

# **INDIA'S FINANCIAL SECTOR AN ASSESSMENT**

**Volume IV**

**Advisory Panel  
on  
Financial  
Regulation and Supervision**

**Committee on Financial Sector Assessment**

**March 2009**



**भारत सरकार  
GOVERNMENT OF INDIA**



**भारतीय रिज़र्व बैंक  
RESERVE BANK OF INDIA**

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## Composition of the Advisory Panel on Financial Regulation and Supervision

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Shri M.S.Verma	Former Chairman State Bank of India	Chairman
Shri Nimesh Kampani	Chairman JM Financial Consultants Pvt. Ltd.	Member
Shri Uday Kotak	Executive Vice Chairman and Managing Director Kotak Mahindra Bank Ltd.	Member
Shri Aman Mehta	Former Chief Executive Officer Hong Kong and Shanghai Banking Corporation	Member
Dr. M.T.Raju	Professor and In-charge Indian Institute of Capital Markets	Member
Smt. Shikha Sharma	Managing Director ICICI Prudential Life Insurance Co.	Member
Shri U.K.Sinha	Chairman and Managing Director UTI Asset Management Co. Pvt. Ltd.	Member

### Special Invitees

Shri G.C.Chaturvedi	Joint Secretary (Banking and Insurance) Department of Financial Services Ministry of Finance Government of India	
Dr. K.P.Krishnan	Joint Secretary (Capital Markets) Department of Economic Affairs Ministry of Finance Government of India	
Shri Amitabh Verma	Joint Secretary (Banking Operations) Department of Financial Services Ministry of Finance Government of India	
Shri Anand Sinha	Executive Director Reserve Bank of India	
Shri C.R.Muralidharan	Member Insurance Regulatory and Development Authority	
Smt Usha Narayanan	Executive Director Securities and Exchange Board of India	
Shri Arun Goyal	Director Financial Intelligence Unit Government of India	

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## Chapter I

### Approach to Assessment

#### 1. Approach To Assessment

The Government of India in consultation with the Reserve Bank constituted the Committee on Financial Sector Assessment (CFSA) in September 2006, with a mandate to undertake a comprehensive assessment of the Indian financial sector focusing upon stability and development. The CFSA was chaired by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India. The Co-Chairmen were Shri. Ashok Jha, Dr. D. Subbarao and Shri. Ashok Chawla, Secretary Economic Affairs, Government of India. The Committee also had officials from the Government of India as its members.

Taking into account the legal, regulatory and supervisory architecture in India, it was felt that there was a need for involving and associating closely all the major regulatory institutions, *viz.*, The Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA), in addition to representatives from the Government for this exercise. In order to leverage the available expertise to the maximum permissible extent, it was also deemed fit to involve, besides the regulatory authorities other agencies as relevant to the work.

To assist the Committee in the process of assessment, the CFSA constituted four Advisory

Panels for Financial Stability Assessment and Stress Testing, Financial Regulation and Supervision, Institutions and Market Structure and Transparency Standards respectively in August 2007. While the Panel on Financial Stability Assessment and Stress Testing conducted macro-prudential surveillance to assess the soundness and stability and developmental aspects of financial system, the other three Panels identified and evaluated the implementation of relevant standards and codes in different areas. All Panels have dealt with measures for strengthening the financial system from a medium-term perspective. The Panels were assisted by Technical Groups comprising mainly of officials from relevant organisations to provide technical inputs and data support, as appropriate to the respective Advisory Panels. A Secretariat was constituted within the Monetary Policy Department (MPD) in the Reserve Bank to provide logistical and organisational support to the Advisory Panels and Technical Groups.

#### **Advisory Panel on Financial Regulation and Supervision**

As part of the assessment of standards and codes, the terms of reference of the Advisory Panel on Financial Regulation and Supervision were to identify and consider the relevant standards and codes as currently prescribed and applicable for financial

regulation and supervision pertaining to the banking sector, securities markets and insurance and evaluate their implementation in the Indian context; identify the gaps in adherence to these standards and codes and the reasons therefor; and suggest possible roadmaps addressing, *inter alia*, the developmental issues relating to these standards and codes, in the medium-term perspective. The Advisory Panel chaired by Shri M S Verma comprised of non-official experts as members and officials representing Government and other agencies as special invitees – **Annex A**.

#### **Technical Group on Financial Regulation and Supervision**

A Technical Group comprising of officials drawn from Government and other agencies who are directly associated with / handling respective areas of work assisted the Advisory Panel in preparing preliminary assessments and background material which served as inputs to the Advisory Panels work (Please see **Annex B** for the composition of the Technical Group and terms of reference). Apart from the officials indicated in the **Annex B** the Panel also benefited from the inputs of the officials indicated in **Annex C**. The IRDA formed its own Technical Group for assessment of IAIS Core Principles for Insurance Regulation – **Annex D**.

#### **Approach and Methodology**

The Technical Group identified the Basel Core Principles (BCPs) (2006) as the relevant standard applicable to the assessment of the banking sector. In addition to the adherence to the BCPs regarding supervision of

commercial banks, the Group also assessed the adherence of the core principles in other relevant and closely related areas such as the urban co-operative banking sector, rural credit institutions and non-banking financial companies including housing finance companies. The template developed by IMF/World Bank for conducting FSAP was utilised for the assessment.

Likewise, the IOSCO Principles (2003) were identified as the relevant international standard applicable to assess the regulation and supervision in respect of securities market. The assessment of implementation of IOSCO principles encompassed besides corporate bond, equities and government securities markets, money and foreign exchange markets to the extent found relevant and applicable. The IOSCO templates in conjunction with the format developed by IMF/World Bank was utilised to make the assessment.

The adherence to Core Principles of the International Association of Insurance Supervisors (IAIS) (2003) was identified as the relevant international standard for the insurance sector. The IMF/World Bank FSAP templates was utilised for the assessment.

The preliminary assessments made by the Technical Groups were considered by the Advisory Panel with closer involvement of three sub-panels (**Annex E**) in the areas of Banking Supervision (Basel Core Principles), Securities Market Regulation (IOSCO Principles) and Insurance Regulation (IAIS Core Principles).

The Advisory Panel had a total of five meetings to consider the assessments and

recommendations and to finalise the report. In addition, the sub-panel on Basel Core Principles (BCPs) had three meetings, sub-Panel on IOSCO principles had two meetings and sub-Panel on IAIS Principles had three meetings.

#### **Peer review**

At the request of the CFSA, five international experts on areas relating to banking supervision, supervision of securities markets and insurance sector supervision peer reviewed the draft reports on respective assessments and recommendations

#### **– Annex F.**

The Advisory Panel considered in depth the comments made by the peer reviewers and appropriately modified the report after incorporating the comments /suggestions. The Panel had also the option to differ with peer reviewers' comments, if they considered appropriate particularly in the Indian context. In the interest of transparency, the comments of the peer reviewers and the stance taken by the Panel are provided appropriately in respective parts of this report.

#### **Scheme of the Report**

The report is divided into six major Chapters. Following this, Chapter 2 considers some overarching issues pertinent to all regulators. Chapter 3 covers assessment of the Basel Core Principles (BCPs). The assessment covers primarily commercial banks, but as relevant and applicable, also covers Urban Co-operative Banks (UCBs), State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs), Regional Rural Banks (RRBs), Non-banking Finance Companies (NBFCs) and Housing Finance Companies HFCs).

Chapter 4 covers the assessment of IOSCO principles covering primarily equities and corporate bond market and government securities market, but as relevant and applicable also covers money market and foreign exchange market.

Chapter 5 covers the assessment of IAIS Core principles covering essentially insurance companies which are registered with the supervisor.

Chapter 6 concludes with a summary of recommendations pertaining to all issues and assessments.

## Annex A

**RESERVE BANK OF INDIA  
CENTRAL OFFICE,  
SHAHID BHAGAT SINGH ROAD,  
MUMBAI – 400 001, INDIA**

## MEMORANDUM

**Constitution of Advisory Panel on Financial Regulation and Supervision**

A Committee on Financial Sector Assessment (CFSA) has been constituted by the Government of India (GoI) in consultation with the Reserve Bank with the objective of undertaking a self-assessment of financial sector stability and development. One of the analytical components of Financial Sector Assessment would encompass a comprehensive assessment of the status and implementation of various international financial standards and codes.

2. In this connection the CFSA has decided to constitute an Advisory Panel on Financial Regulation and Supervision comprising the following:

Sr. No	Name	Designation/Institution	
1.	Shri M.S.Verma	Former Chairman, State Bank of India	Chairman
2.	Shri Nimesh Kampani	Chairman, JM Financial Consultants Pvt. Ltd.	Member
3.	Shri Uday Kotak	Executive Vice Chairman and Managing Director, Kotak Mahindra Bank Ltd.	Member
4.	Shri Aman Mehta	Former Chief Executive Officer, Hong Kong and Shanghai Banking Corporation	Member
5.	Dr. M.T.Raju	Professor and In-charge, Indian Institute of Capital Markets	Member
6.	Smt Shikha Sharma	Managing Director, ICICI Prudential Life Insurance Company	Member
7.	Shri U.K.Sinha	Chairman and Managing Director, UTI Asset Management Co. Pvt. Ltd.	Member



3. In addition, the Advisory Panel can utilise the expertise of the following *ex-officio* Special Invitees:

Sr. No	Name	Designation/Organisation
1.	Shri G.C.Chaturvedi	Joint Secretary (Banking and Insurance), Government of India
2.	Dr. K.P.Krishnan	Joint Secretary (Capital Markets), Government of India
3.	Shri Amitabh Verma	Joint Secretary (Banking Operations), Government of India
4.	Shri Anand Sinha	Executive Director, Reserve Bank of India
5.	Shri C.R.Muralidharan	Member, Insurance Regulatory and Development Authority
6.	Smt Usha Narayanan	Executive Director, Securities and Exchange Board of India
7.	Shri Arun Goyal	Director, Financial Intelligence Unit, Government of India

4. The Advisory Panel will have the following terms of reference:

- (i) to identify and consider the relevant standards and codes as currently prescribed and applicable for financial regulation and supervision pertaining to the banking sector, securities markets and insurance and evaluate their implementation in the Indian context;
- (ii) to identify the gaps in adherence to the respective standards and codes and the reasons therefor; and
- (iii) to suggest possible roadmaps addressing, *inter alia*, the developmental issues relating to respective standards and codes, in a medium-term perspective.

5. The Advisory Panel would have the option of co-opting as Special Invitees any other experts as they deem fit.

6. The secretarial assistance to the Advisory Panel will be provided by the Reserve Bank. The Technical Groups on Financial Regulation and Supervision constituted by the Reserve Bank and the Insurance Regulatory and Development Authority (IRDA) at the instance of the Committee have already progressed with the technical work with regard to above terms of reference. The technical notes and background material prepared by these groups would *inter alia* form the basis for discussion by the Panel and in drafting of the Report.

