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Report of the Informal Advisory Group on Regulation and Supervision of Financial Institutions

Reserve Bank of India
Department of Banking Supervision
Financial Institutions Division

May 2000

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Executive Summary

1. The supervision of financial institutions (FIs) continues to be somewhat of a grey area with RBI exercising only a limited oversight and periodic inspection while the primary responsibility continues to be with the Government of India / Board of Directors.

2. It was, therefore, felt necessary to set up an "Informal Advisory Group" to examine and make recommendations on the following aspects :

   (a) Areas of coverage of supervision of FIs;

   (b) Objective and purpose of supervision;

   (c) Type of supervision viz. on-site / off-site or on the basis of CAMELS system through internal or external sources;

   (d) Types of FIs which should be covered under overall supervision;

   (e) Legislative amendments required; and

   (f) Assessment of the need for a Manual and specialised staff with intensive training by outside experts.

3. Given the diverse nature of the FIs, the objectives of supervision can vary. For most of the FIs which are in the nature of banking substitutes, the objectives of supervision may be summarised as under :

   (a) Minimising the systemic risk to the national financial system arising from the destabilising effects of a possible failure of a FI

   (b) As a corollary to the above, maintaining confidence in the financial system.

(c) Improving the effectiveness of monetary and credit policy measures.

(d) Strengthening the internal control systems in the FIs by identifying their vulnerabilities.

(e) Ascertaining that the activities of the FIs are in conformity with the objectives for which they have been created and the further objectives that may have evolved over the years.

4. At present there are 10 All India FIs which have been brought under the regulatory and supervisory domain of RBI and three investment institutions (viz. GIC, LIC and UTI) which are broadly monitored through receipt of periodical returns.

5. In addition, there are 28 State Industrial Development Corporations (SIDCs) incorporated as companies under the Companies Act, 1956, which have not been notified as PFIs. They fall within the definition of NBFCs and till recently, were subject to the Directions of RBI (DNBS) but with effect from January 2000 they have been exempted from the applicability of the Directions. Since April 1994, SIDCs have been subject to guidelines stipulated by IDBI and periodic inspection by IDBI but the prudential norms prescribed by IDBI for SIDCs do not have a sound statutory base and IDBI's inspections have been made as a provider of refinance rather than as a prudential supervisor. Therefore, since January 2000, there has been created a regulatory vacuum for SIDCs. The Group is of the view that in order to obviate the regulatory and supervisory vacuum, the SIDCs, being as they are a close bank-substitute, should be brought within the supervisory ambit of RBI and regulated on par with the All-India financial institutions.

6. There are also 18 State Financial Corporations (SFCs) of which 17 were set-up under the SFCs Act, 1951, while Tamil Nadu Industrial Investment Corporation Ltd. was incorporated under the Companies Act, 1956. With the coming into force of the Public Financial Institutions Laws (Amendment) Act, 1976, with effect from 16 February, 1976, certain functions of RBI in respect of the SFCs, including their inspection, were transferred to IDBI though certain core functions continue to vest with RBI as the central banking authority. Notwithstanding these arrangements, a robust regulatory and supervisory framework for an ongoing financial supervision of SFCs' operations is wanting. There is also a gap in the extant prudential framework as the guidelines issued by IDBI do not appear to be backed by any statutory authority and their validity is questionable. It has been ascertained from IDBI that the inspections (since called Performance Evaluation Studies – PES) could not be conducted annually due to inordinate delays in the preparation of accounts by SFCs and the PES have not proved to be an effective tool for ensuring the financial health of the SFCs. Under the SFCs (Amendment) Bill, 1999, IDBI's responsibilities in this regard are proposed to be transferred to SIDBI. The Group is of the view that the SFCs should be brought within the supervisory domain of RBI and the matter should be brought to the attention of Government before the SFCs (Amendment) Bill, 1999 is enacted.

7. There are also certain other national level financial institutions which, though notified as Public Financial Institutions (PFIs) under Section 4A of the Companies Act, 1956, are not under the supervisory domain of RBI. After a detailed examination of the features of each institution, the group is of the view that:

(a) The following institutions should be brought under the supervisory domain of RBI :-

   (i) Power Finance Corporation Limited
   (ii) Rural Electrification Corporation Limited
   (iii) Indian Renewable Energy Development Agency Limited
   (iv) North Eastern Development Finance Corporation Limited

(b) The following institutions should not be brought under the supervisory domain of RBI :-

   (i) LIC, GIC and UTI
   (ii) The four subsidiaries of GIC
   (iii) Risk Capital and Technology Finance Corporation Limited
   (iv) Indian Railway Finance Corporation Limited
   (v) ICICI Venture Funds Management Company Limited
   (vi) Housing and Urban Development Corporation Limited

However, since certain aspects of the lending operations (bridge loans and credit to NBFCs) of LIC, GIC and UTI are regulated by RBI, it should be sufficient if a system of obtaining annual certificates evidencing due compliance with the applicable RBI regulations, from the auditors of these institutions, is introduced.

8. Since it is likely that the Government may notify some more financial institutions as PFIs, in future, and new institutions might also emerge in the changing economic environment, the Group is of the view that it is necessary to institutionalise an ongoing mechanism which ensures that there is consideration by the RBI as to whether such new / newly notified institution should be brought within its supervisory domain.

9. The key elements in determining an adequate coverage of the supervisory process for FIs are – a full and proper understanding of the risks to which FIs are exposed, the manner in which these risks differ from the risks to which banks are exposed and the processes by

which those risks should be addressed. This also requires an understanding of the differences between FIs and banks as regards their respective objectives and the nature of their respective operations

10. FIs are pre-dominantly lenders of long-term project finance while banks are pre-dominantly lenders of short-term working capital. There is also a fundamental difference in the manner in which banks and FIs fund their operations. The main source of funds for banks is short-term retail deposits from the public whereas traditionally FIs have funded their operations through long-term domestic and foreign currency borrowings. Both these areas of distinction are gradually getting blurred.

11. Apart from the above, banks have the following characteristics which distinguish them from FIs, viz.

    (a) They have custody of large volumes of monetary items, including cash and negotiable instruments, which has to be assured;

    (b) They engage in a large volume and variety of transactions with individual transactions often of small amounts;

    (c) They normally operate through a vast network of branches which are geographically dispersed;

    (d) They often assume significant commitments without any transfer of funds through "off balance sheet" items like letters of credits, acceptances, guarantees, etc. To some extent, FIs also assume such commitments;

    (e) They are a part of the national payment system.

12. While there are many common risks between FIs and banks, there are still significant differences in detail and emphasis which necessitate a consideration of the differences in risks between FIs and banks. These differences arise mainly from differences in the nature of operations.

13. The risks to which FIs and banks are exposed can be broadly grouped into (i) product and service risks and (ii) operational risks. To these may also be added, at a macro-economic level, the economic or business cycle risk. The most significant product and service risk for both FIs and banks is the credit risk. However, while in a bank the risk of non-repayment of an advance is directly linked with the ability of the borrower to sell his inventories and realise his debts, in the case of an FI it is linked with the ability of the borrower to generate cash by use of his productive assets. Similarly, FIs carry a higher economic cycle risk as disbursed and undisbursed loan commitments are spread over several years. There is also a higher concentration of credit risk for FIs as the average size of advance is larger and, therefore, individual exposure is greater. On the other hand, FIs have lower country or transfer risk and replacement risk as they (except for Exim Bank) do not generally finance export operations or deal in foreign exchange.

14. While banks have a higher market risk because of their larger investment in Government securities and bonds, FIs have a higher equity price risk because of their larger investment in equities. With the changes in funding patterns and the longer periods for which they are committed, the liquidity risks of FIs are increasing. Similarly, in recent years, FIs are increasingly exposed to a higher exchange rate risk. FIs have significantly lower operational risks.

15. The Group is of the view that the present coverage of on-site inspection is quite adequate but it suggests the following refinements and fine tuning:

(a) In the open part of the report (as distinct from the confidential part of the report not accessible to FIs) there should be a separate main paragraph on Risk Management to provide an integrated view of the risk management systems adopted by the FI and their efficacy.

(b) The Inspecting Officer (IO), while using ratio analysis as a tool for initial identification of areas of concern, must also subject the ratios to "what if" or sensitivity analysis.

(c) The present system of examination of a prescribed number of accounts to assess the quality of loan assets, should be replaced by a system which addresses itself to the objectives of such examination. These objectives are :-

(i) To determine the quality of assets and the adequacy of provisioning for the FI as a whole;

(ii) To examine the risk assessment procedures and determine whether they have been followed;

(iii) To assess the efficacy of the risk assessment procedures as proved by the results;

(iv) To examine the procedures for recoveries against delinquent accounts and to assess their effectiveness.

The above objectives equally apply to all off-balance sheet commitments that give rise to credit risk exposures.

16. Utmost care needs to be exercised by the IO in drawing conclusions from the results of a test-check. In the event the results are unsatisfactory, the extent of examination should be expanded to a size sufficient to provide meaningful results before a generalisation is made.

17. Special attention needs to be paid to renegotiation of terms of loan agreement regarding interest and principal or grant of additional facilities to projects under implementation as they have serious provisioning implications.

18. In applying the prudential norms, the IO should recognise that the norms prescribe the objective criteria which define only the minimum provision needed but that circumstances may necessitate a higher provision based on subjective considerations. In making this subjective assessment however, the IO should recognise a fundamental difference between the assets of a bank and of an FI. In the case of a bank, the IO is principally concerned with assessing the existence and realisability of the assets. In the case of an FI, he should be concerned with the ability of the assets to generate the cash to service the account through payment of interest and principal when due.

19. Where the IO feels that additional provisioning is warranted on subjective grounds, account-wise details thereof should be included in the confidential part of the report and separately conveyed to the CEO of the FI. The provisioning shortfall due to both objective and subjective factors should, in the interests of transparency and to minimise subjectivity, be discussed with the auditors in the presence of the management of the FI.

20. At present, the IO examines the quality of management by a critical examination of the functioning of the Board, various committees and of the senior management of the FI. The Group is of the view that the mandated examination areas have too broad a sweep and feels that the examination of the management structure should be not with

regard to its detailed functioning but with regard to whether it satisfies the twin criteria of accountability and transparency in its operations The IO should also examine whether the activities of the FI are in conformity with the objectives for which the FI was created or which might have evolved over the years.

21. The level of earnings of an FI is not by itself a primary regulatory concern. However, to the extent that the inadequacy of earnings could impinge upon the FI's future solvency or its ability to maintain a satisfactory Capital Adequacy Ratio, the stability of a FI's earnings is important. The IO should examine relevant ratios and make a comparison with past periods and peer groups. Some of the ratios which need to be examined but which are not captured at present are the following :-

   (a) amounts charged to the profit and loss account for write-off and provisioning of loans as a percentage of total income;

   (b) interest applicable to NPAs not credited to profit and loss account as a percentage of total income;

   (c) expenses (other than interest and loan write-off and provisions) as a percentage of total income.

22. FIs are now increasingly exposed to liquidity risk. The IO should verify compliance with RBI's ALM Guidelines and examine the reasonableness of the assumptions used by the FI in projecting cash inflows and outflows, the proposed funding strategy, the borrowing capacity of the FI in terms of its debt-equity ratio and the hedging of funding cost. He needs to pay particular attention to (a) interest rate mismatch, (b) maturity mismatch, (c) open foreign exchange positions and (d) outstanding loan commitments.

23. The IO's examination of systems and control is intended to obtain assurance regarding the adequacy and effectiveness of the risk management systems. Some of the important aspects which the IO needs to examine are :-

(a) the systems for identifying, measuring, monitoring and controlling credit risks;

(b) the loan pricing mechanisms;

(c) the systems for limiting, monitoring and controlling credit exposure;

(d) the systems for identifying, measuring, monitoring and controlling market risk;

(e) the systems for implementing operational safeguards against the technical and human elements specially in a computerised environment;

(f) the integrity and reliability of the internal and regulatory MIS as also the adequacy of the information provided to senior management and the Board of Directors.

(g) the system by which compliance with statutory requirements is ensured and monitored.

24. The IO should examine the internal audit system with regard to (a) the independence of the function (b) the adequacy of the personnel (c) the scope and frequency of audit (d) the coverage and (e) the follow up. He should also peruse the internal audit reports to identify areas of supervisory concern.

25. The supervision exercised so far has been based almost entirely on periodic on-site examination. Except for ICICI, IDBI, IFCI and IIBI which are currently being inspected annually, all the other FIs

subjected to on-site inspection are inspected biennially. Such a broad-brush standardised supervisory system does not provide for a set of objective criteria to determine the extent of supervisory attention to be devoted to an FI, disregards the strengths / weaknesses, risk-exposure and quality of risk control systems and results in an information and supervisory vacuum between two full-scope on-site inspections. Since July 1999, therefore, an off-site surveillance system-called Prudential Supervisory Reporting System – has been introduced.

26. While, at present, on-site inspection remains at the heart of supervision, over a period of time, off-site surveillance should progressively constitute the mainstay of the supervisory regime and on-site examination should be used primarily to validate the data received and to focus on specific aspects or concerns that may have been identified through off-site surveillance.

27. The Group is of the view that an appropriate rating model should be devised for FIs as has presently been done for banks as a "composite" supervisory rating provides not merely an objective indication of the overall health of the institution but also provides a systematic and objective criteria for allocation of supervisory resources taking into account the unique strengths and weaknesses of each supervised FI. The rating system for FIs must necessarily be different from the rating system for banks given the differences in the respective risk profiles. The rating system should be used not merely for effective on-site inspection and off-site surveillance but also to estimate the off-site rating between two on-site inspections as is done under the SEER system by the Federal Reserve in the U.S.

28. The Group suggests the following refinements in the present system of on-site supervision :-

(a) Until the FIs can be systematically differentiated as per their risk profile based on off-site surveillance and the rating system, all FIs should be inspected annually.

(b) It is not necessary to inspect all locations of an FI if critical areas like advances are centralised.

(c) It is not necessary to evaluate systems at the time of each inspection if they have been evaluated earlier and found satisfactory. It would be sufficient if confirmation is obtained from management regarding changes in the system and the operation of the system is tested through selected transactions.

(d) There is no need for there to be an element of surprise in the on-site inspection. If advance notice is given to the FI and information needed intimated to the FI before the commencement of inspection, unnecessary stress and inconvenience can be avoided.

29. The Group also suggests the following refinements in the present system of off-site supervision :-

(a) Off-site surveillance is at present somewhat handicapped by the difficulty in defining representative peer groups for comparison. For the time being, two groups should be defined viz. one comprising the three refinancing institutions and the second comprising the seven term-lending institutions. When the SFCs and the SIDCs are brought within the purview of RBI, they would each constitute distinct peer groups.

(b) A quarterly off-site report should be required on new activities/lines of business undertaken and new products launched by FIs.

30. The Group endorses following suggestions made at a meeting the Group had with the CEOs of some of the FIs :-

(a) Before the commencement of inspection, the management of the FI should be required to make a presentation to the IO of its perception of the risks to which the FI is exposed and the manner in which those risks have been addressed.

(b) The IO should meet with the internal and external auditors to appreciate the scope of the work and the results of the audit process.

(c) On conclusion of the inspection, the Principal Inspecting Officer should meet not merely the CEO but also the Chairman of the Audit Committee (the Group recommends the full Audit Committee) to discuss the major findings of the inspection.

31. The regular inspection should, in appropriate circumstances, be supplemented by the following :-

(a) targetted appraisal of selected areas like derivatives, swaps and other new products introduced.

(b) commissioned audits by external agencies, either the statutory auditors or other firms of Chartered Accountants.

(c) Snap visits for quick reviews if the "off-site" information highlights areas of concern which cannot await the annual inspection.

32. The optimal allocation of scarce supervisory resources requires a system of Risk Based Supervision (RBS) as such a system distinguishes between FIs in accordance with their risk profiles and thereby determines the nature of the supervisory resources and the tools to be employed. This need is further strengthened by the fact of the growth in the asset base, increasing diversity and complexity of the product portfolios with consequent changes in the risk profiles and a perceptible move on the part of some of the FIs towards universal banking. The Group recommends that, as in the case of banks, the

feasibility of securing expert assistance from outside agencies for implementing RBS in respect of FIs and thereby ensuring a consistent and integrated supervisory approach for the financial system as a whole should be explored.

33. Some of the FIs have subsidiaries/affiliates in the areas of commercial / investment / merchant banking as well as securities trading / primary dealership and mutual funds. With the opening up of the insurance sector in the country, it is likely that some of the FIs may also enter this field, making their present conglomerate structure even more complex. They are, therefore, financial conglomerates (FCs) as defined by the Joint Forum set up by the Basle Committee and other bodies. The need for consolidated supervision of FCs acquires special significance as the operations of subsidiaries and affiliates, particularly the unregulated ones, could expose the group as a whole to a variety of risks. Such risks can hardly be ignored by a prudential supervisor.

34. The RBI's regulation of FI's subsidiaries has so far being confined to the issuance of instructions to the regulated FIs to keep themselves informed of the activities of the subsidiaries, to exercise adequate supervision and to maintain an "arms length" relationship with their subsidiaries. These prescriptions are far from meeting the requirements of consolidated supervision which would require an overall evaluation, both quantitative and qualitative, of the strength of a group to meet the potential impact that the risks assumed by the group entities may have on other entities in the group as also on the group as a whole. The seven papers, released in February 1999, by the Joint Forum, which require supervisory implementation, include various aspects of the supervision of conglomerates. The Group considered in this context the BOPEC rating system used by the

Federal Reserve in USA in respect of Bank Holding Companies (BHCs) which would be akin to some of the FIs in India. This system is used for assessing the health of the BHCs and for prioritising the BHCs for increased supervisory attention. The Group recommends that steps be initiated in this regard and the feasibility of securing expert assistance for the purpose from outside agencies be explored.

35. RBI has fairly wide powers under the RBI Act, 1934, in respect of FIs but the powers are not explicit in regard to several important areas of supervision. This lack of clarity is not conducive to enforcement of prompt corrective action and could hinder the efficacy of the supervisory mechanism. There is, therefore, a need to vest in RBI clearly defined statutory powers for supervision of various financial entities more or less on the lines of the powers vesting with RBI in relation to banks.

36. At present, out of 42 notified PFIs under Section 4A of the Companies Act, 1956, only 9 PFIs and NABARD (which is not notified as a PFI) are covered under the supervisory purview of RBI. There is no statutory provision in place giving power to RBI to notify a financial institution as a "notified financial institution" which would be subject to RBI regulation and supervision. The Group believes such powers should be vested with RBI.

37. In respect of SFCs, under the existing statutory framework there is a dichotomy between the supervisory responsibilities which are entrusted to IDBI under Section 37A of the SFCs Act, 1951, and the enforcement authority for corrective action which is vested in the

respective State Governments under that Section. This has been one of the major constraints in effective regulation and supervision of SFCs. This dichotomy needs to be dispensed with through suitable amendments to the SFCs Act. Similarly, the question of transfer of the power to give instructions on "questions of policy" from the State governments to RBI may also need to be addressed in due course.

38. There are certain other powers incidental to the supervisory process which need to be vested in RBI. These include :

(a) the power to issue directions for securing corrective action on the findings of inspection;

(b) the power to prescribe disclosure norms and formats of the annual financial statements;

(c) the power to give directions to auditors; and

(d) the power to require submission of annual audited financial statements.

39. A draft inspection manual has been prepared by the FID of DBS and has been sent for comment to IDBI, ICICI and IFCI. The inspection manual needs to be finalised expeditiously after consideration of the comments received from those FIs and after incorporating the accepted recommendations of the Group.

40. In view of the fact that inspection of FIs is a new subject and in the context of a proposed shift to a system of Risk Based Supervision, there is likely to be a shortage of experienced officers within the RBI. It is, therefore, necessary that there should be a time-bound programme, for creating, through training, a sufficient cadre of officers

who have specialised knowledge for the inspection of FIs. For this purpose outside assistance may be necessary.

41. In this context, the post-training placement of the trained officers and their retention in the department for some time becomes relevant. Therefore well-defined criteria for entry into and exit from the department would need to be evolved and implemented.

42. The Group recognises that, in the emerging context of Universal Banking in India, the approach to supervision would have to shift from an institutional to a functional perspective cutting across the institutional boundaries. Thus, the specialised training inputs provided to the IOs and the skills developed by them with regard to the supervision of FIs, could be easily transferable across various functionally convergent institutions.

43. While a review of prudential norms is not strictly within the terms of reference of the Group, the matter needs reconsideration for the following reasons :

(a) while the existing norms have been designed primarily in relation to operating accounts, further attention needs to be given to advances in respect of projects under implementation and advances affected by significant changes in industry scenario.

(b) the application of US GAAP by some FIs has revealed significant differences in the amounts of provisioning under the US and Indian systems.

(c) there have been differences in interpretation between the FIs and their auditors on the one hand and the IOs on the other

(d) the decisions of FIs regarding rehabilitation and restructuring have been influenced by their impact on NPAs and the most optimum solutions have not been evolved.

The Group has therefore made some suggestions, which may be considered.

CHAPTER I

Introduction

1.1 Till the year 1990, the Reserve Bank of India (RBI) had not taken upon itself the task of broad oversight of the operations of Financial Institutions (FIs) viz. the All India term lending institutions, Unit Trust of India (UTI), statutory corporations in the insurance sector, National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI). This was largely because till then, the FIs were not subjected to market discipline but were predominantly the instruments for providing capital as per plan priorities and industrial licencing prescriptions of Government of India and were funded through concessional resources by way of Government guaranteed bonds and advances from Long Term Operations (LTO) Funds of RBI. Therefore, RBI had confined itself to calling for statistical returns from FIs for incorporating the data in the RBI's publications. Though the information was also received from the FIs for certain operational purposes, it was limited to the data required for dealing with their proposals under the annual market borrowing programme, for determining the allocations of funds from the Bank's National Industrial Credit (LTO) Fund, National Housing Credit (LTO) Fund as also for fixing their short-term borrowing limits under various provisions of the RBI Act, 1934. However, during the 1980s, with the enormous growth, both in size and depth, of the Indian financial system, in which the All India Financial Institutions ("FIs") had emerged as a significant component, the focus of the policy on monetary and credit aggregates emanating from the commercial and co-operative banking system alone, was found to be inadequate. Hence, an In-house Group comprising the then three Executive Directors of RBI (Shri S.S. Tarapore, Ms. V. Viswanathan and Ms. I.T. Vaz) was set up on 23rd March 1990 to :-

a) work out modalities of systematic calling of information from FIs,

monitoring the data so received and to devise a structured dialogue with FIs;

b) examine the nature of legislative strengthening that would be desirable to enable RBI to give directions on the conduct of business of these institutions as well as to undertake inspections to assess the quality of their assets; and

c) examine how best to organise in RBI the work relating to regulation of the FIs.

1.2 The In-house Group submitted its report on June 2, 1990. The major findings of the Group were:

i) The total financial assets of all FIs were over Rs.89,000 crore at the end of March 1989. The sanctions and disbursements by these institutions showed a growing trend;

ii) The FIs drew large assistance from RBI both from the LTO Funds and by way of short-term credit limits;

iii) The institutions had been projecting increasingly large resource gaps, even after raising large resources from the domestic market as also from abroad through institutional and commercial borrowings and drawing very large resources from RBI; with the buoyancy in the capital market and sizeable mobilisation of funds by UTI, LIC and GIC, the penetration of the capital markets by FIs had become sizeable and their active participation in both the primary and secondary markets had a major impact on stock prices movements.

iv) The In-house Group felt it necessary to devise ways for aggregating data on mobilisation of resources and deployment of funds by the FIs for policy formulation purposes.

1.3 Against the foregoing background, the undernoted broad objectives for monitoring the All India financial institutions and the mechanism therefor were outlined by the In-house Group:

i) To introduce an information system for FIs and monitor their operations so as to know the size and the nature of financial flows, particularly total debt and investments, which go to finance the needs of the non-financial sectors of the economy;

ii) To broadly oversee the operations of FIs with a view to bringing about a better functioning of the financial system and ensuring greater co-ordination between the policies and operations of banks and FIs;

iii) To introduce a system of Annual Financial Review of FIs on the lines of that obtaining for the public sector banks in order to assess the quality of their assets, on which depends the health of these institutions;

iv) To introduce a system of periodical dialogue between the Top Management of the RBI and Chief Executives of the FIs for assessing the overall quality of their functioning, discussing their policy thrusts and identifying the broad areas where improvement/ changes are called for.

The Group was of the view that RBI had sufficient powers under Sections 45K, 45L and 45N of the RBI Act, 1934, for carrying out the foregoing objectives and any amendment to the Act could wait till RBI gained some experience by operating within the existing legislative framework. The Group also recommended setting up of a multi-disciplinary Financial Institutions Cell (FIC) as an independent unit in Central Office of the Bank for the task envisaged.

1.4 The report of the Group was deliberated upon at length at the 272nd meeting of the Management Committee of RBI on 24 July 1990. At the meeting, it was stressed by the then Governor (Shri R. N. Malhotra) that RBI was to concentrate on examining the health and the soundness of the FIs' loan portfolios and the annual financial review was to be undertaken on the basis of the information supplied by the institutions and discussions with them. Thus, with

the approval of the Management Committee and the Committee of the Central Board, an inter-disciplinary FIC was created in 1991 at Central Office of RBI for overseeing the functioning of all-India term lending and investment institutions. Consequently, the FIs came within the regulatory ambit of RBI for the first time in 1991 for the limited purpose of collection of financial data from the institutions for an ongoing monitoring. To begin with, there were 10 FIs (viz. EXIM Bank, ICICI, IDBI, IFCI, NABARD, NHB, IRBI, GIC, LIC and UTI) under the regulatory purview of FIC. Subsequently, the Shipping Credit and Investment Corporation of India Limited (SCICI – now merged with ICICI Ltd.), the Small Industries Development Bank of India (SIDBI), the Tourism Finance Corporation of India Ltd. (TFCI) and the Infrastructure Development and Finance Company Ltd. (IDFC) were also brought within the regulatory and supervisory ambit of RBI.

1.5 Pursuant to the uncovering of the "Securities Scam" in the banking sector in 1991, instructions were issued to FIs for the first time in June 1992 regarding their investment portfolio. Subsequently, prudential guidelines on income recognition, asset classification & provisioning as also on capital adequacy standards were made applicable in a phased manner to term lending institutions with effect from the financial year 1993-94 and to refinancing institutions (i.e., NHB, NABARD & SIDBI) with effect from the financial year 1995-96. In June 1997, the credit exposure norms were extended to term lending institutions. The norms have been progressively refined over the years. No prudential norms, however, have been prescribed by RBI for the investment institutions (viz., LIC, GIC & UTI).

1.6 In November 1994, the Board for Financial Supervision (BFS) was constituted under the aegis of RBI for a comprehensive and integrated regulation and supervision over the commercial banks and FIs under one umbrella and RBI (BFS) Regulations, 1994, were framed. The Regulation 5(1) *ibid,* specifically mentions that the Board shall perform all functions and exercise the powers of supervision and inspection under the Reserve Bank of India Act, 1934 and

under the Banking Regulation Act, 1949, in relation to different sectors of the financial system such as banking companies, FIs and Non-Banking Financial Companies (NBFCs). In pursuance of the above, the monitoring of select FIs was intensified through, inter alia, on-site inspection as well and the responsibility for supervision, including on-site inspection of the FIs, devolved since April 1995 on the then Department of Supervision (DoS) which was subsequently bifurcated into Department of Banking Supervision (DBS) and Department of Non-Banking Supervision (DNBS). The first round of on-site inspections of FIs was conducted during the year 1995/1996. The FIC ceased to function with effect from 1 July 1997 when a new Division, named as Financial Institutions Division (FID), was created under DBS for a more effective and coordinated supervision over FIs. The process of second round of inspections has also been completed. In order to achieve ongoing supervision in respect of this segment too, setting up of a computer-based off site surveillance system at the FID, Central Office is also underway.

1.7 Since the FIs first came under the regulatory purview of RBI, several significant changes have taken place in their operating environment and structure, as a sequel to the financial sector reforms instituted by the Government. With the Government's decision that the entire profit of RBI be transferred to it from the year 1991-92, the earlier practice of appropriating large amounts from the profits of RBI for allocation to various LTO Funds, was discontinued. Also, as a part of financial sector reforms, the Statutory Liquidity Ratio (SLR) was brought down significantly and as a result, the market borrowing allocations of some of the FIs (viz. EXIM Bank, ICICI, IDBI and IFCI) were totally stopped while for other FIs, the allocations were drastically pruned. Thus, with the gradual drying up of the traditional sources of funds (viz. LTO Funds and the Government guaranteed bonds), the FIs were forced to source their funds at market related rates, which raised the cost of funds for them. Some of the FIs have also set up wholly/majority owned subsidiaries in the areas of

investment/merchant/commercial banking, asset management, venture capital financing, etc., which are not subjected to a consolidated or even solo supervision. With the removal of quantitative ceiling on the term loans / project finance that the banks can extend and with the FIs now permitted to access relatively shorter-term funds also (through CDs, ICDs, term money borrowings, term deposits, repos/reverse repos), the distinction between the banks and FIs has got increasingly blurred. Furthermore, the share of FIs in the financial assets of banks and FIs taken together, increased from 34.1 per cent in 1991 to 37.50 per cent (Rs. 4,33,129 crore) as on 31 March 1999.

1.8 In the backdrop of the foregoing, a view has developed that the supervision of FIs continues to be somewhat of a grey area with RBI exercising only a limited oversight and periodical inspection while the primary responsibility continues to be with the Government of India/ Board of Directors. It was, therefore, considered desirable to set up an 'Informal Advisory Group' to examine in depth the various aspects concerning regulation and supervision of FIs and to suggest an appropriate framework therefor. It was, therefore, decided in consultation with the Government of India, Ministry of Finance, to set up an 'Informal Advisory Group' under the Chairmanship of Shri Y.H. Malegam, Director, Central Board of RBI. A copy of the letter dated 15 March, 1999, addressed to Shri Malegam in this regard is furnished at **Annexure I**. The Advisory Group had the following members:

i) Dr. V. V. Desai, formerly, Chief Economist and Director at Asian Development Bank;

ii) Dr. R.H.Patil, Managing Director, National Stock Exchange; and

iii) Shri P.V. Narasimham, Chairman, IFCI Ltd.

Shri K.C. Bandyopadhyay, Chief General Manager, Financial Institutions Division, Department of Banking Supervision, Reserve Bank of India, was the Member Secretary.

1.9 The terms of reference of the Group were to examine and make recommendations on the following aspects:

(i) Areas of coverage of supervision of FIs;

(ii) Objective and purpose of supervision;

(iii) Type of supervision viz. on-site/ off-site or on the basis of CAMELS system through internal or external sources;

(iv) Types of FIs which should be covered under overall supervision;

(v) Legislative amendments required;

(vi) Assessment of the need for a Manual and specialised staff with intensive training by outside experts.

1.10 The Group held meetings in Mumbai with the first meeting being held on 15 April 1999. The Group also held discussions with the CMDs / CEOs of ICIÇI Limited, Industrial Development Bank of India and Industrial Investment Bank of India Ltd., for soliciting their views on various aspects of supervision of FIs by RBI.

Acknowledgements

1.11 The Group gratefully acknowledges the contributions made by Shri G. P. Gupta, CMD, IDBI, Shri K. V. Kamath, MD, ICICI and Shri S. R. Mukherjee, ED, IIBI, during the course of their deliberations in the committee with their in-depth knowledge of the issues pertaining to Financial Institutions. The group would also like to place on record its deep appreciation of the contributions

made by the Member-Secretary, Shri K. C. Bandyopadhyay by presenting background notes, data and valuable materials on several aspects / areas required for the Group's deliberations. Furthermore, the Group places on record its appreciation of the services rendered by Shri A. K. Misra, DGM, FID, Department of Banking Supervision, Reserve Bank of India, Central Office, Mumbai, in providing valuable research support as well as assistance to the Group in finalising the draft of the report. The valuable assistance rendered by Shri A. C. Chakrabarty, Manager and Shri A.M.Tiwari, Manager, both attached to FID, Department of Banking Supervision, Reserve Bank of India, Central Office, Mumbai, in drafting the report and preparing the minutes of the Group's meetings, deserves special mention.

CHAPTER II

Objectives and Purpose of Supervision of Financial Institutions

Diverse nature of Financial Institutions

2.1 Unlike the banks in the Indian banking system, the FIs in India are not homogeneous in their structure, functions and geographical scope. While most of the FIs (viz. IDBI, SIDBI, EXIM Bank, NHB, NABARD, LIC, GIC, UTI and SFCs at the State level) have been established under specific parliamentary enactments and the respective statutes dictate their functions, operations and disclosures, some of the FIs (viz. ICICI, TFCI, IIBI, IFCI, IDFC and SIDCs at the State level) are structured as limited companies under the Companies Act, 1956, and are governed by their respective Memorandum and Articles of Association and the Companies Act. Further, the FIs and SIDCs, which are organised as limited companies fall within the definition of Non- Banking Finance Companies (NBFCs) under the RBI Act, 1934; however, such FIs as are regulated and supervised by FID, have been granted exemption from some of the provisions/ directions normally applicable to NBFCs. Also, even though most of the FIs, including SFCs, stand notified by the Government of India, as "Public Financial Institution" (total 42 in number as on date – listed in **Annexure II**) under Section 4A of the Companies Act, 1956, NABARD and the SIDCs are not so notified, even though in eight States and two Union Territories, the SIDCs function as SFCs also. Functionally, while IDBI, NABARD and NHB are also apex bodies in the fields of industrial, agricultural and housing credit respectively apart from being direct purveyors of credit, SIDBI, NABARD, NHB are primarily refinancing agencies. The investment institutions viz. LIC, GIC, UTI though mainly focusing their operations in the capital and money markets, are also engaged in direct/ indirect lending operations by way of direct subscription to corporate equity/ debentures. IRBI (till its recent reconstitution into a full-fledged FI and renaming as IIBI) was unique in as much as it financed only sick units.

The IDFC was created mainly for credit enhancement though it is also empowered to undertake direct lending. The geographical scope of the State level institutions is naturally confined to their respective States. There is also a diversity in statutory definitions of the terms 'Financial Institutions' and "Public Financial Institutions" under various statutes as enumerated in **Annexure III**.

2.2 It is, thus, obvious that there is no commonality in the definition, constitution, objectives, functions and supervision of various FIs. These diversities need to be kept in view when determining the supervisory scope of RBI in relation to FIs.

Need for supervision

2.3 While the core regulatory and supervisory concern in monitoring the banking sector is the protection of depositors' interest as also of the official safety net of deposit insurance, the rationale for regulatory intervention in respect of FIs, which are primarily not into retail deposit taking, is somewhat different. The principal reason for regulating and supervising the FIs in the Indian context where universal banking is not yet in vogue, is to monitor and control the systemic risk in the national financial system. This is so since failure of a FI, which controls substantial part of financial assets in the system, could shake the public confidence and trigger a rapid spread of the default contagion throughout the system, precipitating a systemic crisis. Besides, from monetary policy angle too, regulation and supervision of FIs by RBI becomes imperative since the FIs – though not so far subject to usual reserve requirements – are directly involved in the process of credit creation and also affect monetary aggregates; hence, the need to monitor them for effective macro-economic and monetary management. Moreover, given the nature of FIs' operations, several FIs have significant amounts of foreign currency borrowings on their balance sheets and need to access international capital markets regularly. If, however, poor financials

of FIs lead to a default to their foreign lenders, it would not only impact their own credit rating adversely but would also jeopardise India's country risk profile internationally. This too warrants an effective regulatory and supervisory apparatus for the FIs.

Objectives of supervision

2.4 Given the diverse nature of the FIs, the objectives of supervision can vary. For most of the FIs which are in the nature of banking substitutes, the objectives of supervision may be summarised as under :

- Minimising the systemic risk to the national financial system arising from the destabilising effects of a possible failure of a FI;
- As a corollary to the above, maintaining public confidence in the financial system;
- Improving the effectiveness of monetary and credit policy measures;
- Strengthening the internal control systems in the FIs by identifying their vulnerabilities; and
- Ascertaining that the activities of the FIs are in conformity with the objectives for which they have been created and the further objectives that might have evolved over the years.

2.5 However, when these objectives are applied to the inspection of individual institutions, they may need to be modified or the emphasis on individual objective varied taking into account the special purpose for which the institution has been created or operating.

CHAPTER III

Types of FIs Which Should be Covered Under

Overall Supervision of RBI

(A) Institutions covered at present under RBI's supervision

A.1 All-India Financial Institutions

3.1 As stated in para 1.4 above, besides 10 All India FIs already brought under the regulatory and supervisory domain of RBI, three investment institutions (viz. GIC, LIC and UTI) are also broadly monitored through receipt of periodical returns. These institutions may be classified into three broad groups viz.,

a) FIs which are mainly direct lending institutions :

i) IDBI
ii) ICICI
iii) IFCI
iv) IIBI
v) IDFC
vi) EXIM Bank
vii) TFCI

b) FIs which are mainly refinancing institutions :

i) NABARD
ii) NHB
iii) SIDBI

c) FIs which are insurance/ investment institutions :

i) GIC
ii) LIC
iii) UTI

3.2 Of the 13 FIs listed above, three FIs viz., GIC, LIC & UTI come under the purview of other regulatory authorities and are monitored by RBI only for the limited purpose of arriving at monetary aggregates through receipt of periodical returns. The other 10 FIs are directly regulated and supervised through periodical on-site inspections as well. This latter group includes NABARD, which has not been notified as a Public Financial Institution (PFI).

A.2 State Level Institutions

3.3 One category of State level institutions is that of State Industrial Development Corporations (SIDCs), which were established under the Companies Act 1956 as wholly owned undertakings of State governments for promotion and development of medium and large industries in the respective States. The SIDCs have not yet been notified by the government as PFIs under the Companies Act, 1956 but being companies and engaged in making loans and advances, fall within the definition of non-banking financial companies under the RBI Act, 1934, and were subject to the RBI (DNBS) Directions till recently. These Corporations provide financial assistance in the form of rupee loans. underwriting /direct subscriptions to shares/debentures and guarantees and also undertake a range of promotional activities. SIDCs are also involved in setting up of medium and large industrial projects in the joint sector /assisted sector in collaboration with private entrepreneurs or as wholly owned subsidiaries. In keeping with the changing environment, many SIDCs are trying to diversify their activities and enter into areas of equipment leasing, merchant banking, venture capital and mutual funds. As on 31 December 1999, there were 28 SIDCs, listed in **Annexure IV**, of which 11 SIDCs – in eight States and three Union Territories** – also function as SFCs to provide assistance to small and medium enterprises and act as promotional agencies. Upto 31 March 1999, the cumulative sanctions and disbursements of all

** Andaman &Nicobar, Arunachal Pradesh, Daman & Diuand Dadra Nagar Haveli, Goa, Manipur, Meghalaya Mizoram, Nagaland, Pondicherry, Sikkim and Tripura

the SIDCs since their inception aggregated Rs. 17,131.6 crore and Rs. 12,901.6 crore respectively while the corresponding figures for the year 1998-99 were Rs. 1595.9 crore and 1362.8 crore.

3.4 It is observed in this context that on 12 May 1993, IDBI had issued guidelines to SIDCs on asset-classification, provisioning and accounting systems. Pursuant to the decision taken on 18 August, 1993, at the meeting of the Chief Secretaries of the State Governments, Chief Executives of the SFCs and of the SIDCs, Chaired by the Finance Secretary, Government of India, the said guidelines were reviewed by a Committee consisting of the representatives of IDBI, SIDBI and RBI. As per the recommendations of the Committee, the guidelines were revised and issued to SIDCs by IDBI on 26 April 1994 in respect of accounting system; asset-classification & provisioning and accounting standards for investments. These guidelines were broadly patterned on the RBI norms applicable to All-India financial institutions but did not address the aspects of capital adequacy and credit exposure norms. It is understood that the guidelines were prescribed under the terms stipulated by IDBI in the refinancing agreements entered into with the SIDCs and hence, could be enforced only so long as the refinance availed by the SIDCs remained outstanding. IDBI has also been conducting periodical inspections of SIDCs but more as a provider of refinance rather than as a prudential supervisor. While the guidelines continue to be applicable to the SIDCs till date, there are no statutory powers vested in IDBI under the IDBI Act, 1964, for regulation or supervision of SIDCs. Hence, the prudential norms prescribed by IDBI for SIDCs do not have a sound statutory base. It is also understood that the authority of IDBI over the SIDCs has been called into question recently by one of the SIDCs.

