ii) maturity mismatch of funds/cash flows. (flow approach)	
iii) access to markets and institutional credits (Back-stop)	

* Strong/Satisfactory/Vulnerable/Critical

6.2 Comments on holding of liquid assets versus potential claims on liquidity (in terms of composition of deposits/liabilities, heavy reliance on few depositors, undrawn credit lines, etc.)

The bank's **prime assets ratio** [i.e. cash, inter-bank placements (due within 30 days) and liquid securities to total assets] was ______%.

Its **market liabilities ratio** (inter-bank and money market deposit liabilities to total assets) was _______%.

6.3 Comments based on maturity mismatches in different time bands and their status versus tolerance limits. (Gap Analysis)

6.4 Assessment of **funding risk** in terms of market access (inter-bank and money markets and institutional credit lines) - committed or indicated.

C. MANAGEMENT APPRAISAL
(including Systems and Controls)

7.1 (a) Board of Directors and its Committees
- Policy and strategic direction and oversight

(b) Owner's influence (i.e. of controlling shareholder/s) on Board and management.

7.2 CEO (Fit and proper criterion)

7.3 Management team (Senior Management/executives) competence, technical expertise, objectivity.

7.4 Organisation

7.5 Management Systems

(i) Liquidity and funds Management (Treasury function)
(ii) ALM (or spread) management
(iii) Portfolio and Risk Management (Loans & Investments)
(iv) Planning & MIS
(v) HRD & Vigilance
(vi) Operations Manuals & Systems

7.6 Management Controls

(i) Maintenance of records and accounts and Accounting controls
(ii) Internal audit (including concurrent) and Branch controls (including branch audit and inspections)

(iii) Risk Management controls (in trading book and loan book) - including market risk and country risk.

(iv) control levels of operational management.

7.7 Branch/Operational Management

D. COMPLIANCE REVIEW

(a) **Regulatory compliance**
(Illustrative)

8.1 Statutory Reserve Requirements, CRR and SLR.

8.2 Statutory Reserve Fund and dividend declaration.

8.3 Statutory ceiling on participation investments.

8.4 Restrictions on investments in shares.

8.5 Rule on credit exposure limits (Large exposures).

8.6 Selective Credit Controls directives.

8.7 Bridge loans guidance.

8.8 Ban on PMS Schemes, repos, etc.

(b) **Policy Compliance**
[Credit Policy (mandatory) guidance]

8.9 Targetted lending to priority sectors with sub-targets for sub-sectors. Lending to exports, mandatory deposits for sub-target lending.

(c) **Integrity of regulatory reporting**
(reliability/correctness of reports furnished to the Regulatory and Supervisory authorities).

E. IDENTIFICATION OF CONCERNS

9. The supervisory concerns in respect of the bank arise in the following areas (listing).

PART II - (CONFIDENTIAL SECTION)

a) Rating of the bank by the Examiners.
b) Critical comments on Managenment (Board, CEO and Senior Management)
c) Special concerns not disclosed/stated in open report.
d) Punitive/supervisory action, if any, recommended on the Management and/or the bank.

F. PROPOSED ACTION PLAN

10. The bank should address the concerns listed in Para 9 by undertaking the undernoted actions/measures as per the time frame indicated against each.

Schedule 1

Examiner assessment of Networth - Comparative Statement

	Date of present examination	Date of last examination	Change (+ / -)
1. Paid-up capital			
2. Reserves			
3. Surplus (on P & L a/c)			
3a. Deficit (-do-)			
4. Net worth (at book value) (Adjustments by examiners)			
- i) Unrealised interest on NPAs taken to income a/c			
- ii) Additional loss provisions (required) for credit exposures on and off balance sheet			
- iii) Other losses not recognised/ brought into books			
- iv) Liabilities (including provisions therefor) understated			
- v) Liabilities not accounted			
5. Assessed/adjusted Networth			

Schedule 2

Statement of large adversely classified/value impaired loans

ANNEXURE D

EXAMINATIONS AND FOLLOW - UP - SEQUENCE PROFILE OF THE PROCESSES

Sequencial Step No.	Process	Responsibility Centre	Remarks
(1)	(2)	(3)	(4)
1.	Annual Plan of examinations and appraisals	Central Office - after reviewing and in consultation with the proposals (draft annual plans) of Regional Offices.	The programme covers examinations and targetted appraisals.
2.	Quarterly programme/s of Examinations and appraisals	Regional Offices (Officer -in - charge)	The approved annual programme is split into quarterly programmes.
3.	Examination Strategy Planning	Senior Officers Group at Regional Offices with PIO and his team.	Senior Officers group at R.Os comprises all officers of DGM and above at R.Os.
4.	Examination Planning and pre-inspection study.	Examiner in Charge i.e. PIO.	
5.	Examination at Site i.e. bank (field operation) and preparation of report.	- do -	

(1)	(2)	(3)	(4)
6.	Editing and pre-approval of examination report and Regional Office recommendations on	Officer in Charge of R.O. of DoS.	Pre - approval is substantial approval of the report.
(a)	Follow - up including furnishing of draft Action Plan		
(b)	Identification of areas for use of supplementary vehicles		
7.	Approval and issue of examination report	Addl. CGM of B.R.O of DoS and CGMs at other offices.	Two copies to be concurrently sent to Central office of DoS.
8.	Issue of supervisory letter to the bank (Management)	Central Office - DoS	Letter to CEO highlighting concerns identified on examination. The letter to be placed before Board.
9.	Review of bank's responses to examination report.	i) Regional Office ii) Reviews and recommendation received from Regional Office/s will be inputted into the "Executive brief " for discussion with Bank Managements.	
10.	Discussion with Bank Management and setting up a Monitorable Action Plan	Central Office - DoS.	Draft MAP of RO to be reviewed and finalised with Bank Mgt in discussion

(1)	(2)	(3)	(4)
11.	Communication of Monitorable Action Plan and Supervisory Rating of the Bank	- do -	Supervisory rating is to be communicated only to the Board of Directors.
12.	Monitoring / Oversight and review of the Monitorable Action Plan	Regional Office	
13.	Conduct of targetted appraisals and issue of reports	Regional Office Officer - in - charge guides and oversees the appraisal exercise and approves and issues the report.	CGM need not come in the approval process for targetted appraisals. Two copies of the reports to be sent to CO. CO issues the supplementary supervisory letter, if necessary.
14.	Conduct of monitoring visits and commissioned audits	C.O. and regional offices in consultation.	Action to be decided at C.O.
15	Review of examination strategy for following year based on outputs of supplementary vehicles (at items 3 & 14)	- do - (Regional office review to C.O.)	