7. The Advisory Panel will prepare a detailed Report covering the above aspects and the Government of India (GoI) The Reserve Bank will have the discretion of making the Report public, after a peer review, as they may deem fit.

8. The Advisory Panel is expected to submit its Report in about three months from the date of its first meeting.

(Rakesh Mohan)

Mumbai  
August 10, 2007

Deputy Governor and  
Chairman of the Committee on Financial Sector Assessment

## Annex B

**RESERVE BANK OF INDIA  
CENTRAL OFFICE,  
SHAHID BHAGAT SINGH ROAD,  
MUMBAI – 400 001, INDIA**

**DEPUTY GOVERNOR**

**MEMORANDUM**

**Constitution of Technical Group on Financial Regulation & Supervision**

The Committee on Financial Sector Assessment (CFSA) will undertake a self-assessment of financial sector stability and development. One of the analytical components of Financial Sector Assessment would encompass a comprehensive assessment of the status and implementation of various international financial standards and codes. CFSA has decided to constitute a Technical Group on Financial Regulation & Supervision comprising the following:

<b>Sr. No.</b>	<b>Name</b>	<b>Designation/Organisation</b>	
1.	Shri G. Gopalakrishna*	Chief General Manager-in-charge, RBI	Member
2.	Shri A. K. Khound	Chief General Manager, RBI	Member
3.	Shri G. Srinivasan	Chief General Manager, RBI	Member
4.	Shri G Mahalingam	Chief General Manager, RBI	Member
5.	Dr. K V Rajan	Chief General Manager, RBI	Member
6.	Dr. Janak Raj	Adviser, RBI	Member
7.	Shri Shekhar Bhatnagar	General Manager, RBI	Member
8.	Shri K. Damodaran	General Manager, RBI	Member
9.	Shri Ananta Barua	Legal Adviser, SEBI	Member
10.	Shri P K Goel	Additional Director, Financial Intelligence Unit	Member
11.	Shri K. Kanagasabapathy	Secretary to CFSA	Convenor

\* now Executive Director, Reserve Bank of India

2. The Group will have the following terms of reference:
  - (i) to identify the relevant standards and codes as currently prescribed and applicable for financial regulation & supervision pertaining to the banking sector, securities market, insurance and market integrity; and
  - (ii) to compile relevant data and information on follow-up of earlier assessments and recommendations made by the earlier FSAP and also internally by the Standing Committee on International Financial Standards and Codes on the relevant standards; and
  - (iii) to contribute to technical work in the relevant area and provide a fair and independent assessment on the matters under the consideration of the Technical Group; and
  - (iv) to identify the gaps in adherence to the respective standards and codes and the reasons therefor; and
  - (v) to suggest possible roadmaps addressing, *inter-alia*, the developmental issues, in the medium term perspective; and
  - (vi) to provide such inputs for discussion to the relevant Advisory Groups constituted by the Reserve Bank and other regulatory agencies.
3. The Group would function under the overall guidance of Shri V. K. Sharma, Executive Director, Reserve Bank of India. Shri Anand Sinha, Executive Director, Reserve Bank of India will be a permanent invitee.
4. The Group will also be guided by decisions taken in the Advisory Panel for Financial Regulation & Supervision.
5. A list of Special Invitees who could act as resource persons to the Group and whose expertise can be called upon by the Group while preparing inputs for the Advisory Panels is provided in the Annex C. The Group may co-opt as special invitees, one or more of the identified officials, or any other officials from RBI, Government or other agencies as they deem appropriate.
6. The Group is expected to complete its task in the minimum possible time which, in any case, would not go beyond three months from the date of its constitution.

(Rakesh Mohan)

Mumbai  
March 1, 2007

Chairman

## Annex C

**List of officials who assisted the Advisory Panel**

The Panel has also benefited considerably from the inputs provided by following officials from different agencies.

<b>Sr. No.</b>	<b>Name</b>	<b>Designation</b>
1.	Shri V K Sharma	Executive Director, RBI
2.	Shri V S Das	Executive Director, RBI
3.	Shri S K Mitra	Executive Director, NABARD
4.	Shri A V Sardesai	former Executive Director, RBI
5.	Ms. Vani Sharma	former Chief General Manager, RBI
6.	Shri S.R. Kamath	former General Manger, Securities Trading Corporation of India

Further, the Panel also acknowledges the contributions made by the following officials in preparation of the draft reports.

<b>Sr. No.</b>	<b>Name</b>	<b>Designation</b>
1.	Shri P. Krishnamurthy	Chief General Manager-in-charge, RBI
2.	Shri Prashant Saran	Chief General Manager, RBI
3.	Shri Salim Gangadharan	Chief General Manager, RBI
4.	Shri Chandan Sinha	Chief General Manager, RBI
5.	Shri Vinay Baijal	Chief General Manager, RBI
6.	Smt. Surekha Marandi	Chief General Manager, RBI
7.	Shri B. B. Mohanty	Chief General Manager, NABARD
8.	Shri R C Sarangi	General Manager, RBI
9.	Shri Rakesh Bhalla	General Manager , NHB
10.	Shri P R Ravimohan	General Manager, RBI
11.	Shri K Bhattacharya	General Manager, RBI
12.	Shri Ramanathan Subramaniam	Deputy General Manager, RBI
13.	Shri Navin Bhatia	Deputy General Manager, RBI

14.	Shri P K Das	Deputy General Manager, RBI
15.	Smt. Molina Chaudhury	Deputy General Manager, RBI
16.	Shri Himanshu Mohanty	Deputy General Manager, RBI
17.	Shri. Susobhan Sinha	Deputy General Manager, RBI
18.	Smt. Anupam Sonal	Deputy General Manager, RBI
19.	Shri Aditya Gaiha	Deputy General Manager, RBI
20.	Shri Sunil T.S.Nair	Deputy General Manager, RBI
21.	Shri V I Ganesan	Deputy General Manager, NABARD
22.	Ms. Mamta Suri	Deputy Director, IRDA
23.	Shri Anup Kumar	Assistant General Manager, RBI
24.	Shri S Subbaiah	Assistant General Manager, RBI
25.	Shri Puneet Pancholy	Assistant General Manager, RBI
26.	Shri Prabhat Gupta	Assistant General Manager, RBI

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**Annex D**

**List of Members who were part of Technical Group for Assessment of  
IAIS Core Principles**

<b>Sr. No.</b>	<b>Name</b>	<b>Designation</b>
1.	Shri C.N.S. Shastri	Adviser, IRDA
2.	Shri N.M. Goverdhan	Former Chairman, LIC of India
3.	Shri K.N. Bhandari	Secretary General, General Insurance Council
4.	Shri Thomas Mathew	Managing Director, Life Insurance Corporation of India
5.	Shri Deepak M. Satwalekar	Chief Executive Officer, HDFC Standard Life Insurance Company Ltd.

## Annex E

### Details of Sub-Panels formed by the Advisory Panel on Financial Regulation and Supervision

<b>Sr. No.</b>	<b>Subject</b>	<b>Name/s of the peer reviewer/s</b>
1.	Banking Supervision (Basel Core Principles)	Shri M S Verma Shri Aman Mehta Shri Uday Kotak
2.	Securities Market Regulation (IOSCO Principles)	Shri Nimesh Kampani Dr. M T Raju Shri Uday Kotak
3.	Insurance Regulation (IAIS Core Principles)	Smt. Shikha Sharma Shri U K Sinha

**Annex F**

**List of Peer Reviewers who reviewed the Reports**

<b>Sr. No.</b>	<b>Subject</b>	<b>Name/s of the peer reviewer/s</b>
1.	Banking Supervision (Basel Core Principles)	Mr. Eric Rosengren, President and CEO, Federal Reserve Bank of Boston.
2.	Securities Market Regulation (IOSCO Principles)	1. Mr. Shane Tregillis, Deputy Managing Director, Monetary Authority of Singapore 2. Mr. Ranjit Ajit Singh, Managing Director, Securities Commission of Malaysia.
3.	Insurance Regulation (IAIS Core Principles)	1. Mr. Michael Hafeman 2. Mr. Carl Hiralal, Inspector of Financial Institutions, Trinidad and Tobago.





## Chapter II

### Overarching Issues

#### 1. Introduction

The Advisory Panel on Financial Regulation and Supervision was assigned the following tasks:

- (i) Assessment of Basel Core Principles
- (ii) Assessment of IOSCO Principles
- (iii) Assessment of IAIS Core Principles

The assessment of the Basel Core Principles covers commercial banks, urban co-operative banks, State Co-operative Banks, District Central Co-operative Banks, Non-Banking Finance Companies and Housing Finance Companies. The assessment of IOSCO principles covers the equities/corporate bond market, the Government Securities market, the money market and the foreign exchange market and their related derivatives. The assessment of IAIS Core Principles covers the insurance sector. The assessments in respect of all the three principles have been made not merely on the issuance of rules/guidelines by the regulatory authorities, but also taking into account the ground realities as regards the effective implementation of these rules/guidelines by the regulated entities. It reveals that the regulatory and supervisory structure of the Indian financial system is both elaborate and adequate. Over the years the regulatory and supervisory structure of

banks, insurance companies and markets has strengthened significantly and has acted as an effective mitigating factor against systemic vulnerability. The gradual and calibrated approach of the authorities in adopting a more liberal financial system has paid dividends and India has not been subject to any major financial stress for nearly 20 years. While assessing the regulatory and supervisory environment against accepted international benchmarks, the Panel feels that there is still some way to go in terms of the adoption of international best practices by India. Accordingly, the Panel has identified the major gaps in regulation and supervision and recommended the way forward from a medium-term perspective by providing specific recommendations. Certain overarching issues across sectors/markets have also arisen during the course of the assessment. These are delineated in Section 2.

#### 2. Overarching Issues

##### 2.1 Applicability of Principles-Based Regulation in the Indian Context

The Panel discussed at length as a developmental issue the choice between principles-based and rules-based regulation in the Indian context (Box 2.1). India follows

a model of regulation which is primarily rule-based. The High Powered Expert Committee on making Mumbai an international financial centre (set up by the Ministry of Finance) had argued strongly in favour of a shift to principles-based regulation to bring about greater flexibility in the regulatory environment, and make it more adaptable to global financial demands. The environment, the Committee argued, would be innovation-friendly and therefore appropriate and necessary for the transition of Mumbai to a IFC.

Over a period of time, India has built up a large repository of subordinate laws through a codification of detailed rules and regulations by specialised regulators. These give in detail the permissible features of financial products and services as also the functioning of financial markets. This helps to avoid legal ambiguity through precise codification. For instance, in the banking sector, there are varied sets of entities ranging from commercial banks, urban co-operative banks and rural financial institutions. The commercial banks are the most advanced and are in the Basel I mode and have started migrating to the Basel II mode in a phased manner from March 31, 2008. Urban Co-operative Banks are only partly in the Basel I mode and it may take some time before they migrate to the Basel II mode. Rural Co-operatives at present have no stipulation of capital adequacy. A roadmap has been drawn for their transition to capital adequacy and it will take some time for them to migrate to the Basel mode. Thus, these entities though in the same regulatory segment, are in various stages of development. An effort to regulate them by

principles-based regulation will be ineffective and may not yield the desired results.