3.5 With the amendment to RBI Act, 1934, vide RBI (Amendment) Act, 1997, comprehensive powers got vested in RBI for regulation of NBFCs. The amendments specifically empowered RBI, inter alia, to determine policy and issue directions to NBFCs on various prudential aspects (such as capital adequacy, asset classification & provisioning, purpose and quantum of loans,

deployment of funds, etc.) as also to their auditors regarding matters relating to annual accounts, disclosure, etc. Accordingly, RBI issued a new set of three "Directions" to NBFCs in January 1998 relating to Acceptance of Deposits, Prudential Norms and the Auditors' Report. Being structured as companies under the Companies Act 1956 and engaged in making loans and advances, the SIDCs fall within the definition of "non-banking finance company" under Section 45-I (f) (ii) (inserted vide the Amendment Act, 1997) of the RBI Act, 1934, and thus, became subject to the RBI's regulations applicable to NBFCs. However, as on 1 February 1999, only two SIDCs (viz. Haryana SIDC and Tamil Nadu SIDC) which accept deposits from public, were registered with RBI (DNBS) and were allowed to hold/accept deposits from public. As such, these SIDCs were subject to the full rigour of "NBFCs Acceptance of Public Deposits (Reserve Bank) Directions, 1998" and "NBFCs Prudential Norms (Reserve Bank) Directions, 1998", till recently.

3.6 The other SIDCs which did not accept public deposits but were classified as 'loan companies' on the basis of their asset / income pattern, were exempted from NBFC Directions relating to interest rate, period and quantum of deposits, obtaining credit rating, maintaining liquid assets, submission of returns and the prudential norms regarding capital adequacy and credit / investment concentration. For availing of these exemptions, such NBFCs were required to get suitable resolutions passed by their Board of Directors, as prescribed by RBI. These NBFCs (SIDCs) were, however, required to comply with other prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to them. The compliance with these norms is to be verified by the auditors of all the NBFCs as mandated under "NBFCs Auditor's Report (Reserve Bank) Directions 1998". The auditors were required to report to Reserve Bank, the details of any non-compliance by the NBFC with the RBI Directions on acceptance of deposits or on prudential norms.

3.7 Thus, since January 1998 – when the RBI's Directions to NBFCs came into force – there had been a regulatory overlap for the SIDCs since the RBI norms as well as the norms prescribed by IDBI in 1993, were concurrently applicable to SIDCs. Nonetheless, the regulatory framework for SIDCs, on account of their NBFC status, was quite comprehensive and robust. However, RBI (DNBS), vide their circular No. 12 dated 13 January 2000, has exempted all Government owned NBFCs from applicability of the provisions of RBI act relating to maintenance of liquid assets and creation of reserve funds, and the directions relating to acceptance of public deposits and prudential norms. Hence, SIDCs, being government companies, have now moved out of the purview of the Directions of RBI (DNBS) – though the requirement of registration with RBI continues to apply – while the statutory authority of IDBI for regulating SIDCs is non-existent. This peculiar situation creates a regulatory vacuum for SIDCs – which is undesirable. The Khan Working Group, constituted by RBI in December 1997, on 'Harmonising the Role of Development Financial Institutions and Banks' has also, *inter alia*, recommended that the State Level Institutions should be brought within the ambit of RBI. **The Group is, therefore, of the view that in order to obviate the regulatory and supervisory vacuum, the SIDCs, being as they are a close bank-substitute, should be brought within the supervisory ambit of RBI and regulated on par with the All-India financial institutions**.

(B) The institutions which should be under RBI's supervisory domain

B.1 State Financial Corporations

3.8 As stated earlier, at present there are 42 PFIs notified by the Government. These include 18 State Financial Corporations (SFCs) of which 17 were setup under the SFCs Act, 1951, while Tamil Nadu Industrial Investment Corporation Ltd., was incorporated under the Companies Act, 1956, but still functions as a SFC. SFCs provide financial assistance to small and medium enterprises by

way of term loans, direct subscription to equity shares/debentures, guarantees, discounting of bills of exchange and seed / special capital. Their main objectives are to finance and promote these enterprises in the states concerned for achieving balanced regional growth, catalyse investment, generate employment and widen the ownership base of industry. In tandem with the changing environment, the SFCs are expanding the scope of their activities and coverage of their assistance. As on 31st March 1999, the cumulative sanctions and disbursements by all the SFCs aggregated Rs. 30,374.5 crore and Rs. 24,867.8 crore respectively while these figures for the year 1998-99 were Rs. 1,864.5 crore and Rs. 1,626.7 crore respectively. A comparative position of the financials of the SFCs as on 31 March 1998 is furnished at **Annexure V.** It would be observed that the total assets of the SFCs as on that date aggregated Rs. 13693.77 crore with the combined NPAs of the SFCs constituting as much as 44% of their combined loan assets.

3.9 The supervision of SFCs through on-site inspection, as also several other matters relating to SFCs, was attended to by the erstwhile Industrial Finance Department of RBI till 16 February 1976. However, with the coming into force of the Public Financial Institutions Laws (Amendment) Act, 1976, with effect from 16 February 1976, the following items of work in respect of SFCs were transferred to IDBI in terms of Chapter VI of the Act:

(i) establishment of joint State Financial Corporations (Section 3A of the SFCs Act, 1951);
(ii) issue of special class of shares (Section 4A *ibid*);
(iii) appointment of Managing Directors of SFCs (Section 10(f) *ibid*);
(iv) underwriting obligations (Section 25(1)(f) *ibid*);
(v) inspection (Section 37A *ibid*);
(vi) issue of instructions (Section 39 *ibid*);
(vii) approval of regulations framed by SFCs (Section 48 *ibid*).

However, the core functions of the Reserve Bank as a central banking authority with regard to borrowing, etc. of SFCs continued to be vested with RBI and were discharged in consultation with IDBI. Certain other obligations envisaged in the SFCs Act, 1951, as amended by PFIs Laws (Amendment) Act, 1975, were to be processed between RBI and IDBI in the following manner:

(a) the IDBI would scrutinise proposals for issue and sale of bonds and debentures so far as individual SFCs are concerned and will present a consolidated picture to the Reserve Bank, which would then advise the IDBI, after consulting the Secretary's Department (now IDM Cell), indicating the total amount, the distribution and the terms.(cf. Section 7(1) of the SFCs Act, 1951);

(b) The IDBI would deal directly with the Department of Accounts and Expenditure (DAE) with regard to the borrowing of money by SFCs from the Reserve Bank. The DAE would consult the IFD (now RPCD) on each reference before taking a decision. (cf. Section 7(2) and 7(2A) of SFCs Act, 1951);

(c) With regard to borrowings by the SFCs from the State Government, the IDBI, after consulting the SFC and the State Government concerned, would refer proposals individually to the Industrial Finance Department (IFD) of RBI. The IFD (now RPCD) would then accord RBI's approval in each case in terms of Section 7(3) of SFCs Act;

(d) In respect of the acceptance of deposits by the SFCs under Section 8 of the SFCs Act, the IFD would convey general guidelines to IDBI for communication to SFCs.

(e) The IFD was to continue to receive and analyse the monthly and quarterly returns from SFCs under Section 38 of the SFCs Act, as was done prior to 16 February 1976, for purposes of assessing the resources position of SFCs, preparation of statistical statements, notes, etc.

The foregoing working arrangement by and large continues even now but primarily the Central Office of Rural Planning and Credit Department now handles these functions in RBI. Notwithstanding the foregoing arrangements in respect of work relating to SFCs, a robust regulatory and supervisory framework for an ongoing financial supervision of SFCs' operations is wanting.

3.10 As regards the ongoing regulation of SFCs, there is a gap in the extant prudential framework. Even though under the provisions of SFCs Act, 1951, the respective State Governments are the sole authority for giving directions to SFCs in the matters of policy (for which they may be guided by the advice of IDBI), yet such policy directions have not evolved into a well structured prudential regulatory framework for the SFCs. In April 1993, IDBI had issued guidelines to SFCs on asset classification, provisioning and accounting systems. Pursuant to the decision taken at the meeting convened on 18 August 1993, by the then Finance Secretary, Government of India (cf. Para 3.4 above), the aforesaid guidelines issued by IDBI, were reviewed by a committee of representatives from RBI, IDBI & SIDBI. As per the recommendations of the committee, IDBI issued revised guidelines to SFCs on Asset classification, Provisioning and Accounting System, in March 1994. However, neither under the IDBI Act, 1964, nor under the provisions of SFCs Act, 1951, are any powers vested with IDBI for issuing instructions / directions to SFCs – which can be issued only by the respective State Governments. Thus, the guidelines to SFCs issued by IDBI do not appear to be backed by any statutory authority and their validity is questionable.

3.11 In terms of section 37A of the SFCs Act, 1951, IDBI is empowered to undertake the inspection of SFCs but with the prior approval of the Central Government. Accordingly, the Government, vide their letter dated 24 March 1976, had conveyed its approval to IDBI for undertaking annual inspection of the SFCs. As stated in the letter, it was the Government's expectation that such inspections would guide and assist the Corporations in establishing sound

practices and traditions. However, it has been ascertained from IDBI that the inspections (since called Performance Evaluation Studies - PES) could not be conducted annually mainly because of inordinate delay on the part of the SFCs in finalising their annual accounts and in submission of pre-inspection data called for from them. The PES is designed to cover the aspects of organisation and management, operations, quality of loan assets, sources and uses of funds, etc. However, a perusal of the reports revealed that the coverage had not been upto the mark and a proper system for follow-up of compliance was also wanting. IDBI also obtains certain periodical returns from SFCs but these are more to serve the information needs of IDBI as a lender to SFCs rather than a prudential regulator or supervisor of SFCs. Moreover, since as per SFCs Act, the decision of the State Government is final as regards any matter pertaining to policy, IDBI has no powers to take any action against the SFCs for non-compliance with the inspection findings. As such, the PES or the inspections have not proved to be an effective tool for ensuring the financial health of the SFCs.

3.12 In the light of the foregoing, the Group is of the view that there is an element of regulatory as well as supervisory vacuum in respect of SFCs. The Working Group constituted by RBI in December 1997 on 'Harmonising the Role and Operations of DFIs and Banks' (Chairman: Shri S. H. Khan), which submitted its report in May 1998, has recommended that the State Level Institutions (SLIs) should be brought within the supervisory ambit of RBI; the corporatisation, restructuring and change in ownership of SLIs from IDBI to SIDBI has also been recommended. In this context, it may be mentioned that in pursuance of the decision taken at the aforesaid meeting of 18 August 1993 (cf. Para 3.4 above), a committee was formed under the Chairmanship of the then CMD of IDBI (Shri S. H. Khan) to undertake a comprehensive review of the SFCs Act, 1951. The committee submitted its report in May 1994. The summary of the conclusions / recommendations of the committee is furnished at **Annexure VI**. It is understood that based on the recommendations of the committee, the

SFCs (Amendment) Bill, 1999, was drafted and is under active consideration of the Government. An extract from the Bill is furnished at **Annexure VII.** It would be observed that Clause 6 of the Bill seeks to insert a new Section 4H in the SFCs Act, 1951, providing for transfer of all the shares of every SFC held by IDBI to SIDBI on the date to be notified by the Central Government while the Clause 30 of the Bill seeks to amend Section 37A of the Act, such that the responsibility of inspecting SFCs would stand transferred from IDBI to SIDBI. However, reckoning the facts that:

- The regulation and supervision of the SFCs in the recent past has not proved to be effective for want of necessary regulatory powers with IDBI;

- The financial health of the SFCs is far from satisfactory and is a cause of supervisory concern (cf. Annexure V);

- The SFCs' combined assets at Rs. 13,693.77 crore (as on 31 March 1998) constitute a significant component of the financial assets of the Indian financial system; and

- The proposed transfer of supervision of SFCs from IDBI to SIDBI is presumably on account of transfer of transfer of ownership and is not by itself a sufficient reason for transfer of supervision of SFCs to SIDBI; and

- The Khan Working Group, constituted in December 1997 much after the Khan Committee of 1993 under the chairmanship of the same person, has recommended that the "supervision and monitoring of SLIs should be brought under the supervisory ambit of RBI which at present monitors banks, financial institutions as well as NBFCs",

the Group is of the view that the SFCs should be brought within the supervisory domain of RBI, rather than being supervised by SIDBI as proposed in the Bill, so as to secure an integrated supervision of the

Indian financial system. Since the legislative bill amending the SFCs Act, 1951, is at an advanced stage of consideration by the Government, the Group recommends that RBI should take up the matter with the Government for entrusting the regulatory and supervisory responsibilities in respect of the SFCs to RBI through suitable amendments to the SFCs (Amendment) Bill, 1999 or otherwise. Moreover, since the draft bill for amending the SFCs Act is based on the recommendations of the Khan Committee which was formed way back in 1993, it is likely that its recommendations would have become somewhat outdated as the Indian financial system has undergone a structural transformation in the past few years.

B.2 <u>Other All-India Public Financial Institutions</u>

3.13 Apart from the 18 SFCs, there are certain other national level financial institutions also which though notified as PFIs under Section 4A of the Companies Act, 1956, are not under the supervisory domain of RBI at present. These 12 FIs, besides the UTI, LIC and GIC, are the following:

a) the four subsidiaries of GIC (viz. National Insurance Company Limited, New India Assurance Company Limited, Oriental Fire and General Insurance Company Limited and United Fire and General Insurance Company Ltd.);

b) Power Finance Corporation Limited (PFC)

c) Indian Railway Finance Corporation Limited(IRFC)

d) Rural Electrification Corporation Limited (REC)

e) Indian Renewable Energy Development Agency Limited (IREDA)

f) Risk Capital and Technology Finance Corporation Limited (RCTC)

g) ICICI Venture Funds Management Company Limited (ICICI – VFMC) (formerly Technology Development and Information Company of India Limited – TDICIL)

h) North Eastern Development Finance Corporation Limited (NEDFC)

i) Housing and Urban Development Corporation Limited (HUDCO)

The Group recognises that, ideally, the institutions designated as PFIs ought to have a homogenous regulatory and supervisory framework since as a class, the PFIs become a bank-substitute, even though less than a perfect one, and the regulatory framework should be driven by a "functional" rather an "institutional" perspective to secure a level playing field and to promote competitive efficiency of the market participants. However, the unique functions and features (including the nature and scale of operations) of various PFIs, need to be kept in view in formulating the recommendations. It would, therefore, be appropriate to briefly review the features of each of the aforesaid PFIs with a view to suggesting the desirable regulatory framework for them.

3.13.1 The GIC's subsidiaries being insurance / investment institutions, would be governed by the regulations framed by the recently created Insurance Regulatory and Development Authority and SEBI, in respect of their insurance and capital market operations respectively. These Corporations thus need not be brought under the full scope of RBI's regulation and supervision. As regards the capturing of the monetary aggregates emanating from these subsidiaries, the information system already in place within RBI in respect of GIC (and LIC and UTI) adequately covers the data relating to these subsidiaries.

3.13.1.1 In this context, however, it needs being pointed out that certain aspects of the lending operations (such as bridge loans, credit to NBFCs) of the GIC, LIC and UTI are already regulated by RBI, guided by the imperatives of the Monetary and Credit Policy of the RBI. Nonetheless, there is neither any information system in place nor a system of periodical targeted appraisals / on-site examinations, to verify compliance with these regulations on an ongoing basis. Hence, there is an obvious case for bridging this supervisory gap. **The Group is of the view that a system of obtaining annual certificates, evidencing due compliance with the applicable RBI regulations, from the auditors of these institutions should be introduced** which would provide an effective solution.

3.13.2 As regards the PFC, IRFC, REC and HUDCO, these are Public Sector Undertakings of the Central Government under the Ministries of Power, Railways, Power and Housing & Urban Development, respectively. These PFIs are not only sector specific but by virtue of being PSUs, are also governed by the directions issued by Department of Public Enterprises (DPE), Government of India. The salient features of these as well other PFIs are briefly enumerated in the following paragraphs.

3.13.2.1 PFC Limited

The PFC was set up as a company, wholly owned by the Central Government, under the Companies Act, 1956, in July 1986 under the Ministry of Power, with the mission of serving as a nodal Development Financial Institution for the power sector. It was notified by the Government under Section 4A of the Companies Act, 1956, as a PFI on 31 August 1990. PFC has also been declared by the Government of India as a "Miniratna" Category - 1 Public Sector Enterprise that allows it certain operational freedom. As a PSU, it is also subject to the audit by the Comptroller and Auditor General of India. The total assets of PFC as on 31 March 1999 aggregated Rs. 9448.64 crore, of which its loans portfolio constituted Rs. 9081.85 crore as against its owned funds (i.e., capital and reserves & surplus) of Rs. 2901.78 crore. The credit exposure of PFC is predominantly to public sector entities – viz. the State Electricity Boards, State Power Generating Companies and Electricity Departments of State Governments – aggregating Rs.8248.90 crore but its exposure to private sector entities has been on the rise in the recent past. As on 31 March 1999, its sanctions to the private sector power projects aggregated Rs. 1700 crore against which the amount disbursed was Rs. 152.50 crore. It also mobilises resources in the domestic markets and during 1998-99, it raised funds to the extent of Rs. 1072.65 crore – Rs.462.65 crore through bonds and Rs. 610 crore through term loans, including term loans from commercial banks.

3.13.3.1 Being a company under the Companies Act, 1956, and engaged in deposit taking and lending activity, PFC is at present registered with RBI (DNBS) as a NBFC and is governed by the norms applicable to such companies. However, it has been granted exemption till 30 June 2000 from the "NBFCs Acceptance of Public Deposits (Reserve Bank) Directions, 1998" and is, thus, not constrained by the ceilings on the quantum of "public deposits" and the rate of interest that it can offer therefor, as applicable to other NBFCs. It has also been exempted, till 30 June 2000, from the prudential norms relating to "concentration of credit and investment" while all other prudential norms under the "NBFCs Prudential Norms (Reserve Bank) Directions, 1998" were to be applicable to it. During 1998, it had approached RBI for being brought under the regulatory and supervisory purview as an all-India FI rather than its treatment by RBI as a NBFC. The move was motivated by the somewhat liberal regulatory regime applicable to the FIs as compared to the NBFCs particularly in respect of capital adequacy ratio, access available to an FI to the call money market as lender and the repo market. **Annexure VIII** presents a comparison of the salient RBI regulations applicable to FIs and NBFCs. Since, however, the exposure of the PFC to the private sector at that time was very limited and being a PSU, it falls within the purview of DPE which constrains its operational autonomy and self-governance ability as compared to other PFIs, its request was not accepted. Thus, it continued to be governed by the RBI regulations applicable to NBFCs to the extent it had not been exempted therefrom. However, as stated at para 3.7 above, with effect from 13 January 2000, the government owned NBFCs stand exempted from the RBI Directions on acceptance of public deposits and on prudential norms. Hence, it is no longer mandatory for it to comply with the RBI norms as applicable to NBFCs.

3.13.3.2 The Group is of the view that with increasing privatisation of the power sector, the exposure of PFC to private entities is very likely to increase in the days to come which would increasingly make it a bank-substitute as

more and more private sector entities would have access to it. Correspondingly, its reliance on the public funds for mobilisation of resources through bonds and deposits, would also increase over the years. Also, the power sector constitutes an important segment of the social and economic infrastructure of the country and there is a need to ensure greater flow of credit to this sector through a sound and healthy institutional structure. Moreover, IDFC, which also caters to the needs of, among others, the power sector, is already within the regulatory purview of RBI even though it has a much smaller balance sheet size than PFC. To the extent that the borrowing and lending operations of PFC impact the monetary aggregates in the economy, there is a case for its regulation and supervision. In order, therefore, to ensure healthy growth of the power sector consistent with the macro-prudential regulatory and supervisory goals for the financial system, the Group is of the considered view that **PFC should be brought within the supervisory domain of RBI on par with the all-India FIs for prudential regulation and supervision specially since, as a government owned NBFC, it now stands exempted entirely from the prudential norms applicable to it as an NBFC.** This could accelerate the growth of PFC in tune with the growing financial needs of the power sector. The apprehension regarding the potential regulatory conflict between the directions of RBI and DPE, on account of continuance of PFC under the umbrella of BPE, does not appear to be well founded since no such conflict had been experienced even though the RBI norms as applicable to NBFCs applied to PFC till recently and were complied with by it, concurrently with the DPE guidelines.

3.13.4 IRFC Ltd.

IRFC was incorporated in 1986 as a wholly owned Central Government company with the principal objective of raising resources from the market for the Ministry of Railways (MoR) since MoR can not borrow from the market under the business allocation rules of the GoI. About 30% of the annual plan expenditure of the MoR is financed by the market borrowings through the IRFC. Its primary function

is to acquire the "Rolling Stock" (i.e. the locomotives, freight wagons and passenger coaches) for leasing out to Indian Railways for which it mobilises funds from various sources. The lease rentals from the Indian Railways form its principal source of income. As on 31 March 1999, with owned funds at Rs. 1509.22 crore, its total assets aggregated Rs. 13,273.71 crore of which the rolling stock (written down value) constituted Rs. 9430.56 crore while the loans & advances constituted Rs. 559.05 crore which were entirely extended to Indian Railways and Konkan Railway Corporation. During 198-99, it raised Rs. 2955 crore in the domestic and foreign markets, mainly through 15 year term loans from banks and financial institutions. The total borrowings of IRFC as on 31 March 1999 aggregated Rs. 11764.48 crore of which Rs. 1629.25 crore was foreign currency borrowings abroad. Incidentally, IRFC also does not hold even the restricted AD authorisation from RBI (ECD), unlike some of the FIs. Of the total domestic borrowings of Rs. 10135.23 crore, long term loans from commercial banks constituted Rs. 2358.35 crore while the remaining amount of Rs. 7726.88 crore had been raised through several series of tax-free and taxable bonds issued over the years under private placement as well public issues. As a PSU, it enters in to annual MoU with the DPE setting out various performance targets, is subject to the CAG's audit and the guidelines of the DPE.

3.13.4.1 IRFC, at present, functions merely as an extended arm of the Ministry of Railways with no credit exposure to the private sector. However, it has been mobilising significant quantum of resources from the domestic markets and for the year 1999-2000, it has a target of raising Rs. 2900 crore. Even though the resource mobilisation of this scale by a PFI would have macro-economic implications from the monetary policy perspective, yet the resource-raising of IRFC is not subject to any prior scrutiny or approval of RBI unlike the fund-raising by other regulated FIs – some of which mobilise resources at a much smaller scale. A comparative position of the resource mobilisation by

the FIs that are regulated by RBI for the year 1998-99 is at **Annexure IX**. Since the borrowings of IRFC are outside the Central Government's annual borrowing programme, and for all purposes, such borrowings are on par with the resource mobilisation by the regulated FIs, it would be only logical to accord the same regulatory treatment to the resources raised by IRFC. Even though it is registered with RBI (DNBS) as a NBFC, it has not been permitted to raise "public deposit". Even it were permitted to raise "public deposits", the resources raised by a NBFC by way of bonds / debentures secured by the assets of the company do not fall within the definition of the term "public deposit", as defined under " NBFCs Acceptance of Public Deposits (Reserve Bank) Directions 1998". However, as stated above, with effect from 13 January 2000, the government owned NBFCs have been exempted from the RBI (DNBS) Directions. Hence, reckoning the fact that IRFC's operations are geared exclusively for financing Indian Railways, the **Group does not consider it necessary to bring IRFC under the supervisory domain of RBI as an All-India financial institution.**

3.13.5 REC Limited

REC was set up in 1969-70 as a company under the Companies Act, 1956, wholly owned by the Central Government with the mission of facilitating the provision of electricity in rural areas of the country and acting as an institution for financing and promoting power generation, conservation, transmission and distribution projects in the country. For the purpose, it was expected to extend loans to the State Electricity Boards, State Governments, Rural Electric Cooperatives, Non-Government Organisations (NGOs) and private developers.

3.13.5.1 As on 31 March 1999, the assets of the REC aggregated Rs.8687.38 crore against its owned funds of Rs.1578.87 crore and its loans and advances portfolio aggregated Rs. 8981.42 crore against which the overdues were Rs. 1781.13 crore; the beneficiaries were the SEBs, State Governments and Rural Electric Cooperatives. The sanctions and disbursements during 1998-99 amounted to Rs.2878.73 crore and Rs.2202.60

crore respectively. During 1998-99, it raised Rs. 435.50 crore in the domestic market through Priority Sector Bonds. (Thus, the REC bonds are on par with the RIDF bonds of NABARD and those issued by SIDBI and NHB, all being priority sector bonds). As at 31 March 1999, the outstanding REC bonds aggregated Rs. 2091.03 crore, of which bonds for Rs. 636.36 crore were guaranteed by the Government of India. Besides, the GOI had also granted to REC an unsecured loan of Rs. 5017.49 crore. Though at present, REC has not financed the private entities, reckoning its articulated mission of financing even the private developers, it is likely that the profile of its loans portfolio would change in the days to come. As a PSU, REC too is subject to the DPE guidelines, enters into a MoU with it and is audited by CAG. It was registered with RBI (DNBS) as a NBFC during 1997-98 but had not accepted any public deposits till 31 March 1999 (the latest available position). As a government owned NBFC, it stands exempted from the RBI (DNBS) Directions with effect from 13 January 2000.

3.13.5.2 Since the lending operations of REC are also geared to the power sector and are thus, no different from the operations of PFC (which is recommended to be brought under the RBI's domain) except that its focus is on rural electrification, **the Group recommends that REC too should be brought within the supervisory purview of RBI and regulated as a financial institution.**

3.13.6 IREDA Ltd.

IREDA was set up in 1987-88 as a company, wholly owned by the government, for financing and promoting self-sustaining investment in energy generation from renewable sources, under the administrative control of Ministry of Non-conventional Energy Sources (MNES). With its owned funds of Rs. 278.29 crore as on 31 March 1999, the total assets aggregated Rs. 964.49 crore of which the loans and advances amounted to Rs. 807.25 crore. Its resource base, apart from owned funds, consisted of secured borrowings through bonds.

loans from GOI and from LIC (guaranteed by GOI) which, as on 31 March 1999, aggregated Rs.385.99 crore, 212.97 crore and 84.39 crore, respectively. Out of total resource mobilisation of Rs. 204.48 crore during 1998-99, it mobilised Rs. 90 crore through tax-free bonds from the domestic markets and the disbursements aggregated Rs. 225.74 crore during the year, spread over 19 States. As a PSU, it is subject to the DPE guidelines, MoU with the GOI and the CAG audit. It is also registered with RBI (DNBS) as a NBFC and stands classified as a Loan Company and was thus, subject to the norms applicable to NBFCs. However, as a government owned NBFC, it stands exempted with effect from 13 January 2000 from the RBI (DNBS) Directions for NBFCs.

3.13.6.1 Notwithstanding a relatively small size of its operations and consequently, insignificant level of systemic risk entailed in its operations, the **Group is of the view that the supervisory umbrella of RBI should be extended to IREDA also since with the growing liberalisation of the economy and with the growing size of such institutions, effective supervision of such entities would acquire increasing prudential significance.**

3.13.7 RCTC Ltd.

It was set up in 1995 as a majority holding subsidiary of IFCI Ltd., with IFCI holding 76.43 per cent shares, for risk / venture capital financing. RCTC operates three schemes viz., Risk Capital Scheme, Venture Capital Scheme and Technology Finance & Development Scheme. With the owned funds of Rs. 15.14 crore, its total assets aggregated Rs. 34.01 crore as on 31 March 1999 and the cumulative disbursements since inception till 31 March 1999 under these schemes aggregated Rs.94.86 crore. The name of the company is proposed to be changed to "IFCI Venture Capital Funds Limited" so as to reflect the shift in its role and activities as also to highlight its status as a subsidiary of IFCI.

3.13.7.1 Till 1997-98, RCTC had been following the prudential norms of RBI as applicable to the all-India term lending institutions. However, during 1998-99, it was registered with RBI as a NBFC and has accordingly, switched

over to the norms applicable to NBFCs. Reckoning that RCTC is essentially a venture capital fund and not a FI in the true sense and is already subject to the RBI's prudential norms for NBFCs, **the Group does not consider it necessary that RCTC be regulated as a financial institution by RBI and does not suggest any change in the existing supervisory framework.**

3.13.8 ICICI – VFMC Limited (formerly TDICI Limited)

It was set up as TDICI Ltd., under the Companies Act, 1956, by ICICI and UTI in July 1988 as the country's first venture capital finance company and became operational in August 1988. It took over the venture capital operations of ICICI Ltd. It primarily provides assistance to small and medium industries conceived by technocrat entrepreneurs in the form of project loans, direct subscription to equity and a quasi-equity instrument called conditional loan.

3.13.8.1 ICICI - VFMC sanctioned and disbursed Rs. 308.1 crore and Rs. 301.7 crore respectively upto the end of March 1999. Bulk of assistance sanctioned was by way of equipment leasing (46.4%) followed by rupee loans (33%) and the balance by way of rupee loans. Further, industry-wise, the bulk of sanctions (40.2%) was claimed by computer software and services, followed by energy related activities (10.3%) while the balance was accounted for by other industries, industrial automation and medical industries. As at end-March 1999, paid-up capital of ICICI - VFMC was Rs.3 crore and reserves & surplus amounted to Rs. 13.6 crore. It had total assets of Rs. 25.0 crore including 'other assets' aggregating Rs. 17.2 crore.

3.13.8.2 Reckoning that ICIC–VFMC is primarily a venture capital fund and not a financial institution in the real sense, the Group does not consider it necessary to bring it under the supervisory domain of RBI as an all-India FI.

3.13.9 NEDFC Limited

NEDFC set up on August 9, 1995 under the Companies Act, 1956, aims at

providing finance and other facilities for promotion, expansion and modernisation of industrial and infrastructure projects in the North-eastern Region comprising Arunachal Pradesh, Assam, Manipur, Mizoram, Nagaland and Tripura. As at end-March 1999, cumulative assistance sanctioned and disbursed aggregated Rs. 54 crore and Rs. 21.9 crore respectively while the corresponding figures for 1998-99 were Rs. 28 crore and Rs. 12.2 crore. Almost the entire assistance during 1998-99 was by way of rupee loans. Infrastructure accounted for 41.1% of total sanctions during the year followed by services (35.4%), food products (6.8%) and Chemicals & chemical products (1.4%).

3.13.9.1 As at end-March 1999, the paid-up capital of NEDFC stood at Rs.100 crore, while reserves and funds amounted to Rs. 69.5 crore. Its assets stood at Rs. 169.7 crore of which investments accounted for Rs.130.4 crore.

3.13.9.2 Union Budget 1998-99 had proposed that the refinancing to SFCs and SIDCs in the North East be taken over by NEDFC from IDBI and SIDBI respectively. The proposal, when implemented, would enlarge the role of NEDFC from a direct lending institution to that of a refinancing agency as well and its scale of operations may also expand. **Since the nature of operations of the NEDFC is similar to that of the SFCs and the SIDCs, which are recommended to be brought within the supervisory ambit of RBI, the group recommends that NEDFC too should be brought within the supervisory purview of RBI and regulated as a financial institution.**

3.13.10 <u>HUDCO Limited</u>

HUDCO was set up in 1969-70 as a company wholly owned by the Central Government, under the Ministry of Urban Development, initially for financing of public sector housing agencies such as Housing Boards and Development Authorities. It later on diversified into financing of cooperative housing in mid-seventies and subsequently also undertook financing of corporates – both in public and private sector. It has further diversified into financing real estate

builders and is progressively moving towards provision of individual housing loans as also techno-financial assistance to individuals. With the allocation of additional equity by the Government, its equity base is set to increase to Rs. 898 crore by 31 March 2000. Its total assets as on 31 March 1999 aggregated Rs. 10315.44 crore of which the loans and advances amounted to Rs. 9927.43 crore. During 1998-99, it mobilised Rs. 3240 crore from the domestic and external funding sources, including equity contribution of Rs. 192 crore from GoI. Its resource mobilisation through term loans from the banking / insurance sector, public sector bonds and public deposits during 1998-99 amounted to Rs. 1729 crore, Rs. 645.60 crore and Rs. 36.90 crore respectively. It accepts public deposits under Section 58A of the Companies Act,1956, as also under the provisions of the Housing Finance Companies (National Housing Bank) Directives. As a PSU, it is subject to the directions of the DPE, enters into annual MoUs with it and is subject to audit by CAG.

3.13.10.1 Thus, despite sizeable assets and resource mobilisation from the markets by HUDCO, it continues to be essentially a financial institution dedicated to housing finance and urban development. At present, as a Housing Finance Company, it falls within the regulatory and supervisory domain of National Housing Bank. Reckoning the specialised nature of HUDCO's operations and the regulatory & supervisory domain of NHB already extending to it, **the Group does not consider it necessary to disturb the existing framework of its regulation and supervision.**

Future strategy for identifying the FIs for supervision by RBI

3.14 The Group has made a comprehensive analysis of each (category) of FIs, which stand notified by the Government as PFIs as on date as also of the SIDCs, from the perspective of their supervisory coverage. It is likely that the Government might notify some more FIs as PFIs in future and new institutions might also emerge in the changing economic environment. **It would, therefore,**

be necessary to institutionalise an ongoing mechanism to ensure that, in future, any FI getting notified by the Government as a PFI or any new financial entity which by the nature of its constitution or the nature of its business is specifically excluded from the purview of supervision of the Department of Non Banking Supervision, gets considered by RBI for an assessment of whether it should be brought within the supervisory domain of RBI as a FI. For this purpose, the FIs notified by the Government from time to time as PFIs as well as any other financial entities coming up, should be kept under continual review by FID so as to make the aforesaid assessment and to ensure that no supervisory vacuum is allowed to exist for the institution. Such an assessment would be required to be made on a case-to-case basis and should be guided by the nature of business of the institution, the extent of systemic risk it entails for the financial system and the impact its operations might have on the credit and monetary aggregates in the economy. In this context, the Group has also suggested the concept of "notified financial institutions" at para 6.4.1.2.

3.14.1 In case, a PFI notified by the Government in future or any new financial entity happens to be structured as a company (not owned by the Government) under the Companies Act, 1956, it would automatically fall within the definition of a NBFC and hence, would be already subject to the Directions of RBI (DNBS) as applicable to the NBFCs. As regards the Government owned NBFCs, the requirement of registration with RBI (DNBS) would continue to apply. If, however, after due assessment it is decided to regulate such a PFI or other financial entity as a financial institution, requisite co-ordination with DNBS would be required for exemption from their directions before the DBS (FID) norms are made applicable to such body corporates.

3.14.2 As regards the statutory powers required by RBI for effective supervision of the FIs, necessary amendments to the statute will have to be promoted, which have been detailed in Chapter VI.

CHAPTER IV

The Areas of Coverage in RBI Supervision of FIs

4.1 The key to determining an adequate coverage of the supervisory process for FIs is a full and proper understanding of the risks to which FIs are exposed, the manner in which these risks differ from the risks to which banks are exposed and the processes by which these should be addressed. This also requires an understanding of the differences between FIs and banks as regards their respective objectives and the nature of their respective operations.

Differences between the operations of FIs and banks

4.2 Traditionally, there has been a segmentation of the different institutions, which provide finance to commerce and industry. While banks mainly provided short-term working capital finance, the FIs were created as developmental institutions to provide long-term project finance. In recent years this distinction is getting somewhat blurred as both segments move towards a concept of "universal banking" but yet FIs are pre-dominantly lenders of long-term project finance and banks are pre-dominantly lenders of short-term working capital finance.

4.2.1 There is also a fundamental difference in the manner in which banks and FIs fund their operations. The major source of funds for a bank is short-term retail deposits from the public, whereas traditionally, FIs have funded their operation through long-term domestic and foreign currency borrowings. Here again, the distinction is gradually getting blurred as FIs target the retail market through frequent short-term borrowings and provide re-purchase facilities, after a lock-in period of one year, for bonds issued.

4.2.2 Apart from the above, banks have the following characteristics which distinguish them from FIs namely :

(a) They have custody of large volumes of monetary items. including cash and negotiable instruments, which has to be assured.

(b) They engage in a large volume and variety of transactions with individual transactions often of small amounts.

(c) They normally operate through a wide network of branches, which are geographically dispersed.

(d) They often assume significant commitments without any transfer of funds through "off balance-sheet" items like letters of credits, acceptances, guarantees etc. To some extent FIs also assume such commitments.

(e) They are a part of the national payment system

Differences between the nature of risks in FIs and banks

4.3 While there are many common risks between FIs and banks, there are still significant differences in detail and emphasis which necessitate a consideration of the differences in risks between FIs and banks. These differences arise mainly as a result of differences in the nature of operations. The risks to which FIs and banks are exposed can be broadly grouped as (i) product & service risks – further bifurcated into credit and market risks, and (ii) operational risks – which would also include legal risk and reputational risk. At the macro-economic level, the "economic or business cycle risk" i.e., the risk of an unforeseen downturn in the economy as a whole or in a particular business / industry, either nationally or globally, could also be envisaged. Such potential downturn, which is a part of overall business risk, would get translated into higher financial risks (credit or market risk) for a FI or bank. In that sense, the economic cycle risk could be viewed more as a fundamental cause aggravating the financial risks of a FI or bank, rather than being a direct financial risk by itself.

4.3.1 The most significant product and service risk in FIs, as in banks, is the credit risk i.e. the risk that the counter-party will be unable or unwilling to honour its obligations in relation to lending, trading, hedging, settlement and other financial transactions. Though the nature of credit risk (i.e. the possibility of default by a counter-party) in a lending transaction in a FI is not significantly different from the nature of credit risk in a bank, yet the extent and severity of credit risk varies between them on account of different types of mitigation available The difference arises mainly because of the difference in the nature of assets that provide the security for the advance. Since banks mainly provide short-term working capital, the credit extended finances short-term assets like inventories and debtors. The funds for repayment of the loans are generated from the realisation of the assets and therefore the risk of non-repayment is directly linked with the ability of the borrower to sell the inventories at a profit and to realise the debts. In the case of a FI, the funds borrowed are mainly used to finance fixed productive assets like buildings, plant and machinery, etc.. The repayment of the loans to FIs is, therefore, contingent upon the ability of these assets to generate cash and not on their realisable value on sale, except in distress situations.

4.3.2 There is also a difference in the impact of the economic cycle risk on the credit risk exposure of the FIs vis-à-vis the banks. Since the FIs primarily provide long term project finance, the disbursed and undisbursed loan commitments are usually spread over several years during which the possibility of an economic downturn would generally be higher than in short term financing extended by banks. The higher credit risk of FIs emanates from their subsisting loan commitments which have to be honoured regardless of the stage of the prevailing economic / business cycle even though a sluggish business phase could be clearly seen to be adversely impacting the prospects of the project financed. During a recessionary phase, the borrowing concerns, however, are observed to be servicing their working capital obligations first before meeting the dues of the FIs – which heightens their credit risk.

4.3.3 There is another aspect of credit risk, which is also an important area of distinction between FIs and banks. In the case of FIs, the average size of an advance when related to the total funds advanced is significantly higher than in the case of banks. Therefore, despite the identical prudential credit exposure norms applicable to the banks and the FIs in terms of their "capital funds", there is a much higher concentration of credit risk exposure for the FIs in terms of individual borrowers, a group of borrowers or even an industry segment, as a proportion to the total size of the loans portfolio.

4.3.4 In the context of cross-border transactions, the credit risk includes country or transfer risk, that is, the risk that foreign customers and counter parties will fail to settle their obligations because of a deterioration of the economic, political or social conditions in a foreign country. This risk is much lower in the case of a FI as compared to a bank since FIs don't normally give loans in foreign countries or finance export operations, except the EXIM Bank which has substantial cross border credit exposures.

4.3.5 In relation to a trading transaction, the credit risk also includes replacement risk, i.e., the risk of the failure of a counter-party in a market deal to perform the terms of the contract, necessitating a replacement of the contract at the going market rates with the attendant loss or the settlement risk (time-zone risk or Herstadt risk or the 'free-delivery' risk), i.e., the risk that one side of the transaction will be settled without value being received from the customer or the counterparty. This risk normally arises in transactions like dealings in foreign exchange, securities, commodities, derivatives, etc. As the FIs are not full-fledged Authorised Dealers in foreign exchange and have a limited securities portfolio, this risk is correspondingly much less in the case of FIs as compared with the banks.

4.3.6 Another important dimension of the product & service risks is the market risk, i.e., the risk of loss arising from an adverse movement in the market

variables such as interest rate, currency exchange rate, market liquidity, commodity price or equity price. The interest rate risk (IRR) is traditionally ramified into gap or mismatch risk, basis risk, embedded option risk, yield curve risk, reinvestment risk and the net interest position risk. The basis risk, for instance, is the risk arising from a change in interest rates on borrowings, not matched by an equivalent change in interest rates on on-lendings or vice versa. As FIs both borrow and lend for long-terms this is a significant risk for FIs. Similarly, in the past when FIs were in a 'sellers' market, the interest rate gap or mismatch risk was neutralised by back to back borrowing and lending but with the spread of competition and increasing reliance by FIs on short-term borrowings, this risk has significantly increased in the last few years. The IRR is not confined to only loans portfolio but the investment portfolio of the FIs is also exposed to the IRR since the bond prices and hence, the depreciation in the value of bonds, depend on the market interest rates. The exposure of the investment portfolio to IRR exists equally for the FIs and banks except that the investment portfolio of FIs normally includes a smaller proportion of bonds and government securities (due to non-applicability of SLR requirement to FIs) and larger equity component as compared to banks. The FIs are, therefore, more prone to equity price risk.

4.3.7 Similarly, in the past, FIs were not significantly exposed to the liquidity risk, that is, the risk of the loss arising from the possibility of not having sufficient funds to meet the obligations and the inability to raise sufficient funds promptly and at reasonable cost. This risk has also significantly increased in recent years because of short-term borrowing and also because of a growing gap between total commitments and total advances. Moreover, the "market funding risk", which is a component of liquidity risk, is higher in case of FIs compared to the banks since their undisbursed loan commitments are spread over longer periods than of banks and the market conditions or the borrowing / funding capacity of the FI could change adversely over a longer time-horizon.

4.3.8 Equally, in the past, FIs were not exposed to the currency risk in respect of their borrowings in foreign currencies since institutionalised mechanisms were available for insulating them from the exchange rate risks. For instance, there was a "Scheme of Parking of Funds by Financial Institutions" evolved by RBI in 1986, under which foreign currency funds raised by FIs, pending utilisation, were parked with RBI (Department of External Investments & Operations), for selling back the forex to FIs, at level exchange rates, when needed by them. Thus, RBI absorbed the exchange rate risk. The Scheme was, however, discontinued since 1 February 1992. Also, the Exchange Risk Administration Scheme (ERAS) introduced by the Government of India in 1989, under which the Government of India used to bear the exchange rate risk in respect of the rupee on-lending out of the foreign currency resources mobilised by the FIs, also stands discontinued. Hence, the FIs are now increasingly exposed to the exchange rate risk in respect of their foreign currency operations. Moreover, as long term borrowers of foreign currency, the FIs are often exposed to higher exchange rate risk than the banks. This is so because even when the exchange rate risk is passed on to the borrowers, financial crises in Asia, Mexico and elsewhere show that the borrowers may not hedge the risks adequately and it may finally devolve on the FIs.

4.3.9 All the residual risks, other than the credit and market risk, are placed in the category of operational risk i.e., the risk of loss arising from a breakdown of internal controls and corporate governance, human or technical error including frauds, which could also trigger the credit, market, legal or reputational risks. Most of the operational risks of banks arise from the special characteristics of banks like the need to process high volumes of transactions accurately within short time frames; the need to use electronic systems to transfer large volumes of money; the need to monitor and manage significant exposures which can arise over short-time frames; the dealing in large volumes of monetary items and the conduct of operations in a number of widely-spread geographical locations. Even though the FIs' nature of operations is quite different from banks

in respect of large volume transaction processing, the FIs too are vulnerable to the operational risks arising from technological, human and control elements, though not to the same significant extent as banks.

4.3.10 Some of the risks outlined above may to some extent get mitigated in the future due to better legal system for recovery of outstanding e.g., the Debt Recovery Tribunal as also through the development of a secondary debt market.

<u>The areas of coverage under the extant supervisory framework</u>

4.4 As stated at paragraph 1.6, the on-site inspection of FIs under Section 45N of the RBI Act, 1934, was started in 1995-96. The coverage of inspection has been broadly similar to what was prescribed for commercial banks pursuant to the recommendations of the Working Group to Review the System of On-site Supervision of Banks (Chairman: Sri S. Padmanabhan) which had submitted its report in November 1995. Thus, the inspection of FIs at present is primarily based on the "CAMELS" parameters and the inspection report comments on the **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity and **S**ystems & controls in the FI concerned. However, on the basis of the experience gained in the inspection of FIs, in November 1998, the areas of coverage were fine-tuned and a structured format for inspection report (and the annexures thereto), was also prescribed by RBI (FID) in respect of all the FIs. A copy of the relative circular is furnished at **Annexure X**. While the broad pattern of the inspection report still follows the CAMELS approach, the Inspecting Officers (IOs) are also required to comment on the developmental / promotional role, if any, assigned to the FI. The inspection report is divided into two parts: the "open" portion which is transmitted to the FI inspected and the "closed" or the "confidential" portion which is meant for the Top Management of RBI and is not accessible to the FI. The major heads of the "open" part of the Inspection Report on the FIs, as prescribed at present, are:

a) Solvency and capital adequacy

b) Asset quality
c) Management
d) Earnings appraisal
e) Funds management and liquidity
f) Systems and control
g) Foreign exchange business
h) Off-balance-sheet business
i) Para-banking activities
j) Promotional and other important activities
k) Compliance review

The open part of the report is also supplemented by the following six pre-designed and exhaustive annexures indicating the FI's position as on the reference date of inspection:

a) Statement of assets and liabilities;
b) Statement of profile of investments;
c) Earnings appraisal;
d) Statement of Profile of NPAs;
e) Statement of divergence in classification, provisioning & evaluation of assets and understatement of liabilities & expenditures;
f) Review of computation of capital adequacy

4.5 If in the course of inspection, the IO feels the need to comment on any issue, which reflects on the competence or integrity of the Board, CEO or the Senior Management, such comments are made in the confidential portion of the inspection report. Besides, any special concerns not disclosed / stated in the "open" part of the report; supervisory action, if any, recommended as also the proposed plan of corrective action to be adopted by the FI concerned, also find a place in the confidential portion of the report. While in case of banks, this part of the report also contains the examination 'rating' of the banks as finalised by the Principal Inspecting Officer – based, *inter alia*, on which a Composite

Rating is assigned to the banks by Central Office and conveyed confidentially to the CEO of the bank – the system of Supervisory Rating as a summary indicator of the financial health of the FIs, has not been put in place for them for the time being.

Improvements required in the areas of coverage

4.6 The Group is of the view that the scope of coverage of the on-site inspections is quite adequate. However, the **Group is of the view that it would be desirable to include a separate main paragraph on Risk Management in the open part of the report, instead of a sub-para under Systems and Control paragraph, as prescribed at present. The para should provide an integrated view of the risk management systems adopted by the FI and the efficacy thereof in respect of various risk exposures of the FI** – which would be useful in an overall risk assessment of the FI as a whole. It is also understood that a comprehensive Inspection Manual for inspection of FIs containing detailed guidance on various aspects to be examined under each of the CAMELS parameters in the course of examinations, has already been drafted for use of the inspecting officers and is in the process of being finalised The Group, therefore does not wish to duplicate those efforts. However, the **Group is of the view that the examination of certain aspects (not unique to the FIs alone) of their functioning needs to be refined and fine-tuned as indicated below**

4.7 **While ratio analysis is a very effective tool for the initial identification of areas of concern, the IO should be cognisant of the inherent limitations of ratio analysis as a supervisory tool** since any ratio, by definition, is a static measure at a particular point in time relating the two variables and does not by itself indicate dynamically the trend or the circumstances in which the ratio may get adversely affected – which would require "what if" or sensitivity analysis. Hence, the capital adequacy ratio, the ratio of NPAs, profitability ratios, etc., need to be interpreted with circumspection unless they have been subjected to sensitivity analysis.

4.8 Perhaps the most significant risk to which an FI is exposed is the credit risk and the evaluation of asset quality is one of the most important aspects of on-site inspection. In assessment of asset quality, the main emphasis is on the system of credit risk management and its observance. The IOs are required at present to evaluate the loan assets with outstanding balance of Rs. 5 crore and above with a view to verifying the correctness of classification, provisioning for value impairment and the consequent valuation of the asset. In addition, the IOs are required to examine the accounts in detail, in the following manner:

- Top 50 standard accounts in terms of the outstanding balance;
- Top 50 NPAs, in terms of the outstanding balance, under each of the sub-standard, doubtful and loss categories, also for ascertaining the reasons for their turning NPA and the efforts made for recovery;
- Top 20 "group" borrowers' accounts irrespective of the outstanding balance; and

Even though the accounts being inspected would have already been subjected to the statutory audit, the IOs are required to scrutinise in detail aforesaid 200 borrowal accounts apart from the 20 group borrowers' accounts, in the course of the inspection. The IOs have not been granted the flexibility of varying their sample size for such test-checking, regardless of the size of a FI or of its loans portfolio.

4.8.1 The Group is of the view that detailed examination of loan assets should subserve the following objectives:

(a) To determine the quality of assets and adequacy of provisioning for the FI as a whole;

(b) To examine the risk assessment procedures and determine whether they have been followed;

(c) To assess the efficacy of the risk assessment procedures as proved by the results; and

(d) To examine the procedures for recoveries against delinquent accounts and to assess their effectiveness.

4.8.2 To achieve the above objectives, the **Group is of the view that discretion should be given to the IO to do a test-check of the accounts within specified limits in the following manner and to extend the scope of his inspection in any direction if the results of the test-check prove to be unsatisfactory:**

(a) He should examine at least a minimum number of accounts which in the aggregate have a value of not less than 20% of the total portfolio to assess the quality of the assets and the adequacy of the provisioning for the FI as a whole.

(b) In his examination, he should include at least 10%, in number, of the accounts where the outstanding balance in the accounts is Rs. 10 crore or more and at least 5%, in aggregate value, of the accounts where the outstanding balance is less than Rs 5 crore.

(d) He should examine all the accounts, which have been classified as NPAs for the first time during the inspection period and understand the reasons why the accounts have become NPAs and whether there is any indication that the risk assessment procedures have not been observed or have proved ineffective.

(e) He should examine the accounts, which became NPAs during the last five years and determine the recoveries made thereagainst in each of the five years to assess the recovery procedures prescribed and their effectiveness.

4.8.3 The FIs also undertake a variety of off-balance sheet commitments that give rise to contingent credit risk exposures for them, which can potentially

create assets in their books. The considerations of asset quality, therefore. apply equally to the off-balance sheet items on account of subsisting exposures. Hence, the Group recommends that **in the context of asset quality examination, the forgoing norms for test-check of loans portfolio should be applied by the IO also to the off-balance sheet business undertaken by a FI (including the take-out finance commitments, if any, entered into by the FI) with a view to evaluating the adherence to the laid down risk management systems of the FI in respect of its off-balance sheet commitments.**

4.8.4 Utmost care needs to be exercised by the IO in drawing conclusions from the results of the test-check. The purpose of a test-check is to obtain satisfaction that the prescribed procedures are in fact functioning and if the results of the test-check prove unsatisfactory, he needs to determine whether the area of the test-check needs to be expanded before meaningful conclusions can be drawn. Therefore, where the test-check is of the loan portfolio, **the IO should consider the result of the test-check in the context of the sample examined by him and whether the sample examined, when considered in the context of the total portfolio, provides an adequate basis for making a generalisation**.

4.8.5 Renegotiation of terms or grant of additional facilities to projects under implementation is not uncommon phenomenon in FIs. These accounts need the special attention of the IO as they have serious provisioning implications. Particular attention needs to be paid to the period during which the projects have remained under implementation, the reasons for the delay in implementation and its consequential effect on the viability of the project and also whether grant of additional facilities is necessary for project implementation or project expansion or is a form of "ever greening".

4.8.6 The prudential norms provide an objective criterion which defines the minimum provisioning which is needed but additional provisioning may be warranted on a subjective assessment. There may, therefore, exist circumstances where an objective assessment would not by itself be adequate to determine the amount of provisioning needed because the objective assessment uses surrogates like non-recovery of interest or loan installment for a specified period and adequate time may not have elapsed between the occurrence of an event which has created doubts about the recoverability of the security or for other reasons, and the date on which the norms are applied In such circumstances, provisioning beyond what is determined on an objective assessment may be necessary At the same time, **it is very necessary when making the subjective assessment that the inspector recognises the fundamental difference between the assets of a bank and the assets of an FI. In the case of a bank, adverse financial performance of the borrower normally results in a deterioration of the quality of the assets, which are meant for sale or realisation and therefore, the inspector has to be particularly careful in verifying the existence and realisability of the assets. However, in the case of a FI, the assets are held by the borrower, not for the purposes of sale but for the income they generate.** Therefore, the IO has to evaluate the ability of the assets to generate the cash needed to service the account through payment of interest and principal when due. In many cases, given a highly capital-intensive nature of the operations, the borrower may incur financial losses but may still have present and projected cash profits which enable him to adequately service the FI's loans

4.8.7 The Group notes that whenever the inspector differs from the FI's interpretation of the provisioning norms or feels further provision is necessary on the basis of an objective or subjective assessment, the amount of the difference or the additional provision required as the case may be, is at present quantified and disclosed borrower-wise in Annexure V (Part I) to the inspection report along with the reasons for assessing additional provision in each of such

accounts. This is a salutary practice and the Group commends its continuance. **The Group is, however, of the view that the amount of additional provisions assessed by the inspecting officer on account of qualitative (subjective) factors should not be disclosed, account-wise, in the main report (open part of the report) but should form a part of the confidential portion of the report. Only the total amount of such provisions should be stated in a separate paragraph in the main report and given effect to in assessment of net worth, capital adequacy, asset quality, profitability, etc., of the FI. However, the account-wise details of such provisions should be separately conveyed to the CEO of the FI, confidentially.** In cases where the amount of provisions assessed by the inspecting officer based on objective (quantitative) grounds differs from the amount assessed by the auditor, the auditors should be called upon to explain the variance and should be held accountable for such divergence. However, where the provision made is considered inadequate on the basis of a subjective assessment, it must be recognised that subjective assessments are a matter of opinion and opinions can differ. The **Group, therefore, also recommends that a system of discussing the provisioning-shortfall, owing to the objective as well as subjective factors, by the inspection team with the auditors in the presence of the management of the FIs, should also be introduced to enhance transparency and minimise the element of subjectivity**. Recognising, however, that the RBI inspection, by its very nature, is an *ex post* exercise, it should be ensured that the IOs do not rely on the information or developments subsequent to the reference date of inspection in assessing the shortfall in provisioning. It also needs to be recognised that while the determination of adequacy of provisioning is important, even more important is the strengthening of the system by which exposures are controlled and further provisioning mitigated. The supervisory focus should, therefore, primarily be on the systemic deficiencies in the FIs, which could be responsible for loan delinquencies.

4.9 While evaluating the management aspects of a FI, at present the IO is required to take an integrated view of the quality of Management and to examine the corporate mission and the governance structure of the organisation as a whole, taking due cognisance of the unique functions of each institution. Thus, he would critically comment on not only the organisational set up but equally on the composition and effectiveness of functioning of the Board, Management Committee, Audit committee and the other committees of the Executives functional at Head Office of the FI. Likewise, the functioning of the CEO, EDs and other senior functionaries of the FI is also evaluated. The efficacy of control exercised by the HO over the field offices and over subsidiaries, the level and quality of compliance as well as the adequacy of the MIS in vogue are also some of the areas commented upon. In the opinion of the Group, the mandated examination areas have too broad a sweep and **the Group would like to emphasise that the management structure of the organisation should be examined not with regard to its detailed functioning but mainly to see whether it satisfies the twin criteria of accountability and transparency in its operations**.

4.9.1 Accountability requires that the role and responsibilities of each segment of management is clearly defined and that each segment is accountable to a higher segment for its operations. Transparency requires that the accountability is discharged through formal reporting systems which identify the key elements of accountability and provide evidence of satisfactory performance. It must be recognised that there can not be a uniform management structure applicable to all institutions and therefore, merely because a structure is different does not necessarily mean that it is inadequate. FIs must be encouraged to develop a management structure which they believe is most suitable to their organisation so long as the criteria of accountability and transparency are satisfied. The inspector, therefore, needs to examine the adequacy of the management system and its operation in practice with this approach.

4.9.2 An area which the inspector should examine when considering the parameter of management is whether the activities of the FI are in conformity with the objectives for which it was created or which might have evolved over the years. This is particularly important in the case of specialised institutions like NABARD, SIDBI, NHB, etc.

4.10 When examining the parameter of earnings, the inspector needs to recognise that the level of earnings is not by itself a primary regulatory concern. However, to the extent that inadequacy of earnings can impinge upon the FI's future solvency or its ability to maintain a satisfactory Capital Adequacy Ratio, the stability of an FI's earnings is important. The IO should therefore examine the earnings in the context of relevant ratios and compare the results with past periods to establish a trend and with other peer groups to determine their adequacy. **Some of the ratios which need to be examined but which are not captured at present, are the following**:-

(a) amounts charged to the profit and loss account for write-off and provisioning of loans as a percentage of total income.

(b) amount of interest applicable to NPAs not credited to profit and loss account as a percentage of total income.

(c) expenses (other than interest and loan write-off and provisions) as a percentage of total income.

4.11 The parameter of liquidity is of particular significance in the inspection of an FI. As stated earlier, FIs are now increasingly exposed to liquidity risk. The liquidity of an institution refers to its ability to meet its commitments as they fall due. The importance of liquidity transcends the individual institutional boundaries since a liquidity shortfall at a single institution could have system-wide repercussions. In this context, the verification of compliance with the recently issued Asset Liability Management (ALM) Guidelines of RBI would be a significant aspect, particularly since it is a rather new concept in the Indian context. To ensure that a FI has adequately addressed the liquidity risk, the

setting up of an adequate MIS to provide feedback to the Asset Liability Committee would be of critical importance. In respect of the items where the underlying cash flows have been behaviouralised by the FI, **the IO should particularly examine the reasonableness of the assumptions used by the FI in projecting various cash inflows and outflows based on which the liquidity mismatches have been arrived at, in various time buckets. The proposed funding strategy for bridging the liquidity gaps should also be consistent with the borrowing capacity of the FI in term of its debt-equity ratio, its ability to borrow at reasonable cost and the system for hedging its funding cost through suitable covenants in the loan agreements**. Also, there should be an integrated liquidity management in place capturing rupee as well as foreign currency resources in respect of all assets, liabilities and contingent commitments of the FI. The **inspector needs to pay particular attention to the following areas :-**

(a) **interest rate mismatch** – to the extent it could have an impact on liquidity;

(b) **maturity mismatch** – in rupee as well as foreign currency operations;

(c) **open foreign exchange positions** – causing mismatches within various currencies; and

(d) **the outstanding loan commitments** – which could impact liquidity through contingent cash out-flows;

4.12 The IO's examination of systems and control is intended to obtain assurance regarding the adequacy and effectiveness of the risk management systems as also the system of internal control including the MIS, laid down by the management. For this purpose he needs to identify the major risk exposures of the FIs and the manner in which the risk management systems in place, address those risks. The FIs are usually exposed to the credit, market and operational risks to varying degrees as per the nature of their operations, for which **the following are some of the important aspects the IO needs to**

examine:

(a) the systems for identifying, measuring, monitoring and controlling credit risks of the counterparties in lending / investment as well as in trading transactions;

(b) the loan pricing mechanisms – to see that pricing is based on sound financial factors reflecting the degree of credit risk involved and not merely driven by competition;

(c) the systems for limiting, monitoring and controlling credit exposure (including for non-funded facilities and derivatives) to individual & group borrowers and industry exposures;

(d) the systems for identifying, measuring, monitoring and controlling various elements of market risk such as liquidity, interest rate and exchange rate risks;

(e) the system of implementing operational safeguards against the technical and human elements specially in a computerised environment;

(f) the integrity and reliability of the internal and regulatory MIS as also the adequacy of the information provided to senior management and the Board of Directors;

(g) the systems by which compliance with statutory requirements, including RBI regulations, is ensured and monitored.

4.12.1 An important responsibility of management is to ensure that the FI has a satisfactory system of internal control and an important aspect of internal control is a sound internal audit system. The IO therefore needs to examine the internal audit system with particular relevance to:-

(a) the independence of the internal audit function, the seniority of the person who heads the internal audit department (IAD) and the adequacy of the level to which he reports;

(b) The staffing pattern of the IAD and the qualifications of the persons manning it;

(c) the scope and frequency of the internal audit exercise.

(d) the quality of coverage and the manner of reporting the findings of audit;

(e) the procedure for follow-up and the quality of compliance with the audit observations;

The IO should also peruse the internal audit reports to identify any specific areas of supervisory concern highlighted therein.

CHAPTER V

Nature of Supervision

Limitations of the present inspection system

5.1 The supervision exercised by RBI so far in respect of the FIs had been based almost entirely on the periodical on-site examinations of the institutions and the findings of the inspection had been the starting point for the supervisory action. Since in a rapidly changing financial environment, the risk profiles of the supervised institutions could change dramatically between the two full-scope examinations, the system of periodical inspections as virtually the sole supervisory tool, did not provide a robust and seamless supervisory system for the FIs.

5.2 Since the commencement of the on-site inspections of the FIs in 1995-96, there had been, till 1998, a uniform prescription of biennial on-site examinations when it was decided to inspect the three major FIs (viz., ICICI, IDBI and IFCI) every year and the other FIs every alternate year. Subsequently, since 1999, the IIBI has also been placed on an annual inspection cycle. While the policy decision is understandable given the size and market share of these four term lending FIs in the project financing in India, the approach to supervision does not systematically reflect the risk complexion of the supervised FIs but has been guided more by the size of the institutions. Such a broad-brush, standardised supervisory system, with pre-determined frequency and coverage of the on-site examinations, suffers from the following infirmities:

a) Absence of a set of objective criteria for systematic determination of the extent of supervisory attention to be devoted to a FI based on its financials or risk-profile;

b) Disregard of the varying strengths / weaknesses, risk-exposures and the quality of risk control systems in place in the FI concerned and the standardised frequency, coverage and intensity of

examinations of all the areas mandated in the report format. for each and every on-site examination of a FI;

c) Information and supervisory gap between two full-scope on-site inspections due to lack of a structured MIS and of a system of "targeted appraisals" or "commissioned audits" of the FIs' select portfolios which might arouse supervisory concerns, as a "bridging vehicle" between the two regular examinations,

Off-Site Surveillance System

5.3 Taking cognisance of the information and supervisory vacuum in the extant supervisory arrangement, an off-site surveillance system – called Prudential Supervisory Reporting System – was introduced in July 1999 for the FIs, effective from March 1999, on the lines of the system already in vogue for the banks. Under the system, the following seven prudential returns have been prescribed, for submission to RBI with a view to building up an institutional memory within RBI in respect of the FIs as also as a means of exercising 'continuous' supervision:

a) Report on assets and liabilities (Quarterly)
b) Report on capital adequacy (Half-yearly)
c) Report on quarterly operating results (Quarterly)
d) Report on asset quality (Half yearly)
e) Report on large credits (Quarterly)
f) Report on ownership, control and management (Annual)
g) List of subsidiaries / associates (Annual)

Though the information flow has started, the system is expected to stabilise in the near future. The main advantages of the off-site surveillance system are:

- It is a continuous process while the 'on-site' inspection can only be done periodically with the attendant limitations and helps to develop a more comprehensive understanding of the institution.

- It provides the data for monitoring and comparing the performance of FIs through the compilation of appropriate accounting ratios. A comparison of these ratios with past performance and with the ratios of peer groups can reveal trends and areas of weakness, which also helps in identifying the areas of specific enquiry during 'on-site' inspection. Thus the results of 'off-site' surveillance are an essential tool in the planning of "on-site" inspection.
- It improves the quality of MIS in the FIs themselves on account of the structured and detailed nature of the prescribed returns.
- The data integrity of the "off-site" information furnished by the FIs can be ascertained during the "on-site" inspection by verifying it with the original records of the FI.
- It can be used to alert the managements of FIs to emerging problems or concerns of the regulator as soon as possible without waiting for a formal report based on on-site inspection.

The improvements required

5.4.1 Despite several merits of the "off-site" monitoring, the 'on-site' inspection remains at present at the heart of supervision as it enables examination in depth in selected areas and an assessment of the adequacy of management systems and their operation in practice. However, over a period of time, the off-site surveillance should progressively constitute the mainstay of the supervisory regime and the on-site examination should be used primarily to validate the data received and to focus on specific aspects or concerns that may have been identified through off-site surveillance.

5.4.2 At present, during the on-site examination of the FIs, the inspecting officers undertake a detailed assessment of each of the CAMELS parameters. However, the system of determining the supervisory rating, as a part of the on-site examination, has not so far been adopted for the FIs, which could serve as a summary measure of the overall health of a FI. Such a system is already in vogue for the banks. The Group studied the details of the rating model adopted for the banks. It was observed that the "composite" supervisory rating provided

an objective indicator of the overall health of a bank, based on its "component ratings" as per its performance on each of the six CAMELS parameters and provided systematic and objective criteria for allocation of supervisory resources taking into account the unique strengths and weaknesses of each supervised bank. Also, the changes in the rating profile of a bank or a FI – component as well as composite rating – would also signal the areas of concern warranting supervisory intervention. **Having regard to the utility of the rating exercise as a supervisory tool, the Group recommends that an appropriate supervisory rating model, for use during on-site inspection, be developed and implemented for the FIs also, at the earliest.**

5.4.3 The rating system for FIs must necessarily be different from the rating system for banks given the differences in the respective risk profiles. In this context the Group noted that the Federal reserve in the US has developed a system called SEER – System to Estimate Examination Rating, to provide an estimate, between two on-site examinations, of the financial condition of commercial banks and savings banks, insured by the Federal Deposit Insurance Corporation. The details of the SEER methodology are furnished at **Annexure XI. The rating system envisaged for the FIs can similarly be used not merely for effective off-site and on-site surveillance but also for estimating off-site rating between two on-site inspections.**

5.5.1 The Group would like to suggest certain refinements in the present system of on-site supervision.

5.5.2 The Group is of the view that as against the bi-ennial system of on-site examination of some of the FIs, all the FIs should be inspected at annual intervals with reference to the balance sheet dates till the FIs can be systematically differentiated as per their risk profile based on the off-site surveillance data and the proposed supervisory rating system. The present approach of discriminating among the FIs as per their size is not well founded in logic since a smaller institution could be carrying higher risks with weaker

control systems than a larger FI.

5.5.3 Unlike a bank, the locations at which an FI operates are likely to be restricted. Whether the inspectors should visit these locations would depend upon the operating systems of the FI. **Where operations are decentralised, it will be necessary to inspect the locations simultaneously with the corporate office but where operations in respect of critical areas like advances are centralised, such visits may not be necessary.**

5.5.4 As stated earlier, the main emphasis in the inspection should be on identification of the risks to which the FI is exposed and the management systems by which those risks are addressed. It will therefore become necessary to make a detailed evaluation of the system and to test through selected transactions that the system is functioning. **It is, however, not necessary to evaluate the systems at the time of each inspection if they had been evaluated earlier and found satisfactory**. It would be sufficient if on subsequent inspections, confirmation is obtained from management regarding any changes in the system and if the operation of the system is tested through selected transactions.

5.5.5 At present, the on-site inspection of the FIs contains an element of surprise from RBI and no advance intimation is given to them. The inspection team raises its information-indents after reaching the institution and the collation of information by the FI starts only thereafter. Such an approach is not very time-efficient – neither for the inspection team nor the FI concerned – and leads to avoidable stress and inconvenience. Also, given the fact that unlike banks, Fis do not hold large volumes of cash and negotiable instruments and operational risks are lower, an element of surprise in inspection may not be necessary. Since, a major part of the information required for on-site inspection is fairly standardised, **the Group suggests that the information requirement should be advised to the FIs at least a month before the commencement of inspection to ensure better time-management and efficiency of the examination process.**

5.6.1 The Group would also like to suggest certain refinements in the present

system of off-site supervision.

5.6.2 The off-site surveillance of the FIs is somewhat handicapped by the difficulty in defining a fairly representative peer group for comparison across FIs, unlike commercial banks which are quite homogenous and comparable in their functions and operations. The difficulty arises from the unique nature and functions as also a small number of the FIs under the supervisory domain of RBI at present. Thus, even though NABARD, NHB and SIDBI are categorised as "refinancing institutions", in view of their substantially divergent sectoral emphasis, they could not be reasonably placed in the same peer group for a comparative analysis. Likewise, even among the "term lending institutions", all the seven FIs (viz., EXIM Bank, ICICI, IDBI, IDFC, IFCI, IIBI and TFCI) do not constitute a homogenous peer group due to their unique functions. While recognising the incomparability of the existing FIs within any defined peer group, **the Group suggests that to begin with, only two peer groups be defined – one comprising the three refinancing institutions and the other comprising the seven term-lending institutions, on an experimental basis.** The SFCs and the SIDCs, as and when brought within the purview of RBI, would easily constitute two peer groups among themselves, for each category. As more experience is gained in the off-site analysis, the definition of the peer group could be further refined.

5.6.3 In the context of the emerging market dynamics wherein some of the FIs have been rapidly diversifying into new activities and products for which prior RBI's approval may not be necessary, **the Group recommends that a quarterly off-site report, on new activities / lines of business undertaken and new products launched by the FIs, should be introduced as part of the off-site surveillance system.** This would enable an ongoing monitoring of the new risks assumed by the FIs. A system of providing a formal feedback to the FIs on the areas of concern identified from the off-site reports should also be introduced so as to alert the FIs of the emerging vulnerabilities.

5.7 In the course of a meeting the Group had with the CEOs of some FIs, some interesting suggestions, as enumerated below, came up, which the Group would endorse:-

(a) **Before the commencement of the inspection, the management of the FI should be required to make a presentation to the IO indicating what in its perception were the risks to which the FI was exposed, the manner in which these risks had been addressed in the past and what the management proposed to do in the future.**

(b) **The IO should meet with the internal and external auditors to appreciate the scope of work and the results of the audit process.**

(c) **On conclusion of the inspection, there should be a meeting between the Principal Inspecting Officer and the chairman of the Audit Committee of the FI to discuss the major findings of the inspection, in addition to having such a meeting with the CEO of the FI. In the opinion of the Group, the meeting should be with the Audit Committee and not merely with its Chairman.**

5.8 Besides regular inspection, **the following supplementary vehicles of supervision may also be adopted depending upon circumstances :-**

(a) There may be **targetted appraisal** of selected areas like derivatives, swaps and other new products introduced.

(b) In exceptional circumstances, there may be **commissioned audits** by external agencies for examining specific areas of supervisory concern. Such audits could be conducted at the instance of RBI by:

- Either the statutory auditors of the FI concerned; or

- Any other firm of Chartered Accountants designated by RBI for the purpose, as its agent, on the lines of the system of "Reporting Accountants" followed in the United Kingdom by the Financial Services Authority under Section 39 of the Banking Act, 1987, of the UK

(c) There may be snap visits for quick reviews if the "off-site" information highlights areas of concern which cannot await the annual inspection

Supervisory paradigm for the future

A. Risk Based Supervision (RBS)

5.9 It is axiomatic that any supervisory system to be effective as well as efficient requires an optimal allocation of scarce supervisory resources so that the objectives of supervision are accomplished at an optimal cost and with the least possible regulatory burden on the regulatees. A system of Risk Based Supervision (RBS) serves these objectives by allocating supervisory attention as per the riskiness of a supervised entity rather than its size. It is not a new concept since the technique goes back 20 years or more when the supervisory agencies in the USA shifted their emphasis to the "top-down" approach to bank examinations which has since been revised and enhanced to evolve into risk-focused supervisory approach. **Annexures XII-A** and **XII-B** present an outline of the supervisory systems adopted by the Financial Services Authority of the United Kingdom and by the Federal Reserve of the USA, respectively. Thus, a FI with lower risk profile and strong risk management systems could expect less frequent and less intensive on-site examinations than a FI with high-risk profile and weak risk management systems. Hence, the distinguishing feature of RBS vis-à-vis the traditional supervisory approach could be summed up as

> The RBS discriminates amongst the supervised entities as per their risk-profile / exposure and the control systems in place therefor within

the institution; and

- The risk-profile and the control system therefor determine the extent and the nature of supervisory resources and tools deployed (e.g. the frequency, nature and the intensity of inspection) for the FI.

The Group is, therefore, of the opinion that **the RBS of the FIs should constitute the supervisory paradigm for the future.** The ability to judge the risk profile of various FIs would be possible if, as stated above, a rating system is implemented and the risk profiles are monitored on an ongoing basis through off-site surveillance. While the rating could become the benchmark for appropriately modulating the supervisory attention without compromising the quality or objectives of supervision, the off-site system could also provide the early warning signals for supervisory intervention. Various "Trigger Points" in the performance and profile of the FIs for initiating supervisory action would also need to be developed based on the off-site analysis of prudential data. The need for RBS is further strengthened by the fact of the growth in the asset base, increasing diversity and complexity of the product portfolio with consequent changes in the risk profile and a perceptible move on the part of some of the FIs towards universal banking. In these circumstances, a gradual progression to RBS is necessary. It is understood in this context that the risk-based supervisory approach for the banks, as already approved by the BFS, is to be implemented with the assistance of foreign consultants. **A similar approach would also need to be adopted for the FIs. The Group would, therefore, recommend that the feasibility of securing expert assistance from outside agencies for implementing RBS in respect of the FIs too, should be explored to ensure a consistent and integrated supervisory approach for the financial system as a whole.**

B. Consolidated supervision of financial conglomerates (FCs)

5.10.1 The Tripartite Group of bank, securities and insurance regulators formed in 1993 at the initiative of the Basle Committee on Banking Supervision, defined a FC as a "group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two

different financial sectors (banking, securities, insurance)". In this context, the Joint Forum on Financial Conglomerates (Joint Forum)** refers to FCs as "corporate groups which provide a wide range of financial services typically incorporating at least two of banking, securities and insurance." Guided by these definitions, this **Group recognises that some of the FIs, on account of their numerous subsidiaries and affiliates, have emerged over the years as domestic FCs**. While the structure of a FC can be banking, security or insurance as per the nature of predominant activity at the parent level, the FIs in India on account of their predominantly lending operations at the parent level would fall within the 'banking structure'. The FIs under the supervisory domain of RBI have numerous subsidiaries and affiliates, as indicated in **Annexure XIII**. It would be observed therefrom that some of the FIs have subsidiaries / affiliates in the areas of commercial / investment / merchant banking as well as securities trading / primary dealership & mutual funds. With the opening of the insurance sector in the country, it is likely that some of the FIs may also enter this field, making their present conglomerate structure even more complex

5.10.2 In the context of risk based supervision discussed above, theconcept of consolidated supervision of FIs as FCs acquires special significance. This is so since the operations of the subsidiaries and affiliates, particularly the unregulated ones, could expose the group as a whole to a variety of risks – particularly in respect of group-wide adequacy of capital and credit risk concentration. Such risks can hardly be ignored by a prudential supervisor specially when some of the activities of the FCs, undertaken through their subsidiaries / affiliates, may **not** be subject to even solo prudential supervision of any supervisor. In this context, the Group recognises that the present RBI supervision of the FIs is conducted only on a "solo" basis and a

**The Joint Forum was set up in early 1996 under the aegis of the Basle Committee on Banking Supervision the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to take forward the work of a predecessor group the Tripartite Group. The Forum comprises an equal number of senior bank, insurance and securities supervisors representing 13 countries.

consolidated supervision of FIs, encompassing their subsidiaries also, is not in place. SIDBI, a wholly owned subsidiary of IDBI; the banking subsidiaries and the mutual fund / merchant banking, etc., subsidiaries of the FIs get regulated and supervised by RBI / SEBI on a 'solo' basis in their own right rather than as a subsidiary of the respective parent FI. Thus, the extant supervisory framework does not capture the group-wide picture of the FIs as a FC, mainly due to the lack of compulsion in the present statutory regime for consolidation of accounts by the parent entities. This leads to a somewhat fragmented supervision, which does not recognise the ownership linkages within the conglomerate and the concomitant risks. While the subsidiaries are no doubt separate legal entities. yet the parent FI might be forced to step in to bail out its troubled subsidiary to obviate any reputational risk to the group as a whole. The doctrine of "source of strength" too would oblige the parent to help a financially distressed subsidiary, thus, in effect, transferring the risks of subsidiary to itself. The instance of Canara Bank and its subsidiary Canfina, where the former had to bail out the latter at a huge cost, is a case in point in the recent Indian history. These considerations underline the need for a consolidated supervision of the FIs whose conglomerate structure gives rise to several critical supervisory issues. These issues are briefly enumerated in **Annexure XIV**

5.10.3 The RBI's regulation of FIs' subsidiaries has so far been confined to the issuance of instructions issued in April 1994 to the regulated FIs to keep themselves informed of the activities of their subsidiaries; to exercise adequate supervision over them and also to maintain an "arms length" relationship from their subsidiaries. These prescriptions, though a step in the right direction, are far from meeting the requirements of consolidated supervision of the regulated FIs. The consolidated supervision refers to an overall evaluation, both quantitative and qualitative, of the strength of a group to meet the potential impact that the risks assumed by the group entities may have on other entities in the group as also on the group as a whole. The risks could be financial, relating to capital levels, risk concentration and intra-group transactions &

exposures, or non-financial such as reputational risk and various corporate governance issues. The said evaluation is based on a number of information sources. The quantitative assessment could rely largely on consolidated returns – where group-wide consolidation is mandated – and would primarily focus on the group-wide capital adequacy, large exposures and intra-group exposures. Though the intra-group exposures would stand netted and will not get reflected in the consolidated returns, the objective of the consolidated supervision is to ensure that the group as a whole is strong enough to cope with the risks arising from such deals. The qualitative assessment goes beyond the quantitative assessment of the whole group and could address issues such as conflict of interest, controls within the group vis-à-vis the fit and proper criteria/ management autonomy, ownership structures, etc. In case of mixed conglomerates, it could also assess the risks arising for the group from the industrial / commercial activities.

5.10.4 The Group notes that the Joint Forum has released seven Papers in February 1999 with a recommendation to supervisory community that they implement the principles set out in them. While the work relating to (1) intra-group transactions and exposures and risk concentrations in FCs, and (2) the transparency of conglomerate structures, is still underway, the documents released deal with the following matters:

- Techniques for assessing the capital adequacy of conglomerates including detecting excessive gearing;
- Facilitating the exchange of information among supervisors;
- Co-ordination among supervisors;
- Testing the fitness and propriety of managers, directors and major shareholders of conglomerates.

5.10.5 In this context, the Group noted that in respect of Bank Holding Companies (BHCs) in USA, - which would be akin to some of the

, the Federal Reserve of the USA uses the BOPEC rating model. BOPEC is an acronym formed with the first letters of: **B**ank subsidiaries, **O**ther (non-bank) subsidiaries, **P**arent company, **E**arnings (consolidated) and **C**apital adequacy (consolidated). Based on the rating on each of the five parameters, an overall rating is assigned to the BHC on a five point scale of 1 to 5, with one being the highest rating and five being the lowest rating. An outline of the BOPEC rating model of the Federal Reserve is furnished at **Annexure XV**. Since the condition of a consolidated holding company is typically highly correlated with the conditions of its bank susidiary(ies), the Federal Reserve makes use of the off-site SEER ratings and on-site CAMEL ratings of the bank subsidiaries in assessing the health of the BHCs. As a part of the off-site analysis, the BOPEC ratings of the BHCs are compared with the CAMEL / SEER ratings of their subsidiary bank(s) for monitoring purposes and for prioritising the BHCs for increased supervisory attention.

5.10.6 In this context, the Group has recommended (Cf. Paragraph 6.4.2.2) enabling legislative amendments to empower RBI for regulating the format of accounts of the 'notified financial institutions'; such powers could possibly also encompass the prescription of consolidation of accounts by the FIs. This would, however, at best cater to the quantitative aspects of a conglomerate structure. **The Group is of the opinion that** pending such mandatory prescription for consolidation and **keeping in view the emergence of FIs as financial conglomerates in the Indian financial system, steps would need to be initiated in future to upgrade the off-site surveillance capabilities within RBI for undertaking quantitative as well as qualitative, group-wide, assessment of the financial conglomerates following the principles and techniques enunciated in the documents released by the Joint Forum on Financial Conglomerates. For the purpose, the feasibility of securing expert assistance from outside agencies could also be explored.**

CHAPTER VI

Legislative Amendments Required

The existing statutory powers of RBI in respect of FIs

6.1 Chapter III-B of the Reserve Bank of India Act, 1934, vests in RBI various powers in respect of the "non-banking financial institutions receiving deposits and financial institutions". In respect of all-India financial institutions supervised by RBI at present, the powers are derived, *inter alia,* from Sections 45K, 45L and 45N *ibid;* these Sections are reproduced at **Annexure-XVI**. Section 45 K of the Act deals with the power of the Bank to collect information from non-banking institutions as to deposits and to give directions relating to deposits Section 45L empowers RBI to call for information from and to give directions relating to conduct of business, to "financial institutions" and the powers of this Section are quite independent of the deposit-taking activity of the institution Further, Section 45N empowers RBI to carry out inspection of a non-banking institution and financial institution, for verifying the correctness or completeness of the information received or if the Bank considers it necessary or expedient to inspect that institution. This Section also casts a duty on the Management of the FI to furnish any statement/ information relating to the business of the institution as the inspecting authority may require of it. Chapter III-B also defines the terms "financial institution", "non-banking institution" and "non-banking financial company" The term "financial institution" is very widely defined and includes in its ambit the insurance corporations, mutual funds, non-banking financial company, the FIs structured as statutory bodies as also those in the form of companies or co-operative societies. Thus, the SFCs, SIDCs and other government owned NBFCs, recommended by the Group for RBI's supervisory coverage in Chapter III of this report, would, *prima facie,* be covered within the ambit of this definition.