As regards financial markets, the Indian equities market is one of the most advanced in the world. The foreign exchange market has also acquired considerable depth and vibrancy. In the debt market, while the government securities market has expanded, it needs to acquire further depth. However, the corporate bond market is yet to take off in any significant way. After the abolition of the office of the Control of Capital Issues, SEBI devised a new regime which has moved away from the old merit-based regulation to disclosure-based and market-based regulation. Some principles such as treating the customer fairly, avoidance of conflicts of interest, maintenance of integrity, etc., have been prescribed as the code of conduct for market intermediaries. There are also specific regulations where investors have been given enforceable rights. Thus, a hybrid approach is prevalent as far as regulation of intermediaries is concerned. As regards product regulations, SEBI requires the disclosure of risk factors, suitability to investors, avoidance of systemic risk and mis-selling. In the securities market too, conditions are far from ripe to move to principles-based regulation. Other markets too need to acquire further depth and maturity before a transition to principles-based regulation can be successfully attempted.

The insurance sector is in a nascent stage of development, and given the fact that it was liberalised only in 1999/2000, it may not be appropriate to move to a principles-based

supervisory approach right now. The setting up of a principles-based approach with activity-based supervision will have to wait till the industry develops adequate data bases and skill sets. Rule-based and institution-based supervision has to continue till public confidence in the sector improves significantly and regulatory comfort reaches a satisfactory level.

The implementation of principles-based regulation requires a high degree of market integrity and maturity. The existence of strong and effective Self-Regulatory Organisations (SROs) is an important pre-requisite. In this context, however, concerns over potential conflicts of interest need to be addressed. The Panel feels that the bodies, if designated to be SROs, might either have to suspend their functions as trade/industry associations (e.g., Investment Dealers' Association, Canada) or change their governance structure to ensure a separation of operations as trade organisations and SROs (e.g., Japan Securities Dealers Association, Japan). Properly functioning SROs could act as unbiased interpreters and monitors ensuring due adherence to the prescribed principles of regulation. Further, regulatory principles need to evolve with time and changes in the background of regulation. The SRO's role lies also in ensuring that in the course of such contextualisation and evolution, the spirit behind the principle remains protected. It, therefore, requires to be examined in detail whether the set of pre-conditions to be met for successful implementation of principles-based regulation exist in the Indian context.

There is a strong and inseparable link between human resource challenges and effective implementation of principles-based regulation. Also, principles-based regulation requires the staff of regulatory agencies to have both a holistic

understanding of financial institutions and financial markets and a technical understanding of modern risk management models. Such individuals are in short supply, and there is intense competition from the private sector for them. Given the state of our development, markets, expertise and skills, the level of compliance, etc., at the ground level, the Panel, while appreciating the advantages of principle-based regulations, still had reservations about its early introduction in the current Indian environment.

There could, however, be a mix of approaches in adopting an appropriate regulatory model for India, with elements of both principles-based and rules-based regulation. A regulatory regime could be adopted in which a principles-based approach is applied initially only for the development of new and innovative products, thus creating a conducive atmosphere for product development without curtailing innovation, and continue otherwise with the rules-based approach. An alternative approach could be to apply a principles-based approach only in advanced market segments in the country. But in view of the variety of segments and the differing levels of their development and regulation, defining a threshold level for this purpose would be a formidable task at this stage. It needs to be kept in mind that adopting either approach could result in a fair degree of ambiguity in the overall regulatory environment at least in the initial stages of their introduction.

The Panel therefore, concluded that before any large scale migration to an alternative regulatory regime is effected, the relevant issues would need to be examined in detail. Significant amendments to existing legislations governing the regulatory framework of the financial system, would also be needed.

#### Box 2.1: Principles-based regulation v/s. Rules-based regulation

There are two forms of regulation prevalent across countries: rules-based regulation and principles-based regulation. Countries following the principles based regulation are UK, Ireland and Australia, while countries like USA, India and continental Europe follow the rules-based regulation.

Rules-based regulation has two strengths: Market players are aware of the certainty of the rules and able to abide by these rules governing all aspects of the business. The financial regulators and supervisors are also able to operate with certainty, but in a non-discretionary manner. The proponents of the principles-based regulation point to some inherent weaknesses in the rules-based approach:

- The focus is on the letter of the law and not on the spirit.
- It bridles innovation inasmuch as every new idea on products, services, markets or even new ways of doing business requires regulatory approval/clearance and often a modification of rules.
- Vested interest groups seek to influence the evolution of rules to favour themselves.

The alternative to rules-based regulation is principles-based regulation which was first introduced in the UK in 1997. The new approach is gradually finding favour among International Financial Centres (IFCs) like Singapore. This method places greater emphasis on principles and is outcomes-focused, high-level rules as a means to achieve the regulatory goals. The proponents of principles-based regulation favour it for the following reasons:

- Detailed rules have become an increasing burden on regulators and the country's resources
- Regulation that focuses on outcomes rather than prescription is more likely to support development and innovation.

- A large volume of detailed, prescriptive and highly complex rules diverts attention towards adhering to the letter rather than to the spirit of guidelines.

Under principles-based regulation the top management of a financial firm is held accountable for ensuring that the business plan of the firm and all its activities are consistent with the principles defined by the regulator. Instead of supervision in terms of checklist compliance, supervisors are required to understand the entire gamut of financial firms' activities, financial and governance indicators, its corporate culture, as well as the strength and depth of its compliance procedures. It has also been argued that while rules-based regulations are eminently suitable for entities dominated by retail investors, principles-based regulation is more suited in environments characterised by a preponderance of institutional investors.

According to the US Securities Exchange Commission (SEC), the move to principles-based regulation is driven by commercial competitiveness among financial centres in the world today. These centres are doing so to gain a competitive edge over others overlooking the inherent dangers.

As compared to rules-based regulation which is specific and thus leaves limited discretion with the regulated in matters of adherence to the rules, principles-based regulation provides far greater discretion to the regulated which can and often does result in the principles being compromised due to the regulated entity's inadequate appreciation of the principles or cutting corners under stress.

**Reference:** (i) Report of the High Powered Committee on making Mumbai an International Financial Centre, Ministry of Finance, Government of India  
(ii) Speech by SEC Commissioner: Principles vs. Rules by Commissioner Roel C Campos.

## **2.2 Independence of Regulatory and Supervisory Authority**

SEBI is a statutory body established under the SEBI Act, 1992. Its powers and functions are specified in the SEBI Act. It also exercises powers under SC (R) Act, Depositories Act and certain provisions of Companies Act. It is empowered to frame regulations without the approval of the Central Government and is able to operate and exercise its powers given under various Acts referred to above without external political and commercial interference. Section 6 of the SEBI Act, 1992 states that a member can be removed in circumstances referred to therein after being afforded a reasonable opportunity of being heard. Only in cases of grave emergencies or where SEBI is unable to discharge its functions or in public interest can the Board of SEBI be superseded by the Central Government in accordance with the procedures provided in Section 17 of the SEBI Act.

However Section 5(2) gives the Central Government the right to terminate the services of the Chairman or Member at any time by giving a notice of three months. This appears to be in apparent conflict with the tenor of the other sections in the SEBI Act and could have implications for the independence of SEBI. The Panel feels that Section 5(2) can be removed from the SEBI Act.

The Insurance Regulatory Development Authority (IRDA) is an independent agency which reports to Parliament through the ministry of finance. The Chairperson of IRDA is appointed by the Cabinet Committee on Appointments headed by the Prime Minister. The Central Government reserves the right to remove any member including the Chairman, under specified conditions. The chairperson, members, officers and staff of the IRDA are provided protection through their status as "public servants" and are protected from legal action for acts done in good faith under the Act, Rules and Regulations. While, as per the precedent and practice, the Government of

India has always recognised and fostered the independence to the IRDA, there are no doubt legacy issues arising from the provisions of the Insurance Act which vests several powers with the Government of India in the context of the insurance sector. However, these would largely be addressed in the proposed amendment Bill which is now under consideration of the government.

Recognising regulatory independence as one of the key objectives, the relevant provisions in the RBI Act were examined by the Panel in detail. The Reserve Bank's governance structure is laid down clearly and it was felt that there is adequate openness and transparency in its decision making. It also enjoys the required autonomy in setting rules and regulations for the sectors under its supervision. Section 35A of the Banking Regulation Act, 1949, empowers the Reserve Bank to issue directions to banks. Further, as per Section 54 of the Banking Regulation Act, 1949, bank supervisors enjoy legal protection when executing their jobs. However, it was observed that though Section 8 of the RBI Act provides for the composition of the Central Board and terms of office of its directors, it does not provide any procedure for the appointment of the Governor or the bank's governing board. The terms of office of the Governor are contractual (as specified in the appointment order). While the directors nominated to the Board can be removed only on incurring disqualifications mentioned in the RBI Act (Section 10), for the Governor and Deputy Governors there are no explicit provisions detailing the situations in which they can be removed. In fact, Section 11 of the Act provides that the Central Government may remove the Governor or Deputy Governor from office (without specifying any reasons for the same). Further, according to Section 30 of the RBI Act, the government has the power to supersede the Central Board of the Reserve Bank in specific circumstances.



The Reserve Bank's tasks and goals are multifarious in nature. In addition to being the regulator and supervisor of commercial banks and various other categories of financial institutions, it is the monetary authority of the country. Its tasks encompass, *inter alia*, sovereign debt management, foreign exchange

reserve management and issuance of currency. These role requirements can be conflicting in some situations. The case for complete institutional independence of the Reserve Bank as a regulator needs to be viewed in this overall context. The convention that has developed in this regard over time also merits attention. While

#### Box 2.2: Regulatory Independence

The need for regulatory and supervisory independence has been in sharp focus in recent times. An analysis of the causes of the financial sector crises of the 1990s, indicates that the lack of independence of supervisory authorities from political influence has been one of the contributing factors to the deepening of the crisis. A second factor to have highlighted the importance of regulatory and supervisory independence is the discussion on the most appropriate regulatory and supervisory structure, including the organisational structure of banking supervision within or outside the central bank.

Some countries have shown a tendency to move to a unified financial sector supervision by removing the banking supervision function from the central bank. Quintyn and Taylor argue that while the separation of the monetary policy function from the regulatory and supervisory functions could have implications for the independence of the regulator and supervisor as removing supervision from the central bank could create a less independent function than has previously existed. The appropriate degree of independence for the new, unified 'super regulator' is a matter still being debated. At the same time, the creation of a supervisory superpower raises fears regarding the concentration of power, thereby reopening the unsettled debate about well-established accountability. It can be argued that bank regulatory and supervisory independence is for financial stability what central bank independence is for monetary stability and that independence of the two agencies in charge of monetary and financial stability would have a mutual reinforcing effect.