The Scope of the extant statutory powers of RBI

6.2 At the instance of the In-House Working Group constituted by the Reserve Bank in 1990, the Legal Department of RBI had examined in detail the scope of RBI's powers in respect of **FIs**. Having regard to the Statement of Object and Reasons appended to the Banking Laws (Miscellaneous Provisions) Bill, 1963 and the observations of the then Hon'ble Minister of Planning while moving the Bill in the Lok Sabha on 19 December 1963, the Legal Department had then opined that :

a) The intention of the law has been that the Reserve Bank should exercise comprehensive oversight over the financial system as a whole and that the provisions relating to financial institutions have been conceived as an adjunct to monetary and credit policy;

b) The powers to give directions to financial institutions under Section 45L are fairly wide and would allow the Reserve Bank to give directions on interest rates and deployment of credit. It was also stressed in this context that these powers can be exercised by RBI only for the purpose of enabling it to regulate the credit system of the country to its advantage and the directions so issued should not come in conflict with the provisions of the statute under which these institutions have been created.

c) The present provisions are, however, not explicit on matters such as stipulation of reserve requirements. Under the existing provisions, the Reserve Bank would be able to indicate that FIs should, as part of prudent management, hold a certain proportion of their funds in liquid assets. The stipulation of reserve requirements to be maintained by FIs with RBI, akin to cash reserve ratio in case of banks, would require amendment of RBI Act.

The In-House Working Group had, however, then taken a view that any amendments to the RBI Act on matters relating to financial institutions should be considered only after gathering some more experience of operating within the then existing legislative framework. The on-site inspection of the FIs having been commenced by RBI in 1995, the Group is of the view that it is quite opportune to take stock of the existing statutory provisions of the RBI Act.

6.3 It would be observed from the foregoing that even though RBI has fairly wide powers under RBI Act in respect of the "financial institutions", the powers are not explicit in regard to several important areas of supervision unlike the case of banks in respect of whom the powers are clearly spelt out under the provisions of Banking Regulation Act, 1949. The lack of clarity in the available statutory powers is not conducive to enforcement of prompt corrective action measures in respect of the FIs and could hinder the efficacy of the supervisory mechanism. This also creates a non-level playing field between the banks and the FIs even though the FIs are, in effect, bank-substitutes, in so far as their lending operations are concerned. **The Group is, therefore, of the view that to make supervision of the financial institutions more effective, to achieve the aforesaid legislative intent of a comprehensive oversight of the Indian financial system, and reckoning that even State level institutions have been recommended by the Group for coverage under the RBI's supervisory domain, there is an imperative need to vest in RBI clearly defined statutory powers for supervision of various financial entities.**

Legislative amendments required

6.4 It is understood in this context that a proposal, initiated by RBI, for deletion of the Chapters IIIB and IIIC from the RBI Act, 1934, is under active consideration of the Government of India and the provisions of these chapters are expected to be substituted by a new parliamentary enactment. In case the proposal is finally approved by the Government, it would be necessary to vest in RBI, the

powers available to it at present in respect of FIs under the provisions of Chapter IIIB of the Act. The Group is of the view that the requisite powers in RBI could be vested in a variety of ways: through a separate legislation for FIs on the lines of Banking Regulation Act, 1949 ("B R Act"); or an amendment to the RBI Act, 1934; or by inserting a separate chapter in the RBI Act or the B R Act, which should be applicable exclusively to the financial institutions. Consequential amendments to certain other statutes might also become necessary. The exact modality or the route for suitably empowering RBI could be decided as per expert legal advice. The following paragraphs briefly enumerate the areas in which the additional / explicit powers for RBI, are considered necessary by the Group.

6.4.1 Powers required for effective supervision of FIs

6.4.1.1 Inspection of financial institutions: The inspection of financial institutions at present is conducted by RBI in terms of the provisions of Section 45N(1) of the RBI Act. While the inspections under Section 45N(1)(i) can be caused "for the purpose of verifying the correctness or completeness of any statement, information or particulars furnished to the Bank or for the purpose of obtaining any information or particulars which the non-banking institution has failed to furnish on being called upon to do so", the inspections under Section 45N(1)**(ii)** can be caused "if the Bank considers it necessary or expedient to inspect that institution". The powers of RBI relating to inspection of FIs under RBI Act differ from its corresponding powers in respect of banks under the B R Act, 1949, in the following aspects:

- While the inspection of banks under Section 35 of the B R Act can be undertaken by RBI any time at its discretion or when directed by the Government, the inspection of FIs can be caused by RBI if the RBI considers it necessary or expedient to do so – implying that the FIs can be inspected only sporadically if and when considered necessary.

- The existing provisions of RBI Act for inspection of FIs, do not distinguish between a full-scope inspection and a "scrutiny", which could be short

/ special / portfolio or account specific investigations For such scrutinies relating to banks, separate provision exists under Section 35-1A of the B R Act, in addition to the provisions of Section 35(1) for regular inspection of banks.

Under Section 35(1) of the B R Act, an obligation is cast upon RBI to furnish a copy of its report on inspection to the bank inspected. Also, under Section 35-1A of the B R Act, it is obligatory for RBI to furnish a copy of the report of the scrutiny to the bank if it requests for it or if an adverse action is contemplated against the bank on the basis of the scrutiny. There are no such obligations mandated under RBI Act in respect of the FIs.

While the inspection or scrutiny in respect of banks, under Section 35 of the B R Act, can be caused only by one or more officers of RBI, the inspection of the FIs under the RBI Act can be caused not only by one or more officers of RBI but also by "other persons". Thus, apparently, RBI can also designate an external agency for causing an inspection of the FIs under the RBI Act, which is not permissible in case of banks under Section 35 of the B R Act.

Section 35(4) of the B R Act makes an enabling provision for RBI to report to the Central Government on any inspection or scrutiny made under Section 35 of the Act. The Government may, after considering the report of RBI, take the actions prescribed under the Section if it is of the opinion that the affairs of the banking company are being conducted to the detriment of the interests of its depositors. The Government is also authorised under section 35(5) of the B R Act to publish the said report submitted by RBI or such portion thereof as may appear necessary, after giving due notice to the bank concerned. There are no corresponding provisions under the RBI Act in the context of inspection of the FIs even though FIs too are permitted to access funds from public through term deposits and bonds.
(It may be mentioned here that at present the FIs are permitted, within an "umbrella limit" equal to their net owned funds, to raise funds through specified instruments, which include term deposits from public. Besides, the FIs also raise funds from public through issue of bonds)

Since the powers of RBI for inspection of FIs under Section 45 N (1) of the RBI Act are not as explicit and comprehensive as in respect of banks under the B R Act, the Group is of the view that it would be desirable to substitute the provisions of Section 45 N (1) of the RBI Act, by the provisions similar to the provisions of Section 35 (1) and 35-1A of the B R Act.

6.4.1.2 Notification of financial institutions by RBI for supervisory coverage: At present, out of 42 notified PFIs, only 10 PFIs are covered under the supervisory purview of RBI. Even these PFIs were brought within RBI's coverage in phases, on a case-to-case basis, based on the internal decisions of the Top Management of RBI. There is no provision in place at present providing for a statutory notification of a financial institution for its supervisory coverage by RBI unlike the inclusion of a bank in the Second Schedule to the RBI Act or the notification of a non-banking institution or a class of such institution, as NBFC, under Section 45-I (f)(iii) of the RBI Act. In view of the Group's recommendation for supervisory coverage of SFCs, SIDCs and other Government owned NBFCs, by RBI, as financial institutions, it would be imperative to vest in RBI the powers to notify an entity as a "financial institution". Only such "notified financial institutions" would be subject to regulation and supervision by RBI as a financial institution. While the FIs already within the supervisory purview of RBI could be notified together, the identification of the new institutions to be notified for the purpose would have to be done on a case-to-case basis and should be based on the nature of business of the institution, the extent of systemic risk it entails for the financial system and the impact its operations might have on the credit and monetary aggregates in the economy.

6.4.1.3 It is observed in this context that that under Section 45-I (c) of the RBI Act, 1934, the term "financial institution" is very widely defined (cf. Annexure III) and means any "non-banking institution" (which means a company, corporation, or co-operative society) which carries on as its business or part of

its business, *inter alia*, "the financing, whether by way of making loans or advances or otherwise, of any activity other than its own". Thus, the various institutions recommended by the Group for RBI's supervisory coverage would fall well within the aforesaid definition of FI. Further, the statutory powers for giving directions to and undertaking inspections of the 'financial institutions' are already vested in RBI in terms of the provisions of Sections 45 L and 45 N respectively, of the RBI Act. While – as stated at para 6.2 above – the RBI's powers to give directions to FIs can be exercised only for the purpose of regulating the credit system of the country to its advantage, the powers for inspection are discussed at para 6.4.1.1 above. **The Group is, therefore, of the view that for extending the RBI's supervisory umbrella to the various entities recommended by the Group, no legislative amendment to the RBI Act, 1934, would be necessary except that a provision for notifying such institutions as "notified financial institutions" as suggested above, should be inserted in the Act.** As regards the SFCs, these are at present governed by the provisions of the SFCs Act, 1951, and IDBI is the agency designated in Section 37-A of the Act for inspection of the SFCs at present. Hence, supervision of SFCs by RBI would also require an amendment to the provisions of the SFCs Act, 1951, – as enumerated below.

Amendments to the State Financial Corporations Act, 1951

6.4.1.4 At present, the inspection of SFCs is the responsibility of IDBI under Section 37-A of the SFCs Act, 1951. Prior to 1976, as stated at para 3.9 of the report, the inspection of SFCs was conducted by RBI under the same Section when by the Public Financial Institutions Laws (Amendment) Act, 1976, the Section was amended to substitute RBI by IDBI. As mentioned at para 3.12 above, this Section is again sought to be amended by the SFCs (Amendment) Bill, 1999, to transfer the supervision of SFCs from IDBI to SIDBI along with the envisaged transfer of IDBI's shareholdings in all the SFCs to SIDBI. Thus, there is an apparent trend of linking the ownership and the supervisory functions in regard to the SFCs. To enable the inspection of SFCs by the RBI as recommended by the Group, it would be necessary to carry out suitable

amendments to the provisions of the SFCs Act, 1951 also. As stated at para 3.12 above, the legislative Bill for amending the SFCs Act, 1951, is at an advanced stage of consideration by the Government. **The Group is of the view that the issue of entrusting supervisory responsibilities in regard to SFCs, to RBI instead of SIDBI, so as to ensure an integrated supervision of the Indian financial system, should be taken up by RBI with the Government, on priority basis**. The possibility whether the Bill itself could be suitably modified for the purpose before its enactment, should be expeditiously explored. This is also necessary since the Bill is based on the recommendations of the Khan Committee, which was constituted as far back as in 1993, and the Indian financial system has undergone a sea change since then.

6.4.1.5 In this context, it is observed that under section 39 of the SFCs Act, 1951, the powers to give instructions to SFCs on "questions of policy" are vested in the respective State governments which may issue such instructions "in consultation with and after obtaining the advice of" IDBI. The Section 39 (2), *ibid*, also empowers the State governments to decide whether a question is a question of policy and such a decision would be final. Furthermore, after considering the report of inspection of SFCs conducted by IDBI under Section 37-A, *ibid*, the State governments may issue necessary instructions under Section 37A(4), *ibid*, to the Boards of the SFCs and the Boards are duty bound under the Act to comply with such instructions. In case of non-compliance with such instructions, the State governments are also empowered, under section 39 (3) of the Act, to supercede the Boards of the SFCs.

6.4.1.6 It would thus be seen that under the extant statutory framework, there is a dichotomy between the supervisory responsibilities – which are entrusted to IDBI under Section 37A, *ibid*, – and the enforcement authority for corrective action pursuant to the findings of inspection, which is vested in the respective State governments under Section 37A(4), *ibid*. The Group is of the view that such a dichotomy has been one of the major constraints in effective regulation and supervision of SFCs by IDBI, since IDBI does not have the necessary powers for enforcement of requisite corrective action on the part of

SFCs. In order, therefore, to ensure the efficacy of the envisaged supervision of the SFCs by RBI, the **Group considers it essential that such dichotomy between the regulatory and supervisory authority is dispensed with in the SFCs Act, 1951. For the purpose, RBI should be vested with not only the powers to inspect the SFCs but also to give binding instructions to the Boards of the SFCs, instead of the respective State governments issuing such instructions as stipulated at present, for securing corrective action from the SFCs in respect of any area of supervisory concern which may come to the notice of RBI through inspection / scrutiny, off-site surveillance, market intelligence or otherwise. Suitable amendments to the SFCs Act would, therefore, be necessary for the purpose.** The feasibility of amending the SFCs (Amendment) Bill, 1999, itself before its enactment, should also be explored expeditiously.

6.4.1.7 As stated at paragraph 6.4.1.5, the powers to give instructions to SFCs on "questions of policy" are vested in respective State governments under Section 39 of the SFCs Act while in the preceding paragraph, the Group has recommended that the powers for supervisory enforcement under Section 37A(4), *ibid*, should be vested in RBI instead of the respective State governments. It needs being pointed out here that such an arrangement could potentially hamper the effectiveness of supervisory system envisaged for SFCs as the instructions of the State governments could conceivably be at variance, at times, with the supervisory norms of RBI. Moreover, in respect of All-India FIs, RBI has powers to issue directions to the FIs and also supervises them, which provides an integrated supervisory system for the All-India FIs. In order, therefore, to obviate a potential conflict due to separation of statutory powers for issuing instructions on "questions of policy" to SFCs and supervision / supervisory enforcement in respect of SFCs, the issue of transferring the powers vested in State governments under Section 39 of the SFCs Act, to RBI, will also need to be addressed by RBI in due course.

6.4.2 Powers required being incidental to the supervisory process

6.4.2.1 Powers of enforcement pursuant to findings of inspection: Under section 45 K (3) of the RBI Act, RBI is empowered to give directions, in the public interest, to the non-banking institutions in matters connected with the receipt of deposits, including the period of deposits and the rate of interest payable on such deposits. In respect of the FIs, Section 45 L of the RBI Act, empowers RBI to give directions to FIs for calling for statements, information or particulars relating to the business of the FI, and to give directions relating to the conduct of business by them. The powers under Section 45 L can be exercised only for the purpose of enabling RBI "to regulate the credit system of the country to its advantage", having due regard to the objects and the statutory responsibilities of the FI concerned and the effects that the FI's business may have on the trends in the money and capital markets. Thus, the scope for exercise of the powers to give directions to FIs is rather circumscribed by, *inter alia*, the need to regulate the credit system of the country as also by the objects and the statutory responsibilities of the FIs. The existing provisions of Sections 45 K or 45 L do not vest any powers in RBI to issue directions to the FIs for securing compliance with the findings of inspection which can impair the RBI's ability to enforce prompt corrective action and thereby the efficacy of the supervisory mechanism. **The Group is, therefore, of the view that it would be desirable to amend the RBI Act empowering RBI to issue directions to the FIs for securing corrective action on their part in respect of any areas of supervisory concern that may come to the notice of RBI through the findings of inspection / scrutiny, off-site surveillance, market intelligence or otherwise and for enforcement of these directions.**

6.4.2.2 The format of annual accounts: Unlike the case of banks for whom a uniform format of balance sheet and the profit & loss account has been prescribed vide the Third Schedule to the B R Act under Section 29 of the Act, there is no uniformity in the presentation of the annual reports of the financial institutions. While the FIs structured as companies adopt the format mandated under the Companies Act, 1956, the FIs incorporated under the statutes present

their results in the format prescribed under the respective statutes. This not only creates a significant divergence in the level of disclosure and degree of transparency in the financials of the FIs but also makes a meaningful comparison across FIs, difficult. **It would, therefore, be desirable to vest in RBI enabling powers on the lines of Section 29 of the B R Act, for prescription of the disclosure norms and the format of the annual financial statements in respect of the envisaged "notified financial institutions".** Incidentally, a committee appointed by RBI, which submitted its report in September 1999, has recommended a separate form of balance sheet and profit & loss account for the NBFCs.

6.4.2.3 Directions to Auditors: Under Section 30 of the B R Act, RBI may direct the auditor of a banking company to audit the accounts of the bank in relation to any transaction or class of transactions. Further, Section 45MA(1A) of the RBI Act, 1934, empowers RBI to give directions to the auditors of NBFCs in respect of the balance sheet, profit and loss account, disclosure of liabilities in the books of accounts or any matter relating thereto, if it is necessary to do so in the public interest. RBI lacks at present such powers in respect of non-NBFC financial institutions (viz. IDBI, NABARD, NHB, SIDBI and EXIM Bank) which could be a hindrance in adopting the supervisory approach of portfolio-specific "commissioned audits" by RBI – as recommended by the Group at para 5.7 above – in respect of such FIs. Hence, it would be desirable to vest suitable powers in RBI in this regard.

6.4.2.4 Submission of annual accounts: In respect of banks, Section 31 of the B R Act mandates the publication of the prescribed accounts and the balance sheet together with the auditors' report in the prescribed manner and submission thereof to RBI within three months from the end of the period to which the accounts relate. This period of three months is extendable by RBI upto a maximum of further three months. There are no corresponding provisions available in the RBI Act in respect of the FIs. It would be desirable to stipulate similar statutory requirements for the "notified' FIs also to instill some discipline.

specially in view of the fact that IDBI reportedly could not carry out timely inspection of SFCs due to inordinate delay in finalisation of their annual accounts.

CHAPTER VII

Need for Manual and Training

7.1 The inspection of FIs by RBI is of recent origin. Started in 1995, only two rounds of inspection have been concluded so far and officers attached to the Regional Offices of DBS have conducted the inspections. These inspections were conducted using the inspection manual intended for the inspection of commercial banks with certain modifications considered necessary. However, given the difference in the nature of operations between banks and FIs, a need was felt for a separate manual for inspection of FIs. Accordingly, a draft manual has been prepared by the FID of DBS and the same has been sent for comment to IDBI, ICICI and IFCI. **The Group would suggest that the inspection manual be finalised expeditiously after consideration of the comments from those FIs and after incorporating the accepted recommendations of the Group.**

7.2 Training of officers to carry out the inspection of FIs should be a continuous process. Since the inspection of FIs is a new subject so far as the RBI is concerned, there would be a shortage of experienced officers within the RBI in this area and it would be necessary to take outside assistance. This is particularly relevant in the context of a proposed shift to a system of Risk Based Supervision. **The Group is of the view that given the urgency of the matter, there should be a time-bound programme for creating a sufficient cadre of officers who have specialised knowledge for the inspection of FIs.** This programme should include specialised training courses to be organised by outside agencies like NIBM; attendance in courses of study in specialised subjects at outside training institutions such as IIMs and ASCI; and in-house programmes with the help of RBI's own and outside faculty. The feasibility of organising training programmes in collaboration with the financial supervisors of other countries like Federal Reserve of USA and FSA of UK, could also be examined, particularly in the specialised areas of risk-assessment of the financial

intermediaries and the risk-based supervision.

7.3 In this context, the Group would like to emphasise that **the post-training placement of the officers trained would be crucial** to maintaining core competence of the RBI in carrying out increasingly complex supervision of the Indian financial system. The Group also recognises that while the entire complement of the inspecting officers could not to be expected to be equally experienced and seasoned, it would be essential to ensure an optimal balance between the experienced and relatively new hands, in a specialised area like financial supervision. For the purpose, **well-defined criteria for entry into and exit from the department concerned would also need to be evolved and meticulously implemented.**

7.4 The Group recognises that in the emerging context of Universal Banking in India, under which there would be greater functional convergence between the banks and the traditional FIs, the approach to supervision would have to shift from an institutional to a functional perspective cutting across the institutional boundaries. However, **the specialised training inputs provided to the IOs and the skills developed by them with regard to supervision of FIs, could be easily transferable across various institutional forms** and would contribute to enhancing and strengthening the supervisory capabilities of RBI for the Indian financial system as a whole.

CHAPTER VIII

Other Matters

8.1 While the review of prudential norms is not strictly covered by the terms of reference of the Group, in the opinion of the Group, the matter needs reconsideration for the following reasons :-

(a) the norms have been designed primarily to identify NPAs in relation to operating accounts and to determine appropriate levels of provisioning there against but further attention needs to be given to advances in respect of projects under implementation and also advances which are affected by significant changes in industry scenarios.

(b) the application of US GAAP by some FIs to their loan portfolio has revealed significant differences between the amount of provisioning norms and the amount of provisioning necessary when US GAAP is applied.

(c) there have been differences in interpretation of the norms between the FIs and their auditors and the IOs of RBI resulting in significant differences in the amount of provision considered necessary.

(d) the decisions of FIs regarding rehabilitation and restructuring of advances have been influenced by their impact on NPAs and consequently such proposals have sometimes been structured in a manner which is not the most optimum solution in the circumstances.

8.2 One of the areas in which clarity is needed is in respect of "projects under implementation". Currently, a project is deemed to be under implementation until the concern commences commercial production and the date of commencement of commercial production is left to be determined by the management of the FI. "Projects under implementation" are considered as standard assets and reschedulement of the terms can be freely done.

8.3 While the Group recognises that when a project commences commercial production is a subjective concept and also that the period of construction can, due to valid reasons, get extended beyond the period envisaged when the advance was sanctioned, there is need for some discipline and objective criteria in this matter. For this reason the **Group would suggest the following guidelines:-**

(a) The date of commencement of commercial production should be determined by the management of the FI in accordance with the guidance given in Accounting Standard AS10, "Accounting for Fixed Assets" issued by the Institute of Chartered Accountants of India.

(b) Where the date of commencement of commercial production extends beyond a period of six months after the date on which construction is completed, the account should be treated as a sub- standard asset or doubtful asset as the case may be, if the prescribed norms regarding payment of interest or repayment of loan installments are not complied with.

8.4 There are also cases when the completion of projects is unduly delayed. In all such cases, the account continues to be treated as a standard asset and rescheduling of the terms of payment of interest and repayment of loan installments is freely permitted without the account being considered as a sub standard asset. While the Group recognises that completion of construction may be delayed for genuine reasons it also recognises that such delay could affect the viability of the project because of increased cost of the project resulting from escalation in costs as also capitalisation of interest during the extended period. **The Group would therefore suggest that a delayed project may be considered as a standard asset only for a period not exceeding two years beyond the date for completion of the project envisaged when the loan was originally granted.**

8.5 There are cases where during the course of construction, a project is substantially modified by the inclusion of a new or an increased facility and additional finance is loaned to the borrower. In such cases it is argued that the project continues to be a 'project under implementation' and should be treated as a standard asset. In the opinion of the Group, **it is necessary to distinguish between the expansion of a facility under Construction and a new facility. While in the former case, the original project may be considered as being under implementation, in the latter case, the new facility must be treated as a new project and the original project must be treated as an independent project subject to the normal income recognition and provisioning norms.**

8.6 Representatives of the FIs who appeared before the Group have argued that traditionally FIs have not determined the repayment schedules in respect of loans granted based on the ability to generate cash for repayment but have fixed common repayment terms – generally repayment in five annual installments with a two year moratorium – for all loans. With the liberalisation process in the last few years and the emergence of a competitive economy, even healthy and viable projects are finding it difficult to meet the stipulated terms of repayment and are asking for reschedulement. It was therefore suggested that a reschedulement in such circumstances should not result in the account being considered as a NPA.

8.7 The Group finds some merit in this representation. A borrower's ability to service a loan depends not merely on the initial viability of the project but also on the changes in the economic environment which may taken place during its lifetime. As financial intermediaries have to work with imperfect and uncertain knowledge of the future, it is not uncommon that a repayment schedule initially fixed may need some amendment during the lifetime of the project. At the same time, unbridled freedom to FIs to reschedule repayment terms would be inimical to credit discipline and sound banking and may adversely affect the quality of the asset. It therefore needs to be guided by selectivity and consistency.

8.8 While changes in the economic environment may be good grounds for reschedulement, all such changes cannot be accepted as grounds for reschedulement. Many of the changes such as increased supply and price competition, demand failure, entry of better quality products etc. may be considered as normal business risks which an entrepreneur is expected to foresee from past experience and build into the debt repayment schedule. Therefore reschedulement would be justified only when there are major changes in the economic environment which are "unforeseeable" i.e. the change is far different and greater than could have been reasonably foreseen. Examples of such changes would be major changes in the policy regimes such as deregulation and reduction in import duties since 1991, the oil price increases in early 1970s and 1980s and the devaluation of Asian Currencies in 1997.

8.9 The Group would therefore suggest that reschedulement should be considered as a "selective" rather than a general option. When reschedulement is done on that basis, the account should not be treated as a NPA provided the following conditions are satisfied :

(a) the borrower has not defaulted in the payment of interest.

(b) no additional funds are released.

(c) the period of rescheduled repayment is in accordance with what is considered fair for the industry, in the context of a given economic situation and is not longer than the period currently prescribed for fresh advances being granted by the FI to other units in the industry.

(d) The re-schedulement is done after a proper study which confirms the viability of the project.

8.10 Some of the representatives of the FIs who met the Group also

suggested that the provisioning norms should be revised on the lines presented in US GAAP i.e. the realisable value of the security should be determined on the basis of the present value of the security determined by discounting the expected future recoveries of interest and principal at an appropriate rate.

8.11 While the Group recognises the conceptual superiority of the US GAAP model, it also recognises that :-

(a) in the absence of adequate objective data, it is difficult to predict the period over which recovery of interest and principle will be made; and

(b) under the present legal system the ability of the FI to realise the security is deferred for an extremely long time.

The Group also noted that the provision needed under the US GAAP model would presumably be much larger than the provision needed under the current norms and may affect the ability of the FIs to make provision on that basis. **The Group is therefore of the view that a shift to the US GAAP model may be deferred for some time.**

CHAPTER IX

Summary of Recommendations

9.1 This chapter contains the summary of major recommendations made by the Group in various chapters of its report. For understanding the rationale of the recommendations, a reference may be made to the respective paragraphs indicated against each recommendation.

The Institutional scope of the supervisory domain of RBI

9.2 For the reasons detailed in the report, the following institutions should be brought within the supervisory domain of RBI:

a) State Industrial Development Corporations; (Paragraph 3.7)

b) State Financial corporations; (Paragraph 3.12)

c) Power Finance Corporation Limited; (Paragraph 3.13.3.2);

d) Rural Electrification Corporation Limited; (Paragraph 3.13.5.2)

e) Indian Renewable Energy Development Agency Limited; (Paragraph 3.13.6.1)

f) The North Eastern Development Finance Corporation Limited; (Paragraph 3.13.9.2);

9.3 the following institutions need not be brought within the supervisory domain of RBI for the reasons detailed in the report:

a) Indian Railway finance Corporation; (Paragraph 3.13.4.1)

b) Risk Capital and Technology Finance Corporation Limited; (Paragraph 3.13.7.1)

c) ICICI Venture Funds Management Company Limited; (Paragraph 3.13.8.2)

d) Housing and Urban Development Corporation Limited; (Paragraph 3.13.10.1)

9.4 For ascertaining the due compliance with the RBI regulations applicable

to GIC, LIC and UTI, a system of obtaining annual certificates evidencing due compliance with the applicable RBI regulations from the auditors of these institutions should be introduced. (Paragraph 3.13.1.1)

9.5 While all the Public Financial Institutions notified till date have been comprehensively analysed by the Group from the perspective of their supervisory coverage, it is necessary to institutionalize an on-going mechanism to ensure that in future any financial institution getting notified as a PFI or any new financial entity which by the nature of its constitution or the nature of its business is specifically excluded from the purview of supervision of the Department of Non Banking Supervision, gets considered by RBI for assessment of whether it should be brought within the supervisory domain of RBI as a FI. For the purpose. the FIs notified by the Government from time to time as PFIs as well as other financial entities coming up, should be kept under continual review by RBI. FID. (Paragraph 3.14)

<u>The areas of coverage in RBI supervision of FIs</u>

9.6 The scope of coverage of the on-site examination of the FIs is considered quite adequate. However, a separate main paragraph on risk management should be included in the open part of the inspection report to provide an integrated view of the risk management systems in vogue in a FI. Further, the examination of certain aspects of functioning of the FIs needs to be refined and fine-tuned, as briefly enumerated below (Paragraph 4.6):-

9.6.1 While ratio analysis is a very effective tool for the initial identification of the areas of concern, the inherent limitations of ratio analysis as a supervisory tool need to be taken due cognisance of by the Inspecting Officers. (Paragraph 4.7)

9.6.2 The extent of on-site verification of asset quality and provisioning should not be kept rigid but should depend upon the outcome of a limited test check which should be conducted following the system recommended by the Group.

as detailed in the body of the report. Accordingly, the Inspecting Officer should have the freedom to widen or narrow the scope of his full-scale verification, guided by the outcome of the suggested test-checks. (Paragraph 4.8.2)

9.6.3 In the context of asset quality examination, the forgoing norms for test-check of loans portfolio should be applied by the IO, also to the off-balance sheet business undertaken by a FI (including the take-out finance commitments, if any, entered into by the FI) with a view to evaluating the adherence to the laid down risk management systems of the FI in respect of its off-balance sheet commitments. (Paragraph 4.8.3)

9.6.4 Utmost care needs to be exercised by the IO in drawing conclusions from the results of the test-ckeck. The IO should consider the result of his test check in the context of the sample examined by him and whether the sample examined, when considered in the context of the total portfolio, provides an adequate basis for making a generalisation. (Paragraph 4.8.4)

9.6.5 It is very necessary when making the subjective assessment that the inspector recognises the fundamental difference between the assets of a bank and the assets of an FI. In the case of a bank, adverse financial performance of the borrower normally results in a deterioration of the quality of the assets, which are meant for sale or realisation and therefore, the inspector has to be particularly careful in verifying the existence and realisability of the assets. However, in the case of a FI, the assets are held by the borrower, not for the purposes of sale but for the income they generate. (Paragraph 4.8.6)

9.6.6 The amount of additional provisions assessed by the I.O. on account of qualitative (subjective) factors should not be disclosed account-wise in the main report (open part of the report) but should form a part of the confidential portion of the report. Only total amount of such provisions should be stated in a separate paragraph in the main report and given effect to in assessment of net worth, capital adequacy, asset quality, etc. of the FI. However, the account-wise details

of such provisions should be separately conveyed to the CEO of the FI, confidentially. (Paragraph 4.8.7)

9.6.7 A system of discussing the provisioning shortfall, owing to the objective as well as subjective factors, by the inspection team with the auditors in the presence of the management of the FIs, should be introduced to enhance transparency and minimise the element of subjectivity. (Paragraph 4.8.7)

9.6.8 In the evaluation of management aspects of an institution, the management structure of the organisation should be examined not with regard to its detailed functioning but mainly to ascertain whether it satisfies the twin criteria of accountability and transparency in its operations. (Paragraph 4.9)

9.6.9 In the earnings analysis of the institution, certain accounting ratios (as detailed in the report), which are not analysed at present also need to be computed and examined to study the trend over a period of time as also for a comparison with the peer group. (Paragraph 4.10)

9.6.10 In the assessment of liquidity, apart from the adequacy of the MIS for the Asset Liability Committee, the IO should particularly examine the reasonableness of the assumptions used by the FI in projecting various cash inflows and outflows based on which the liquidity mismatches have been arrived at, in various time buckets. The proposed funding strategy for bridging the liquidity gaps should also be consistent with the borrowing capacity of the FI in term of its debt-equity ratio, its ability to borrow at reasonable cost and the system for hedging its funding cost through suitable covenants in the loan agreements. Besides, particular attention should be given to the interest rate mismatch, maturity mismatch, open foreign exchange position and outstanding loan commitments insofar as they could impact the liquidity profile of the institution. (Paragraph 4.11)

9.6.11 In assessing the parameters of systems and control for a FI, attention needs to be given to the system of identifying, measuring, monitoring and

controlling credit risks (including loan pricing mechanism and credit exposure ceilings), market risks, operational risks and the integrity and reliability of internal and regulatory MIS as well as the system for ensuring the statutory and regulatory compliance. (Paragraph 4.12)

Nature of Supervision

9.7 In order to address some of the limitations of the present system of inspection and having regard to the utility of rating exercise as a supervisory tool, an appropriate supervisory rating model for use during on-site inspection should be developed and implemented in respect of the FIs, at the earliest. The rating system envisaged for the FIs could be used not merely for effective off-site and on-site surveillance but also for estimating the off-site ratings of the FIs between two on-site examinations. (Paragraphs 5.4.2 and 5.4.3)

9.8 As against the biennial system of the on-site examination of some of the FIs, all the FIs under the supervisory purview of RBI should be inspected at annual intervals with reference to the balance sheet dates till the FIs could be systematically differentiated as per their risk profile based on the off-site surveillance data and the proposed supervisory rating system. (Paragraph 5.5.2)

9.9 The geographical scope of on-site examination of FIs should reflect the degree of centralisation in the operations of FIs. Where the operations are de-centralised, simultaneous examination of several field locations along with the corporate office would be necessary but where operations in respect of critical areas like advances are centralised, the visits to remote locations may not be necessary. (Paragraph 5.5.3)

9.10 In evaluating the systems, it is not necessary to undertake such evaluation at the time of each inspection if the system had been evaluated earlier and found satisfactory; a confirmation from the management of the FI regarding any changes in the system would be sufficient during subsequent inspections if the operation of the system is tested through selected transactions. (Paragraph 5.5.4)

9.11 The information requirement of the inspection team should be advised to the FIs at least a month before the commencement of inspection to ensure better time management and efficiency of the examination process. (Paragraph 5.5.5)

9.12 For off-site analysis and comparison of data across the FIs, two peer groups should be defined to begin with – one comprising the three refinancing institutions (SIDBI, NABARD and NHB) and the other comprising seven term lending institutions, on an experimental basis. As experience is gained in the off-site analysis, the definition of the peer group could be further refined. (Paragraph 5.6.2)

9.13 A quarterly report on new activities / lines of business undertaken and new products launched by the FIs should be introduced as part of the off-site surveillance system. (Paragraph 5.6.3)

9.14 Before the commencement of inspection, the management of the FI should be required to make a presentation to the inspection team on the FI's perspective of its own risk exposures, and the manner in which these risks were addressed in the past and the future strategy of the FI in this regard. The inspection team should also meet the internal and external auditors to appreciate the scope of their work and the results of their audit. On conclusion of the inspection, the Principal Inspecting Officer should meet the Audit Committee as also the CEO of the FI to discuss the major findings of the inspection. (Paragraph 5.7)

9.15 Supplementary supervisory vehicles such as targetted appraisal of selected portfolios, and in exceptional circumstances, commissioned audit, by the statutory auditors of the FI concerned or by any other firm of Chartered Accountants designated by RBI, of the identified areas of concern and snap visits for quick reviews of the concerns highlighted by the off-site data, should also be deployed as a part of the supervisory process. (Paragraph 5.8)

9.16 Reckoning the growth in the asset base, increasing diversity and complexity of the product portfolio with consequent changes in risk profile and a perceptible move on the part of some of the FIs towards Universal Banking, the risk-based supervision of FIs should constitute the supervisory paradigm for the future. The feasibility of acquiring expert assistance from outside agencies for implementing the risk-based supervision in respect of the FIs should be explored. (Paragraph 5.9)

9.17 The Group recognises that some of the FIs, on account of their numerous subsidiaries and affiliates, have emerged over the years as domestic financial conglomerates. Hence, the concept of consolidated supervision of FIs acquires special significance since the operations of the subsidiaries and affiliates of FIs could expose the group as a whole to a variety of risks. Steps would, therefore, need to be initiated in future to upgrade the off-site surveillance capabilities within RBI for undertaking quantitative as well qualitative, group-wide assessment of the financial conglomerates following the principles and techniques enunciated in the final documents released by the Joint Forum on Financial Conglomerates. For the purpose, the feasibility of securing expert assistance from outside agencies could also be explored. (Paragraphs 5.10.1 to 5.10.6)

Legislative Amendments Required

9.18 In order to make the supervision of the FIs more effective and to achieve the stated legislative intent of a comprehensive oversight of the Indian financial system, and reckoning the fact that even State level institutions have been recommended by the Group for coverage under RBI's supervisory domain, there is a need to vest in RBI clearly defined statutory powers for supervision of various financial entities. The exact modality or route for suitably empowering RBI could be decided as per expert legal advice. (Paragraphs 6.3 and 6.4)

9.19 The statutory powers, for effective supervision as also those incidental to the supervisory process, in the following areas are considered necessary to

be vested in RBI:-

a) Inspection of FIs; (Paragraph 6.4.1.1)

b) notification of FIs by RBI for supervisory coverage; (Paragraph 6.4.1.2)

c) inspection of State Financial Corporations; (Paragraph 6.4.1.4)

d) issuance of binding instructions to SFCs for corrective action; (Paragraph 6.4.1.6)

e) enforcement pursuant to findings of inspection for FIs other than SFCs; (Paragraph 6.4.2.1)

f) format of annual financial statements; (Paragraph 6.4.2.2)

g) directions to auditors; (Paragraph 6.4.2.3)

h) submission of annual accounts; (Paragraph 6.4.2.4)

9.20 The inspection manual for the FIs should be finalised expeditiously after consideration of the comments from the FIs and after incorporating the accepted recommendations of the Group. (Paragraph 7.1)

9.21 There should be a time bound programme for creating a sufficient cadre of officers who have specialised knowledge in the field of inspection of FIs. This is particularly relevant in the context of a proposed shift to a system of Risk Based Supervision. For the purpose, specially designed training courses organised by outside agencies could be utilised. The feasibility of organising training programmes in collaboration with the financial supervisors of other countries should also be examined. The Group recognises that in the emerging context of Universal Banking in India leading to greater functional convergence across the financial intermediaries, the specialised training inputs provided to the IOs and the skills developed by them with regard to supervision of FIs, could to be easily transferable across various institutional forms. (Paragraph 7.2 and 7.4)

9.22 The post-training placements of the officers trained is crucial for maintaining the core competence of RBI in carrying out increasingly complex financial supervision. For the purpose well-defined criteria for entry into and exit from the department concerned would need to be evolved and meticulously implemented. (Paragraph 7.3)

Other Matters

9.23 In respect of projects under implementation, the date of commencement of production should be determined by the management of the FI in accordance with the guidance given in Accounting Standard AS10 ('Accounting for Fixed Assets") issued by the Institute of Chartered Accountants of India. In case the date of commencement of commercial production falls beyond a period of six months from the date on which construction is completed, the account should be treated as sub-standard or doubtful, as the case may be, if the prescribed norms for payment of interest / repayment of principal have not been complied with. (Paragraph 8.3)

9.24 Reckoning the fact that the completion of construction might get delayed for genuine reasons affecting the viability of the project, the delayed project may be considered as standard asset only for a period not exceeding two years beyond the date of completion of the project originally envisaged when the loan was granted. (Paragraph 8.4)

9.25 It is necessary to distinguish between the expansion of a facility under construction and a new facility for the purpose of asset classification. While in the former case, the original project may be considered as being under implementation, in the latter case, the new facility must be treated as a new project and the original project must be treated as an independent project subject to the normal income recognition and provisioning norms. (Paragraph 8.5)

9.26 A borrower's ability to service a loan depends not merely on the initial viability of the project but also on the subsequent changes in the economic environment, which may necessitate some amendments to the repayment schedule. Such changes in the repayment schedule need to be guided by selectivity and consistency so as not to vitiate credit-discipline and sound banking. The reschedulement would be justified only when the changes in the economic environment were "unforeseeable". Thus, reschedulement should

be considered as a "selective" rather than a general option. When reschedulement is done on that basis, the account should not be treated as a NPA provided the following conditions are satisfied:-

a) the borrower has not defaulted in payment of interest;

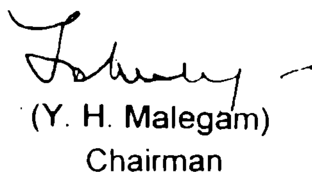
b) no additional funds are released;

c) the period of rescheduled repayment is in accordance with what is considered fair for the industry in the context of a given economic situation and is not longer than the period currently prescribed for fresh advances granted by the FIs to other units in the industry;

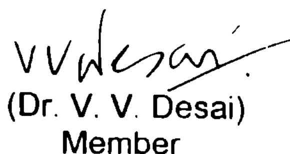
d) the reschedulement is done after a proper study which confirms the viability of the project.

(Paragraphs 8.7, 8.8 and 8.9)

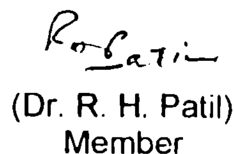
9.27 Though the US GAAP Model for determining the provisioning requirement for the loan assets is conceptually superior to the Indian Model in vogue, yet on account of absence of adequate objective data and the present time-consuming judicial system of the country, a shift to the US GAAP Model should be deferred for some time. (Paragraph 8.11)



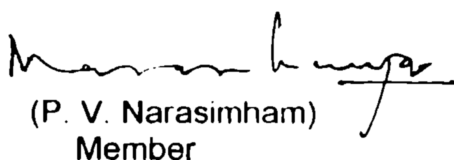
(Y. H. Malegam)
Chairman



(Dr. V. V. Desai)
Member



(Dr. R. H. Patil)
Member



(P. V. Narasimham)
Member

(K. C. Bandyopadhyay)
Member-Secretary

10 May 2000

ANNEXURE I
(Cf. Paragraph 1 8)

Letter regarding constitution of the Informal Advisory Group

D.O.DBS.FID.No.668/01.02.00-98/99 March 15, 1999

Dear Shri Malegam,

Informal Advisory Group on the Regulation and Supervision of Financial Institutions

It has been decided to set up, in consultation with the Government of India an Informal Advisory Group under your Chairmanship to examine the various areas concerning regulation and supervision of Financial Institutions, with the following members :-

i) Dr. V. V. Desai
ii) Mr. P. V. Nararsimham, Chairman, IFCI
iii) Dr. R. H. Patil, MD, NSE

2. The terms of reference of the Informal Advisory Group are as under :-

a) Areas of coverage of supervision of FIs
b) Objective and purpose of supervision
c) Type of supervision viz. On-site / Off-site or on the basis of CAMELS System through internal or external sources
d) Type of FIs which should be covered under overall supervision
e) Legislative amendments required
f) Assessment of the need for a Manual and specialised staff with Intensive training by outside experts

3. Shri K.C. Bandyopadhyay, Chief General Manager, Financial Institutions Division, Department of Banking Supervision, Reserve Bank of India, Central Office, Mumbai, will be the Member-Secretary.

4. We look forward to your active participation and fruitful association in the deliberations of the Advisory Group.

With regards,

Yours sincerely,
Sd/-
(S. P. Talwar)

Shri Y. H. Malegam
Director – Central Board
Reserve Bank of India
Meher Chambers (2nd Floor)
R. Kamani Road, Ballard Estate
Mumbai – 400 038

ANNEXURE – II

(Cf. Paragraph 2.1)

Financial Institutions included / notified as Public Financial Institutions under Section 4A of the Companies Act, 1956 as on 31st March 1999

Name of the Institution	Date of Notification
1. Industrial Credit and Investment Corporation of India Ltd.	1 February 1975
2. Industrial Development Bank of India	1 February 1975
3. Industrial Finance Corporation of India / Industrial Finance Corporation of India Limited	1 February 1975 / 15 February 1995
4. Life Insurance corporation of India	1 February 1975
5. Unit Trust of India	1 February 1975
6. General Insurance Corporation of India	8 May 1978
7. National Insurance Company Ltd.	8 May 1978
8. New India Assurance Company Ltd.	8 May 1978
9. Oriental Fire and General Insurance Company Ltd.	8 May 1978
10. United Fire and General Insurance Company Ltd.	8 May 1978
11. Industrial Reconstruction Bank of India / (now Industrial Investment Bank of India Limited)	9 October 1987
12. Tourism Finance Corporation of India Ltd.	3 January 1990
13. Risk capital and Technology Finance Corporation Ltd.	20 March 1990
14. Technology Development and Information Company of India Ltd.	12 April 1990
15. Power Finance Corporation Ltd.	31 August 1990
16. National Housing Bank	26 July 1991
17. Small Industries Development Bank of India	2 December 1991
18. Rural Electrification corporation Ltd.	11 February 1992
19. Indian Railways Finance Corporation Ltd.	8 October 1993

20. Andhra Pradesh State Financial Corporation	28 March 1995
21. Assam Financial Corporation	28 March 1995
22. Bihar State Financial Corporation	28 March 1995
23. Delhi Financial Corporation	28 March 1995
24. Gujrat State Financial Corporation	28 March 1995
25. Haryana Financial Corporation	28 March 1995
26. Himachal Pradesh Financial Corporation	28 March 1995
27. Jammu & Kashmir State Financial Corporation	28 March 1995
28. Karnataka State Financial Corporation	28 March 1995
29. Kerala Financial Corporation	28 March 1995
30. Madhya Pradesh Financial Corporation	28 March 1995
31. Maharashtra State Financial Corporation	28 March 1995
32. Orissa State Financial Corporation	28 March 1995
33. Punjab Financial Corporation	28 March 1995
34. Rajasthan Financial Corporation	28 March 1995
35. Uttar Pradesh Financial Corporation	28 March 1995
36. West Bengal Financial Corporation	28 March 1995
37. Indian Renewable Energy Development Agency Ltd.	17 October 1995
38. Tamilnadu Industrial Investment corporation Ltd.	27 October 1995
39. North Eastern Development Finance Corporation Ltd.	23 July 1996
40. Housing and Urban Development Corpn. Ltd.	9 December 1996
41. Infrastructure Development Finance Company Ltd.	13 December 1997
42. Exim Bank	14 June 1999

Total 42 Public Financial Institutions

ANNEXURE III

(Cf. Paragraph 2.1)

Statutory definitions "Public Financial institutions" (PFIs) and "Financial Institutions" (FIs)

I. "Public Financial Institution"

A. Under the Companies Act, 1956 – Section 4A

(1) Each of the FIs specified in this sub-section shall be regarded, for the purposes of this Act, as a public financial institution, namely :-

i) the ICICI Ltd., a company formed and registered under the Indian Companies Act, 1913;

ii) the IFCI, established under section 3 of the Industrial Finance Corporation Act, 1948;

iii) the IDBI, established under section 3 of the Industrial Development Bank of India Act, 1964;

iv) the LIC, established under section 3 of the Life Insurance Corporation Act, 1956;

v) the UTI, established under section 3 of the Unit Trust of India Act, 1963.

(2) Subject to the provisions of sub-section (1), the Central Government may, by notification in the Official Gazette, specify such other institution as it may think fit to be a public financial institution:

Provided that no institution shall be so specified unless –

i) it has been established or constituted by or under any Central Act; or

ii) not less than fifty-one percent of the paid-up share capital of such institution is held or controlled by the Central Government.

B. Under the Public Financial Institutions(Obligation as to Fidelity and Secrecy) Act, 1983 - Section 2

In this Act, "public financial institution" means –

(a) the Industrial Credit and Investment Corporation of India Limited, a company formed and registered under the Indian Companies Act, 1913 (7 of 1913);

(b) the Industrial Reconstruction Corporation of India Limited, a company formed and registered under the Companies Act, 1956 (1 of 1956); or

(c) any other institution, being a company as defined in Section 617 of the Companies Act, 1956 (1 of 1956) or a company to which the provisions of Section 619 of that Act apply, which the Central Government may, having regard to the nature of the business carried on by such institution, by notification in the official Gazette, specify to be a public financial institution for the purposes of this Act.

II. "Financial Institution"

A. Under IDBI Act, 1964 – Section 6-A

Each of the institutions specified in this section, and no other institution, shall be regarded, for the purposes of this Chapter, as a **financial institution**, namely –

i) the ICICI Ltd., formed and registered under the Indian Companies Act, 1913 (7 of 1913);

ii) the IFCI, established under Section 3 of the Industrial Finance Corporation Act, 1948 (15 of 1948);

iii) the Industrial Reconstruction Corporation of India Ltd., formed and registered under the Companies Act, 1956 (31 of 1956);

iv) the LIC, established under Section 3 of the Life Insurance Corporation Act, 1956 (31 of 1956);

v) the Unit Trust; and

vi) such other institution as the Central Government may, by notification in the Official Gazette, specify in this behalf.

B. Under RBI Act, 1934 – Section 45 I (c)

"Financial institution" means any non-banking institution which carries on as its business or part of its business any of the following activities, namely –

i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;

ii) the acquisition of shares, stock, bonds, debentures or securities issued by a government or local authority or other marketable securities of alike nature;

iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972 (26 of 1972);

iv) the carrying on of any class of insurance business;

v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;

vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lump sum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any otherway, to persons from whom monies are collected or to any other person,

but does not include any institution, which carries on as its principal business –

(a) agriculture operations; or

(aa) industrial activity; or

(b) the purchase or sale of any goods (other than securities) or the providing of any services; or

(c) the purchase, construction or sale of immovable property, so, however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons.

ANNEXURE IV

(Cf. Paragraph 3.3)

List of State Industrial Development Corporations

1. Assam Industrial Development Corporation Limited, Guwahati – 781 024
2. Andhra Pradesh Industrial Development Corporation Limited, Hyderabad – 500 029
3. Bihar State Credit & Investment Corporation Limited, Patna – 800 001
4. Economic Development Corporation of Goa, Daman & Diu Limited, Goa – 403 001
5. Gujarat Industrial Investment Corporation Limited, Ahmedabad – 380 009
6. Haryana State Industrial Development Corporation Limited, Chandigarh – 160 017
7. Himachal Pradesh State Industrial Development Corporation Limited, Shimla – 171 001
8. Industrial Promotion & Investment Corporation of Orissa Limited, Bhubaneswar – 751007
9. Jammu & Kashmir State Industrial Development Corporation Limited, Srinagar
10. Karnataka State Industrial Investment & Development Corporation Limited. Bangalore-560052
11. Kerala State Industrial Investment & Development Corporation Limited, Thiruvananthapuram – 695003
12. Madhya Pradesh State Industrial Development Corporation Limited, Bhopal 462 003
13. Meghalaya Industrial Development Corporation Limited, Shillong – 793 003
14. Nagaland Industrial Development Corporation Limited, Dimapur – 797 112
15. Pondicherry Industrial Promotion Development & Investment Corporation Limited, Pondicherry – 605001
16. Pradeshiya Indstrial & Investment Corporation of Uttar Pradesh Limited. Lucknow – 226 021
17. Punjab State Industrial Development Corporation Limited, Chandigarh – 160017
18. Rajasthan State Industrial Development & Investment Corporation Limited. Jaipur – 302005

19. State Industrial & Investment Corporation of Maharashtra, Mumbai-400 021
20. State Industries Promotion Corporation of Tamil Nadu Limited, Chennai -- 600088
21. West Bengal Development Corporation Limited, Calcutta 700 001
22. Sikkim Industrial Development & Investment Corporation Limited, Gangtok -- 737 103
23. Arunachal Pradesh Industrial Development & Financial Corporation Limited, Itanagar 791110
24. Tripura Industrial Development Corporation Limited, Agartala – 799 005
25. Mizoram Industrial Development Corporation Limited, Aizwal – 796 007
26. Manipur Industrial Development Corporation Limited, Imphal – 795 001
27. The Andaman & Nicobar Islands Integrated Development Corporation Limited, Port Blair – 744 101
28. Omnibus Industrial Development Corporation of Daman & Diu and Dadra & Nagar Haveli Limited, Nani, Daman – 396 210

ANNEXURE – V
(Cf. Para 3.8)

Select Financial Indicators of SFCs as on 31 March 1998

(Rs. in lakhs)

Sr. No.	Name of the SFC	Paid-up Capital	Free Reserves	Total Assets	Loans Out-Stand-ing	Std. Assets %	Total NPAs %	% of D/ful Assets to total NPAs	Profit Or Loss	CAR (%)
1.	Andhra Pr. SFC	8805	146	84149	71867	39	**61**	48	-111	0.35
2.	Assam F C	1242	319	7469	6721	6	**94**	84	-607	-40.64
3.	Bihar SFC	7810	1321	33371	33551	5	**94**	90	-2489	-297.3
4.	Delhi F C	1548	2314	10711	7752	56	**43**	24	512	33.27
5.	Gujrat SFC	9353	5459	133606	109522	70	**29**	10	2282	13.2
6.	Haryana F C	3387	431	68555	59022	64	**35**	17	1051	11.17
7.	Himanchal F C	2795	458	18912	13893	36	**64**	48	11	-10.93
8.	J & K SFC	6330	559	44921	43347	NA	**NA**	NA	-620	-8.5
9.	Karnataka F C	8810	445	212446	181627	73	**26**	14	499	4
10.	Kerala SFC	9200	1157	64341	61708	73	**27**	9	901	12.47
11.	M P F C	8448	371	37771	34494	33	**68**	45	10	10.26
12.	Maharashtra SFC	6140	3923	118818	100535	58	**42**	15	-132	-0.75
13.	Orissa SFC	8757	1	75923	51300	26	**74**	41	23	-18
14.	Punjab SFC	2705	0	47797	44234	37	**63**	42	-1749	-15.73
15.	Rajasthan FC	6753	0	92366	68848	52	**48**	33	-1538	5.27
16.	TN Industrial Investmt. Corpn.	4249	337	135300	101407	NA	**39**	NA	1442	10.3
17.	U P SFC	100000	21	149888	128723	58	**41**	26	-8167	-8.87
18.	W B SFC	5445	1827	42712	32985	55	**45**	35	67	3.5
	TOTAL			**1369377**	**1149536**	**56**	**44**	**27**		

ANNEXURE VI

(Cf. Paragraph 3.12)

Summary of Conclusions and Recommendations of the Committee to Review the State Financial Corporations Act, 1951

The more important of the recommendations made by the Committee are summarised below :

(i) The definition of "industrial concern" be further widened to enable SFCs to finance additional / new industrial activities.

(ii) Considering the role of SIDBI in the small scale sector, the Committee recommends to include the definition of SIDBI also in the SFCs Act.

(iii) To cope with the growth in business and to meet capital adequacy norms, the existing upper limit of fifty crore of rupees in respect of authorised capital which may be increased upto one hundred crore of rupees with the permission of the Central Government be raised to five hundred crore of rupees which may be increased upto one thousand crore of rupees with the permission of the State Government based on the IDBI's recommendation.

(iv) The shareholding pattern of SFCs should be on the basis of 51:49. While fifty one percent of the issued share capital shall be held by the State Government, IDBI, RBI, SIDBI, scheduled banks in the public sector, Life Insurance Corporation of India and such other institutions owned and controlled by the State or Central Government, the remaining forty nine percent shall be issued to the public.

(v) In view of the change suggested in the shareholding pattern, the existing restrictions on transfer of shares be removed and a suitable mechanism be built into the SFCs Act to maintain a minimum holding of fifty one percent of the issued capital by the State Government. IDBI, RBI, SIDBI, scheduled banks in the public sector, LICI and other institutions owned

or controlled by the State or Central Government.

(vi) The State Government guarantee in respect of repayment of principal and payment of annual dividend at minimum rate be dispensed with and SFCs be allowed to declare dividend at a rate determined by them based on performance as in the case of corporations / companies. The existing shareholders of SFCs may be given an option to convert their existing shares into shares of the same nominal value without State Government guarantee or to receive the principal amount of the shares held by them so that the shareholders exercising the former option would get the benefit of the higher dividend as and when declared by SFCs.

(vii) A shareholder in the forty nine percent category to be eligible to be elected as a director, shall hold minimum unencumbered shares of a nominal value of at least ten thousand of rupees.

(viii) A provision may be incorporated in. SFCs Act to provide for a limit on the voting rights to be exercised by individual shareholders other than the State Government, RBI, IDBI, SIDBI, public sector scheduled banks and other institutions owned and controlled by Central Government / State Governments, without restrictions on individual holdings.. Such shareholders may be allowed to exercise voting rights in respect of shares held up to one percent of the total voting of all shareholders of SFCs.

(ix) Prior approval of IDBI to be obtained by SFCs for borrowing money from RBI and consultation with IDBI and RBI before SFCs borrow money from State Government be dispensed with. SFCs may be allowed to borrow money from any financial institutions, scheduled bank, insurance company or any other person approved by IDBI and also from multilateral organisations with the approval of both IDBI and the State Government.

(x) SFCs be allowed to accept deposits on terms generally or specially approved by RBI. The requirement of approval of the State Government and IDBI in this regard be dispensed with.

(xi) In view of the suggested change in the shareholding pattern, the composition

of the Board be changed providing adequate representation to private shareholders by correspondingly reducing the number of State Government and IDBI nominees. The Board should be empowered to appoint the Managing Director who may hold office for a term of three years and who shall be eligible for re-appointment without any restriction on the maximum period. In the case of a nominated / elected director, his tenure may be three years and he shall be eligible for re-nomination / reelection, so, however, that he shall not hold office continuously for a period exceeding six years in all.

(xii) The Board should be empowered to elect one of its members as Chairman for a period not exceeding three years as against the existing period of four years and who shall be eligible for re-appointment, so long as he remains a director.

(xiii) In view of the change proposed in the composition of the Board, the composition of the Executive Committee be changed to include representatives from the elected / co-opted directors appointed by the Board.

(xiv) The Board be empowered to determine at its discretion the conditions of appointment and service and remuneration of officers, advisers and employees and the requirement of these being determined by regulations be dispensed with. This will enable in appointing professionally qualified officers.

(xv) To improve their profitability, SFCs to undertake new activities like merchant banking, leasing, issue of letter of credit, mutual fund activity, factoring, etc.

(xvi) Considering the substantial increase in the capital outlay of industrial concerns, the existing limit of accommodation of sixty lakh of rupees be increased to one hundred fifty lakh of rupees. In other cases, the present limit of thirty lakh of rupees be increased to ninety lakh of rupees.

(xvii) To enable SFCs to continue to provide financial assistance to good constituents and improve the quality of their portfolio, SFCs be allowed

to finance industrial concerns in respect of which the aggregate paid-up share capital and free reserves does not exceed ten crore of rupees. On the recommendations of IDBI, the State Government may increase this limit up to thirty crore of rupees.

(xviii) Suitable provisions be made in the SFCs Act granting immunity to employees of SFCs for action taken in good faith in exercise of the rights and powers of SFCs under section 29 of the SFCs Act. Suitable provision may also be made in the SFCs Act to enable SFCs to transfer properties as agents of the industrial concerns so as to vest in the transferee all rights in or over such property and at the same time to ensure that proceedings by others for recovery .of dues of all types lie only against the industrial concern and not against the SFC. [Section 29(5)].

(xix) As the existing procedure in the SFCs Act in regard to recovery of SFCs' dues as arrears of land revenue [section 32(G)] is time consuming the same be modified empowering the State Government to authorise the Chief Executives of SFCs to issue certificates of recovery to the Collector.

(xx) SFCs may be allowed to invest funds in such securities as the Board may decide.

(xxi) In view of the changes proposed in the shareholding pattern of the SFCs and keeping in view the practice prevailing in the corporate sector, the power to appoint auditors to audit the affairs of SFCs, determining the remuneration payable to the, approval of the rate of dividend recommended by the Board and approval of annual accounts, capitalisation of reserves, etc. be vested with the General Body.

(xxii) In view of the proposed change in the shareholding pattern and considering the functional autonomy and operational flexibility envisaged for the Boards of SFCs, the State Governments may continue to have powers to give instructions to SFCs on questions of policy so long as they hold not less than fifty one percent of he issued capital and in cases where the State Governments' holding in the share capital of SFCs is less than this

percentage, the Boards should be competent to decicde policy matters on their own.

(xxiii) SFCs Act may provide for nomination facilities for deposits, bonds, etc. to ensure smooth and prompt transmission of title to the legal heirs / representatives in the case of death of depositors and bond holders.

(xxiv) SFCs be enabled to approach the Debts Recovery Tribunals for recovery of their dues. This will help SFCs to speed up the recovery.

(xxv) SFCs may be notified by the Central Government as public financial institutions under section 4A of the Companies Act in view of the benefits the public financial institutions enjoy under certain provisions contained in Income Tax Act, 1961.

ANNEXURE VII

(Cf. Para 3.12)

An extract from the State Financial Corporations (Amendment) Bill, 1999

	6. After section 4C of the principal Act, the following sections shall be inserted, namely:-	**Insertion of new sections 4D to 4H**
	"4D.(1) On and after the commencement of the State Financial corporations (Amendment) Act, 1999, the Financial corporation may -	**Issue of redeemable preference shares**
	(a) issue redeemable preference shares on such terms and in such manner as the Board may decide; and	
	(b) convert such number of equity shares as it may decide into redeemable preference shares with the prior approval of the State Government and the Small Industries Bank by a resolution passed in the general meeting of the shareholders:	
	Provided that such conversion shall in no case reduce the equity shares held by the parties referred to in clauses (a), (b) and (c) of sub-section (3) of section 4 to less than fifty-one per cent of the issued equity capital of the Financial corporation.	
	(2) The redeemable preference shares referred to in sub-section (1) shall -	
	(a) carry such fixed rate of dividend as the Financial Corporation may specify at the time of such issue or conversion and	
	(b) neither be transferable nor carry any voting rights.	

	(3) The redeemable preference shares referred to in sub-section (I) shall be redeemed by the Financial Corporation within three years from the date of such issue or conversion in such instalments and in such manner as the Board may determine.
Reduction of share capital	4E. (1) The Financial Corporation with the prior approval of the State Government and the Small Industries Bank may, by resolution passed in a general meeting of the shareholders, reduce its share capital in any way.
	(4) Without prejudice to the generality of the foregoing power, the share capital may be reduced by – a) Extinguishing or reducing the liability on any of its equity shares in respect of share capital not paid-up; or b) Either with or without extinguishing or reducing liability on any of its equity shares, cancelling any paid-up share capital which is in excess of the wants of the Financial corporation. c) either with or without extinguishing or reducing liability on any of its equity shares, paying off any paid-up share capital which is in excess of the wants of the Financial Corporation.
Restric-tion on exerci-sing of voting right	4F. Every shareholder of the Financial Corporation holding equity shares shall have a right to vote in respect of such shares on every resolution and his voting right on a poll shall be in proportion to his share of the paid-up equity capital of the Financial corporation : Provided, however, that no shareholder, other than shareholder referred to in clauses (a), (b) and (c) of sub-section (3) of section 4, shall be entitled to exercise voting rights in respect of any equity shares held by him in excess of ten per cent of the issued equity capital.
Proxy voting.	4G. In a general meeting referred to in clause (b) of sub-section (1) of section 4E, the resolution for conversion or reduction of share capital shall be passed by shareholders entitled to vote, voting in person, or, where proxies are allowed, by proxy, and the votes cast in favour of the resolution are not less than three times the number of votes, If any, cast against the resolution by shareholders so entitled and voting.

Transfer of share capital to Small Industries Bank.	4H. On such date as the central Govemment may, by notification in the Official gazette, specify (hereinafter referred to as the specified date) **all the shares of every Financial Corporation subscribed by the Development Bank** and the amount outstanding in respect of loans in lieu of capital provided by the Development Bank as on the date immediately preceding the specified date **shall stand transferred to, and vested in, the Small Industries Bank** at such rate and subject to such terms and conditions as may be mutually agreed to upon between the Development Bank and the Small Industries Bank."	
Amend-ment of section 37A	**In section 37A of the principal Act, for the words "Development Bank" wherever they been, the words "Small Industries Bank" shall be substituted.**	

ANNEXURE VIII
(Cf. Para 3.13.3.1

Comparison of Prudential Norms for NBFCs & Financial institutions

Sr. No.	Parameter	NBFCs	FIs
1.	Capital Adequacy	NBFCs which have Net Owned Funds of Rs 25 lakh and above and are accepting / holding public deposits, were required to have a minimum 12% CRAR, except Loan & Investment companies which attracted 15% CRAR,with effect from 31 March 1999 and 15% from 31 March 2000.	FIs were required to maintain at least 9% CRAR with effect from the financial year ending 31 March, 2000
2.	Asset Classifica -tion	In the loans portfolio (other than lease and hire purchase assets), the assets are to be classified as NPA if the interest amount remains "past due" for six months or the instalment of principal (in case of a term loan) remains overdue for six months.	A loan asset is treated as NPA if the interest remains "past due" for 180 days and / or the principal amount remains past due for more than 365 days.
3.	Disclosure in the balance sheet	Every NBFC which has Net Owned Funds of Rs. 25 lakhs and above and is accepting / holding deposits from public, is required to separately disclose in its balance sheet the provisions made for its loan portfolio without netting them from the income or against the value of assets.	No disclosure norms have so far been prescribed by RBI in respect of the FIs.
4.	Exposure Norms	The prudential ceiling on **credit** by a NBFC to a single borrower and a single group of borrowers is prescribed at 15% and 25% respectively of its Net Owned Funds while the ceiling on **investment in shares** of a single company and a single group of companies has been set at 15% and 25% respectively of its NOF. However, the composite ceiling on the credit and investment in a	The credit exposure ceilings for a FI are set at 25% and 50% of its "capital funds" in respect of an 'individual borrower' and 'group borrowers' respectively. However, the ceiling for 'individual borrower' has been reduced to 20% with effect from 1 April 2000 and any excess exposure as on 31 October 1999, is required to be brought within 20% by 31 October 2001. An additional credit exposure of up to 10% of capital funds in respect of group

Sr. No.	Parameter	NBFCs	FIs
	Exposure Norms (contd.)	single entity or a single group of entities is stipulated at 15% and 40% respectively, of its NOF. For the purpose of exposure norms, the credit exposure in respect of off-balance sheet items of NBFCs is computed by applying the credit conversion factors and risk weights as prescribed for capital adequacy assessment.	borrowers, is also permitted provided the additional exposure is on account of infrastructure financing. No separate ceiling for investment exposure has been prescribed. The off-balance sheet items of the FIs are taken at 50% of their value for reckoning the credit exposure.
5.	**Transfer to Reserves**	Every NBFC is required, under Section 45-IC(1) of the RBI Act, to create a reserve fund and transfer therein an amount not less than 20% of its net profit as disclosed in its profit and loss account and before any dividend is declared.	This provision is not applicable to the FIs which are statutory bodies. The FIs which are companies under the Companies Act, 1956, and attract this provision of the RBI Act, have generally been granted exemption from it by RBI subject to certain conditions.
6.	**Maintenance of Liquid Assets**	Every NBFC is required, under Section 45-IB (1) of the RBI Act, to maintain a certain percentage, as prescribed by RBI (at present 15%), of its outstanding public deposits, in unencumbered approved securities.	This provision is not applicable to the FIs, which are statutory bodies. The FIs which are companies under the Companies Act, 1956, and attract this provision of the RBI Act, have generally been granted exemption from it by RBI subject to certain conditions.
7.	**Operations in the Money Market**	NBFCs are, generally, not authorised to deal in Money Market.	Most of the FIs have been authorised to deal in the money market, but only as a lender.
8.	**Treatment under FERA 1973**	Generally, NBFCs are not authorised to deal in foreign exchange under FERA 1973	Some of the FIs have been granted a limited authorisation to deal in foreign exchange.

ANNEXURE IX
(Cf. Para 3.13.4.1)

Comparative statement of resources mobilised during 1998- 99 by select all- India Financial Institutions

(Amount in Rs. crore)

	ICICI				IDBI				IFCI			
	1997-98	**% to total**	**1998-99**	**% to total**	**1997-98**	**% to total**	**1998-99**	**% to total**	**1997-98**	**% to total**	**1998-99**	**% to total**
Public Issue of Bonds/ Debentures	3064	23.9	1734	22.0	984.9	12.1	4342	34.2	0.0	0	0	0
Private placement of Bonds / Debentures	9742	76.1	6132	78.0	7186.5	87.9	8341	65.8	3367.1	100	3545.5	100
Total	**12806**	**100.0**	**7866**	**100.0**	**8171.4**	**100**	**12683**	**100**	**3367.1**	**100**	**3545.5**	**100**

Source Respective FI

ANNEXURE X

(Cf Para 4 4)

भारतीय रिज़र्व बैंक

RESERVE BANK OF INDIA

बैंकिंग पर्यवेक्षण विभाग,

Department of Banking Supervision,

केन्द्रीय कार्यालय, वित्तीय संस्था प्रभाग,

द आर्केड, कफ परेड, कोलाबा, मुंबई-400 005

Central Office,Financial Institutions Division,
The Arcade, Cuffe Parade, Colaba,,Mumbai,**400005**

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हिन्दी आसान है इसका प्रयोग बढ़ाइये ।

संदर्भ पर्य सं.

/Ref DBS.FID ROC No.32 /18.02.851/ 98-99

November 10, 1998

Officer-in-Charge of all Regional Offices of DBS

Dear Sir,

Inspection of financial Institutions under Section 45(N) <u>of RBI Act, 1934 – Guidelines and Format of the report</u>

As you are aware, RBI started conducting inspection of financial institutions (FIs) in the year 1995 under the provision of Section 45(N) of Reserve Bank of India Act, 1934. In view of the special characteristics of All India Financial Institutions (FIs), the objective and scope of inspections has an additional dimension viz., the developmental and apex role assigned to institutions like IDBI, NABARD, NHB, etc. as enshrined in the respective Acts, which is also required to be looked into at the time of inspection in addition to the following objectives of on-site inspection;

- Capital adequacy assessment,
- Evaluation of asset quality, investment portfolio, adequacy of loan loss provisions held,
- Management including broad directions, internal control and audit,
- Assessment of earnings performance including analysis of profitability.
- Assets/liabilities mis-matches and funds management.

At present the Inspecting Officers (I. Os.) are broadly following the format of Inspection Report specified for Inspection of Commercial Banks. In the light of the experiences gained by our IOs, a need has been felt to suitably revise the format for inspection of FIs. Further, there are certain areas like Statutory Liquidity Ratio, Cash reserve Ratio and Credit Control Directives, etc. which are not relevant to FIs. At the same time there are certain areas which require different approach / greater emphasis while conducting inspections of FIs.

In view of the above, a new format of Inspection Report for use of I.Os. while conducting the Inspections of FIs has been prepared. Some of the important changes / additions made in the format of the Inspection Report are discussed below.

1. <u>Capital Adequacy</u>

It is proposed that the analysis of the divergence between the reported and assessed CRAR may be given in new Annexure VI instead of giving in the body of the report. Further, the calculation of Risk Weighted Assets as done by the FI and as done by the Inspecting officer are proposed to be shown as Part C of Annexure VI.

2. <u>Loan Assets</u>

i) The system for computation of funds requirements of borrowers is to be examined for each of the financial product introduced by the FI.

ii) In addition to examination of top 50 standard accounts in the descending order of outstanding balances, the Inspecting Officer should also examine all the borrowal accounts belonging to <u>top 20 group borrowers</u> irrespective, of whether these borrowal accounts fall under the category of top 50 accounts or not.

iii) The I.O. may also examine top 50 NPAs under each category (20 in cases of branch/controlling offices) viz., sub-standard, doubtful and loss assets, for ascertaining the reasons for the accounts becoming NPAs, efforts made for recovery, upgradation, compromise settlement etc. and also for ensuring appropriate classification and assessing the extent of under-provisioning, if any. However, such analytical comments on

individual accounts need not be made available to the CEO of the FIs.

iv) The cut-off point for ascertaining appropriate classification and assessing shortfall in provisions, if any, will be Rs. 5.00 crores in respect of all FIs

v) The I.O. is also required to give industrial sector-wise profile of NPAs in addition to stating the general risk profile of the advances portfolio

3. Funds Management and Liquidity

The I.O. should offer his comments on maturity mismatches in different time bands and their status versus tolerance limits (Gap Analysis).

External borrowings may be discussed in a separate paragraph.

4. Systems and Control

The I.O. should also offer his comments on investors' relationship - the manner of disposal of complaints, system for grievance redressal, etc.

5. Foreign Exchange Business

The I.O. should also offer the detailed comments on the following points:

- Opening of letters of credit / merchant contracts - scrutiny of proposals, status report of the overseas exporter / banker - compliance with the regulatory norms.
- Lines of credit - deployment of funds and follow up.
- Liability / risk management through forward covers, swaps, options etc. - adequacy and effectiveness of the system.

6. Off Balance Sheet business

In this para the I.O. should also discuss separately the guarantees furnished by FIs for external commercial borrowings (ECBs) and the control exercised by the FIs over the utilisation of funds raised by the companies against ECBs.

7. Promotional and other important activities

The I.O. should discuss the promotional and special development role, if any, assigned to the institution and offer his comments on the achievement of

objectives by the institution.

8. Rating System

It has been decided that for the present we may not have Rating System for FIs as has been introduced for banks.

The enclosed new format may be implemented with immediate effect. If an inspection is already underway, the PIO could endeavour to see to present the Inspection Report in line with the new format as far as possible.

Please acknowledge receipt.

Yours faithfully,

Sd/-

(K. C. Bandyopadhyay)
Chief General Manager

Encl: As Above

Department of Banking Supervision

Financial Institutions Division

Format of Inspection Report for Financial Institutions

Open Section : Part I (For transmission to the FI)

1. Introduction

An Inspection of ——— under Section 45(N) of RBI Act, 1934, was conducted between ——— and——— with reference to the financial position as on — Besides the Head Office. —— Zonal/ Regional Offices and -- branches were also inspected for the purpose. The last inspection of the Institution was conducted with ——— as reference date. The developments in the FI's affairs since then have been reviewed in the Inspection Report.

During the period under review :-

a) There has/ has not been any significant change in the ownership pattern and control of the Institution.

b) Shri ——— has continued to be the Chief Executive Officer (CEO) of the Institution./ There has been a change of incumbency with Shri —— taking over as CEO of the Institution from Shri —— since (date):

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

d) The subsidiaries of the Institution have remained at —— /; it set up — subsidiaries since last Inspection. New financial investments in subsidiaries/ associates/ affiliates have/ have not been made.

e) Its branch network has gone up/ down by – to —.

f) In the financial accounts for ——— (financial year), it reported an operating profit before provisions of Rs.——— and net profit (i.e. profit after provisions & taxes) of Rs.-.

g) The risk based capital ratio (CRAR) of the FI stood at ——% as against — —% as on the date of last inspection.

2. Summary Review

Major Findings of the Inspection to be listed.

3. Solvency and Capital Adequacy

3.1 Solvency Appraisal

3.1.1 Shareholder Equity (Net Worth)

The net worth (at book value) stood at Rs.—— crore as on the date of Inspection, posting an increase/ decrease of Rs.— crore (— %) since the date of last Inspection. The increase/ decrease in net worth resulted from the following changes:

(Rs. in crore)

Net Worth as on the date of last Inspection

Add : Retained Earnings added to Reserves

(Deduct) Loss

Add : New Equity

(of which share premium)

Net Worth as on the date of present Inspection

3.1.2 Determination of outside liabilities

Identification of liabilities, which have impact on net worth assessment; liabilities not brought on books and provisions or additional provisions required for liabilities (Details of understated liabilities are furnished in Annexure V)

3.1.3 Assessed Net Worth

The Inspector assessed the real value of shareholder equity i.e. the assessed net worth (ANW) at Rs. —— crore, i.e. Rs. — crore less/ more than the book value. The difference between the ANW & book value of net worth is analysed as under :

1. Paid –up Capital
2. (+) Reserves
3. (+) Surplus in P&L Account Or
4. (-) Accumulated Loss

Net Worth (book value)

Adjustments following Inspection findings:

5. (-) Additional loan loss provisions required
6. (-) Additional investment provisions (depreciation) required
7. (-) Provisions required for losses in other assets
8. (-) Provisions required for likely losses in off- balance sheet items
9. (-) Additional provisions required for any other liabilities (e.g. tax, gratuity, pension, bonus etc.)
10. (-) Any liabilities likely to devolve but not recognised
11. (-) Intangibles
12. (-) Unrealised interest on NPAs taken to income
13. (+) Any items included under Liabilities (other than provisions) which may not be outside liabilities
14. (+) Any excess or surplus provisions or provisions no longer required

———

Real net worth or real / exchangeable value of paid-up capital and reserves (ANW) ———

There has been increase/ decrease of Rs. — crore in the ANW since the date of last Inspection when it was placed at Rs. ——— crore.

The ANW further shows that with reference to the book value, the Shareholders Equity (Capital + Reserves) is

a) Intact

b) Impaired to the extent of Rs. — crore, indicating erosion of Reserves (Rs. — crore) and Capital (Rs. — crore)

c) Totally lost

The ANW covers — % of outside liabilities as compared to — % at last Inspection

3.2 Capital Adequacy

The Inspector has assessed the Capital to Risk- weighted Assets Ratio (CRAR)

at —— % and core CRAR at — % as against — % and —% respectively computed by the Institution as on the date of Inspection. The divergence between the reported and assessed CRAR is analysed in Annexure VI.

4. Asset Quality

This section is to be divided into three parts covering loan assets, investments & other assets.

4.1 Loan Assets

Under the loan assets, following aspects should be commented upon :

4.1.1 Size & composition of loan portfolio; Industry-wise distribution (in case of IDBI, ICICI, IFCI & IIBI only) – trends.

4.1.2 Assessment of loan policy document — system of ensuring compliance with loan policy

4.1.3 Adherence to delegated authority — system of reporting credit sanctions by various functionaries — action taken in cases of transgressions.

4.1.4 Standard of credit appraisal—— Assessment of system for computation of Term loan/ Short-term loan (including working capital finance) under Project finance and non- project finance —— System for each of the financial product introduced by the FI may be discussed.
The policy/ procedure regarding sanction of Buyer's Credit and Lines of Credit to Overseas entities may also be discussed in the case of Exim Bank.

4.1.5 In case of Refinancing Institutions — Policy/ procedures for refinancing and adherence to the same —— analysis of defaults and measures adopted to recover the same.

4.1.6 Direct discounting & Rediscounting of Bills —— Policy framed by the Institutions – Adherence to the policy particularly in respect of purpose, margin, limit, endorsement, physical possession of the bills etc.

4.1.7 System of customer rating and pricing of loans.

4.1.8 Quality of credit supervision —— Systems and effectiveness.

4.1.9 Role of nominee directors on the Board of assisted companies — policy

for appointment of nominee directors —— follow up of nominee directors' reports. .

4.1.10 Credit concentration/ dispersal of risk — compliance with prudential exposure ceilings – large exposure to a particular group of industry/ borrower groups and geographical sector.

4.1.11 System to ensure compliance with prudential norms relating to income recognition, asset classification & provisioning – incorrect classification of loans or computation of provisioning and its impact on overall level of NPAs.

4.1.12 Non-performing advances (gross & net) as per Institution and as identified by the Inspector and the reasons for divergence.

(Profile of non-performing advances is to be furnished in Annexure IV)

a) The risk profile of the advances portfolio as assessed by the Inspector is furnished below in juxtaposition to Institution's classification:

(Rs. in crore)

Category	**As per classification of the Institution**	**As per classification of the Inspector**
A. Standard	(%)	(%)
B. Impaired comprising		
Sub- standard	(%)	(%)
Doubtful	(%)	(%)
Loss	(%)	(%)
Total Impaired Loans	(%)	(%)

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

The Inspector has assessed — % of the portfolio to be impaired as compared to — % of portfolio impairment assessed as on the date of last inspection.

b) **Industry- wise (Top 20 in order of exposure) break- up of NPAs :**

(Rs.in crore)

Industry	Total advances	Amount of NPAs	NPAs as % to total advances
Cement			
Textile			
Chemicals			
Iron & Steel			
Power Generation			
Electronics			
Paper			
SSIs etc.			
Others			
Total			

c) Statistical information about number of accounts downgraded to NPAs/ upgraded to standard assets during the period under Inspection :

Asset Categories	Position as on the date of last Inspection		Position as on the date of present Inspection	
	No. of accounts	Outstanding Balance	No. of accounts	Outstanding Balance
Standard				
Sub-standard				
Doubtful				
Loss				
Total				

Summary of evaluation of NPAs above a cut-off point. (details to be furnished in Annexure IV)

4.1.13 Assessment of recovery policy ——— recovery/ credits written off/ compromise settlements and their conformity to recovery policy.

4.1.14 Assessment of measures taken for improving asset quality/ upgradation of NPAs.

4.1.15 Policy/ system in place for fixation of staff accountability in cases of slip back of advances from standard to NPAs.

4.1.16 Sick Industrial Units/ BIFR cases – industry-wise analysis of sickness — role of the FI as operating agency —— parameters for sacrifices on the part of the FI.

4.2 Investments

The following aspects should be critically commented upon :-

4.2.1 Size of the portfolio —significant changes, if any, in the composition since the date of last Inspection. (Details of Investments are furnished in Annexure II)

4.2.2 Assessment of Investment policy – whether the policy, interalia, includes the procedure for:

i) Investments in shares & debentures of assisted companies (including exercise of conversion option) ;

ii) Stipulating limit for underwriting, buy-back facility, stand-by arrangements etc. within the aggregate exposure limit of individual/ group companies;

iii) Divestment of shares – the price realised ;

4.2.3 Compliance with the regulatory norms relating to classification of Investments, valuation, income recognition, provisioning for depreciation and accounting standards. (Details of divergence in valuation of Investments are furnished in Annexure V)

4.2.4 Private placement of shares, debentures etc. – whether any abnormal loss was incurred by the FI on sale of these shares/ debentures ——

evaluate the performance of the FI as to total business handled, amount devolved & the price performance of these shares etc.

4.2.5 Bought out deals — comment on the system put in place by the FI as regards appraisal of the projects, track record of the promoters, pricing of the issues, projected profitability, book value of shares, compliance with statutory clearances etc.

4.2.6 Sale of shares under buy- back arrangements to the promoters of the companies —— scrutinise the deals to study that the price realised was in alignment with market movements and whether any undue favour was shown to the promoters.

4.2.7 Analysis of yield/ return on investment and its trend , capital gain/ loss booked by the FI etc.

4.2.8 Reporting system to the Board

4.3 Other Assets

4.3.1 Analysis of other assets

4.3.2 Assessment of 'intangible assets'. (Details of 'intangible' assets are furnished in Annexure V)

5. Management

5.1 Organisational set-up

5.2 Working of the Board, Management Committee & Audit Committee of the Board

5.3 Functioning of CEO, ED, CGMs/ GMs of Head Office

5.4 Corporate mission & corporate governance

5.5 Effectiveness of control exercised by H.O. over controlling offices in ensuring compliance with regulations/ statutes, H.O. instructions etc.

5.6 Efficacy of various committees of executives in H.O.

5.7 Adequacy of effectiveness of reviews/ information placed before top management

5.8 Adequacy of compliance with RBI Inspection Report

5.9 Functioning of subsidiaries — corporate separateness, control exercised over subsidiaries.

6. Earnings Appraisal

The paragraph should contain critical comments on the following aspects :

6.1 The earnings of the FI improved/ deteriorated in the year ended ——— as compared to the previous year as shown below.

(Earnings analysis of the two years is to be furnished in Annexure III)

(Amount Rs. in crores)

For the year ended

Items	Current year		Previous year	
	Amount	% to Total Assets	Amount	% to Total Assets
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 eamings)				

6.2 Earning ratios especially of ROA & ROE

The FI's pre-tax ROA improved/ deteriorated from —— %.to ———% during the period. The reasons include:

- Improvement or deterioration in net interest margin
- Higher/ lower loan loss provisions
- Lower / higher operating costs (cost-income ratio)
- Higher income by one-time transactions last year/ this year.