According to Quintyn and Taylor, there are four dimensions of independence:

(i) **Regulatory independence**, which refers to the ability of the agency to have an appropriate

degree of autonomy in setting rules and regulations for the sectors under its supervision within the confines of law.

(ii) **Supervisory independence** can be increased through provision of legal protection to supervisors, introduction of rules-based sanctions and interventions, appropriate salary levels and clarity of banking law regarding layers of decisions and time allowed for appeal by institutions sanctioned by supervisors. The supervisor should have autonomy related to licensing and exit procedures.

(iii) The critical elements in **Institutional independence** are terms of appointment and dismissal of senior supervisory personnel, the agency's governance structure and its openness and transparency in decision-making

(iv) **Budgetary independence** refers to the role of the executive/legislature in relation to the funding requirements of the agency.

The appropriate degree of independence would, however, be country specific depending on the existing institutional framework, including specific co-ordination arrangements to ensure information exchange and policy co-ordination among all autonomous institutions, be it monetary management or regulation and supervision. The recent 'sub-prime' crises in some instances have brought to the fore the possibility of role conflict between the monetary and supervisory authorities and lack of effective communication between the two.

**Reference:** IMF Working Paper No. WP/02/46 – *Regulatory and Supervisory independence and financial stability* – Marc Quintyn and Michael W. Taylor

the Central Government, *de jure*, is empowered to remove the Governor without assigning any reason, such power has never been exercised and, over time, the Reserve Bank has come to be perceived as one of the most independent and autonomous bodies in the Indian financial sector. With such a convention already in place, and the checks and balances of a strong and vibrant democratic system, the government would run a huge reputational risk if ever it decides to remove the Governor/Deputy Governor without sufficient cause. Considering the Reserve Bank's success as a regulator amidst its diverse activities, and the fact that by convention the Reserve Bank's independence is fairly well established, the Panel feels that at this stage there is no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/Deputy Governor could be removed. Such changes are not likely to add or make any material difference to the autonomy the Reserve Bank already enjoys as a regulator.

### **2.3 Financial Independence**

The Reserve Bank was established under the RBI Act, 1934 on April 1, 1935 as a private shareholders' bank. Since its nationalisation in 1949, it is fully owned by the Government of India. The Preamble to the RBI Act lists basic objectives as: "to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India, and generally, to operate the currency and credit system of the country to its advantage". There is no inherent limitation on the part of the Reserve Bank in obtaining and deploying the resources required for carrying out its supervisory mandate. The Reserve Bank is financed by its own budget and has not been required to receive any financial support from the Central Government. With a view to maintaining the strength of the Reserve Bank finances, the transfer of the balance of profits, after necessary provisions, to the Central Government has been rationalised as part of the reform process in 1997. The present arrangement is governed by the objective of reaching a stipulated level of reserves in the Reserve Bank's balance sheet over a period –

though the time-frame to reach the level is extended by mutual consent to accommodate immediate fiscal compulsions. The cost of sterilisation in the form of interest costs under the Market Stabilisation Scheme is borne by the Central Government. Sterilisation through the Cash Reserve Ratio (CRR) on an unremunerated basis also helps to minimise the cost of such interventions. Under these circumstances, the Reserve Bank may be considered as enjoying a very high degree of financial independence.

SEBI is empowered to levy fees and other charges for performance of its functions. It is not dependent on the government or any authority for its funds. During its initial days, the government had provided it interest-free loans which are being repaid by SEBI from its fund. The provision for fees and penalties under the SEBI Act are considered adequate at present to meet the resource needs of the SEBI.

The IRDA is an autonomous body formed by the Insurance Regulatory Development Authority Act, 1999. The Insurance Act, 1938 and the regulations framed thereunder lay down the regulatory framework for supervision of entities operating in the sector. With respect to financial independence, an issue has been raised by the government on the transfer of IRDA's funds to the exchequer (Public Account of India). The instructions were issued invoking Article 266 (2) of the Constitution of India. However, the IRDA has taken the stand that it is not carrying on sovereign functions on behalf of the government. As such, the provisions of the said Article are not applicable to it. While the request has not yet been acceded to and is under examination, any action in this regard would be detrimental to and raise serious concerns relating to the supervisor's stature as an autonomous regulator.

Regulators provide a public good at a cost. The Panel underscores the need to maintain their financial independence.

#### 2.4 Capacity Building and Skill Enhancement

Migration to Basel II norms presupposes familiarity and expertise in quantitative techniques and statistical methods. There is a

need for capacity building both from the perspective of the regulated and the regulator. Recruitment and development of a specialised cadre to cater to the impending requirements of Basel II in banks is a must. Lateral

#### Box 2.3: Implementation of Basel II in India

In order to strengthen the capital base of banks, the Reserve Bank decided in April 1992 to introduce a risk based capital adequacy system for commercial banks along the lines of the Basel Committee on Banking Supervision (BCBS) framework on capital adequacy (1988). This takes into account the elements of credit risk in various types of assets in the balance sheet as well as in the off-balance sheet business. Non-banking finance companies and housing finance companies introduced the risk-based capital adequacy norms from January 1998 and March 2001 respectively. Risk-based capital adequacy norms were extended in a phased manner to urban co-operative banks from March 31, 2002. Capital adequacy norms in line with Basel I prescriptions are yet to be introduced for rural financial institutions, *viz.*, regional rural banks, state co-operative banks and district central co-operative banks.

Further, the Reserve Bank issued guidelines to banks in June 2004 on the maintenance of capital charges for market risks on the lines of the 'Amendment to the Capital Accord to incorporate market risks' issued by the BCBS in 1996. Banks were required to apply the Standardised Duration Approach (SDA) for computing capital requirements for market risks.

In June 2006, the BCBS released the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" popularly called the Basel II. The framework is expected to promote the adoption of stronger risk management practices in commercial banks. Basel II is based on three mutually reinforcing pillars – minimum capital requirements, supervisory review and market discipline. Under Pillar I, the framework offers three distinct options for computing capital requirements for credit risk and operational risk respectively.

These approaches are based on increasing risk sensitivity and allow banks/supervisors to select an approach which is most appropriate to the stage of development of the bank's operations. The approaches available for credit risk are the Standardised Approach (SA), Foundation Internal Rating-Based Approach and Advanced Internal Rating-Based Approach. The approaches available for computing capital charges for operational risk are the Basic Indicator Approach (BIA), Standardised Approach and Advanced Measurement Approach.

In order to have consistency and harmony with international standards, the Reserve Bank decided that all commercial banks in India (excluding local area banks and regional rural banks) shall adopt SA for credit risk and BIA for operational risk. Foreign banks operating in India and Indian banks having an operational presence outside India should adopt SA for credit risk and BIA for operational risk for computing their capital requirements under the Revised Framework with effect from March 31, 2008. All other commercial banks (excluding local area banks and Regional Rural Banks) are encouraged to migrate to these approaches under the Revised Framework in alignment with them not later than March 31, 2009.

After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to the Internal Rating Based Approach for credit risk and the Standardised Approach or the Advanced Measurement Approach for operational risk for computing regulatory capital requirements after obtaining specific approval from the Reserve Bank.

**Reference:** RBI circular on implementation of Basel II in banks



recruitment of specialists with requisite skill sets could also be considered by banks and the Reserve Bank. The incentive structure and compensation package should be in alignment with market trends. There is also a need to examine the HR policies including transfer policies in the banking sector (particularly of public sector banks).

This aspect is equally true for SEBI. Though the compensation package offered by SEBI is comparable to other regulators in the financial market, its attrition rate is very high as the remuneration or compensation package of the financial services industry is much higher. Further, it is noticed that SEBI staff quits after gaining some experience mostly to join regulated entities subject only to the requirement of prior permission or a cooling off period. With liberalisation and opening up, a steady outflow of its staff to regulated entities is bound to create an adverse balance of skills on the part of the regulator. This will weaken the efficiency and credibility of regulation. Capacity building and skill enhancement are also issues, more so, with various innovations and new developments taking place in the securities market.

As regards the insurance sector, while IRDA has been taking a number of steps to increase and empower its manpower to discharge its functions, given the fact that the insurance sector is fast expanding, a number of new issues are required to be addressed. As such, there is a continuing need for enhancing the skill sets. With the insurance regulator thinking in terms of risk-based capital requirements and aspects relating to risk management for insurance companies, the agency needs to take steps to strengthen its machinery in terms of adequate skills for its officials which would require capacity building. Similarly, there could be issues regarding the retention of skilled staff. While regulators may be unable to match their remuneration structure with industry levels, the incentive

structure for staff including top management should be built up to retain the best talents and sustain the morale.

The Panel regards capacity building of regulators as a serious issue and recommends a market related incentive structure to attract and retain talent and added attention to training and development. It recognises that every effort has to be made to match industry level remuneration to attract and retain the best available talent for regulation. While in the Indian context it would never be easy for the regulator to match the ever-increasing remuneration levels of industry, it will have to be ensured that the gap between the two remains manageable and the efficacy of the system is not undermined.

## **2.5 Co-operation between Regulators**

In India, banks are regulated and supervised by the Reserve Bank/NABARD, non banking finance companies (NBFCs) are regulated and supervised by the Reserve Bank and the Ministry of Corporate Affairs and housing finance companies (HFCs) are regulated and supervised by the National Housing Bank. The equities/corporate bond market / exchange traded derivatives and mutual fund industry is regulated by the Securities Exchange Board of India. The government securities market, money market and foreign exchange market are mainly regulated by the Reserve Bank. The insurance sector is regulated by IRDA.

Given the multiplicity of regulators and overlaps in their functioning, there is a need for effective inter-regulatory co-operation. This need is further reinforced by the following:

- Government securities and related derivatives and money market instruments are listed on stock exchanges. To that extent, some aspects of the government securities market/ money market regulation are shared by the Securities Exchange Board of India

(SEBI). SEBI is vested with the task of investor protection, regulating various market intermediaries and the securities market. Thus, any violation committed by market intermediaries or any violation which is not in the interest of investors is looked into by SEBI. Any other violations in respect of the government securities market or the money market come under the purview of the Reserve Bank. Likewise, though banks are regulated and supervised by the Reserve Bank/NABARD, there are instances wherein they need to interact with the regulator of markets, because of their exposures in the equities market or stakes in subsidiaries which deal in equities or insurance. This underscores the need for inter-regulatory co-operation given the fact that regulators are different for these areas.

- A significant portion of the funding of non-deposit taking NBFCs and investment companies, in particular, is through debt mutual funds. These NBFCs are then dependent on retail funds in the nature of '*quasi deposits*'. Though there are exposure limits for funds in respect of individual companies (to the extent that a mutual fund cannot invest more than 15 per cent of its NAV in debt instruments issued by a single issuer) there is no restriction of their total quantum of exposure to the NBFC sector as a whole. Also, NBFCs do not have any regulatory limits on their exposure to sensitive sectors like real estate or capital markets. There exists, therefore, a significant risk

of contagion as retail funds are exposed to these sectors, which, in the event of an asset price correction, may crystallise into significant losses. This contagion may get magnified during a liquidity crisis as NBFCs and debt mutual funds would be more susceptible to liquidity mismatches compared to banks. Further, they neither have mandated pre-emption funds, nor access to last resort emergency lending. Therefore a crisis can be handled only if mechanisms/ institutions providing and ensuring timely and adequate inter-regulatory co-operation are in place.

- During the initial phase of growth of the insurance sector, Unit Linked Insurance Plans (ULIPs) were seen to be somewhat analogous to the Equity Linked Savings Scheme (ELSS) and similar mutual fund schemes. ULIPs are issued by insurance companies (regulated by IRDA), mutual fund schemes are issued by mutual funds (regulated by SEBI). Thus, insurance companies and mutual funds operate under different regulatory regimes with separate prudential norms. New guidelines issued by IRDA in 2006 have stopped ULIPs from being positioned as short-term investment product. In order to ensure that these two different saving instruments with short and long-term investment objectives are positioned appropriately to reflect the respective position, steps are being taken towards inter-regulatory co-operation on an on-going basis.

The Panel noted that there exists a formal information sharing platform in the form

of a High Level Co-ordination Committee on Financial Markets (HLCCFM) comprising the Governor of the Reserve Bank, chairman of SEBI, IRDA and PFRDA and the Finance Secretary, Government of India, which serves as a forum for discussing common regulatory issues.

- Also, the Reserve Bank had constituted a Working Group to advise on a special monitoring system for systemically important financial intermediaries (SIFIs also known as financial conglomerates or FCs). The Group, in its report submitted in May 2004 suggested criteria for identifying financial conglomerates, a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-regulatory exchange of information in respect of conglomerates.

This oversight framework is complementary to the existing regulatory structure i.e., supervision of individual entities by respective regulators, *viz.*, the Reserve Bank, SEBI and IRDA and the system of consolidated financial statements/consolidated prudential reporting applicable to banks. The details of intra-group transactions and exposures to some important market segments such as debt and inter-bank and non-fund based exposures are monitored through the returns prescribed by the financial conglomerates monitoring mechanism. An analysis of the returns, follow-up action thereon and quarterly discussions with the CEOs of the entities belonging to the Groups is currently being looked after by the Financial Conglomerates Cell located in the Reserve Bank. In addition, the Reserve Bank and SEBI have jointly put in place an integrated system of alerts

which would piece together disparate signals from different elements of the market.

However, it is possible that there may be some entities in the conglomerate that do not fall under the regulatory/supervisory ambit of any single regulator. These may conduct many internal transactions and such intra-conglomerate cash flows can remain invisible. Such conglomerates can pose systemic threats to stability. Therefore, there should be adequate mechanisms for the relevant agencies to issue regulations and enforce supervisory actions as necessary. In this context, the Reserve Bank has initiated a move to insert a new clause 29 A under the Banking Regulation Act, 1949, which would give it powers to inspect the books of accounts and other records of all entities that are subsidiaries/associates of a bank, irrespective of whether the subsidiary / associate is under any other regulator. A similar change in law may also be appropriate for the other regulators (specifically SEBI and IRDA) who may require inspecting the books of accounts and other records of subsidiaries/associates of the regulated entity.

The Panel feels that despite such mechanisms, there are areas where inter-regulatory co-operation needs to be strengthened further. It is necessary that the HLCCFM should be given the responsibility of ensuring close co-ordination and monitoring of markets by the respective regulators and transactions and the functioning of conglomerates. The following steps can be taken in this regard:

- (i) The HLCCFM should be supported by a formal institutional mechanism enabling it to give directions to regulatory authorities on issues cutting across regulatory domains.

- (ii) The role of the HLCCFM and its functions should be clearly delineated and placed in the public domain.
- (iii) The membership of the HLCCFM should be made more broad-based and diversified and market participants should also be represented. As representation by market participants could sometimes lead to a conflict of interests, such participation should be through representative bodies of the industry or the SROs, to ensure that it remains objectively constructive.
- (iv) The frequency of the meetings of the HLCCFM needs to be increased.

The Panel also critically considered the feasibility of unified regulation in the Indian context. It was of the view that a unified regulator is not entirely suited to the present state of the country's overall financial system and its markets. It observed that though the presence of a unified regulator could reduce regulatory overlaps and address the regulatory gaps in the system, for the present it would be best not to go beyond common guidelines. Depending on its primary function, the regulated entity should be regulated by a 'lead regulator' who exercises regulatory and supervisory authority in relation to the entity's primary function. As part of this, supervision of entities with multifarious activities that cut across regulatory domains could be conducted collaboratively with other regulators. For instance, the lead regulator could have the option of requesting other regulators in the supervisory process to comment upon any specific aspects. Further, in order to make such

collaborative supervision effective, every effort should be made to ensure that the parameters of such co-ordination are well defined and that ground rules are specified.

#### 2.6 Home-host Country Co-operation

Just as it is crucial to foster greater co-operation among domestic regulatory agencies, it has become increasingly important to promote greater and more effective cross-border collaboration among regulators as the financial sector assumes global dimensions. In the Indian context, though there has been an exchange of supervisory information on specific issues between the Reserve Bank and a few other overseas banking supervisors/regulators, no formal/ legal arrangement or Memorandum of Understanding (MoU) has been entered into between the Reserve Bank and outside supervisory authorities for cross-border supervisory co-operation. This is partly because of the legal impediments to sharing of credit information and permitting an agency other than the Reserve Bank to inspect a bank in India.

SEBI has established information sharing mechanisms for sharing information with domestic and foreign regulators. As regards its foreign counterparts, SEBI has signed MoUs with foreign regulators of many countries. SEBI may extend informal assistance to foreign regulators in conducting enquiries or investigations of domestic-regulated entities.

IRDA approaches its counterparts in other countries as part of the due diligence examination process of foreign joint-venture partners of proposed new insurers while

considering applications for registration of insurers in India. It also interacts with other supervisors to draw on their experiences related to regulatory supervision or to gain insights on issues which do not have precedence in the host country. However, in instances such as informing the home regulator in advance of taking action that affects the parent company, observance has not been tested.

The Panel feels that there should be specific provisions in the RBI Act, 1934 and Banking Regulation Act, 1949 and IRDA Act, 1999 along the lines of SEBI Act, 1992 so that a MoU can be entered with the foreign supervisors, thus establishing a formal communication mechanism.

## **2.7 Reducing the Scope for Regulatory Arbitrage**

In India, NBFCs are important components of the financial services sector. They provide financial intermediation and contribute significantly to economic growth. While the range of activities by NBFCs which are bank subsidiaries are under the control of the Reserve Bank, other NBFCs can undertake activities that are not permitted to be undertaken by banks or which banks are permitted to undertake in a restricted manner (e.g., financing of acquisitions and mergers, capital market activities, etc.). Such differences in the level and intensity of regulation create scope for regulatory arbitrage by routing transactions through NBFCs instead of banks to avoid bank regulation. This is particularly relevant for a banking group/financial conglomerate. Also, there could be regulatory gaps in intra-group transactions and exposures between NBFCs and their parent entities.

To address the concerns that arise out of the divergent regulatory requirements for various aspects of functioning of banks and NBFCs, in December 2006 the Reserve Bank brought out regulatory guidelines by

reclassifying NBFCs. For the purpose of regulation, NBFCs are now divided into deposit taking NBFCs (NBFCs-D) and non deposit taking NBFCs (NBFCs-ND) of which NBFCs-ND with the size of Rs.100 crore or more are considered systemically important and are subject to prudential regulation which includes capital adequacy and exposure norms. The other main category of NBFCs is the residual non-banking companies (RNBCs).

The ownership structure of NBFCs can be categorised under the following four broad heads:

- (i) Stand -alone NBFCs;
- (ii) NBFCs which are subsidiaries/associates/joint ventures of banking companies;
- (iii) NBFCs and banks which are under the same holding company, i.e., sister concerns; and
- (iv) NBFCs which are subsidiaries/associates of non-financial companies.

There appears to be no scope for regulatory arbitrage of stand-alone NBFCs. But there does exist a difference in regulatory treatment inasmuch as NBFCs which are part of a banking group are subject to stricter prudential norms in respect of their scope of activities. For example, stand-alone NBFCs can offer discretionary portfolio management schemes which cannot be offered by NBFCs within a banking group. At the same time, it must be appreciated that NBFCs which are part of a banking group have recourse to cheaper funding sources because of parent banks' ability to raise low cost deposits. The Panel feels that from the prudential standpoint, the regulatory structure should duly recognise both the advantages and disadvantages of operational environment of respective NBFCs.

Regulatory arbitrage of NBFCs which are subsidiaries/joint ventures/associates of bank holding companies has been addressed to a



significant extent through the introduction of consolidated supervision and the stipulation of capital requirements for the banking group as a whole. Mandatory regulatory limits on sensitive exposures (e.g., capital market exposure) for the banking group as a whole have also been prescribed. Further, inspection of banks by the Reserve Bank provides for the 'review' of the 'overall activities' on a group-wide basis in respect of the banking group. It should, however, be noted that sister concerns, i.e., banks and NBFCs under the same holding companies, do not fall within the ambit of consolidated supervision. To address this gap, the Reserve Bank, IRDA and SEBI are developing a process for regulation and supervision of financial conglomerates. Under the current financial conglomerate monitoring mechanism, banks which have been termed 'designated entities' submit information to the supervisory department of the Reserve Bank on group-level issues, and also in respect of individual entities of the group. Some of the group-level information submitted to the Reserve Bank relates to intra-group transactions, exposures and capital adequacy. Similarly, IRDA has also been assigned lead responsibility where an insurance company is the major player along with companies in the Asset Management sector. The process of forming an appropriate structure for regulation and supervision with apposite legislative authority, which is under progress, needs to be expedited.

Other than requirements prescribed for listed entities, non-financial companies are currently not within the purview of financial regulation. In view of the existing intra-group linkages, the Panel feels that the possibility of

bringing non-financial entities which have financial subsidiaries/associates or are sister concerns within the same holding company, the scope of supervision of financial conglomerates needs to be examined. Regulatory and supervisory reach has to extend to all those unsupervised entities whose condition could affect the supervised entities.

There could be arbitrage issues regarding both institutions and markets across the regulatory jurisdictions of the Reserve Bank, SEBI and IRDA. If a level playing field and a competitive environment is to be maintained across markets and institutions, duly taking into account the operational objectives and differences in nature, the present arrangement of inter-regulatory co-ordination needs to be strengthened and made transparent.