The FI's net margin (net income/ total income) was — % as compared to —— % in the previous year.

The FI's ROE (at —%) was higher/ lower than —% in the last year (comments, if any, on the reasons).

6.3 Portfolio-wise analysis of adjusted return i.e. segment-wise income earned from advances, market lendings, investments, off-balance sheet activities etc. duly adjusted for write-offs, provisions for losses/ value impairment

6.4 Growth of retained earnings —— dividend pay-out ratio —— transfer to reserves

6.5 Policy relating to general provisions/ reserves

6.6 Adequacy of provisions based on the Inspecting Officer's assessment and its impact on net profit

6.7 Assessment of expenditure policy —— capital and revenue budget—- cost control measures and their effectiveness

6.8 Impact of para-banking activities such as leasing, merchant banking etc on the working results

6.9 Impact on net profit due to the financial performance/ condition of subsidiaries

7. Funds Management and Liquidity

The following aspects need to be critically commented upon :

7.1 Assessment of Asset-Liability management policy—functioning of ALCO – integrated treasury management — sources and reliability of the basic inputs

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

7.3 Compliance with the regulatory norms for mobilisation of resources.

7.4 Prudence in raising of resources and their deployment —— Average surplus funds and yield thereon — domestic and external borrowings may be discussed separately.

7.5 Call money lendings — fixation of bank-wise exposure limits and adherence to the same .

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

8. Systems and Control

The following aspects need to be critically commented upon :

8.1 Adequacy of the internal inspection/ audit and concurrent audit

8.2 Assessment of risk management models adopted by the FI to identify, measure, monitor and manage all types of risks

8.3 Systems & controls in place for ensuring good house-keeping — balancing of books — reconciliation of inter-branch/ office accounts — long outstanding entries in nominal/ general accounts

8.4 System of EDP audit of computer systems and software

8.5 Integrity & reliability of MIS

8.6 Integrity & reliability of regulatory reporting including returns under off-site surveillance system

8.7 Complaints, fraud and vigilance system for corrective action including removal of systemic deficiencies

8.8 Investors' Relationship —— The manner of disposal of complaints, system for grievance redressal.

9. Foreign Exchange business

The following aspects need to be commented upon :

9.1 Merchant turn over and the income earned therefrom

9.2 Compliance with Internal Control Guidelines issued by RBI and the bank's internal controls.

9.3 Opening of letters of credit/ merchant contracts – scrutiny of proposals, status report of the overseas exporter/ banker – compliance with the regulatory norms.

9.4 Lines of credit – deployment of funds and follow up.

9.5 Liability/ risk management through forward covers, swaps, options etc. – adequacy and effectiveness of the system.

9.6 Nostro accounts – cost of overdrafts and return on deployment of funds in these accounts – reconciliation of accounts.

9.7 Analysis of fee income and exchange profit.

9.8 Working of overseas offices (EXIM Bank)

10. Off Balance Sheet business

Assessment of policies, systems and controls for monitoring/ controlling these activities, return vis-à-vis risk arising from them. Critical comments on the following items particularly in respect of devolvement of liabilities and recovery/ adjustment thereof :

10.1 Letters of credit .

10.2 Guarantees including guarantees given for external commercial borrowings (ECB) —-
utilisation of funds raised by companies against ECBs.

10.3 Deferred payment guarantees.

10.4 Under-writing .

10.5 Others, if any.

11. Para-banking activities

Critical comments, particularly in respect of policy framed, adherence to the same, compliance with all Regulatory norms, documentation, income earned from such activities etc., need to be made on the various para-banking activities undertaken by the FI, viz :

11.1 Leasing/ hire purchase business.

11.2 Merchant Banking business.

11.3 Custodial services.

11.4 Venture Capital Assistance

11.5 Others, if any.

12. Promotional & other important activities

12.1 Role as apex institution (if applicable).

12.2 Promotional Role

12.3 Supervisory Role, if any.

12.4 Others, if any.

13. Compliance Review

13.1 CRAR

13.2 Exposure ceiling

13.3 Investment in Shares

13.4 Prudential norms for advances & investments and provisioning therefor.

Confidential Section : Part II

The closed confidential supplement to the Inspection Report.

1. Supervisory Concerns

i) Critical comments on Management (Board, CEO and Senior Management) covering their competence and integrity.

ii) Special concerns not disclosed/ stated in open report

2. Proposed Action Plan

Regional Office Recommendations

Regional Office comments on the perceptions of the Inspecting Officer in respect of supervisory concerns as also proposed action plan are to be furnished.

Annexure – I
(of the inspection report)

Statement of Liabilities & Assets of the FI as on..........

(Rs. in crore)

A) Liabilities

1. Capital		
i) Equity Capital		
ii) Preference Capital		
2. Reserves & Surplus		
i) General Reserve		
ii) Capital Reserve		
iii) Other Reserves (to be specified)		
iv) Balance in P&L account		
v)		
3. Subordinated Debt (Tier II Capital)		
4. Deposits		
i) Certificate of Deposit		
ii) Fixed Deposits		
iii) Others (to be specified)		
5. Borrowings		
i) Government of India		
ii) RBI		
iii) Other institutions & agencies (to bespecified)		
iv) Bonds/ Debentures		
a) In India		
b) Outside India		
v) Foreign Currency Borrowings		
6. Other Liabilities & Provisions		
i) Interest Payable accrued		

ii) Inter-office adjustments (net) iii) Unclaimed Dividends		
iv) Income received in advance		
v) Provisions (to be specified)		
vi) Others (to be specified)		
TOTAL		

B) Contingent Liabilities

1. Claims against the FI not acknowledged as debts
2. Partly paid shares, debentures etc.
3. Guarantees issued
4. Outstanding Letters of Credit
5. Capital Issues underwritten
6. Outstanding forward exchange contract
7. Estimated amount of contracts remaining to be executed on capital account not provided for (net of advance paid)
8. Others (to be specified)

C) Assets

1. Cash in hand and balances with banks		
i) Cash in hand		
ii) Balances with RBI		
iii) Balances with other banks in India		
iv) Balances with other banks outside India		
v) Money at call & short notice		
2. Investments		
i) Govt. Securities		
ii) Other approved securities		
iii) Shares		
iv) Bonds & Debentures of FIs		
v) Bonds & Debentures of Industrial concerns		
vi) Subsidiaries/ Joint Ventures		
vii) Units of Mutual Funds/ UTI		
Viii) Others		

3. Advances		
i) Bills discounted/ Rediscounted		
ii) Working Capital/ Short-term loans		
iii) Term Loans		
a) Rupee loans		
b) Foreign currency loans		
iv) Refinance to banks, SFCs/ SIDCs etc.		
4. Fixed Assets		
i) Premises		
ii) Furniture & fixures		
iii) Assets on lease		
5. Other Assets		
i) Interest & other dues receivable		
ii) Other Accrued Income		
iii) Prepaid taxes and TDS		
iv) Exchange fluctuation recoverable		
v) Others (to be specified)		
TOTAL		

Annexure - II

(of the inspection report)

Statement showing the profile of investments as on.....(the reference date of Inspection)

(Rs. in crores)

Category	Permanent		Current		Total		Depreciation in current investment	Provision held for depre. in current investment	Shortfall in provisioning
	Book Value	Market Value	Book Value	Market Value	Book Value	Market Value			
Government securities									
Other approved securities									
Shares									
Debentures / bonds									
Subsidiaries / joint ventures									
Others									
TOTAL									

Annexure - III
(of the inspection report)

Earnings Appraisal

(Rs. in crores)

(A) Break-up of Income and Expenditure		
1. Interest/discount earned (2+3+4+5)		
2. Interest/discount earned on loans and advances		
3. Interest on investments		
4. Interest on additional balance with RBI		
5. Interest on market lendings		
6. Commission, exchange and brokerage		
7. Other operating income		
8. **Total Income (1+6+7)**		
9 Interest expended (10+11)		
10. Interest expended on deposits		
11. Interest expended on borrowings		
12 Staff expenses		
13. Other overheads (14+15+16+17+18+19+20+21)		
14. Directors fees		
15. Rent, taxes, insurance and lighting		
16. Law charges		
17. Postage, telegrams and stamps		
18. Auditors' fees		
19. Depreciation on and repairs to bank property		
20. Stationery, printing and advertising		
21. Other expenses		
22. **Total operating expenses (9+12+13)**		
24. Bad debts written off		
25. Other assets written off		
26. Capitalised expenses written off		
27. Provisions and contingencies (28+29+30+31)		
28. Provisions for loan losses		
29. Provisions for depreciation in investments		
30. Provisions for tax		
31. Other provisions		
32. **Operating profit before provisions (8-22)**		
33. Net operating profit (32-23-28-29-31)		
34. Realised gains/(losses) on sale of assets		
35. Profit before tax (33+34/33-34)		
36. **Profit after tax (35-30)**		

(B) Certain Key Figures		
37. Dividend paid/proposed		
38. Retained earnings (36-37)		
39. Earnings assets		
40. Non-earning assets		
41. Average total assets		
42. Total equity		
43. Total equity at the end of the previous year		
44. Average interest earning assets		
45. Average interest bearing liabilities		
46. Average yield (1/44)		
47. Average cost (9/45)		
48. Net interest income (1-9)		
49. Non-interest income		
50. Non-interest expenditure		
51. Net total income (8-9)		
(C) Measures of Return		
(i) Return on Assets		
- before tax (35/41)		
- after tax (36/41)		
(ii) Return on Equity		
- before tax [35/(42+43/2)]		
- after tax [36/(42+43/2)]		
(iii) Accretion to Equity (38/43)		
(iv) Cost income (efficiency) ratio (50-51)		
(D) Core income analysis		
(i) Interest spread (46-47)		
(ii) Net interest margin [(1-9)/41]		
(iii) Risk adjusted net interest margin [(1-9-28)/41]		
(iv) Non-interest margin [(49-50)/41]		

(E) Net margin analysis		
(i) Net margin (36/8)		
(ii) Interest expense/total income (9/8)		
(iii) Staff costs/total income (12/8)		
(iv) Other overheads/total income (13/8)		
(v) Risk provisions or losses/total income [(23+27-30)/8]		
(vi) Tax/total income (30/8)		
(vii) Asset productivity (8/41)		
(viii) Employee productivity (Average business/Number of employees)		

Notes

(i) **Wherever the term 'average' referred to, fortnightly average may be taken.**

(ii) **Interest earning assets include advances, investments and deposits with / market lendings to banks / others.**

(iii) **Interest bearing liabilities include deposits, borrowings and refinance.**

(iv) **In respect of banks having overseas branches, figures relating to domestic branches may also be furnished in addition to global figures.**

(v) **Total equity includes paid up capital, reserves (excluding revaluation reserves) and surplus (Less deficit in P & L account).**

Annexure — IV

(of the inspection report)

Statement showing the profile of Non- performing advances

(Rs. in crore)

Category of asset	Balance outstanding	Provision required	Provision held	Additional provision required
Loss				
Doubtful				
Sub-standard				
TOTAL				

Annexure - V
(of the inspection report)

Part I : Statement showing the details of NPAs where there is divergence in asset classification and provisioning requirement between the assessment made by the bank and the I.O.

(Rs. in crores)

Name of the borrower	Balance outstanding	Asset classification as per the FI	Asset classification as per the IO	Provision held by the FI	Provision required as per IO	Shortfall in provisioning	Remarks (IO should state the reasons for his assessment
TOTAL							

Part II : Statement showing the divergence in evaluation of investments and "other assets"

Nature of asset	Book value	Provision, if any, held by the FI	Erosion in value / provision required as per IO	Shortfall in provision	Remarks (IO should state reasons for his assessment)
TOTAL					

<u>Part III</u> : Statement Showing the details of understatement of other liabilities/expenditure

Nature of liability	Amount	Provision,if any, held by the FI	Erosion in value / provision required as per IO	Shortfall in provision	Remarks (IO should state reasons for his assessment)
TOTAL					

Annexure - VI

(of the inspection report)

Review of computation of Capital Adequacy as on.........

Part A – Capital

(Rs. in crore)

Item	Reported by the FI	Assessed by the Inspecting Officer of RBI
A. SHARE HOLDER EQUITY		
1. Paid up Capital		
2. Free Reserves (disclosed)		
3. Share Premium		
4. Capital Reserves		
5. Surplus in P & L account		
Total (A)		
B. (Deduct)		
i) Accumulated Losses		
ii) Equity Investments in subsidiaries		
iii) Intangible Assets		
iv) Income wrongly recognised		
v) Additional loan loss provision required		
vi) Additional investment (depreciation) provisions required		
vii) Provisions required for likely losses in other assets/ off-balance sheet items		
Viii) Additional provisions required for any other liabilities (e.g. tax, gratuity, pension etc.)		
ix) Open foreign currency exposure @ 5% of the 'own open position' limit approved by ECD		
x) Any liabilities likely to devolve, but not recognised		
Total (B)		
C. CORE CAPITAL (Tier I) (A - B)		
D. Supplementary Capital (Tier II)		
i) undisclosed Reserves		
ii) General provisions & loss reserves		
iii) Revaluation reserves		
iv) Hybrid debt capital instruments		
v) Subordinated debt		
Total (D)		
E. TOTAL CAPITAL i.e. (C+ D)		

N.B.

i) **Tier II Capital will be limited to 100% of Tier I Capital.**

ii) **Subordinated debt instruments will be included in Tier II Capital up to a maximum of 50% of Tier I Capital.**

iii) **General provisions / loss reserves will be admitted as Tier II Capital up to a maximum of 1.25% of risk weighted assets.**

Part B - Risk based Capital Ratios

(Rs. in crore)

Items	Reported by the FI	Assessed by Inspecting Officer of RBI
a) Core Capital		
b) Supplementary Capital		
c) Total Capital (a+ b)		
d) Risk Weighted Assets (vide Part D)		
e) CRAR (%) (c/d)		
f) Core CRAR ratio (a/d)		

Part C - Risk Weighted/ Adjusted Assets

(Rs. in crore)

a) On-balance sheet items

Items	Amount reported by the FI	Amount assessed by the IO of RBI	Risk weighted value computed by the FI	Risk weighted value assessed by the IO of RBI
1. Cash & Bank Balances				
2. Short Term Deposits with Banks				
3. Money at call & short notices				
4. Claims on banks / FIs				
5. **Investments** a) Govt. & other trustee Securities				
b) Others				

6. Advances and refinance				
a) Guaranteed by Govt. / ECGC / DICGC				
b) Bills rediscounted				
c) Bills discounted				
d) Staff Loan				
e) Others				
7. Fixed Assets				
8. Other Assets				
9. TOTAL (a) #	**#**	**#**		

b) <u>Contra / Off Balance Sheet Items</u>

Items	**Reported by the FI**	**Assessed by Officer of RBI**	**Computed by the FI**	**Assessed by Officer of RB**
1. Guarantees/ Letters of credit				
2. Claims against FI not acknowledged as debts				
3. Estimated amounts of contracts remaining to be executed on capital account not provided for				
4. Foreign exchange & interest rate related contracts				
Total (b) #	**#**	**#**		
Grand Total (a+ b)				

 # Totals should tally with the balance-sheet figures.

Part D — REVIEW OF RISK WEIGHTED ASSETS

(a) Computation by the FI

(Rs. in crore)

Risk Band – Risk-Based Assets & OBS exposures (at converted credit equivalent values)		Total Amount	Liquid Margins	Loss reserves	Net amount	R.W. value
Zero risk	BS OBS					
20% risk	BS OBS					
50% risk	BS OBS					
100% risk	BS OBS					
Total						

(b) Computation by Inspecting Officer of RBI

(Rs. in crore)

Risk Band – Risk-based Assets & OBS Exposures (at converted credit equivalent values)		Total Amount	Liquid Margins	Loss reserves	Net amount	R.W. value
Zero Risk	BS OBS					
20% Risk	BS OBS					
50% Risk	BS OBS					
100% Risk	BS OBS					
TOTAL						

NOTES:-

BS = On Balance Sheet
OBS = Off Balance Sheet Items (at converted credit equivalents)

* Consists of the following items :-

a) Loan loss provisions
b) Investment depreciation
c) Intangible assets etc.

Total ________________

ANNEXURE - XI

(Cf. Para 5.4.3)

**FIMS : A new monitoring system for banking institutions#

Abstract:

In 1993, the Financial Institutions Monitoring System (FIMS) was developed to provide the Federal Reserve with estimates of the financial condition of commercial banks and savings banks insured by the Bank Insurance Fund between on-site examinations. FIMS has several advantages over the Federal Reserve's previous off-site surveillance systems and the expert-based models used by other federal regulators. Most important, the accuracy of the new system in estimating the financial condition of banks as indicated both by subsequent on-site examination ratings and by subsequent failures is superior to that of the Federal Reserve's previous mode. In addition, the new system provides objective measures of a bank's financial condition. Both the variables and the variable weights that are used to calculate these measures are determined by rigorous statistical testing rather than by subjective judgement. The new system is also more flexible than alternative systems. Finally, FIMS can identify deterioration or improvement in the banking industry within peer groups and systemwide.

Full text :

One of the primary responsibilities of bank regulatory agencies is to minimize the financial loss to the Bank Insurance Fund that results from the failure of insured depository institutions. To discharge this responsibility, bank regulators evaluate the financial performance and condition of depository institutions and

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** The SEER methodology is described in detail in this paper. The acronym FIMS was substituted in the article for the acronym SEER. However, both the acronyms describe the same system.

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initiate prompt corrective actions when they find signs of distress. In the evaluation, regulators use a combination of on-site examinations and off-site monitoring systems.

In 1993, the Federal Reserve instituted the Financial Institutions Monitoring System (FIMS), which is significantly more accurate than previous off-site monitoring systems in identifying financially troubled banking institutions. This article gives the background of FIMS, describes the new system, and explains How it improves on previous systems.

BACKGROUND

As a result of the National Bank Acts of 1863 and 1864, the United States has a dual banking system in which some banks are federally chartered and some are state chartered. The primary bank supervisor and regulator of federally chartered (national) banks is the Office of the Comptroller of the Currency, whereas the responsibility for the supervision and regulation of state-chartered banks is shared by the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the fifty state banking agencies. The primary supervisor and regulator of bank holding companies is the Federal Reserve. Depending upon their activities, bank holding companies may also be subject to regulation by other government agencies, including the Securities and Exchange Commission and the Office of Thrift Supervision.

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the bank regulators generally must examine all banks on-site at least once each year; before FDICIA, banks were examined less frequently, except for the state-chartered banks regulated by the Federal Reserve, which were in general subject to annual examinations. FDICIA does not require annual inspections of bank holding companies. According to Federal Reserve policy, bank holding companies that are in sound financial condition are subject to

less frequent on-site inspections than are state member banks.

During an on-site examination, regulators visit an institution's offices to evaluate the institution's financial soundness and compliance with laws and regulatory policies, to assess the quality of the institution's management team, and to evaluate the institution's systems of internal control. (I) After the examination, regulators assign the institution a rating that summarizes its financial condition and performance. The rating is known by the acronym CAMEL, which refers to the five components of the rating system—capital, asset quality, management, earning and liquidity (see box "The Uniform Financial Institutions Rating System").

Between on-site examinations, regulators monitor financial institutions off site using computer- based systems. These monitoring systems typically analyze the financial information that each institution must report to regulators quarterly.

Two circumstances in the 1970s prompted the development of such monitoring systems. First, the large number of banking organizations in the United States – more than 14,000 banks and 1, 500 bank holding companies as of year end 1975—and the growing complexity of their financial reports increased the difficulty of systematically analyzing each institution. Second, technological advances in the fields of computer science and data processing significantly reduced the cost of analyzing information. In addition, a precipitous rise in the 1980s in the number of bank failures made clear the need for auxiliary means of supervising banks (see box "The Pattern of Bank Failures since 1980").

BANK REGULATORY SURVEILLANCE SYSTEMS

Over the past two decades, various monitoring systems have been developed, but their objectives have generally been the same — to identify developing financial problems at banking institutions between examinations in order to set priorities for the allocation of scarce examination and other supervisory resources. Output from the systems is used to accelerate the on-site examinations of institutions showing financial deterioration; to identify the areas of most supervisory concern in those institutions scheduled for examination and to allocate the more experienced examiners to troubled institutions.

Uniform Bank Surveillance Screen

Since the mid-1970s, the Federal Reserve System has monitored the financial performance and condition of banking organizations by screening financial ratios calculated from the Reports of Condition and Income (Call Report) filed quarterly by each banking organization. (2) To improve this monitoring effort, the Federal Reserve System in the mid-1980s adopted the Uniform Bank Surveillance Screen (UBSS) as its primary surveillance system. With some changes, the UBSS remained in service until 1993, when it was replaced by FIMS. The UBSS used financial data from regulatory reports to identify individual institutions whose financial ratios had deteriorated relative to the averages of their respective "peer groups," institutions with similar sizes of assets. (3) The effectiveness of this system, however, was limited by certain methodological weaknesses.

The UBSS was structured around six financial ratios computed from quarterly Call Report data. For both banks and bank holding companies, the first four ratios—tier I capital, net income, net liquid assets, and the sum of past due and non-accrual loans (each expressed as a percentage of total assets) — were the components of a primary surveillance screen. (4) (A surveillance screen uses a set of financial ratio values to identify, or screen, institutions whose

condition warrants special supervisory attention.) Within each peer group, the four financial ratios for each institution were sorted from best to worst, and percentile rankings relative to the peer group were calculated. The four ranks were summed to form a bank's composite score, with each rank receiving equal weight in the summation. The resulting composite scores were used to calculate composite percentile rankings within each peer group. These composite percentile rankings served as the basis of the primary surveillance screen. Institutions with the highest composite percentile rankings were placed on an "exception list." Institutions on this list were subjected to more in-depth, off-site analysis by Federal Reserve Bank staff.

The UBSS was supplemented by the quarterly Uniform Bank Performance Report and the Bank Holding Company Performance Report, both from the Federal Financial Institutions Examination Council. These reports are analytical tools created for bank and bank holding company supervisory personnel. In a concise format, they show the effect of management decisions and economic conditions on a banking organization's financial performance and balance sheet composition. The data on performance and balance sheet composition contained in the reports can aid in decisions about capital adequacy, asset quality, earnings, liquidity, and asset and liability management. Each quarterly report shows financial information for multiple time periods. The financial data are presented in the form of ratios, percentages, and dollar amounts. Each report also shows corresponding average data for the institution's peer group along with information identifying how the data ranked the institution relative to its peers.

If this off-site analysis led to the conclusion that the financial condition of an institution had worsened significantly since its most recent on-site examination, a suitable supervisory response was developed and implemented, including contact with the institution's management to obtain additional information and acceleration of the institution's next scheduled on-site examination.

CAEL System

During the mid-1980s the FDIC developed a surveillance system known as CAEL, which is methodologically similar to the UBSS. The acronym CAEL refers to four CAMEL component ratings that the system evaluates—capital, asset quality, earnings and liquidity. The system does not provide a management rating. Like the UBSS, CAEL is based upon quarterly bank Call Report data; but whereas the UBSS calculated a composite percentile ranking, CAEL calculates off-site surrogates for CAMEL ratings.

CAEL ratings are calculated in a manner similar to that by which the surveillance scores were calculated in the UBSS, although the calculation of CAEL ratings is considerably more complex and involves many more financial ratios. Like the UBSS, the CAEL system divides banks into peer group based upon asset size and calculates percentile ranking for four sets of financial ratios that correspond to the four component ratings. Each of the four component ratings is calculated as a weighted average of the corresponding set of financial ratios. The composite CAEL rating is calculated as a weighted average of the four component ratings. Both the ratios used to calculate the ratings and the weights associated with each ratio are determined by a panel of bank examiners. CAEL remains in place today as the FDIC's primary off-site surveillance system.(5)

Limitations of the UBSS and CAEL

The UBSS and CAEL use a set of financial ratios to calculate a composite score with which bank regulators can assess the financial condition of a depository institution between on-site examinations. One limitation of such systems is the subjective manner in which the ratios were selected. Regulators selected these ratios from a much larger set of variables that academic researchers had shown to be correlated with an institution's financial condition, but the ratios used to calculate the surveillance scores were not statistically

validated as being sufficiently inclusive to produce accurate off-site assessment of risk. In fact, other ratios, when combined with those of these systems, produce superior assessments of risk.

A related limitation is the manner in which each ratio was weighted. These weights, which were fixed across estimation periods, were determined subjectively rather than by rigorous statistical testing. The UBSS applies equal weights to each of the four financial ratios used to construct the composite surveillance score. CAEL applies a system of weights determined by a panel of senior examiners. Even if the selected financial ratios contained all the information necessary for an accurate assessment of risk, improper weighting of those ratios would reduced the accuracy of estimation. Moreover, even if optimal weights had initially been assigned, the failure to adjust for temporal shifts would also have reduced estimation accuracy.

A third limitation of these systems is the reliance upon peer-group analysis. Both systems divide banks into peer groups based upon asset size because the average values of key financial ratios are significantly different for banks of different sizes. Without a peer-group analysis, differences in the financial ratios associated solely with bank size could be mistakenly interpreted as differences in financial condition. Because performance is measured relative to that of other banks of similar size, however, systemic changes in the performance either of peer groups or of the banking system as a whole are not incorporated into the composite surveillance scores. Hence, if an entire peer group deteriorates, the percentile scores of individual banks within that peer group may not change, even though the banks have become riskier

With peer group analysis, an additional complication arises when the size of an institution changes in a manner that places it in a larger or smaller peer group than it was in during t he previous quarter. In such a case, the institution's percentile scores may change significantly, even if its financial condition has not changed.

FIMS

Addressing the limitations of the previous off-site bank monitoring systems, FIMS provides two complementary surveillance scores based upon two distinct econometric models—the FIMS rating and the FIMS risk rank. The FIMS rating is an assessment of a bank's current condition, whereas the FIMS risk rank is a longer-term assessment of the bank's expected future condition.

The FIMS rating represents an estimate, based upon the most recent Call Report data, of what a bank's CAMEL rating would be if it were assigned during the current quarter. Because the relationship between financial ratios and CAMEL ratings may change over time, the FIMS rating model is updated each quarter. The updates reflect the most recent relationship between financial ratios derived from the two most recent quarters of bank Call Report data and supervisory ratings based upon the most recent on-site examination. Empirical testing indicates that using data from the two most recent quarters to estimate the historica relationship maximizes the classification accuracy of the rating model.

The FIMS risk rank represents an estimate, based upon a bank's financial condition as measured by the most recent Call Report data, of the probability that a bank will fail during the subsequent two years. (6) Like the FIMS rating model, the risk rank model is updated quarterly to determine which ratios to include and how to weight these ratios. But the risk rank model is updated using financial ratios derived from Call Report data from the same quarter two years previously and information classifying banks as failing or surviving during the intervening period. This procedure enables the risk rank model to incorporate change over time and produces a much longer-term assessment of a bank's financial viability than does the FIMS rating model.

Estimation Techniques

Both the FIMS rating and risk rank are based upon variables representing categories of financial condition. The FIMS rating is based upon the composite CAMEL rating, which can take on integer values from 1 to 5; the FIMS risks rank is based upon a variable that has only two values—0 for failure and 1 for survival. Because such variables represent categories of condition, standard estimation techniques (such as ordinary-least-squares regression analysis) do not provide accurate results. To account for the statistical characteristics of categorical variables, FIMS uses specialized "limited dependent variable" estimation techniques to produce its two surveillance scores. (7)

Explanatory Variables

In the literature on financial economics, the numerous studies that model the financial condition of depository institutions show a relatively consistent set of variables to be related to bank financial condition. (8) These variables, which generally include measures of capital adequacy, asset quality, earnings, and liquidity, form the basis for the off-site monitoring systems used by both the Federal Reserve and the FDIC.

To develop FIMS, staff members of the Federal Reserve System selected from the financial literature and the financial ratios commonly used in examination reports approximately thirty financial and structure variables that they considered most likely to be useful in estimating the CAMEL rating and the probability of failure. They tested an additional set of variables measuring regional economic conditions. For the FIMS rating model, the prior period composite CAMEL rating and the prior-period management component rating were also tested as explanatory variables. The prior-period composite rating was included in the model because the proportion of banks for which the CAMEL rating changes from one examination to the next is less than one-third. The prior-period

management component rating was chosen to augment the ability of financial and structure variables to incorporate the management dimension of bank performance into the FIMS rating.

All of the potential explanatory variables except for the prior-period examination rating and the measures of regional economic conditions can be calculated with bank Call Report data (table 1). (Table 1 omitted). Income statement variables are based upon data from the previous four quarters. For each variable that is a financial ratio, a four-quarter rate of change is included in the FIMS models. These rates of change are defined as the difference in the values of the current and year-before values of each ratio's numerator, divided by the year-before value of assets.

From this set of potential explanatory variables comes a subset of variables that produces the best estimates of the CAMEL ratings. This subset is selected using a step-wise procedure that evaluates the explanatory power of the entire set of independent variables and sequentially removes from consideration those variables that do not significantly improve estimates of the historical relationship. (9). A similar procedure is employed in selecting the explanatory variables for estimating the risk rank. From the large set of potential explanatory variables, the subset of variables that produces the best estimate of the probability of failure is chosen. As with the FIMS rating model subset, this subset is selected with a step-wise procedure that first evaluates the explanatory power of the entire set of not significantly improve estimates of the probability of failure. (10)

Estimating the Historical Relationship between Call Report Data and CAMEL Ratings

The directions of the estimated historical relationships between the explanatory variables and the CAMEL ratings are shown in table 2. (Table 2 omitted). Only variables that are statistically significant in each of the ten quarters are shown.

Eleven explanatory variables are statistically significant in each period analyzed. Four of these variables relate to asset quality — the ratios to assets of loans past due 3-89 days and still accruing interest, of loans past due 90 or more days and still accruing interest, of non-accrual loans, and of foreclosed real estate. Each asset-quality variable is positively related to the numerical CAMEL rating, indicating that higher values of these variables are associated with worse CAMEL ratings.

Of the remaining seven variables that are significant in every period tested, three are negatively related to the numerical CAMEL rating — the ratios to assets of tangible capital, net income less security gains and losses, and investment securities – indicating that higher values for these variables are associated with better CAMEL ratings. These three variables measures the capital, earnings and liquidity position of an institution, corresponding to three of the five components of the CAMEL rating system.

The remaining four variables significant in every period are positively related to the numerical CAMEL rating. The UBSS asset-growth and composite percentile rankings are consistently positive, indicating that higher values of these variables are associated with worse CAMEL ratings; also consistently positive are the prior management CAMEL component rating and the prior composite CAMEL rating, indicating that a bank's current rating is a function of its previous ratings. Indeed, a review of the sample banks' ratings reveals that the examination rating of a bank is the same as its previous rating in more than two-thirds of all cases analyzed.

Several additional variables are statistically significant in at least one but no more than five of the ten periods analyzed. Empirical analysis revealed, however, that inclusion of these additional variables in the model does not significantly improve the accuracy of out-of-sample estimation; in most cases their inclusion usually degrades such accuracy. Of considerable interest is the

finding that the regional economic variables tested do not significantly improve out-of-sample estimation. Further analysis indicated that, by themselves, these variables have considerable explanatory power but that this power is attenuated by the inclusion of bank-specific variables in the model.

Estimating the Historical Relationship between Call Report Data and Bank Failure

The directions of the estimated historical relationship between the explanatory variables and the incidence of bank failure are shown in table 3.(Table 3 omitted). Only the nine explanatory variables that are statistically significant in each period examined are included in the table. Four of these variables relate to asset quality the ratios to assets of loans past due 3-89 days and still accruing interest, of loans past due 90 or more days and still accruing interest of non-accrual loans, and of foreclosed real estate. Higher levels of each of these variables are associated with a greater likelihood of failure (see note 6 for definition).

Of the remaining five variables, four are consistently negative the ratios to assets of tangible capital, net income, allowance for loan loss, and investment securities indicating that higher levels of each are associated with a lower likelihood of failure. The coefficient of the final variable the ratio of domestic certificates of deposit greater than or equal to $100,000 to assets is positive, indicating that higher levels of this variable are associated with a greater likelihood of failure. This finding is consistent with the financial literature on bank failure, which provides evidence that high-risk banks use volatile liabilities as a funding mechanism to a greater extent than other banks and that these funds can be quickly withdrawn as a bank's condition deteriorates, causing liquidity problems.

ACCURACY OF CLASSIFICATION

For a surveillance mode, the most meaningful measure of accuracy is the ability

to classify institutions correctly in a future period rather than the ability to classify institutions correctly in previous periods. Therefore, the following procedure was used to assess the accuracy of the FIMS models. Parameter estimates were generated by applying the econometric models to Call Report data from the beginning of a given period and to data from events (that is, examinations or bank failures) occurring during the period. These parameter estimates were then applied to Call Report data from the beginning of the subsequent period to generate classification for events occurring during that subsequent period. Finally, these classifications were compared with actual events that occurred during the subsequent period.

For example, to assess the accuracy of the FIMS rating model, parameter estimates were generated using data from the March and June Call Report and corresponding examination data from the quarters ending in June and September. These parameter estimates were then applied to September Call Report data to generate estimates of the CAMEL rating assigned after examinations based upon the September Call Report data (11). Finally, the estimates based upon the September Call Report data were compared with the actual ratings assigned during examinations based on the same data. This procedure was repeated for ten different estimation periods.

A similar procedure was used to assess the accuracy of the FIMS risk rank model. For example, parameter estimates were generated using data from the December 1984 Call Report and data classifying banks as failing during or surviving through 1985-96. These parameters estimates were then applied to December 1986 Call Report data to classify banks as failing during or surviving through 1987-88. Finally, the classifications based upon the December 1986 data were compared with the actual status of banks at the end of 1988. This procedure was repeated for five different estimation periods.

FIMS Rating Model : Estimating the CAMEL Ratings

The broadest measure of estimation accuracy in estimating the CAMEL rating is the ability to classify correctly the actual CAMEL ratings of individual banks. To assess the accuracy of the FIMS rating model, one can compare its ratings classifications to those derived from the UBSS the surveillance system that FIMS replaced. This comparison measures how often each system's estimated quarterly CAMEL rating corresponds with the actual CAMEL rating assigned by examiners based upon the same financial data (table 4). (Table 4 omitted).

Table 4 combines classification results from ten separate quarterly estimates based upon the Call Reports from December 1989 through March 1992. For example, the parameters generated from Call Report data for the second and third quarters of 1989 were used to estimate ratings assigned from Call Report data for the fourth quarter of 1989; parameters generated from Call Report data for the third and fourth quarters of 1989 were used to estimate ratings assigned from Call Report data for the first quarter of 1990; and so forth. A total of 27,083 ratings estimates were made.

The FIMS estimates were identical to the subsequently assigned CAMEL rating for 74.6 percent of examinations. Less than 0.5 percent of the estimates were more than one level better than the actual rating, whereas 12.1 percent of the FIMS estimates were exactly one level better than the subsequently assigned CAMEL rating. FIMS was most accurate in estimating CAMEL ratings of 1 (77.5 percent) and 2(.9 percent). It also was extremely accurate in identifying banks that failed during the subsequent quarter. Of the 262 failing banks included in the sample, 97.7 percent received a FIMS rating of 5, 1.9 percent received a 4, and the remaining 0.4 percent received a 3; none received a FIMS rating 1 or 2.

Also in table 4 are the out-of-sample estimation accuracy results for the UBSS. Although the UBSS was not designed specifically to estimate the CAMEL ratings

of banks, it did provide a score for each bank, and this score can be used to estimate the examination rating. If all banks are ranked by their UBSS score, CAMEL rating estimates based on the distribution of actual CAMEL ratings can be assigned. For example, if 20 percent of the banks in the sample are 1-rated, 50 percent are 2-rated, 20 percent are 3-rated, 5 percent are 4-rated, and 5 percent are 5-rated, then banks with UBSS scores in the 1st-20th percentiles are classified as 1-rated, and banks with UBSS scores in the 96th-100th percentiles are classified as 5-rated; banks in intervening percentile ranges receive the corresponding ratings.

When ratings estimates were assigned in this manner, the UBSS estimate was equal to the actual CAMEL rating 56.9 percent of the time. Approximately 19.4 percent of the UBSS rating estimates were one level better than the actual CAMEL rating, whereas 2.3 percent of the rating estimates were more than one level better than the actual rating. Like FIMS, the UBSS was most accurate in estimating CAMEL ratings of 1 (58.6 percent) and 2 (67.2 percent), but these percentages were much lower than those for FIMS (77.5 percent and 79.9 percent, respectively). The UBSS also was much less accurate than FIMS in identifying banks that failed during the subsequent quarter. Of the 262 failing banks in the UBSS sample, only 61.5 percent received a 5-rating; 27.9 percent received a 4-rating; 8.8. percent received a 3-rating; and 1.9 percent received a 1or 2 rating.

FIMS Rating Model: Identifying Unsatisfactory Banks

Regulators often divide banks into two broad groups those that are satisfactory and those that are unsatisfactory. In defining satisfactory banks, regulators typically label banks with CAMEL ratings of 1 or 2 as satisfactory and banks with ratings of 3,4 and 5 as unsatisfactory. As a second measure of estimation accuracy, this classification scheme was used to analyse the ability of the FIMS rating model and the UBSS to classify banks correctly as satisfactory or unsatisfactory.

Two types of errors can be made in using an off-site monitoring system to classify banks in this manner. First, banks that actually are unsatisfactory can be misclassified by the system as satisfactory. Misclassification of unsatisfactory banks as satisfactory is referred to as a "type-1 error". The second type of error is to misclassify satisfactory banks as unsatisfactory, a "type-2 error". The cost of a type-1 error can be high because it can result in a bank failure that might have been prevented by early supervisory intervention. The cost of a type-2 error is usually much lower because it is limited to the sum of the unnecessary expenditure of supervisory or examination resources on a healthy bank and the costs of examination that are borne by the bank.

The accuracy of the FIMS rating model and of the UBSS in identifying satisfactory and unsatisfactory banks is compared in table 5. (Table 5 omitted). FIMS incorrectly identified approximately 17.1 percent of the unsatisfactory banks as satisfactory (type-1 error) while incorrectly identifying 7.4 percent of the satisfactory banks as unsatisfactory (type-2 error). The UBSS incorrectly identified approximately 32.7 percent of the unsatisfactory banks as satisfactory (type-1 error) and incorrectly identified 12.2 percent of the satisfactory banks as unsatisfactory (type-2 error).

The information in table 5 is based on the assumption that a FIMS rating model score of 2.5 differentiates satisfactory banks (score of 2.5 or less) from unsatisfactory banks (scores greater than 2.5). The ability of the FIMS rating model and the UBSS to identify unsatisfactory banks can be increased by adjusting the cutoff score between satisfactory and unsatisfactory downward from 2.5. For example, FIMS scores of 2.3 or less could be classified as satisfactory, whereas scores greater than 2.3 could be classified as unsatisfactory. Such an adjustment would increase the number of banks classified correctly as unsatisfactory and decrease type-1 error, but at the cost of decreasing the number of satisfactory banks correctly classified and increasing

type-2 error. A larger percentage of the unsatisfactory banks would be identified, but a larger percentage of satisfactory banks would be misclassified.

Chart 1 demonstrates this trade-off graphically for the FIMS rating model and for the UBSS. (Chart 1 omitted). Each line in the figure starts at the upper left corner because labeling no banks as unsatisfactory implied that all of the truly unsatisfactory banks are mislabeled, so that type-1 error is 100 percent and type-2 error is zero. Similarly, each line in Chart 1 ends at the lower right corner, because labeling all banks as unsatisfactory implies that none of the satisfactory banks are correctly labeled, so that type-1 error is zero and type-2 error is 100 percent. The ideal model would produce a plot that follows the vertical axis from its top to the origin and then follows the horizontal axis from the origin to its end.

When the plots for the FIMS rating model and the UBSS are compared, the plot for FIMS lies below and to the left of the UBSS for all values. This pattern means that, for any level of type-2 error, type-1 error is lower for FIMS than for the UBSS.

FIMS Rating Model : Estimating Downgrades

A primary function of a surveillance model is the ability institutions that are not known to be financially troubled but that are in fact troubled or will be troubled in the near future. Thus, another criterion for the success of a model is the ability to identify those banks that are rated satisfactory (CAMEL 1 or 2) but that will be downgraded to unsatisfactory (CAMEL 3, 4 or 5) in the near term. Once again, a trade-off exists between type -1 and type -2 error rates (table 6). (Table 6 omitted). In this case, a type-1 error occurs when the model incorrectly classifies a downgraded bank, and a type-2 error occurs when the model misclassifies a bank that is not downgraded.