The Panel strongly feels that a well-established co-ordinating mechanism for the financial system as a whole would be most beneficial in the current circumstances. Inter-regulatory co-operation and a collaborative approach would result in most of the advantages available in unified regulation without exposing the system to its pitfalls.

### **2.8 Synergies between Regulation and Supervision and Promotion of Financial Stability**

The Reserve Bank is the monetary authority as well as the regulator and supervisor of banks and financial institutions. Regulation of money, government securities and foreign exchange markets also come within the scope of activities of the Reserve Bank. This puts the Reserve Bank in a position of advantage regarding information flow from

regulator and supervisor to the monetary authority and vice versa. According to the Chairman<sup>1</sup> of the Federal Reserve Bank of Boston, effective exploitation of synergies between the regulator, monetary policy maker and Lender of Last Resort (LoLR) is advantageous from the stability perspective, as their roles often become blurred during crises or periods of significant illiquidity.

The Panel admitted that though the dual roles of monetary authority and regulator and supervisor of banks and FIs have some scope for conflict, in the Indian context the issue has been resolved to a great extent. This is because within the Reserve Bank, a separate Board for Financial Supervision (BFS)<sup>2</sup>, a committee of the Reserve Bank's central board of directors, is specifically entrusted with the responsibilities of financial supervision, including banking supervision. The BFS ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban co-operatives banks and primary dealers. The Panel feels that the current structure of the Reserve Bank as the monetary policy maker, LoLR and regulator and supervisor, though quasi-independent, is appropriate and may continue. It reduces the information risk that would otherwise be embedded between the monetary authority and regulator and supervisor.

## **2.9 Institutional Infrastructure**

### **Legal Issues**

The failure of co-operative banks and rescue measures in this sector continues to be an area of considerable concern mainly on account of dual control of these entities by the Reserve Bank and State Governments.

Delay in recovery proceedings before debt recovery tribunals (DRTs) results in the locking up of huge amount of public money. Therefore

necessary steps are needed to address the delays in the recovery process by increasing the number of debt recovery tribunals. Although the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, has given a major boost to the recovery process of banks and helped them reduce NPAs, the pendency of litigation in India remains a major concern. There is also a need to keep insolvency procedures for entities with systemic risk (like banks/insurance companies) separate from insolvency relating to ordinary companies. The Panel feels that the law should provide for a definite time-frame to conclude liquidation proceedings.

### **Accounting Standards**

The Reserve Bank has issued detailed guidelines on accounting and disclosure norms which require that banks maintain adequate records drawn up in accordance with these accounting policies. The Reserve Bank has laid down asset classification and provisioning norms which have to be adhered to by banks. Banks are required to follow norms for valuation of collateral and this is not reduced from non-performing loans. Financial statements are prepared based on accounting standards prescribed by the ICAI, except for those that have been specifically modified by the Reserve Bank in consultation with the ICAI keeping in view the nature of the banking industry.

It is mandatory for all banks to get their annual accounts audited every year by external auditors who are appointed with the prior approval of the Reserve Bank under Section 30(1-A) of the Banking Regulation Act, 1949. The scope of statutory audit is defined in Section 30 of the Banking Regulation Act, 1949. Auditors are required to report specifically whether the financial statements exhibit a true

<sup>1</sup> Speech by Mr. Eric S Rosengren, President and CEO, Federal Reserve Bank of Boston on Bank Supervision and Central Banking : Understanding Credit During a Time of Financial Turmoil.

<sup>2</sup> Constituted by the Bank's Central Board (RBI {BFS} Regulations, 1994 as a part of delegated legislation as per Regulation under sub -section (i) of Section 58 of the RBI Act 1934.

and fair view of the affairs of the bank under section 30(3) of the Banking Regulation Act, 1949. Banks incorporated in India are required to publish their balance sheet and profit and loss account together with the auditor's report in a newspaper in circulation at the place where the bank has its principal office. Disclosure standards are reviewed by the Reserve Bank by critically analysing balance sheet formats, accounting policies and disclosures forming part of financial statements. The Reserve Bank has powers to penalise banks in the event of wrong data being furnished by banks in off-site returns and balance sheets. As regards derivative accounting, Accounting Standards along the lines of IAS 30 and 32 would be recommendatory from April 1, 2009 and mandatory from April 1, 2011.

Given the increase in derivatives activities in Indian financial markets, an earlier adoption of IAS 30 and 32 would have been preferable. The Panel recommends that in order to encourage corporates to adopt the revised Accounting Standards at an early date (earlier than 2011), it would be desirable that banks enter into derivative contracts with only those corporates who adopt the revised accounting standards.

The Institute of Chartered Accountants of India (ICAI), establishes accounting and auditing standards for companies including listed companies. ICAI has constituted Accounting Standards Board (ASB) and Auditing and Assurance Standard Board (AASB) for this purpose. SEBI is member of both the Committees. Both these Boards adopt International Standards as a base to formulate standards for accounting and auditing and assurance services.

Oversight mechanism, so far as formulation of accounting standards are concerned, was introduced in 2001 through establishment of National Advisory Committee on Accounting Standards (NACAS) under the Indian Companies Act, 1956. This is an independent Committee and accounting standards formulated by ICAI are notified by Government for adoption by companies on the basis of advise of NACAS. Central Government has issued Company (Accounting Standard) Rules, 2006 vide notification dated 07 December, 2006 u/s 211(3C) of the Companies Act, 1956. As per Section 211(3A) it is mandatory for every company to comply with the accounting standards as prescribed under the Accounting Standard Rules, 2006. Clause 50 of Listing Agreement makes it mandatory for listed companies to follow Accounting Standards Issued by Institute of Chartered Accountants of India (ICAI).

ICAI has proposed to move to International Accounting Standards, i.e. International Financial Reporting Standards (IFRS) from April 1, 2011 for public interest entities which includes listed companies. The financial statements of all companies, whether listed or unlisted, must be audited by members of ICAI who are obliged to perform audit in accordance with Auditing and Assurance Standards issued by ICAI. ICAI is moving fast to pronounce assurance and auditing standards on all subjects on which International Standards are issued and revising standards when International Standards are modified under the Clarity Project undertaken by the International Auditing and Assurance Standards Board of IFAC.

ICAI has constituted Financial Reporting Review Board (FRRB) which, *suo moto*, at



random, picks up financial statements issued by listed companies to assess compliance with Accounting Standards in preparation and presentation of financial statements. Non-compliance noticed during review are reported to relevant regulatory authority. The report of FRRB is required to be submitted to the regulator and the regulator should be empowered to deal with such reports and take steps as may be appropriate in the facts and circumstances of the case. When financial statements with qualifications are submitted by regulated entities, mechanism be established to take steps to resolve the differences and to ultimately, do away with such differences.

As regards financial accounting and reporting, insurers are required to comply with provisions of Insurance Act, 1938; IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 and various circulars issued by IRDA from time to time on specific operational issues. As per the stipulations laid down, all insurers are required to file the annual accounts with the Authority which comprise of the Balance Sheet and Profit and Loss Account (shareholders' A/c), segment-wise Revenue Account (Policyholders' A/c) and the receipts and payments A/c on the direct method basis.

The books of every insurer are subject to annual audit. The accounts are required to be prepared in conformity with the Accounting Standards (AS) issued by the ICAI. Any variations from the same are laid down in the regulations. The IRDA is further vested with the powers to decline to accept the returns in case these are found to be inaccurate or defective. The Authority further examines the issues which arise through off-site inspections, through targeted on-site inspections.

In the adoption of the Accounting Standards, there is no major separate distinction for insurers. As regards the evolving standards on fair value accounting, insurance

contracts are still outside the purview of the proposed AS30. Against the background of the Council of the ICAI to achieve full convergence towards the International Financial Reporting Standards (IFRS) by 1st April, 2011, the IRDA is examining the issues in the particular context of the insurance sector and has initiated steps to lay down the way forward.

### **Liquidity Infrastructure**

Recent events like the sub-prime crisis and the treatment of Northern Rock in UK and Bear Sterns in US have highlighted the need for more careful management of liquidity risk. Section 17 of the RBI Act, 1934 empowers the Reserve Bank to grant advances to scheduled banks by rediscounting the bills of exchange and to grant advances to various entities notified by the Central Government. Further, Section 18 of the RBI Act, 1934 empowers the Reserve Bank to purchase, sell or discount any bill of exchange or promissory note although it may not be entitled to purchase or discount or make loans or advances to any entity in case of a special occasion.

Although the existing provisions in the RBI Act, 1934, empower the Reserve Bank to provide liquidity in times of crisis, the Panel feels that the recent global financial turmoil has necessitated the need to examine its conventional role of LoLR. Given the increasing integration of global markets and innovations taking place, conventional methods of a LoLR may not be sufficient, as is evident from the recent crisis. Accordingly, it recommends that the Reserve Bank may consider constituting a Working Group to look into the gamut of issues relating to liquidity with a specific mandate to look into (i) powers available as per extant provisions with the Reserve Bank as regards its role of LoLR (ii) the scope for putting in place a mechanism whereby the same can be activated at the shortest possible notice and (iii) the scope for expanding instruments permitted for providing liquidity.

## Chapter III

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## List of Acronyms

AFC	Asset Finance Company	CCB	Central Co-operative Banks
AFIs	Annual Financial Inspections	CEOs	Chief Executive Officers
AFS	Available for Sale	CFS	Consolidated Financial Supervision
AIFIs	All India Financial Institutions	CLF	Centralised Liquidity Facility
ALCO	Asset Liability Committee	CoR	Certificate of Registration
ALM	Asset Liability Management	CPR	Consolidated Prudential Reports
AMA	Advanced Measurement Approach	CRAR	Capital to Risk Weighted Assets Ratio
AML	Anti Money Laundering	CRCS	Central Registrar of Co-operative Societies
AS	Accounting Standards	CRR	Cash Reserve Ratio
BCBS	Basel Core Principles on Banking Supervision	CTR	Cash Transactions Report
BCP	Basel Core Principles	DCCBs	District Central Co-operative Banks
BFS	Board for Financial Supervision	DICGC Act	Deposit Insurance and Credit Guarantee Co-operation Act
BIA	Basic Indicator Approach	EDs	Executive Directors
BR Act	Banking Regulation Act, 1949	FCs	Financial Conglomerates
BR Act (AACS)	Banking Regulation Act (As Applicable to Co-operative Societies)	FCM	Financial Conglomerate Monitoring
CAs	Chartered Accountants	FDIC	Federal Deposit Insurance Corporation
CAS	Common Accounting System	FIs	Financial Institutions
CALCS	Capital Adequacy, Asset Quality, Liquidity, Compliance and Systems and Control	FIIs	Foreign Institutional Investors
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems and Control	FDI	Foreign Direct Investment
CAMELSC	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Procedure and Compliance	FIU	Financial Intelligence Unit
CAR	Capital Adequacy Ratio	FIU-Ind	Financial Intelligence Unit – India
		FSAP	Financial Sector Assessment Program

FSLIC	Federal Savings and Loan Insurance Corporation	MPIs	Macro Prudential Indicators
		MSS	Market Stabilisation Scheme
GoI	Government of India	MTR	Mid-Term Review
HFCs	Housing Finance Companies	NABARD	National Bank for Agriculture and Rural Development
HFI	Housing Finance Institution		
HFT	Held for Trading	NBFCs	Non-Banking Financial Companies
HLCCFM	High-Level Co-ordination Committee on Financial Markets	NBFC-D	Non-Banking Financial Company – Deposit Taking
HPC	High-Powered Committee		
HTM	Held to Maturity	NBFC-ND	Non-Banking Financial Company – Non-Deposit Taking
ICAI	Institute of Chartered Accountants of India	NBFC-ND-	Non-Banking Financial Company
ICBS	International Conference of Banking Supervisors	Others	– Non-Deposit Taking- Others
		NBFC-ND-SI	Non-Banking Financial Company – Non-Deposit Taking
ICAAP	Internal Capital Adequacy Assessment Process		– Systemically Important
IRB	Internal Ratings Based Approach	NBFI	Non-Banking Financial Institution
IRDA	Insurance Regulatory Development Authority	NOC	No-Objection Certificate
IT	Information Technology	NOF	Net Owned Funds
JPC	Joint Parliamentary Committee	Non-SLR	Non-Statutory Liquidity Ratio
KYC	Know Your Customer	NPAs	Non-Performing Assets
LAB	Local Area Bank	NPLs	Non-Performing Loans
LDB	Land Development Bank	NRI	Non-Resident Indian
LFAR	Long-Form Audit Report	ORM	Operational Risk Management
LTCCS	Long-Term Co-operative Credit Structure	OSS	Off-Site Surveillance
		OSMOS	Off-Site Monitoring and Surveillance
MCA	Ministry of Corporate Affairs		
MDs	Managing Directors	OTS	One-Time Settlement
MIGR	Minimum Investment Grade Rating	PACS	Primary Agricultural Credit Societies
MIS	Management Information System	PCA	Prompt Corrective Action
		PCARDB	Primary Co-operative Agriculture and Rural Development Bank
MoU	Memorandum of Understanding		

PFRDA	Pension Funds Regulatory Development Authority	SCB/StCBs	State Co-operative Banks
PML	Prevention of Money Laundering	SDA	Standard Duration Approach
PMLA	Prevention of Money Laundering Act	SEBI	Securities Exchange Board of India
PSUs	Public Sector Undertakings	SFCs	State Financial Corporations
RBI	Reserve Bank of India	SIFIs	Systemically Important Financial Intermediaries
RBI Act	RBI Act, 1934	SLICs	State-Level Implementation Committees
RBS	Risk-Based Supervision	SLR	Statutory Liquidity Ratio
RCS	Registrar of Co-operative Societies	SREP	Supervisory Review and Evaluation Process
RNBC	Residuary Non Banking Company	STCCS	Short-Term Co-operative Credit Structure
RoA	Return on Assets	STR	Suspicious Transactions Report
RRBs	Regional Rural Banks	TAFUCB	Task Force for Urban Co-operative Banks
RTC	Resolution Trust Corporation	TGA	Traditional Gap Analysis
SA	Standardised Approach	UCBs	Urban Co-operative Banks
SAIF	Savings Association Insurance Fund	UPSCB	Uttar Pradesh State Co-operative Bank
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002	VaR	Value at Risk
SBI	State Bank of India	VC	Vaidyanathan Committee
SCARDB	State Co-operative Agriculture and Rural Development Banks	WOS	Wholly Owned Subsidiary
		WTO	World Trade Organisation



## Chapter III

# Assessment of Adherence to Basel Core Principles

### Section 1

#### Background

##### 1.1 Basel Core Principles as a Benchmark

The development of criteria against which supervisory systems can be assessed took shape in the late 1990s with the work commissioned by the Basel Committee on Banking Supervision (BCBS). As a result, the first *Core Principles for Effective Banking Supervision* was issued in September 1997. Soon after, an attempt was made to survey a large number of countries with a view to assessing the degree of adherence with the new principles in the lead-up to the October 1998 International Conference of Banking Supervisors (ICBS) held in Sydney. The results of the survey pointed to the need for further refinement of the principles and greater rigour both in the detail and the presentation of the Principles. The Sydney ICBS, therefore, called for evolving a more precise and useable form of guidelines. The Committee accordingly issued a revised Core Principles Methodology in October 1999. These principles were refined further in October 2006 by placing greater emphasis on risk management and disclosure. The ICBS in 2006 endorsed the updated version of the Basel Core Principles for Effective Banking Supervision (BCPs) and its methodology.

The BCPs have now become the *de facto* standard for benchmarking sound prudential regulation and supervision of banks. An

assessment of a country's compliance with the principles acts as a useful tool in the implementation of an effective system of banking supervision. Assessments of observance of the BCPs help in identifying areas that need strengthening and that can contribute to the stability of the financial system directly by improving supervision and indirectly by promoting a robust financial infrastructure. The BCPs seek to ensure that the supervisor can operate effectively and banks can operate in a safe and sound manner. The methodology adopted is objective, detailed and designed to facilitate cross-country comparisons for assessors. But it does not totally preclude the need for subjective judgement.

In the backdrop of the developments, the primary objective of the current assessment is the identification of the nature and extent of compliance to revised BCPs of the supervisory system in India.

##### 1.2 A Review of Earlier Assessments

The FSAP conducted in 2001 by the IMF in respect of commercial banks revealed that based on essential criteria, India was fully compliant with 15 BCPs, largely compliant with eight and materially non-compliant with two, thus leaving none of the BCPs non-complied. However, if both essential and additional criteria are taken into account, India was fully compliant with 15 BCPs, largely compliant with six, materially non-



### Assessment of Adherence to Basel Core Principles

compliant with three and non-compliant with one. The principle-wise assessment is furnished in **Appendix 1**.

Concurrently, in order to guide the process of implementation of international standards and codes in India and to position India's stance on such standards, the Reserve Bank (RBI) in consultation with the Government of India (GoI) constituted on December 8, 1999, a Standing Committee on International Financial Standards and Codes. One of the Advisory groups constituted by this Committee looked into banking regulation and supervision. This group evaluated the adherence to Basel Core Principles in respect of regulation and supervision of commercial banks. The recommendations of the Advisory Group are summarised in **Appendix 2**.

A review committee to monitor progress on recommendations emanating from the above exercise, provided *inter alia*, in September 2004 a report on banking supervision. This report covered applicability, relevance and compliance with international standards in respect of the Basel Core Principles, corporate governance, internal control, credit risk, loan accounting, financial conglomerates and cross-border banking. This exercise was limited to commercial banks. The review committee's report on progress made in this regard are summarised in **Appendix 3**.

#### 1.2.1 Key Developments since 2001

The Reserve Bank has been continually reviewing the prudential supervisory framework, duly taking into account recommendations from earlier assessments. Some of the key developments in this regard related to commercial banks are:

- A fit and proper test is applied to evaluate directors and senior management. Fit and proper requirements for the Board of Directors have also been established through regulation.
- Any transfer of shares in a banking company, (GoI) which exceeds 5 per cent of the paid-up capital of the bank requires acknowledgement by the Reserve Bank before the registration of the transfer in their books.
- A Prompt Corrective Action (PCA) framework was introduced by the Reserve Bank in December 2002, linking supervisory responses to three parameters, *viz.*, capital adequacy ratio, net NPA ratio and the return on assets. The PCA framework envisages various structured and discretionary actions by the Reserve Bank at different threshold levels for each parameter.
- The Reserve Bank has off-loaded its stake in SBI (2007).
- Under the earlier guidelines, if a loan in the doubtful category did not migrate to the loss category, the account remained under-provided because after three years only a maximum of 50 per cent provision was created under the secured portion. Under the current guidelines, banks need to make 100 per cent provisioning for the unsecured portion. Provisioning for the secured portion is: 20 per cent upto 1 year, 30 per cent for 1 to 3 years and 100 per cent for more than 3 years.
- A detailed circular has been issued in 2007 wherein detailed guidelines on disclosure have been issued for improving the level of disclosure.



### 1.3 An Outline of the Regulatory Structure of Financial Institutions

In India, the regulatory and supervisory jurisdiction over different segments of the financial system is divided among the three major regulators, *viz.*, the Reserve Bank (RBI), the Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA), while some overarching regulatory powers vest with the Government of India. A new Pension Funds Regulatory and Development Authority (PFRDA) has also been set up.

The Reserve Bank regulates and supervises the majority of financial institutions in India. Its supervisory power extends to commercial banks, non-banking financial companies (NBFCs), co-operative banks and some All-India financial institutions (AIFIs). The Reserve Bank also licenses and regulates local area banks (LAB), which are treated as commercial banks. The Banking Regulation Act, 1949 (BR Act) provides the regulatory and supervisory framework for banks in India. The Reserve Bank derives its powers to regulate NBFCs and AIFIs through an amendment of the RBI Act in 1997.

The Board for Financial Supervision (BFS) constituted in 1994, which operates as a Committee of the Central Board of Directors of the Reserve Bank, functions as an oversight supervisory body for banks (both commercial and co-operative), NBFCs and AIFIs.

Various AIFIs, which are within the regulatory ambit of the Reserve Bank, function, in turn, under various statutes, as regulators and supervisors in some specific sectors. Regional rural banks (RRBs) and central and state co-operative banks are supervised by the National Bank for Agriculture and Rural Development (NABARD); state financial corporations (SFCs) are supervised by the Small Industries Development Bank of India (SIDBI) and housing finance companies are regulated and supervised by the National Housing Bank (NHB). These institutions are outside the purview of the

supervisory oversight of the BFS constituted by the Reserve Bank. In an attempt to separate its development and credit functions from its supervisory role, a Board of Supervision (for SCBs, DCCBs and RRBs) has been constituted as a Committee to the Board of Directors of NABARD. The Committee consists of both internal and external members.

The Registrar of Co-operative Societies (RCS) of different states shares regulatory powers over co-operative banks, both urban and rural. (For multi-state institutions, the Central RCS shares this power). While the banking functions of these entities are regulated and supervised by the Reserve Bank and NABARD, management control rests with the RCS of state/ Central Governments.

Though the Reserve Bank is one of the principal regulators, it is a multifaceted organisation with a variety of functions such as monetary, debt, exchange rate and reserve management and currency issue. It also has regulatory jurisdiction over money, foreign exchange and government securities markets and related derivatives segment. With the passage of the Payments and Settlement Bill, the Reserve Bank has also acquired regulatory and supervisory powers over the payment and settlement system in India.