According to table 6, FIMS incorrectly labeled 58.8 percent of downgraded banks are satisfactory (type-1 error) and incorrectly labeled only 2.7 percent of the CAMEL 1 or 2 rated banks as a downgrade (type-2 error). By comparison, the UBSS incorrectly labeled 55.5 percent of downgraded banks as satisfactory (type-1 error) and incorrectly labeled 11.1 percent of the CAMEL 1 or 2 rated banks as downgrades (type-2 error). Hence, the type-1 error rate for the UBSS is slightly less than that of FIMS, but the type-2 error rate is much greater than that of FIMS.

As with the distinction between satisfactory and unsatisfactory tested earlier, comparing the type -1 versus type -2 error trade-off over all possible cutoff values is a more revealing test. Such a comparison of FIMS and the UBSS in identifying downgraded banks versus satisfactory banks appears in Chart 2. As before, the plot for FIMS lied below and to the left of that for the UBSS for all values, demonstrating that, for any level of type -2 error, type -1 error is lower for FIMS than for the UBSS.

FIMS Risk Rank Model: Accuracy in Estimating Bank Failures

To assess the accuracy of the FIMS risk rank model in estimating the likelihood of bank failure, out-of-sample estimates of the probability of failure within a two-year period were calculated using binary logistic regression methodology. The accuracy of out-of-sample estimation was assessed over the five two-year periods beginning with year-ends 1986-90. For comparison, estimates of failure over these same two-year periods were constructed for the UBSS by ranking banks from worst to best, based upon their UBSS composite percentile scores. Altogether, 48,300 estimates were made over the five periods.
As an additional test of accuracy, banks were ranked by their CAMEL rating as of year-ends 1988, 1989, and 1990 to see how well the CAMEL rating estimated failures during the subsequent two-year period relative to FIMS and the UBSS. Over these periods, a total of 32,306 estimates were made using each system.

The type -1 and type -2 error rates for each system were calculated and are plotted in Chart 3 . (Chart 3 omitted). In this chart, the vertical axis represents the proportion of surviving banks incorrectly identified as failing (type-2 error) The lines plotted on these axes represent the trade-off between these two types of error.

The classification accuracy for each of the three models is good, as indicated by the high degree of curvature in the plots. The plots demonstrate that the FIMS rating model is more accurate than the UBSS or CAMEL, as the FIMS curve lies below and to the left of the UBSS and CAMEL curves. For example, when 5 percent of the surviving banks are misclassified, FIMS misclassifies 20 percent of the failing banks. In comparison, the UBSS misclassifies 28 percent of failing banks and CAMEL misclassifies 32 percent of the failing banks. When 10 percent of the surviving banks are misclassified, FIMS misclassifies 9 percent of the failing banks; the UBSS, 16 percent; and CAMEL, 22 percent. With the current population of approximately 11,000 banks, to reduce the percentage of misclassified failing banks to 9 percent the UBSS and CAMEL would have to misclassify approximately 800 more and 1,300 more surviving banks as failed respectively, than would FIMS.

The relatively poor performance of the CAMEL rating is most probably attributable to the fact that CAMEL ratings available at any given date are based upon information that is more dated than that for the off-site monitoring systems. in many cases, these examinations occurred more than a year before the date of interest. For example, the CAMEL ratings available as of December 31, 1990, were based upon examinations conducted from December 1990, with the average data more than two years old.

Even if all banks were examined once each calendar year, with 25 percent of the examined during each quarter of the year, the examination ratings available at any one time wc ld be, on average, six months old. In contrast, off-surveillance

scores such as those produced by FIMS and the UBSS are based upon the most recent quarterly financial data, which are available approximately, two months after the end of each quarter. (12). In fact, the age of examination ratings is the very reason for off-site systems to monitor the financial condition of banks during the periods between examinations.

FIMS AS A SURVEILLANCE MODEL FOR BANK HOLDING COMPANIES

As part of its regulatory responsibilities, the Federal Reserve is responsible for supervising bank holding companies. The Federal Reserve uses the so-called BOPEC system for rating the financial condition of bank holding companies as determined from on-site inspections. A BOPEC rating consists of a composite rating derived from five component ratings plus a separate management rating. The five component ratings are for the "bank," "other," "parent," "earnings," and "capital" components (hence the acronym BOPEC). The first three components refer to the three segments of the consolidated bank holding company – its bank subsidiaries covered by the Bank Insurance Fund, its other subsidiaries, and its parent company. As with the CAMEL rating, each component rating and the composite rating are scaled from 1 to 5. The separate management rating, however, has only three levels – "S" for satisfactory, "F" for fair, and "U" for unsatisfactory. Thus a bank holding company receiving the highest possible ratings would have a BOPEC of "11111/1-S".

FIMS provides the Federal Reserve with a means for estimating the bank component of the BOPEC rating. Because the bank component rating is very highly correlated with the composite BOPEC rating, this estimate can serve as an off-site surveillance rating for bank holding companies. For a multibank holding company, the FIMS rating is calculated as the asset-weighted average of its subsidiary banks' FIMS ratings. For a one-bank holding company, it is the same as the subsidiary bank's rating.

FIMS also provides a risk rank for the combined bank portion of bank holding companies. Like the FIMS rating for bank holding companies, the FIMS risk rank for a multibank holding company is calculated as the asset-weighted average of its subsidiary banks' FIMS risk ranks, whereas for a unitary bank holding company it is the same as the subsidiary bank's risk rank. Because bank assets comprise the vast majority of a bank holding company's consolidated assets, these asset-weighted risk-rank averages should provide a fairly reliable off-site assessment of a bank holding company's financial condition when used in conjunction with off-site monitoring of the non-bank subsidiaries and consolidated organization.

CONCLUSION

The Financial Institutions Monitoring system has been developed to provide the Federal Reserve System with estimates of the financial condition of commercial banks and savings banks insured by the Bank Insurance Fund between on-site examinations. FIMS has several advantages over the Federal Reserve's previous off-site surveillance systems and the expert-based models used by other federal regulators.

First and most important, the accuracy of the new system in estimating the financial condition of banks as indicated both by subsequent on-site examination ratings and by subsequent failures is superior to that of the Federal Reserve's previous model.

Second, the new system provides objective measures of a bank's financial condition. Both the variables and the variable weights that are used to calculate these measures are determined by rigorous statistical testing rather than by subjective judgement.

Third, the new system provides a consistent measure of banks' financial

condition. Both models that make up the new system can be calculated for each bank.

Fourth, the new system provides a timely measure of financial condition. The FIMS rating and risk rank for an individual bank can be calculated as soon as the bank files its quarterly Call Report rather than later, when enough quarterly Call Report data are available to calculate meaningful peer-group averages.

Fifth, the new system is more flexible than alternative systems. Explanatory variables can be added to or deleted from FIMS with minimal revisions to software or procedures. The UBSS and CAMEL use fixed sets of financial ratios to calculate the surveillance scores, and any change in these ratios would require considerable revision to the surveillance system. The greater flexibility of FIMS should enable staff members at the Board and the Reserve Banks to continue to improve the new system's accuracy over time as experimentation with different variables continues and as feedback from end-users is incorporated into the system. Moreover, because the coefficients on the explanatory variables change each quarter in reflection of the changing conditions in the banking industry, FIMS should continue to be more accurate than existing alternative system.

Finally, the new system can identify deterioration or improvement in the banking industry within peer groups and system-wide. Unlike systems that rely upon peer-group rankings, FIMS measures absolute as well as relative changes in financial condition.

Preliminary testing has indicated that the methodology used to estimate the composite CAMEL rating produces estimates of the five component CAMEL ratings that are as accurate as estimates of the composite CAMEL rating. By providing estimates of component ratings as well as of the composite rating, FIMS could be used to better focus examination efforts on the dimensions of performance that appear to require the most urgent supervisory attention.

FIMS is also being tested for possible use on foreign banks. Most problematic is the assessment of the accuracy of the results, given the lack of CAMEL ratings for foreign banks. Comparison of FIMS ratings for foreign banks with alternative measures of risk, however, suggests that the FIMS approach is a promising avenue of research.

The Pattern of Bank Failures since 1980

From the mid-1930s until the early 1980s, relatively few banks failed, and losses to the deposit insurance fund were minimal. No more than 20 banks failed in any year. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) set in motion the removal of ceilings on the interest rates that institutions could pay on savings and time accounts and removed or weakened barriers separating commercial banks, thrift institutions and credit unions. With increased competition, depository institutions, weakened by the deep recession of 1981-82 failed at increasingly higher rates (chart). (Chart omitted). In 1982, 42 banks failed. In each successive year, bank failures rose until 1988, when they peaked at 221. Since then, the number of failures has declined each year; however, it remained in triple digits through 1992, when 122 banks failed. In 1993, bank failures fell to only 41.

From 1982 through 1992, a total of 1,442 banks failed, more than 10 percent of all banks in the United States at the beginning of that period.

Foot Notes:

1. The American Institute of Certified Public Accountants Committee on Working Procedures defines internal control as follows: "Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence

to subscribed managerial policies."

2. For a description of the bank surveillance systems used by regulators during the 1970s and early 1980s, see Barron H. Putnam, "Early Warning Systems and Financial Analysis in Bank Monitoring; Concepts of Financial Monitoring." Federal Reserve bank of Atlanta, Economic Review (November 1983 pp. 6-13).

3. The UBSS defined nine peer groups based upon bank asset size : $10 million or less, $10 million -$25 million, $25 million - $50 million, $50 million-$100 million, $100 million-$300 million, $300 million-$1 billion, $1 billion-$3 billion, $3 billion-$10 billion and greater than $10 billion. A tenth peer group was defined as banks chartered during the previous five years.

4. For banks, asset growth during the previous four quarters and interest paid on volatile liabilities as a percentage of average volatile liabilities were used as supplemental surveillance screens. For bank holding companies, parent company cash flow and double leverage were used as supplemental surveillance screens. As with the four primary ratios, each supplemental screening ratio was converted to a percentile ranking, and institutions with the highest rankings were placed on the exception list for additional off-site analysis and potentially, for supervisory action. For details on capital standards, see Commercial Banks in 1992." Federal Reserve Bulletin vol. 79 (July 1993) pp. 661-662.

5. The Office of the Comptroller of the Currency relies upon a set of financial ratio screens as its primary surveillance system.

6. "Failure" is defined as encompassing not only those institutions declared equity insolvent by their primary regulator during the two-year period but also those that are classified as "critically undercapitalized" at the end of the period. The latter group is included to identify institutions for which FDICIA mandates "prompt corrective action." In general, that legislation requires regulators to close critically undercapitalized institutions within ninety days. Critical

undercapitalization is defined as a ratio of tangible equity to average assets of less than 2 percent.

7. The ordinal-level logistic regression methodology is used to produce the FIMS rating whereas the binary logistic regressions methodology – a special case of the more general ordinal-level methodology—is used to produce the FIMS risk rank.

Each bank receives a set of five estimates representing the probabilities that the next composite examination rating will be equal to 1,2,3,4 or 5. The FIMS rating or estimated CAMEL rating is obtained from this set of estimates as the sum of the five possible ratings, each weighted by its estimated probability.

Each bank also receives a single estimate representing the probability that the bank will fail within two years. This estimated failure probability is used to rank banks according to riskiness.

The statistical underpinnings of these methodologies are described in G.S. Maddala, Limited-Dependent and Qualitative Variables in Econometrics (Cambridge University Press, 1983). See pp. 22-27 for a description of the binary logistic regression methodology and pp. 46-49 for the ordinal-level logistic regression methodology.

8. For a review of this literature, see Asli Demirgue-Kunt, "Deposit-Institution Failures: A Review of the Empirical Literature." Federal Reserve Bank of Cleveland, Economic Review, vol. 25 (Fourth Quarter-1989), pp. 2-18. Three more recent articles on predicting bank failure are James B. Thomson, "Modeling the Bank Regulator's Closure Option: A Two-Step Logit Regression Approach," Journal of Financial Services Research (May 1992), pp. 5-23; Rebel A. Cole and Jeffery W. Gunther, "Separating the Likelihood and Timing of Bank Failure," Journal of Banking Finance (forthcoming); and David S. Jones and Kathy Kuester King, " The Implementation of Prompt Corrective Action: An Assessment."

Journal of Banking and Finance (forthcoming).

9. To validate this methodology, staff members tested each of the explanatory variables for statistical significance in estimating the CAMEL rating in each quarter from December 1989 through March 1992, a total of ten different estimation periods. Empirical testing verified that inclusion of variables that are not statistically significant often degrades the model's ability to produce accurate estimates for banks not included in the sample used to estimate the model, that is, "out-of-sample" estimates. Empirical testing also has shown that inclusion of variables that consistently are statistically significant improves the ability f FIMS to estimate examination ratings out-of-sample. In the present context, out-of-sample estimation used the relationship between the dependent and explanatory variables estimated during one period to estimate levels during the subsequent period. Out-of-sample tests comparing predicted and actual outcomes are useful because they most closely resemble the manner in which the model is actually used.

10. This methodology was validated through separate estimations using year-end Call Report data from 1984-88 to determine failures in the two years subsequent to the Call Report data. Out-of-sample estimation accuracy was evaluated for each of these five estimations.

11. Three official dates are associated with an examination: the date the examination begins, the date the examination ends, and the date of the Call Report data used by the examiners in assigning supervisory rating. For purposes of estimating and evaluating the accuracy of the FIMS rating model, supervisory ratings are identified by the date of the Call Report data; typically, regulators also identify examinations by that date.

12. For expositional purposes, this discussion assumes that only one date is associated with each examination when, in actuality, three are. See note 11.

Rebel A. Cole, of the Board's Division of Research and Statistics; Barbara G. Cornyn, of the Board's Division of Banking Supervision and Regulation; and Jeffery W. Gunther, of the Federal Reserve Bank of Dallas's Financial Industry Studies Department, prepared this article.

ANNEXURE XII-A
(Cf. Para 5.9)

An Outline of the Risk Based Supervision Deployed by the Financial Services Authority of the United Kingdom @@

I. *Risk Based Supervision*

Background

The increased globalisation of financial markets and cross-border flow of funds, new financial products and institutions have posed fresh challenges to the financial sector regulators, particularly bank regulators. In the UK, two recent bank failures have led the bank regulators to a new approach of bank supervision.

- **BCCI** : The bank had its Principal Office in a tax haven country and although the UK branch was doing well, the failure of bank caught the regulators by surprise.

- **Barings Bank** : In this case, the Singapore Branch of an UK bank contributed to the failure of the bank. The branch was a significant business contributor for theoverall operations of the bank.

While both the cases were just opposite with branch and bank failures caused by HO and branch, these brought to fore the issue of risk based supervision. The Bank of England appointed Arthur Anderson, a consultancy firm, to look into overall gamut of bank supervision. The risk based approach being used by FSA, on the basis of recommendations of the consultants is given below. This approach is known as RATE, which stands for risk assessment, tools of supervision and evaluation.

@@ Source: Report of the Informal Study Group on Moving Towards Risk Based Supervision, DBS, RBI

Objectives

- Assess systematically whether bank continues to meet authorisation criteria
- Gain better understanding of the business and risks faced by the banks
- Links to objectives and standards of supervision
- Prompt, appropriate and consistent action
- Produce effective supervisory programmes
- Allocate scarce supervisory resources according to risk
- In case of foreign bank branches, place appropriate reliance on overseas regulators

Benefits

- More consistency in work
- Better focus of supervisory effort
- Optimises resource allocation
- Greater transparency
- Greater recourse to on-site work
- Enables teamworking

The RATE Framework

It has three phases

- Risk Assessment
- Tools of Supervision
- Evaluation

These phases are described in detail below.

RISK ASSESSMENT

Steps in Supervisory Process

Determine whether there is consolidated group – the process applies to whole group.

Review of Home Supervisor (HS) Assessment - HS is assessed for the supervisory process followed and the extent to which it is RATE equivalent

Identify Significant Business Units (SBUs) – SBU Criteria

- Unit represents 5% or more of
  - Ø Revenue
  - Ø Pre-tax profits
  - Ø Capital requirement (unit included in consolidated returns)

  Capital base (unit deducted from consolidated returns)
- Large Exposures Rule
- Exposure to group company is > 10% of capital base
- Judgemental override

Obtain Pre-visit Information

- Most information available in FSA files
- Additional information, if required is called from the bank. This information includes management accounts, strategy documents, business plans, budgets, and organograms of legal and management structure.
- Other sources of information – exchange of information with Home Supervisor (HS) under MOU or ad-hoc arrangements.

Preliminary Risk Assessment

- Assess key business and control risks.

  Business risks - The CAMELB factors (Capital, Assets, Market risk, Earnings, Liabilities, and Business) are used to assess and record the quantitative and qualitative aspects of the bank's business risk profile.

  Control risks - In analysing the controls over the business a qualitative

assessment is made using the COM factors (Controls, Organisation and Management).

- ♦ Identify information gaps and details to be discussed with the bank during the on-site visit.
- ♦ For non-European banks information is collected at two levels
  - Ø Whole bank – collecting information from HS
  - Ø Branch – from the branch.

- **Undertake On-site Visit**
  - ♦ Generally takes place within a short time-frame
  - ♦ Ensure all significant business units are covered
  - ♦ The process varies in large and diverse banks
  - ♦ The goal is to understand the risk profile and control culture as a whole and for the significant business units.
  - ♦ The meetings in the bank are held at high level i.e. CE, CFO, and heads of significant units e.g. Heads of IT, Risk management, Internal audit, and HR.
  - ♦ The focus of discussion with top management is high level systems and entrails, strategy, organisational structure and management issues.
  - ♦ In case of Heads of business units, the focus of discussion is strategies, controls over the unit, management style, risk and earnings profile, and control framework of the unit.
  - ♦ This completes the process of information collection for risk assessment

- **Formal Risk Assessment**
  - ♦ Use on-site and off-site information to assess risk profile of the bank
  - ♦ Likely change in the risk profile in the supervisory period.
  - ♦ Determine whether bank continues to meet authorisation criteria.
  - ♦ Assessment is done on each of the CAMELB COM factors.
  - ♦ Scoring:

- Each of the CAMELB COM factors assigned a rating of 1 to 4 (1 being good)
- Business and Control Risk – high, medium or low and direction – increasing, decreasing or stable.
- Overall rating on a scale of 1 to 4 is given to a Bank.
- Only business and control risks are disclosed to banks.

- Decide length of Supervisory Period – varies according to Risk Assessment of the bank. The Table below gives indicative supervisory periods.

Business Risk					
High	B.	SP 12 –18 months	C	SP 6 –12 months	High
Low	A.	SP 18 – 24 months	D.	SP 12 months	Low
	Low	control risk		High	

- **Prepare supervisory programme**
  - Identify key objectives
  - Actions necessary to meet key objectives
  - Actions include actions to be completed by the bank as well as FSA.

- **Review Supervisory Process**
  - Use of RATE Panel – consisting of senior FSA officials
  - The RATE Panel ensures consistency and quality of supervisory process
  - It also ensures optimum allocation of supervisory time

- **Formal Feedback to the bank**
  - Preliminary draft of formal feedback given to bank.
  - Discussion with bank to discuss final conclusions
  - Final letter mailed to bank after meeting (after adjustments, if necessary)
  - Letter copied to relevant overseas regulators

The Risk Assessment process may take about 20 weeks; however, time period may vary for different banks.

B. Categories of Risk

FSA considers 10 general categories of risk viz.

- Credit risk
- Price risk
- Interest rate risk
- Foreign exchange risk
- Liquidity risk
- Strategic risk
- Reputation risk
- Legal risk
- Operational risk
- IT Risk

C. CAMELB COM Evaluation Factors

- Capital
    - Composition and quality
    - Adequacy
    - Access to capital
    - Repayment of capital (applicable for Tier 2 & 3
- Assets
    - Composition
    - Concentrations
    - Provisioning and Arrears
- Market Risk
    - Key products and markets
    - Market risk in trading book
    - Interest rate risk in banking book
    - Foreign exchange risk

- Earnings
    - Profitability & Earnings performance
    - Profit plan & budget

- Liabilities
    - Composition
    - Concentrations
    - Liquidity

- Business
    - External Environment
    - Strategic business initiatives
    - Customer base and competitive differentiation
    - Wider group issues
    - IT systems
    - Key staff
    - Other business risks

- Internal Controls
    - Decision making framework
    - Risk management framework
    - Limits and standards
    - Information technology
    - Financial and management reporting
    - Staff policies
    - Segregation of responsibilities
    - Audit and compliance functions
    - Money laundering controls

- Organisation
    - Legal structure
    - Relationships with other parts of the group
    - Reporting lines

- Management
    - Four eyes
    - Fitness and propriety
    - Board composition
    - Non-executive directors
    - Cultural attitude
    - Corporate planning and strategy

D. Impact of ten risks on CAMELB COM factors

Risks and their applicability to CAMELBCOM factors									
	C	A	M	E	L	B	C	O	M
Credit risk		✓					✓		
Interest Rate risk			✓				✓		
Liquidity risk					✓		✓		
Price risk			✓				✓		
Foreign Exchange risk			✓				✓		
Operational risk						✓	✓		
Legal risk						✓	✓	✓	✓
Strategic risk						✓	✓		✓
Reputation risk						✓	✓		✓
Information Technology risk						✓	✓		✓

E. Assessment of Home Supervisors

The following factors are considered for assessment of supervisor:

- **Supervisory relationship and Gateways**
  - Relationship with FSA
  - Gateways to other supervisors
  - MOU with FSA

- **Reliability of Information**

- **Supervisory Legislation**
  - Authorisation
  - Revocation
  - Power to address compliance
  - Ongoing supervision

- **Description of Home Supervisor**
  - Staff – numbers, experience, training
  - Legal ownership
  - Independence / neutrality
  - Other supervisors – overlap / underlap, lead regulator

- **Supervisory approach**
  - Risk base, materiality (supervision of material units of banks)
  - Off-site supervision – returns, guidelines
  - On-site supervision including inspection of overseas offices
  - Use of external auditors
  - Frequency and nature of contact between supervisor and banks

- **How HS assesses CAMELB COM factors**
  - Capital
    - Methodology – Basle/other
    - Capital charge for market risk
    - Minimum net assets
  - Assets
    - Loan classification and provisioning methodology
  - Market risk
  - Earnings
  - Liabilities
    - Liquidity – regulatory requirements, monitoring (global / local, limits)
  - Business
  - Internal controls
    - Assessment of risk management
    - Financial and management reporting
    - Audit and compliance functions
    - IT
  - Organisation
    - Shareholder controllers
    - Board composition
    - Transparency of legal structure and reporting lines
  - Management
    - Checks on fitness and propriety
    - Four eyes
    - Requirement for integrity, quality and skill of management
    - Strategy, objectives and corporate planning

- **Other Banking Act issues**
    - Consolidated supervision – legislation, practice
    - Large exposures
        - regulations, limits, monitoring
        - definitions, clustering, connected exposures, exemptions
    - principal place of business
    - close links
- **Other relevant issues**
    - Accounting/auditing framework
        - Adherence to international accounting standards
        - Presence of international accounting firms
        - Frequency and contents of Bank's published accounts
    - Commercial / legal framework
        - Enforceability of contracts
        - Litigation costs
    - Insolvency regime
        - Single or separate entity, ring-fencing of domestic assets
    - Exchange controls
    - Money laundering – legislation, enforcement, reporting body
    - Deposit protection – details of scheme, coverage
    - Banking system
        - overview of structure, concentration, fragility, power of banks
        - procedure and track record for handling problems
    - Corruption
    - Political interference
    - Culture of compliance

2. TOOLS OF SUPERVISION

Successful completion of Risk Assessment phase leads to identification of key issues and concerns for the institution. These lead to establishment of

supervisory objectives to be achieved during supervisory period

Supervisory Objectives – centred around:

- Discovery – process of gaining understanding of bank's fundamental condition
- Correction – process of addressing concerns identified during discovery phase
- Monitoring - the process of identifying current and prospective issues that could impact the risk profile or overall condition of the bank

For achieving supervisory objectives, actions linked to these to be identified. Actions may outline activities to be completed by the bank, or may involve the tools of supervision.

Tools of Supervision

- Tools of supervision used for the institutions where FSA does not rely on Home Supervisor and UK institutions.
- In case of foreign banks, they are used mainly for branches. Wherever possible, work with Home Supervisor to minimise supervisory duplication.

The following tools of supervision are used:

A. Reporting Accountants (Section 39) Report

- A report prepared by the reporting accountants (usually the bank's external auditors) assessing the bank's internal systems and the adequacy and effectiveness of the controls in place.
- The scope of the report is specified by the FSA.

B. Traded Markets Team Visit – focuses on

- Treasury market function of the bank
- Application of capital adequacy directive

C. Credit Risk Review Team Visit

- Focuses on credit and operational risks of banking

D. Prudential meetings

- Meetings with senior management of the bank to discuss the bank's financial performance, its business and control risk profile, its strategy and the wider market environment in which it operates

E. Ad-hoc meetings

- Meetings either at the FSA or on-site to discuss business developments or plans, and issues or concerns arising from the risk assessment process

3. EVALUATION PHASE

- The objective is to evaluate the adequacy of supervisory activities as well as resources used to meet the supervisory objectives
- An evaluation of the risk assessment, the supervisory programme and its use of the tools of supervision is done at least once in a year and before the next risk assessment.
- This serves as input for the next risk assessment.

II. Actions Available to FSA against Banks

If FSA concerns are not addressed properly by a bank, the following actions are available to FSA:

- Increasing the bank's capital requirement – this is applicable for UK incorporated banks

- Ring fencing of the bank
  - For UK incorporated banks it means protection from group by either limiting financial exposure to rest of group or limiting the control exercised by parent or shareholders.

- For non-UK incorporated banks, it may mean subsidiarisation of its UK operations

- Formal supervisory action under Banking Act
  - Restriction on bank's business
  - Revocation of bank's authorisation.

III. FSA Guidelines for Banks

- **Capital Adequacy**
  - Threshold ratio of 8 per cent for all banks.
  - Banks are assigned trigger and target capital adequacy ratios. Breach of trigger ratio is not allowed. These ratios are prescribed on the basis of riskiness of banks.
  - Consistency in prescribing these ratios for banks with similar type of risk is maintained.

- **Large Exposures** – banks are required to report exposures exceeding 10 per cent of capital to FSA.

- **Liquidity** - two types of approaches viz. stock liquidity and asset-liability matching allowed to banks
  - Stock Liquidity
    - Allowed to large retail banks
    - Banks are required to cover 100 per cent of wholesale and 5 per cent of retail deposits with marketable assets fro a single time bucket of 0 – 5 days.
    - FSA does not monitor liquidity beyond 5 days.
  - Maturity matching approach – this is applicable to all other banks
    - Banks report liquidity in different time bands
    - FSA monitors liquidity for 0 –8 days and 0 – 1 month time bands
    - Liquidity mismatches up to 15 per cent (in terms of deposits) are allowed to banks depending upon their riskiness.

   - Liquidity mismatches prescribed for sterling, other currencies and all currencies
 - Banks required to monitor liquidity on daily basis but required to report to FSA on monthly basis
 - Any breach of liquidity guidelines is to be immediately reported to FSA.

- **Home Country Exposure Limit**
  - Applicable to foreign banks
  - These are prescribed in terms of total assets/capital and vary across banks.
  - FSA is in the process of reviewing and rationalising these guidelines.

ANNEXURE XII-B

(Cf. Para 5.9)

Supervisory System of Federal Reserve System of the USA @@

Supervision in the Federal Reserve System

Introduction

- Risk-based (or Risk focused) supervision, as different from transaction-based or regulatory inspection.

- In a risk focused supervisory set up, focus on:
  - a) those areas which pose the greatest risk to the soundness of banking organisations.
  - b) On the assessment of management processes to identify, measure, monitor and control / manage risks.

- The examination approach is a risk-focus process that relies on an understanding of the institution, the performance of risk assessment, development of a supervisory plan, and examination procedures tailored to the risk profile.

- There is reliance on a central point of contact and detailed risk assessments and supervisory plans prior to the on-site examination/inspection.

- Effective risk management assumes more importance as new technologies, product innovation and the size and speed of financial transactions have changed the nature of banking markets.

- The increased supervisory emphasis on risk management processes reflects the view that properly managed risks are critical to the conduct of safe and sound banking activities.

- Eliminate duplication of efforts.

@@ Source: Report of the Informal Study Group on Moving Towards Risk Based Supervision, DBS, RBI

Objectives of supervisory process:

- **Provide flexible and responsive supervision** - dynamic so as to respond to changes in technology, products, new risk management systems, individual organisations, market

- **Foster consistency, coordination and communication among the appropriate supervisors** - Seamless supervision (which reduces regulatory burden and duplication) is promoted.

  Examiner resources are optimised by using the institutions internal and external risk assessment and monitoring systems and making appropriate use of joint and alternating examinations.

- **Promotes the safety and soundness of financial institutions** - evaluates safety and soundness of banking institutions including assessment of risk management systems and financial condition.

- **Provides a comprehensive assessment of the institution** - integrates specialty areas (IT, capital markets, etc.) and functional risk assessments and reviews into a comprehensive assessment.

Key elements of the framework

1. **Designation of a central point of contact** - to facilitate coordination and communication among numerous regulators and specialty areas.

2. **Review of functional activities** - as large institutions are structured along functional/business lines, a single type of risk may cross several legal entities so assessment along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews integrated into risk assessment for specific legal entities.

3. **Focus on risk management process** - emphasizes each institutions responsibility to be the principal source for detecting and deterring abusive and unsound practices through adequate internal controls and procedures.

Focus on risk management systems, but retains transaction testing and supervisory rating systems. This is more dynamic as it provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges.

4. **Tailoring of supervisory activities** - As risk profiles can change quickly, supervisory activities are tailored according to risk profile. By focusing on major risk areas, examiners achieve a better understanding of institution's condition.

5. **Emphasis on ongoing supervision** - As environment can change rapidly, need for ongoing supervision through increased planning and off-site monitoring. Adjustments to the supervisory strategy can be made as conditions change, either within the bank or within the economy.

Process and products of risk focused supervision

The risk-focused methodology comprises six key steps. Each step uses certain written products, which facilitates communication and coordination.

STEPS	PRODUCTS
1. Understanding the Institution	1. Institutional Overview
2. Assessing the Institution's Risk	2. Risk Matrix 3. Risk Assessment
3. Planning and Scheduling Supervisory Activities	4. Supervisory Plan 5. Examination Program
4. Defining Examination Activities	6. Scope Memorandum 7. Entry Letter
5. Performing Examination Procedures	8. Functional Examination Modules
6. Reporting the Findings	9. Examination Report(s)

I. Understanding the Institution

- Critical to tailor the supervision programme to meet the characteristics of the organisation.
- As an institution financial condition and risk profile can change very fast, it is essential to keep abreast of changes in risk exposure and strategy. Hence central point of contact reviews certain information on an ongoing basis and prepares an institutional overview.
- Source of information include other supervisors reports, external auditor's reports, institution's management information system and publicity available information.
- Information to be reviewed includes size and composition of balance sheets, internal risk rating of loans, internal limits and current risk measures regarding trading activities and internal limits and measures covering the institution's interest rate and market risk as also functional organizational charts, changes on the organization's strategic plan and information provided to the Board of Directors and management committee.
- The central point of contact should hold periodic discussions with the institution's management to cover topics such as credit market conditions, new products, divestitures, mergers and acquisitions and the results of any recently completed internal and external audit.

Preparation of the Institutional overview:

- provides executive summary of institutions present condition, its current and prospective risk profiles as also highlights key issues and past supervisory findings.
- general types of information to be presented in overview include
  - organisational structure
  - business strategies, key business lines, product mix, marketing emphasis, growth areas, new products.

- key issues, either from external or internal factors (e.g. performance vis-a-vis competitors)
- Management overview - Board oversight, leadership strengths/ weaknesses.
- Consolidated financial condition and trends, including earnings, invested capital and return on investment by business line.
- future prospects of the organisation.
- Internal and external audit.
- Supervisory activity performed since last review.
- Consideration for conducting future examinations - logistical and timing considerations.

2. Assessing the Institution's Risks

☛ To focus supervisory activities on areas of greatest risk, risk assessment is peformed This risk assessment highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted.

☛ Assessment applies to entire spectrum of risks (credit risk, market risk, liquidity risk, operational risk, legal risk, reputational risk)

☛ First step in risk assessment is evaluating the institutions risk tolerance and management's perception of the organizations strength and weaknesses. Also institution should have a clearly defined risk management structure.

☛. Then evaluation of institution's internal risk management - of internal audit, loan review and compliance function, other risk management systems. Also consider external audit report. Hold meetings with external auditors and senior management responsible for above areas.

☛ Also compare risk assessments developed by the internal audit department with supervisory risk assessment - this gives an idea as to the level of reliance that examiners can place an institution's internal risk management in

developing the scope of examination activities.

☞ Review adequacy of MIS - and hence adequacy of IT systems.

Preparation of Risk Matrix

☞ **A risk matrix** - is used to identify significant activities, type and level of inherent risks, adequacy of risk management, as also composite risk assessment for each activity and the overall institution.

☞ **Identify significant activities** - from balance sheet, income statement, MIS etc.

☞ **Identify type and level of inherent risk**
- type of risk means credit risk, market risk, etc.
- level of risk:
  - § high - where activity/position is large, potential loss high.
  - § moderate - activity average - loss could be absorbed in normal course of business.
  - § low - activity/position less, risk of loss, remote/loss would have little negative impact.

☞ **Assess adequacy of risk management**
- Importance to be given to such aspects as Active Board and Senior management oversight, adequate policies, procedures, limits, adequate risk management, monitoring, MIS and comprehensive internal controls.
- Then assess relative strength of risk management processes and controls for each identified function or activity:

  Strong Risk Management - management effectively identifies and controls all major types of risk posed by the relevant activity.

Acceptable risk management - risk management systems, though largely effective, may be lacking to some modest degree. There may be minor risk management weaknesses, but these problems have been recognised and are being addressed.

Weak risk management - risk management systems are lacking in important ways and hence are a cause for more than normal supervisory attention.

- **Assess Composite Risk of Significant Activities:**

  The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk management systems for that activity.

RISK MANAGEMENT SYSTEMS	INHERENT RISK OF THE ACTIVITY		
	Low	Moderate	High
	Composite Risk Assessment		
Weak	Low or Moderate	Moderate or High	High
Acceptable	Low	Moderate	High
Strong	Low	Low or Moderate	Moderate or High

- **Assess Overall Composite Risk** - After assessment of composite risk of each identified significant activity/function an overall composite risk assessment is made for off-site analytical and planning purposes.

Preparation of the Written Risk Assessment

- A written risk assessment serves as an internal supervisory planning tool. It presents a comprehensive risk-focussed view of the institution, delineating the areas of supervisory concern and serving as a platform for developing the supervisory plan.

- Risk assessment document includes:
    - Overall risk assessment
    - types and direction of risks
    - major functions, business lines, activities, products from which risks emanate
    - key issues affecting the risk profile.
    - Consider relationship between likelihood of an adverse event and potent impact.
    - Risk management systems.

- Attempt should be made to identify the cause of unfavourable trends, not just report the systems. By identifying the cause of decline, an assessment of prospects for reversal of decline can be made. Risk assessment to reflect a thorough analysis leading to conclusions regarding the banks risk profile rather than a reiteration of the facts.

3. Planning and Scheduling Supervisory activities

- Supervisory plan a bridge between the risk assessment of the bank and the supervisory activities to be conducted. Minimise disruption to the institution and avoid duplicative examination efforts.

- The institutional organizational structure and complexity represent significant considerations in planning specific supervisory activities to be conducted.

Preparation of the Supervisory Plan

- A comprehensive supervisory plan to be developed annually and updated. It should demonstrate that supervisory concerns identified through the risk assessme nt process and the deficiencies noted in the previous examinations are being/will be addressed. To the extent the risk management systems are adequate, the level of supervisory activity may be adjusted.

- Supervisory plan to cover:
    - All supervisory activities to be conducted, their scope, objectives and specific concerns regarding the activities. **Priority to areas of higher risk.** Determine compliance with (or potential for) supervisory action.

- General logistical information (time-table, participants, resource requirements).

- The extent to which audit (internal and external), loan review, other risk management systems will be tested and relied upon.

- Plan generally to cover 18 months.

Preparation of Examination Programme

- A comprehensive schedule of examination activities for the given planning horizon.
- Communicates responsibilities for supervisory activities.
- Covers:
  - schedule of activities, time duration, resource estimate.
  - agencies involved.
  - product for communicating findings (formal report/supervisory memorandum)
  - need for special examiner skills - and extent of participation by specialty disciplines.

4. Defining Examination Activities

- Focus of on-site examination should be oriented to a top-down approach that includes a review of the bank's internal risk management systems and an appropriate level of transaction testing. Amount of on-site transaction testing is flexible - however, an appropriate level of transaction testing and assest review will be necessary to verify the integrity of internal systems.

Scope Memorandum

- It documents specific objectives for the examinations. This document is important as scope of examination will vary from year to year. Thus, it is necessary to identify the specific areas chosen for review and the extent of those reviews. The scope memorandum ensures that supervisory plan is executed and communicates specific examination objectives to the examination staff.

- Scope Memorandum generally includes:
  - statement of objectives.
  - overview of the activities and risks to be evaluated.
  - level of reliance on internal risk management systems and internal or external audit findings.
  - description of procedures to be performed, indicate sampling process and **level of transaction testing.**
  - Identification of procedures expected to be performed off-site.
  - A description of how the findings of targetted reviews, if any, will be used in the current examination.

Entry Letter

- Identifies the information necessary for the successful execution of the on-site examination procedures.
- entry letter to fit the specific character and profile of the institution and scope of activities to be performed. No duplication. Can be supplemented by requests for information on specialty activities (IT, securitization). Some information to be mailed in advance Information that cannot be easily reproduced (minutes, audit work papers) to be reviewed on-site. Allow management sufficient lead time to prepare the requested information.

5. Performing Examination Procedures

- A function of the characteristics of each institution (size/risk profile, etc.)
- Focus on developing appropriate documentation to assess management's ability to identify, measure, monitor and control risks.
- Volume of transaction testing depends on managements ability to identify problem and potential problem credits, etc.

- Focus of functional areas, such as loan portfolio, treasury, internal control, supervisory ratings, information system, etc.

- For each area, modules are developed that define the review objectives, establish examination procedures and assist in documentation of the examination.
- 3 tiers of modules

  Tier I - Core decision factors - considered critical to evaluating the functional area.

  Tier II - Expanded Analysis - set of procedures to be used when deficiencies noted during review of core decision factors.

  Tier III - Impact Analysis - assess financial impact of deficiencies on institution and possible supervisory actions.

- Documentation to include the procedures performed to address the core decision factors, conclusions and the findings that should be carried forward into the examination report.

6. <u>Reporting the Findings</u>

- Examination activities to be planned over the supervisory cycle, culminating with an annual full-scope examination.

- Report to include summary of relevant results of any preceding supervisory activity.

- Report to communicate supervisory issues, problems or concerns related to the institution, as well as disclose the assigned supervisory rating.

- Report to also include appropriate comments of deficiencies noted in its risk management systems. Description accompanying each component of rating systems should emphasize management's ability to identify, measure, monitor and control risks.

ANNEXURE XIII

(Cf. Paragraph 5.10.1)

An overview of the Subsidiaries and Affiliates of the RBI-supervised Financial Institutions

Sl. No.	FI	Name of the Subsidiary / Affiliate	Major activity	Equity held (%) as on 31.03 1999
1.	IDBI	**Wholly owned subsidiaries**		
		SIDBI	Refinancing to SSI sector	100.00
		IDBI Capital Market Services	Capital market services	100.00
		IDBI Investment Management Company Ltd.	Investment banking	100.00
		Majority holding subsidiaries		
		IDBI Bank	Commercial banking	57.10
		Unit Trust of India	Mutual fund	50.00(Ini. Capital Cont.)
		Others		
		National Securities Depository Ltd.	Depository	39.05
		State Financial Corporations	Term-lending	33.08
		Industrial Finance corporation of India Ltd.	Term-lending	28.63
		Biotech Consortium Ltd.	Bio-technology	27.90
		Credit Analysis and Research Ltd.	Credit rating	26.00
		Investor Services of India Ltd.	Investor services	25.00
		North Eastern Development Finance Corporation Ltd.	Term-lending	25.00
		Twin Function State Industrial Development Corporations	Term-lending	24.54
		Over the Counter Exchange of India Ltd.	Securities exchange	17.00
		Stockholding Corporation of India Ltd.	Custodial services	16.96
		National Stock Exchange of India Ltd.	Securities exchange	14.00

		Tourism Finance Corporation of India Ltd.	Tourism financing	11.18
		Infrastructure Development Finance Company Ltd.	Term-lending	5.00
		Discount and Finance House of India Ltd.	Trading in money market Instruments	6.08
		Securities Trading Corporation of India Ltd	Securities trading	3.50
		ICICI Limited	Term Lending	1.40
2.	IFCI	**Wholly owned subsidiaries**		
		IFCI Financial Services Ltd.	Merchant banking	100.00
		IFCI Investors Services Ltd.	Investors services	100.00
		IFCI Custodial Services Ltd.	Custodial services	100.00
		Majority Holding Subsidiaries		
		Risk Capital and Technology Finance Corporation	Risk / venture capital financing	76.43
		Others		
		ICICI Ltd.	Term-lending	--
		Stockholding Corporation of India	Custodian	--
		Tourism Finance Corporation of India Ltd.	Term-lending to tourism industry	--
		DFHI	Trading in money market instruments	--
		LIC Housing Finance	Housing	--
		GIC Housing Finance	Housing	--
		State Bank of India	Commercial banking	--
		Oriental Bank of Commerce	Commercial banking	--
		STCI Ltd.	Securities trading	--
		IDBI	Term-lending	--
		Bank of Baroda	Commercial banking	--
		UTI	Mutual fund	--

3.	ICICI	**Wholly owned subsidiaries**		
		ICICI International Ltd.	Offshore fund management	100.00
		ICICI Infotech Services Ltd.	Investors services	100.00
		ICICI Venture Fund Mgt. Company Ltd.	Venture capital finance	100.00
		ICICI Personal Financial Services Limited	Retail / personal financing	100.00
		ICICI Capital services Limited	Placement /distribution financial products	100.00
		Majority owned subsidiaries		
		ICICI Bank Limited	Commercial banking	74.24
		ICICI KINFRA Limited	Infrastructure financing	76.00
		ICICI WINFRA Limited	Infrastructure financing	76.00
		ICICI Securities & Finance Company Ltd.	Primary dealership, debt and equity placement operations	99.91
		Others		
		ICICI Properties Limited) ICICI Real Estate Limited)) ICICI Realty Limited)	Group property holding & management	50.00 50.00 40.00
		Prudential ICICI Asset Mgt. Coy. Limited	Investment management for Prudential ICICI Mutual Fund	45.00
		Prudential – ICICI Trust Ltd.	Trustee of ICICI Mutual Fund	44.80
		Federal Bank Ltd.	Commercial banking	--
		IDFC Ltd.	Lending to infra-structure projects	--
		South Indian Bank Ltd.	Commercial banking	--

		North Eastern Development Finance Corporation .Ltd.	Developmental financing	--
		CRISIL	Credit rating	--
		Discount & Finance House of India	Trading in money market instruments	--
		HDFC	Housing	--
		LIC housing	Housing	--
		IDBI	Term-lending	--
		STCI Ltd.	Securities trading	--
		SHCIL	Custodial Services	--
4.	NAB ARD*	Agri Development Finance (TN) Ltd.	Financing Hi-Tech. High Value Agriculture	26.00
		Agri Business Finance (AP) Ltd.	Financing Hi-Tech.High Value Agriculture	10.4
		Kamataka Agri Development Finance Co.Ltd.	Financing Hi-Tech.High Value Agriculture	0.83
5.	NHB*	Andhra Bank HFL	Housing Finance	21.10
		BOB HFL	Housing Finance	32.89
		Can Fin HFL	Housing Finance	2.44
		Cent Bank HFL	Housing Finance	16.00
		GRUHFL	Housing Finance	3.38
		FVI Bank HFL	Housing Finance	20.00
		Vysya Bank HFL	Housing Finance	8.33
6.	*SIDBI	IDBI Bank Ltd.	Banking	20.00
		North Eastern Development Finance Corporation Limited	Financial Institution	10.00
		SBI Factors & Commercial Services Ltd.	Factoring	20.00
		CanBank Factors Ltd	Factoring	20.00

*SIDBI, NABARD and NHB do not have subsidiaries. The companies in which they have some stake, therefore, have been listed.

- = Not available

Annexure XIV

(Cf. Para 5.10.2)

Supervisory Issues in Financial Conglomerates

While an argument put forward in favour of a conglomerate set up is that it improves dispersion of risks across the group as a whole and enhances the group's financial capacity, yet the unique features of FCs raise certain supervisory issues and concerns. These issues are briefly enumerated below:

- The **supervisory approaches** adopted by sectoral supervisors for different entites in a conglomerate, vary. For instance, while the bank supervisors reckon the asset side of the balance sheet as the main source of risk, the insurance supervisors have traditionally been primarily concerned with the liability side of the balance sheet as the primary risk-source. The securities supervisors on the other hand stress on sufficient liquid assets to be held by the securities firms to be able to meet promptly all liabilities at any time.

- Assessment of **adequacy of capital of the group as a whole** is a major problem on account of differing prudential requirements for the banking, securities and the insurance sectors. A group-wide perspective, therefore, requires either consolidated type supervision or a "solo plus" approach to supervision. It needs being stressed that in a conglomerate structure, it is possible that all entities in the group meet their individual capital requirements but the owned funds of the group as a whole are less than the sum of these requirements – on account of "**double / multiple gearing**" or "**excessive gearing**".

- The **contagion effect** in a group structure could also be significant due to the risk that the problems of individual entities could adversely impact the group as a whole and possibly even the markets in which the

constituent operates. It primarily refers to the risk that the problems of an unregulated entity within a group could get transmitted to a regulated entity within the domain of a solo supervisor. The contagion effect could work either through affecting the market perception of the entire group or on account of the existence of intra-group exposures, particularly to the regulated entity.

- The **intra-group exposures** within a conglomerate, comprising a variety of direct and indirect claims of the group entities on each other, could be another complicating factor. Such exposures could take the form of lending, shareholding, trading, centralised liquidity management, guarantees and other commitments as also centralised provision of services such as pension arrangements and might have been concluded on terms not available with third parties. Such exposures determine not only the scope of the potential impact of contagion on individual entity, but would also affect the solvency, liquidity and profitability of a group and could as well be used as a means of supervisory arbitrage.

- **Large exposures at the group level** constitute another area of supervisory concern. Though the large exposures are regulated by sectoral supervisors through the credit concentration norms for credit institutions or asset diversification norms in the case of insurance companies, these approaches are sector specific. Thus, from a bank supervisor's perspective, there is a strong case for applying the large exposure norms on a group-wide basis to pre-empt any regulatory arbitrage across the banking, securities and insurance entities within a group.

- **Conflict of interest** arising within a conglomerate structure is another contentious issue. This may occur when one entity, say a bank, lends to another entity or to the (non-bank) parent, or when the insurance firm is required to place its funds within the group rather than deploying it more

widely in more appropriate assets. At another level, the conflict of interest may arise when investors with substantial holdings in the conglomerate, also have contractual relations with entities in the group. Likewise, the shareholders' interests might also conflict with those of the creditors – particularly those whom the supervisor may have a duty to protect.

- Application of **"fit and proper" criteria** for the managers of firms across the group could also pose problems for the supervisors. While the sectoral supervisors would be usually able to enforce these criteria in their respective domains, the managers of the companies in a conglomerate – particularly upstream from the regulated entity – might be able to exercise direct or indirect control over the operations of the regulated entity. Thus, the decision making processes within the conglomerate could stand shifted away from the regulated entities themselves to the parent / holding company at the top of the structure, with the attendant undesirable consequences.

- **Transparency** (or clarity) **of legal and managerial structure** of a FC could be another area of concern for the supervisors. A lack of transparency in the structure of the conglomerate would not be conducive to effective group-wide supervision since in such a situation, the supervisors would be unable to assess the totality of risk exposures of a conglomerate or the risks that the unregulated firms in the group may pose for the regulated entities. The supervisors also need to be assured that the other supervisor(s) in question can be relied upon not only for their quality of supervision but also for providing information necessary for group-wide risk assessment. Information relating to unregulated activities also needs to be available for the purpose.

- **Management Autonomy** in a FC is another vital issue for the supervisors to get the assurance that the management of the supervised entity has

sufficient independence and authority to meet the demands of the regulators. A lack of independence and authority would usually indicate a conflict between the supervisor's requirements of the management and the demands placed on the management by the shareholders themselves or by the management of other more influential parts of the group. In order to help ensure appropriate management autonomy, the supervisors need to know who is exercising control over the regulated entity, who is responsible for statutory and supervisory compliance as also the significant changes in the shareholders and significant management changes in the conglomerate as a whole.

- **Suitability of shareholders** of a FC also becomes a concern for the supervisors since the actions of the shareholders could have potential impact on the interest of the other stakeholders in the FC like customers, depositors and policyholders. The shareholders in a FC, in a position to exert material influence on a regulated entity within the group, should, therefore, meet certain standards. For the purpose of ensuring the suitability, the supervisors may need to apply, on an objective basis, an appropriate test, at the initial / authorisation stage and also on an ongoing basis. Further, for assessing the suitability of shareholders, adequate coordination among the sectoral supervisor would also be essential. For instance, where a non-regulated holding company is a controlling shareholder of more than one group entity falling under different supervisory regimes, the solo supervisors would need to liaise in suitability-assessment of the unregulated parent.

- **The right to access prudential information** by the supervisors in those parts of the FC which they do not supervise, is also a problem area. Lack of powers to access such information may preclude an overview of the legal and management structures and of the transactions / positions that might have an impact on the financial health of the regulated entity.

This may impair the supervisor's ability to identify the threats to the regulated entities supervised by them. In such a situation, nomination by the supervisors / regulators of a '**convenor**' or a '**lead regulator**' could be useful for gathering such information as they may require for obtaining a comprehensive perspective on the risks assumed by the group as a whole, of course, subject to the applicable provisions for confidentiality and use of the information.

- A conglomerate structure also provides **scope for supervisory arbitrage** across the group entities i.e. shifting of certain activities or positions within the group, either to avoid more stringent regulatory / supervisory norms of a sectoral supervisor compared to another supervisor, or to avoid supervision altogether by shifting the position or activity to a non-regulated entity. Since such potential arbitrage is an area of supervisory concern, the ideal solution would be to apply the principle of "same business, same risk, same rules" and to harmonise the regulation applicable to banking, securities and insurance entities. However, a more pragmatic but restricted approach could be to establish a system of exchange of information among the supervisors requiring them to inform each other of the establishment of any part of a conglomerate within their jurisdiction and of any significant transfer of assets, liabilities or contingent liabilities or activities in general between different parts of the conglomerate. This could enable the supervisors to identify any possible instances of regulatory arbitrage and take appropriate action at an early stage.

- The FCs with unregulated entities can also create a situation of **"Moral Hazard" for the supervisors** since the supervisors' quest for information about the operations of the unregulated entities in the group could unwittingly create an impression that the activities of the unregulated entities are in some form being monitored or supervised, even if informally. Hence, the supervisors information gathering efforts need to strive to

avoid giving such an impression, lest it encourages outside observers or internal management to assume risks they would not otherwise have taken in respect of the unsupervised entities.

- The **mixed conglomerates** i.e. the groups predominantly commercially or industrially oriented but containing at least one regulated financial entity as a part of the group structure, also pose their own set of problems for the supervisors, particularly in assessment of their capital adequacy at the group level, since the parent in a mixed conglomerate would normally not be a regulated entity.

ANNEXURE XV

(Cf. Para 5.10.5)

The Bank Holding Company Rating System (BOPEC) adopted by Federal Reserve System of U. S. A.##

Overview

The bank holding company rating system is a management information and supervisory tool that defines the condition of bank holding companies in a systematic way. In employing the system, the Federal Reserve evaluates each bank holding company through a review of its components. The Federal Reserve:

- Evaluates the financial condition and risk characteristics of each major component of the bank holding company.
- Assesses the important interrelationships among the components; and
- Analyzes the strength and significance of key consolidated financial and operating performance characteristics.

This methodology emphasizes the Federal Reserve's doctrine that holding companies are to be a source of financial and managerial strength to their bank subsidiaries. To arrive at an overall assessment of financial condition, the Federal Reserve evaluates these elements of the bank holding company

- Bank subsidiaries;
- Other (nonbank) subsidiaries;
- Parent company;
- Earnings-Consolidated; and
- Capital Adequacy — Consolidated

Risk Management

Source: The Regulatory Risk Management Handbook, 1998-99 Edition, Price Waterhouse Coopers

The BOPEC rating is the acronym derived from the first letters of each of the original five elements. As with most of the other systems of ratings, BOPEC is on the five-point scale with one the highest rating and five the lowest. Since January 1, 1997, examiners disclose both component and composite BOPEC ratings in summary sections of examination reports to senior officials and boards of directors of bank holding companies.

The first three elements of the BOPEC rating, i.e., the bank, other subsidiaries, and parent company, reflect the contribution of each to the fundamental financial soundness of the holding company. The rating of consolidated earnings, capital, and risk management recognizes the importance that regulators place on these factors and their crucial role in maintaining the financial strength and supporting the risk characteristics of the entire organization.

The ability and competence of holding company management have an important bearing on every aspect of holding company operations. Consequently, the Federal Reserve includes that factor in the evaluation of each of the principal elements of the bank holding company rating, as well as in the assignment of an overall holding company rating.

In addition to the individual elements described above, the Federal Reserve assigns each company an overall or composite rating, which has both a financial and managerial component. The financial composite rating is an overall evaluation of the ratings of each of the five principal elements of the holding company's operations as defined above. The financial composite rating is also based upon a scale of one through five in descending order of performance quality.

The managerial composite is a comprehensive evaluation of holding company management as reflected in the conduct of the affairs of the bank and nonbank subsidiaries and the parent company. The managerial composite is indicated by the assignment of a letter rating "S", "F", or "U". Respectively those letters

mean that the Federal Reserve has found management to be satisfactory, fair, or unsatisfactory.

The complete rating represents a summary evaluation of the bank holding company in the form of a rating fraction. The numerator of that fraction reflects the condition of the principal components of the holding company and assessments of certain key consolidated financial and operating factors. The denominator represents the composite rating, as defined in greater detail below, including both its financial and managerial components.

While the elements in the numerator represent the essential foundation upon which the composite rating is based, the composite does not reflect a simple arithmetic mean or rigid formula weighting of the individual performance dimensions. In the view of the Federal Reserve, any kind of formula could be misleading and inappropriate. Rather, the composite reflects the examiner's judgement of the overall condition of the bank holding company based upon his knowledge and experience with the company. Thus, the complete rating is displayed as follows

$\frac{BOPEC}{FM}$ (The highest rating possible is $\frac{11111}{1S}$)

The bank holding company rating system parallels the uniform interagency bank rating system to some degree by employing similar rating scales and performance definitions to evaluate both the individual elements and the summary or overall condition of the holding company. By using this framework, the Federal Reserve intends to provide for consistency and facilitate the adoption and use of the holding company rating system. The rating system is also sufficiently flexible to allow for appropriate differences in appraising shell bank holding companies.

Shell bank holding companies make up the majority of supervised bank holding companies, and involve a substantial volume of banking assets, thus, the rating system must also address them. For shell bank holding companies, the Federal Reserve follows a procedure similar to that so far described. However, in evaluating a shell bank holding company, the examiner assigns a "0" rating for many of the BOPEC elements: the other (nonbank) subsidiaries, consolidated earnings, and consolidated capital. The result is that the rating is made up of these elements for a shell bank holding company:

- The numerator reflects only the ratings of the bank and the parent (with emphasis on cash flow and debt servicing ability), bank; and
- The denominator includes both the financial and managerial elements of the composite rating.

For purposes of the rating, the FRB defines shell companies as bank holding companies that have total consolidated assets less than $150 million *and* that have no significant nonbank subsidiaries. For companies of $150 million or more in assets with no significant nonbank subsidiaries the examiners will assign a "0" for the "other subsidiary" component of the rating.

For non-shell companies under $150 million in consolidated assets with significant nonbank assets, the examiners will assign a rating that includes a component for the nonbank subsidiaries. Thus, these nonshell companies' ratings will include the bank, other nonbank, and parent components, but may exclude consolidated earnings and capital ratings if the needed figures for them are not available. As this scheme suggests, the FRB rates elements whenever they are relevant for a particular company. In practice, this means that

- All companies with $150 million or more in consolidated assets should be given a complete rating,
- Shell companies should receive a rating for the bank and parent components and both composites; and
- Nonshell companies under $150 million in assets *with* significant nonbank operating subsidiaries should receive a rating that includes a nonbank

component.

The FRB gives the examiner discretion to include ratings of consolidated earnings and capital for non-shell companies, if the figures are available or if they are necessary to reflect overall condition.

Financial Composite Rating

The Federal Reserve defines the live composite ratings in words that closely parallel those of the CAMELS and UITRS systems. Therefore the ratings can be described in this shorthand:

- Composite 1 - Sound in almost every respect;
- Composite 2 - Fundamentally sound, limited supervision required;
- Composite 3 - A combination of weaknesses which pose only a limited threat to the company's viability, more than normal supervision required;
- Composite 4 - An immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory requiring close supervision; and
- Composite 5 - The weaknesses are so critical as to require urgent aid from shareholders or other sources to prevent insolvency; these companies require immediate corrective action and constant supervisory attention

Management Composite Rating

The management rating reflects an examiner's overall evaluation of the capabilities and competence of the management of the parent company and senior management of the bank(s) and nonbank subsidiaries. The assessment of management will be unique to each holding company, reflecting its particular situation. Business complexities and operating problems vary with the size and type of holding company activity; management that is competent to effectively discharge responsibilities under one set of conditions may be less competent as these conditions change. In addition to objective operating results, regulators use important subjective considerations in assessing management performance include the following :-

1. Ability to identify and control major sources of risk;
2. Technical competence, leadership, administrative ability and oversight,

management depth, and succession;

3. Knowledge of and compliance with the Bank Holding Company Act and related regulations, and all other relevant laws and regulations;
4. History of serving the banking needs of the community;
5. Ability to plan and respond to changing circumstances;
6. Ability of parent management to monitor and direct subsidiary operations in order to ensure prudent operation and compliance with established holding company policies;
7. Adequacy and scope of internal audit systems and controls and evaluation of them as contained in audit reports; and
8. Attitude toward risk as indicated by any undue reliance on resources of subsidiary bank(s) to support nonbank activities.

A rating of **satisfactory** (S) indicates a management that is fully effective with respect to almost all factors. Management is responsive and has the ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the parent's or subsidiaries' affairs. Management rated satisfactory is knowledgeable concerning relevant laws and regulations, and has demonstrated an understanding of the need to insulate the subsidiary bank(s) from any undue risk associated with nonbank activities.

A rating of **fair** (F) reflects performance that is lacking in some measure of ability that would be desirable to meet responsibilities necessitated by various situations that management must address. Either management has modest talent when above average abilities are called for, or it is distinctly below average for the type and size of organization in which it operates. Thus, its responsiveness or ability to correct less than satisfactory condition may be lacking. Management rated fair may reflect a less than satisfactory understanding of relevant hiolding company laws and regulation.

A rating of **unsatisfactory** (U) indicates a management that is demonstrably inferior or incompetent in relation to the responsibilities or problems it faces. The U rating may also indicate that management is inclined to subject the

subsidiary bank(s) to excessive or unwarranted risk as a result of the activities of the non- bank subsidiaries. Problems resulting from management weakness are so severe that management must be strengthened or replaced before the company can return to a sound condition.

Performance Evaluation (on each Component - Component rating)

The federal reserve evaluates the components of holding company operations (Bank s subsidiaries, non-bank subsidiaries parent only, consolidated earnings, consolidated capital, and risk management) on the five - point scale.

9. Rating No. 1- Strong performance i.e. significantly highere than average. There is no need for supervisory concern.
10. Rating No. 2- satisfactory perfdormance i. e. average or above that adequately provides for the safe and sound operation of the bank holding company and its subsidiaries.
11. Rating No. 3- Fair performance that is neither satisfactory nor marginal but is characterized by performance of below average quality requiring management attention to prevent further deterioration.
12. Rating No. 4- Marginal performance i.e. significantly below average which, if unchecked, might evolve in to conditions that could threaten the viability of the institution.
13. Rating No.5- Unsatisfactory performance i.e. critically deficient and in need of immediate remedial attention. This level of performance by itself. or in combination with other weaknesses, could threaten the viability of the institution.

Bank Condition (B)

The bank condition component reflects the overall condition of the banking subsidiary or subsidiaries. For this purpose, examiners use the subsidiary bank CAMELS composite rating(s). For multibank companies, they will weight each bank's composite rating according to its asset size to arrive at an average bank composite rating. Weighting implies that, in most cases, the bank condition component in the holding company rating system will usually reflect the lead bank's composite according to the bank rating system (CAMELS).

A problem bank could go unnoticed in a multibank holding company whose bank condition component, based on weighted averages, is acceptable (i.e. , bank condition ratings of 1, 2 or 3). To highlight the presence of a 4- or 5- rated bank in the multibank system, the Federal Reserve attaches a problem identifier "P". to the bank condition rating e.g. 1P', 2P', 3P'). For example, a 2P' condition rating indicates that the banking subsidiaries are generally rated satisfactory but a problem bank (composite 4 or 5) exists among the banking subsidiaries. Although the bank condition component is a weighted average, it can be adjusted for subjective, judgemental reasons at the discretion of the examiner.

Other (Nonbank) Subsidiaries

The other subsidiaries rating is an assessment of the condition of the nonbank subsidiaries in the context of their overall impact on the financial condition of the holding company and the subsidiary bank(s).
The examiner emphasizes the asset quality of credit-extending subsidiaries and the profitability and operating soundness of noncredit-extending subsidiaries in making this rating. The other subsidiaries evaluation requires the regulator to concentrate on the quality and condition of these nonbank assets

- The underlying assets of credit-extending nonbank subsidiaries; and
- The parent's investment in and advances to noncredit-extending subsidiaries.

Poorly run servicing or other noncredit-extending subsidiaries can pose significant risk exposure to the holding company, thus the Federal Reserve requires a review of the flow of funds to these subsidiaries. These subsidiaries can expose the parent to the risks of operating losses or off-balance sheet items, such as guarantees. In many cases, because noncredit-extending subsidiaries are not heavy borrowers from external sources, the examiner will use the parent's investments in and advances to these companies as a proxy for the size of their operations.

The Federal Reserve will quantify the degree of risk associated with the **noncredit-extending subsidiaries** by classifying the parent's investments in

and advances to those subsidiaries if the examiner can meaningfully classify the financial condition of the subsidiaries or the characteristics of their assets.This classification might occur, for instance, if the subsidiaries' historical earnings records have not, in the examiner's judgement, adequately accounted for the development of clearly identifiable loss potential associated with the entity's operations. If the examiner cannot make a conventional classification of the investments in or advances to the noncredit-extending subsidiaries, the examiner will analyse the risk exposureposed by the noncredit-extending subsidiaries. The analysis will parallel that for any asset appraisal, with the examiner giving particular attention to the subsidiary's purpose and operating efficiency, management reporting procedures, and profitability. Foreign subsidiaries are subject to the same assessment.

For evaluating the risk associated with **credit-extending subsidiaries**, the regulator will look to the classification of the underlying assets of the subsidiaries. The weights assigned to problem investments and classified assets reflect the severity of their problems; 100 percent of "loss", 50 percent of "doubtful," and 20 percent of "substandard".

In rating nonbank activities the examiner's first step is to appraise their significance to the company's overall financial performance. The appraisal should focus on the potential loss exposure these activities pose to the bank holding company. As a general rule, the Federal Reserve will rate other subsidiaries whenever nonbank assets exceed 5 percent of consolidated capital or $10 million, whichever is lower. The examiner may rate other subsidiary assets that do not meet the significance conditions if not to do so would significantly misrepresent the condition of the holding company.
In rating nonbank activities the examiner considers:

14. The relaltionship of problem investments in and advances to noncredit-extending subsidiaries plus classified assets in the credit-extending nonbank subsidiaries to total nonbank assets;

15. The relationship of problem investments and advances plus classified assets to the sum of parent company and nonbank valuation reserves and ex-bank consolidated equity capital, or other appropriate measure;
16. The ability of nonbank management to supervise and exercise overall control over nonbank subsidiary operations complying with sound asset administration, and established holding company policies and relevant laws and regulations; and
17. Management attitudes toward risk as indicated by any undue reliance on resources of affiliated bank(s) to support nonbank subsidiaries.

In addition, the examiner may consider other relevant factors such as profitability, operating efficiency, management controls, reporting procedures, and any other relevant factors that may be necessary to assess the condition of the nonbank subsidiaries.

An asset quality **rating of 1** indicates sound, well-managed nonbank operations, investments, and loan portfolios raising no supervisory concerns.

A **2 rating** indicates the existence of some asset problems or other minor operational weaknesses warranting minimal supervisory concern. Problems associated with a 2 rating can readily be resolved in the normal course of business.

A **3 rating** represents the existence of deficiencies that, if left unchecked could cause substantial deterioration and have an adverse impact on the banking subsidiaries.

A **4 rating** represents an increased need for supervisory surveillance and concern due to any combination of poor operations, weak management, or severe asset problems affecting the holding company or the banking subsidiaries.

A **5 rating** applied to a critical level of nonbank problems.

Parent Company

The parent company rating reflects a parent company's ability to service its debt and other fixed obligations. It is also an evaluation of the quality of direct

parent credit extensions to entities that are not subsidiaries of the holding company.

In analysing the parent company, the Federal Reserve will consider its ability to generate adequate cash flow from its ongoing operations and the liquidity of its assets. The analysis also takes into account the capacity of the parent company to safely obtain liquidity from its subsidiaries by, for example, the prudent upstreaming of additional subsidiary dividends.

The examiner will analyze these factors:

18. The volume and composition of parent company debt, and resulting cash flow needs;
19. The maturities of parent company borrowings compared with the maturities of the investments that they fund;
20. The quality of credits to nonaffiliated companies;
21. The parent's ability to convert assets readily to cash without incurring serious loss or adversely affecting the banking subsidiaries;
22. Management's ability to plan for liquidity and cash flow needs and respond to changing conditions in the markets for short-term funds;
23. The company's ability to obtain long and short-term funds on reasonable terms, and the existence of firm backup lines of credit;
24. The reasonableness of any management or service fees a bank subsidiary pays to the parent;
25. The company's performance in meeting past and current servicing requirements; and
26. Parent management's ability to ensure prudent operation, sound asset administration, and compliance with established holding company policies and relevant laws and regulations.

Examiners will review a shell company in a similar manner. The major consideration in a shell company is cash flow to service parent company debt because of the likely effect on the subsidiary bank's capital position. In addition, the examiner will compare the amount of parent company debt to the parent's proportionate interest in the subsidiary bank's equity capital.

A **parent company rating of 1** indicates that the holding company can readily generate cash flow that is more than adequate to service its debt obligations and other cash flow needs and provide for the smooth rollover of debt without adverse affect on its subsidiaries.
The rating also reflects good management and the absence of significant asset problems.

A **2 rating**, while reflecting a fundamentally sound situation, indicates a possible trend toward tighter liquidity due to lower earnings, asset quality, or other relevant operating indices.
A **rating of 3** represents a decidedly tight, but still manageable, cash flow situation. The company will likely have little or no liquidity in its asset portfolio or it may be overly dependent on potentially harmful dividends and fees from its subsidiaries. The 3 rating reflects increasing difficulty for the parent company in obtaining short-term funds on favorable terms.
A **rating of 4** indicates serious cash flow problems because of severe asset deterioration or poor or no corporate earnings. Companies rated 4 may be seriously draining funds from bank subsidiaries to service cash flow needs and may be completely unable to serve as a source of funds or financial strength to their subsidiaries.
A **rating of 5** may represent an inability to enter money markets. The problems represented by a rating of 5 reflect an imminent danger of default or insolvency of the parent company.

Earnings – Consolidated

The Federal Reserve bases the rating of earnings on the assessment of fully consolidated profitability. Fully consolidated profitability serves as a source of financial strength and capital growth for the entire organization.

Profitability has two dimensions, quantity and quality, both of which an examiner will incorporate into the evaluation of earnings. Quantity refers to the absolute level of net income and its adequacy in relation to the considerations listed below. The appraisal of quality is an attempt to determine the strength of operating earnings and the degree to which earnings reflect the impact of unusually large securities gains or losses, unusual tax items, or other large, nonrecurring, extraordinary gains or losses. Quality of earnings also refers to the effect on net income of adequately providing additions to the loan loss reserve in order to properly recognize the impact of poor, overstated, or loss assets carried on the balance sheet. In the judgement of the Federal Reserve, consolidated net income that relies unduly on unusually large, nonrecurring gains or that fails to reflect adequate loan loss provisions is of lower quality than net income of equal magnitude that reflects strong operations and adequate loss provisions.

Generally, an examiner will rate consolidated earnings since the prior inspection with emphasis given to the most recent year's performance. The considerations in the earnings evaluation are:

27. The return on consolidated assets, historical earnings trends, and peer group comparisons;
28. The quality of earnings as reflected by the extent of reliance on nonrecurring gains or losses or unusual tax effects and the sufficiency of loss provisions in view of the condition of the asset portfolio and the adequacy of the loan loss reserves;
29. The ability to cover chargeoffs, maintain public confidence, and provide for the safe ongoing operation of the company;

30. Management's ability to plan and devise realistic earnings projections in light of the risk structure and quality of assets;
31. The outlook for earnings as implied by the current risk structure and quality of assets; and
32. The ability of earnings to provide for the growth of capital in light of recent and planned asset growth.

Earnings rated 1 are sufficient to make full provision for the absorption of losses and accretion of capital after considering asset quality and bank holding company growth. Generally, 1-rated holding companies will have earnings well above peer group averages.

A company whose earnings are relatively static or even moving downward may receive a **2 rating** provided its level of earnings is adequate to absorb losses and build capital. A company with a 2 rating will have earnings that are in line with or slightly above peer group norms.

A **3 rating** should be accorded to earnings that are not fully adequate to make sufficient provisions for the absorption of losses and the accretion of capital in relation to company growth. The earnings pictures of such companies may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less than satisfactory asset quality.

Earnings rated 4, while generally positive, are clearly not adequate to make full provision for losses and the necessary accretion of capital. Companies with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings (and the likelihood of the development of a further downward trend), intermittent losses, chronically depressed earnings, or a substantial drop from the previous year. Earnings of 4-rated companies are ordinarily substantially below peer group averages.

Bank holding companies with earnings accorded a **5 rating** are experiencing losses or reflecting a level of earnings that, if not reversed, could represent a

distinct threat to the holding company's solvency through the erosion of capital.

Capital Adequacy – Consolidated.

The Federal Reserve evaluates capital of a holding company with regard to the volume and risk of the operations of the consolidated corporation. It is the holding company's capital on a consolidated basis that the Federal Reserve believes must serve as the ultimate source of support and strength to the entire corporation.

For an examiner to consider capital adequate, holding company capital must:

- ♦ Support the volume and risk characteristics of all parent and subsidiary activities;
- ♦ Provide a sufficient cushion to absorb unanticipated losses arising from holding company and subsidiary activities;
- ♦ Support the level and composition of corporate and subsidiary borrowing; and
- ♦ Serve as a source of strength by providing an adequate base for the growth of risk assets and permitting entry into the capital markets as the need arises.

An essential step in the analysis of capital is the assessment of the risk characteristics and capital requirements deriving from the lending activities and operations of the parent and each of the operating subsidiaries.

Examiners will review capital based on these considerations:

33. The relationship of consolidated capital to consolidated assets as reflected in The ratio of primary capital to consolidated assets and the ratio of total capital to consolidated assets;
34. The capital requirements that derive from the asset quality and risk Associated with each holding company activity;
35. The relationship of consolidated debt to primary capital;
36. The extent the company relies on long-term debt for its capital;
37. The extent the parent uses debt to fund capital investments in subsidiaries;

38. The trends of indices of capital adequacy and peer group ratio comparisons;

39. The management's ability to devise adequate capital plans and retention policies to correct any capital deficiency or planned expansion of risk assets;

40. The company's capacity to enter capital markets or tap other sources of long-term debt and equity;

41. The extent of any balance sheet concentration in any category or related categories of intangible assets, particularly those in excess of the 25 percent threshold, including the reasonableness of the amortization periods of those assets,

42. The relationship of high or inordinate off-balance sheet exposure to primary capital; and

43. Whether the BHC's consolidated capital position at least equals the sum of the capital requirements of the bank and nonbank subsidiaries as well as those of the parent company.

While the Federal Reserve will apply the ratio guidelines to both the bank and its holding company, the agency believes it is the consolidated entity's financial condition and strength that will ultimately determine the condition of the banking organization. To some extent strong consolidated holding company capital positions may offset minor deficiencies in the bank subsidiaries. However, bank capital positions, particularly those that reflect double leveraging, generally do not alleviate consolidated holding company capital deficiencies.

Regulators expect that banks and holding companies will satisfy both the minimum primary and total capital requirements. While both measures are important, the minimum level of primary capital to total assets is the critical first test of an institution's compliance with the guidelines. In meeting the total capital guidelines, examiners may consider secondary components of capital. However, an organization should not unduly rely on secondary components of capital simply to meet the total capital requirements, especially when conditions do

not warrant additional debt. Any reliance on or issuance of debt or limited-life preferred stock to augment total capital should be consistent with the institution's overall financial condition and the general factors that are weighed in approving subordinated debt issues.
Strong primary capital positions may to some degree offset somewhat low total capital positions. Generally, however, primary capital positions below guideline minimums cannot be offset by higher total capital ratios.

The capital adequacy guidelines establish rating benchmarks for consolidated capital in the BOPEC system. While the capital guidelines will apply to the rating systems, ratings will continue to be a function of all the relevant objective and qualitative factors affecting an institution's financial condition that are set forth in the rating system.

The Federal Reserve rates holding company capital in Zones and the BOPEC capital ratings are tied to those Zones. Primary capital ratios exceeding the guideline minimum and total **capital ratios in Zone 1** will justify capital ratings in the BOPEC analysis of 1 (strong) or 2 (satisfactory), depending upon the value of the ratios and provided asset quality is on balance satisfactory for a capital rating of 1 or fair for a capital rating of 2.

A **total capital ratio in Zone 2** generally indicates a BOPEC analysis capital rating of 3 (fair) or possibly 4 (marginal). The latter rating is more likely in the event that the primary capital ratio is below the minimum guideline ratio or if low total capital ratios are combined with serious asset problems. Institutions in Zone 2 with particularly strong primary ratios may qualify for satisfactory capital ratings, depending upon the level of the total capital ratio and overall asset quality.

Total capital ratios in Zone 3 or primary ratios below the minimum level imply capital ratings of 3(fair), 4(marginal) or possibly 5. Institutions in Zone 3 with

primary ratios above the minimum may qualify for a rating of 3, provided asset quality is at least satisfactory. Primary ratios below the minimum or low total capital ratios combined with severe asset problems suggest ratings of 4 or 5. While high primary ratios may to some degree offset deficiencies in total capital ratios, high total capital ratios will not generally offset primary ratios below minimum acceptable levels.

Regulatory Risk: the Silent "R"

Consistent with the greater emphasis given to risk management in Federal Reserve examinations and supervisory policy statements, the BOPEC rating system has been revised to include a new risk management component similar to the new "S" component in the modified CAMELS rating system. Since 1996, examiners assign a formal supervisory rating to the adequacy of a holding company's risk management processes, including its internal controls. This step is a natural extension of current procedures that incorporate an assessment of risk management and internal controls during each on-site, full-scope examination.

The new risk management rating is a significant factor examiners consider when evaluating management under the BOPEC rating system. Examiners place primary consideration on findings relating to the following four elements of a sound risk management system:

- Active board and management oversight;
- Adequate policies, procedures, and limits;
- Accurate and independent measurement procedures and assessments of risk; and
- Strong internal controls.

A greater focus on risk management does not, of course, diminish the importance of reviewing capital adequacy, asset quality, earnings, liquidity, and other areas

relevant to the evaluation of safety and soundness. Rather, the rating of the risk management process will bring together and summarize much of the analysis and many of the findings regarding an institution's process for managing and controlling risks. The formal rating is intended to highlight and incorporate both the quantitative and qualitative aspects of an examiner's review of an institution's overall process for identifying, measuring, monitoring, and controlling risk and to facilitate appropriate follow-up action.

Adequate risk management programs vary considerably in sophistication, depending on the size and complexity of the banking organization and the level of risk that it accepts. While all bank holding companies should be able to assess the major risks of the consolidated organization, parent companies that centrally manage the operations and functions of their subsidiary should have in place more comprehensive, detailed, and developed risk management systems than companies that delegate the management of risks to relatively autonomous banking subsidiaries.

Large, multinational organizations require far more elaborate and formal risk management systems in order to address their broader and typically more complex range of financial activities and to provide senior managers and directors with the information they need to monitor and direct day-to-day activities. For smaller institutions engaged solely in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, relatively basic risk management syst3ems may be adequate.

Like the other BOPEC components, the **risk management rating** is based on a five-point numeric scale. This rating reflects findings within all four elements of sound risk management mentioned above and is reflected in the examiner's overall rating of management.

A **rating of 1** indicates that management effectively identifies and controls all major types of risk posed by the institution's activities, including those from

new products and changing market conditions. The board and management actively participate in monitoring and managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide necessary information and analysis to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution.

A **2 rating** indicates that management of risk is largely effective, but lacking to some modest degree. While minor risk management weaknesses exist, these problems have been recognized and are being addressed. Overall, board and senior management's oversight policies and limits, risk monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.

A **3-rating** signifies risk management practices that are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management are considered fair, and have precluded the institution from fully addressing a significant risk to its operations. Certain risk management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control adequately all significant risks to the institution.

A **4-rating** represents marginal risk management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the board and management. Deficiencies warrant a high degree of supervisory attention. Unless properly addressed, these conditions may result in unreliable financial records or reports or operating losses that

could seriously affect the safety and soundness of the institution.

A **5-rating** indicates a critical absence of effective risk management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient and management and the board have not demonstrated the capability to address deficiencies. An immediate concern exists about the reliability of accounting records and regulatory reports and about potential losses that could result if management does not take corrective measures immediately. Deficiencies in risk management procedures and internal controls require immediate and close supervisory attention.

ANNEXURE XVI

(Cf. Paragraph 6.1)

An extract from the RBI Act, 1934, relating to the Financial Institutions

Power of Bank to call for Information from financial institutions and to give directions

45L.(1) If the Bank is satisfied for the purpose of enabling it to regulate the credit system of the country to its advantage it is necessary so to do, it may –

a) require financial institutions either generally or any group of financial institutions or financial institution in particular, to furnish to the Bank in such form, at such intervals and within such time, such statements, information or particulars relating to the business of such financial institutions or institution, as may be specified by the Bank by general or special order;

b) give to such institutions either generally or to any such institution in particular, directions relating to the conduct of business by them or by it as financial institutions or institution.

(2) Without prejudice to the generality of the power vested in the Bank under clause (a) of sub-section (1), the statements, information or particulars to be furnished by a financial institution may relate to all or any of the following matters, namely, the paid-up capital, reserves or other liabilities, the investments whether in Government securities or otherwise, the persons to whom, and the purposes and periods for which, finance is provided and the terms and conditions, including the rates of interest, on which it is provided.

(3) In issuing directions to any financial institution under clause (b) of sub-section (1), the Bank shall have due regard to the conditions in which, and the objects for which, the institution has been established, its statutory responsibilities, if any, and the effect and business of such financial institution

is likely to have on trends in the money and capital markets.

Inspection.

45N (1) The Bank may, at any time, cause an inspection to be ma one or more of its officers or other persons (hereafter in this section refe as the inspecting authority) –

(i) of any non-banking institution, including a financial instituti the purpose of verifying the correctness or completeness statement, information or particulars furnished to the Bank the purpose of obtaining any information or particulars whi non-banking institution has failed to furnish on being callec to do so; or

(ii) of any non-banking institution being a financial institution, Bank considers it necessary or expedient to inspect that insti

(2) It shall be the duty of every director or member of any Commit other body for the time being vested with the management of the affairs non-banking institution or other officer or employee thereof to produce inspecting authority all such books, accounts and other documents in his cı or power and to furnish that authority with any statements and information re to the business of the institution as that authority may require of him, such time as may be specified by that authority.

(3) The inspecting authority may examine on oath any director or me of any Committee or body for the time being vested with the managem the affairs of the non-banking institution or other officer or employee ther relation to its business and may administer an oath accordingly.

Power of Bank to collect information from non-banking institutions deposits and to give directions.

45K (1) The Bank may at any time direct that every non-banking inst shall furnish to the Bank, in such form, at such intervals and within such

such statements, information or particulars relating to or connected with deposits received by the non-banking institution, as may be specified by the Bank by general or special order.

(2) Without prejudice to the generality of the power vested in the Bank under sub-section (1) the statements, information or particulars to be furnished under sub-section (1), may relate to all or any of the following matters, namely, the amount of the deposits, the purposes and periods for which, and the rates of interest and other terms and conditions on which, they are received.

(3) The Bank may, if it considers necessary in the public interest so to do, give directions to non-banking institutions either generally or to any non-banking institution or group of non-banking institutions in particular, in respect of any matters relating to or connected with the receipt of deposits, including the rates of interest payable on such deposits, and the periods for which deposits may be received.

(4) If any non-banking institution fails to comply with any direction given by the Bank under sub-section (3), the Bank may prohibit the acceptance of deposits by that non-banking institution.

(5) (...)

(6) Every non-banking institution receiving deposits shall, if so required by the Bank and within such time as the Bank may specify, cause to be sent at the cost of non-banking institution a copy of its annual balance-sheet and profit and loss account or other annual accounts to every person from whom the non-banking institution holds, as on the last day of the year to which the accounts relate, deposits higher than such sum as may be specified by the Bank.