Unlike the Reserve Bank, which is a multi-functional authority, SEBI and IRDA are constituted as principal regulators for the securities markets and the insurance sector respectively. As part of the regulation of securities markets, SEBI supervises several institutions such as stock exchanges, mutual funds, venture capital funds and other asset management companies, securities dealers and brokers, merchant bankers and credit rating agencies. Companies in the insurance sector are regulated by IRDA.

Please see Table 1 for a summary presentation of the regulatory structure of financial institutions and the corresponding governing legislations in India.

Table 1: Existing structure of Regulation of institutions in India

Institutions	Regulator	Acts/Guidelines
1	2	3
Commercial banks	The Reserve Bank	Banking Regulation Act, 1949 RBI Act, 1934 State Bank of India Act, 1955 State Bank of India (Subsidiary) Banks Act, 1959 Banks Companies (Acquisition and Transfer of Undertaking) Act, 1970 and 1980 DICGC Act, 1961
Urban co-operative banks	The Reserve Bank Registrar of Co-op. Societies	Banking Regulation Act, 1949(AACS) Co-operative Societies Act (for various State Governments) Multi State Co-operative Societies Act, 2002 DICGC Act, 1961
Regional rural banks	The Reserve Bank NABARD	Banking Regulation Act, 1949 DICGC Act, 1961 Regional Rural Banks Act, 1976 RBI Act, 1934
State co-operative banks/ District central co-operative banks	The Reserve Bank Registrar of Co-operative Societies NABARD	Banking Regulation Act, 1949(AACS) Co-operative Societies Act (for various State Governments) DICGC Act, 1961
Non-banking financial companies	The Reserve Bank Ministry of Corporate Affairs	RBI Act, 1934 Companies Act, 1956
Housing finance companies	National Housing Bank Ministry of Corporate Affairs	RBI Act, 1934 National Housing Bank Act, 1987 Housing Finance Companies(NHB) Directions, 2001 Companies Act, 1956

Against this backdrop, Section 2 gives the scope, coverage and methodology of the present assessment and provides a profile of the categories of institutions including commercial banks covered by the assessment. Section 3 attempts to address a set of broad issues arising out of the assessment. Sections

4 to 9 present, respectively, separate assessments of adherence to BCP along with a summary of recommendations related to commercial banks, urban co-operative banks, state and district central co-operative banks, regional rural banks, non-banking financial companies and housing finance companies.

## Section 2

### Coverage, Scope and Methodology

#### 2.1 Coverage and Scope

The BCPs are basically meant for the assessment of regulatory and supervisory practices with regard to commercial banks and are not strictly applicable to other financial institutions. Recognising, however, the importance of the other segments for the purpose of the current exercise the Panel chose to extend the assessment to urban co-operative banks, rural financial institutions, non-banking financial companies and housing finance companies. Though urban co-operative banks and rural financial institutions are banks, the BCPs are not applicable to them in the strictest sense; as co-operatives, they have a different organisational structure and function with certain broader socio-economic objectives. The non-banking financial companies and housing finance companies do not strictly fall within the ambit of the BCP.

The Panel recognised the difference in the level of development of the various categories of institutions and observed that this difference will have a bearing on the detailed, principle-by-principle assessment. In light of the above, the Panel has viewed the assessments of institutions other than commercial banks largely from a developmental perspective. The approach taken by the Panel in assessing the observance of BCPs in relation to the supervision of entities other than commercial banks:

- i In light of the developmental roles played by these institutions and the supervisory environment in which they function, identify separately principles which could be relevant to each of these sectors.
- ii Aim at adherence to the applicable principles by treating them as attainable benchmarks.
- iii Identify gaps in observance of these benchmarks. and

- iv Delineate an action plan for attaining compliance to these benchmarks in the medium-term.

Compared to earlier assessments, this is therefore a broader assessment extending the scope to entities other than commercial banks as relevant. The Panel feels that the results of such assessments would provide important directions to improve the overall regulatory and supervisory framework of all financial institutions. At the same time, the Panel recognises that it would not be appropriate to assess adherence to BCPs in respect of other financial institutions with the same degree of rigour as that of commercial banks. Given the relative importance of commercial banks in the financial system and the developments in the regulatory and supervisory framework covering them, all principles are applicable to commercial banks and a very stringent assessment of the same has been attempted.

#### 2.2 Methodology

The BCPs revised in 2006 contain essential criteria under each principle for the system to be considered effective, and additional criteria for countries to strive to improve financial stability and strengthen supervision. The templates provided jointly by the Bank for International Settlements and International Monetary Fund have been used for the assessment.

While many Basel Core Principles are applicable to any financial system, its exact implementation has to consider the local context, which is shaped by the specific characteristics of local legal and judicial systems, tax policies, regulatory structure, accounting convention and local custom which have been taken into account.

The 25 Core Principles specify the requirements for ensuring sound banking regulation and supervision. Principles 1 lay down conditions related to the objectives, independence, powers and transparency of the regulatory authority. Principles 2-5 lay down

Assessment of Adherence to  
Basel Core Principles

criteria related to activities, licensing, ownership and acquisitions. Criteria related to prudential requirements and risk management is detailed in Principles 6-18. Principles 19-21 go into the efficacy of the supervisory process. Principle 22 deals with accounting and disclosure and Principle 23 deals with corrective remedial powers. Principles 24-25 highlight issues relating to consolidated and cross-border supervision.

The level of adherence to each principle has been graded on a four-scale measure as (i) compliant (ii) largely compliant (iii) materially non-compliant or (iv) non-compliant.<sup>3</sup> In addition, a principle is considered 'not applicable' when it is felt so, given the structural, institutional and legal features of India.

The assessment of Basel Core Principles was completed in February 2008. The Panel

**Box 3.1: Basel Core Principles**

The Basel Core Principles comprise 25 principles that need to be in place for a regulatory and supervisory system to be effective. The principles relate to the following:-

**Principle 1: Objectives, independence, powers, transparency and co-operation**

**Principle 2 to 5: Licensing and structure**

- Principle 2: Permissible activities
- Principle 3: Licensing criteria
- Principle 4: Transfer of significant ownership
- Principle 5: Major acquisitions

**Principle 6 to 18: Prudential requirements and risk management**

- Principle 6: Capital adequacy
- Principle 7: Risk management process
- Principle 8: Credit risk
- Principle 9: Problem assets, provisions and reserves
- Principle 10: Large exposure limits
- Principle 11: Exposure to related parties
- Principle 12: Country and transfer risks
- Principle 13: Market risk

- Principle 14: Liquidity risk
- Principle 15: Operational risk
- Principle 16: Interest rate risk in banking book
- Principle 17: Internal control and audit
- Principle 18: Abuse of financial services

**Principles 19 to 21: Methods of ongoing supervision**

- Principle 19: Supervisory approach
- Principle 20: Supervisory techniques
- Principle 21: Supervisory reporting

**Principle 22: Accounting and disclosures**

**Principle 23: Corrective and remedial powers of supervisors**

**Principles 24 and 25: Consolidated supervision and cross border banking**

- Principle 24: Consolidated supervision
- Principle 25: Home-host relationship

<sup>3</sup> **Compliant:** A principle would be treated as compliant if all essential criteria applicable for the country are met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the compliance to Principle has been achieved by other means.

**Largely compliant:** A principle would be treated as largely compliant where only minor shortcomings are observed which do not raise any concerns about authority's ability and clear intent to achieve full compliance with the principle within a prescribed period of time.

**Materially non-compliant:** A principle would be treated as materially non-compliant whenever there are severe shortcomings despite the existence of formal rules, regulations and procedures and there is evidence that supervision has clearly been not effective, that practical implementation is weak or that shortcomings are sufficient to raise doubts about authority's ability to achieve compliance.

**Non-compliant:** A principle would be considered non-compliant whenever there has been no substantive implementation of the principle, several essential criteria are not complied with or supervision is manifestly ineffective.

notes that there have been some developments since then (particularly post implementation of Basel II for a section of the commercial banks) some of which could have assessment implications. The Panel also observes that regulators are already in the process of implementing some of its recommendations. The Panel has retained the original assessment with qualifying remarks wherever appropriate.

## 2.3 Brief Profiles of Institutional Categories covered by the Assessment

### 2.3.1 Commercial Banks

At the end of March 2007, there were 82 scheduled commercial banks with 59,036 branches. The dominant component of these banks are the 28 state-owned public sector banks which accounted for more than 70 per cent of the total assets in this sector. There were 25 privately owned Indian banks accounting for 22 per cent of the assets and 29 foreign banks operating in India accounting for 8 per cent of the assets. As on March 31, 2007, assets of the scheduled commercial banks constituted 61 per cent of the total assets of the financial system. (The financial system broadly constitutes the banking sector, broader financial sector and co-

operative banks). The balance sheet profile of scheduled commercial banks at end-March 2006 and 2007 is shown in Table 2.

Commercial banks are required to be fully compliant with Basel I norms and are expected to migrate to adoption of Basel II in two phases. Foreign banks operating in India and Indian banks having an operational presence outside India are expected to adopt the revised framework by March 31, 2008 (12 Indian banks with overseas branches and 29 foreign banks have adopted revised framework). All other banks are expected to migrate to Basel II by March 31, 2009.

The performance of the commercial banks has been strong in recent years. Capital adequacy continued to be comfortable at 12.3 per cent as on March 31, 2007, the same as on March 31, 2006. This was well above the stipulated limit of 9 per cent. The ratio of gross NPAs to gross advances and net NPAs to net advances of commercial banks improved from 3.3 per cent and 1.2 per cent as on March 31, 2006 to 2.5 per cent and 1.0 per cent respectively, on March 31, 2007. The return on equity increased from 12.7 per cent as on March 31, 2006 to 13.2 per cent on March 31, 2007 while the return on assets remained at 0.9 per cent during this period.

**Table 2: Profile of Scheduled Commercial Banks**

(Amount in Rs. Crore)

Item	As on March 31, 2006	As on March 31, 2007
1	2	
<b>Assets</b>	27,85,863 (18.25)	34,11,216 (23.00)
<b>Deposits</b>	21,64,681 (17.80)	27,11,216 (21.00)
<b>Borrowings</b>	2,03,147 (20.86)	2,03,147 (20.86)
<b>Advances</b>	15,16,811 (31.80)	19,81,216 (30.62)
<b>Investments</b>	8,66,508 (-0.37)	9,50,769 (9.72)

Figures in brackets indicate growth in per cent over the previous year

Source: Report on Trend and Progress of Banking 2006-07

### 2.3.2 Urban Co-operative Banks

Urban co-operative banks (UCBs) are an important part of the financial system in India, providing need based quality services, essentially to the middle and lower middle classes and weaker sections of the urban areas. There were 1,813 urban co-operative banks including 53 scheduled UCBs and 1,760 unscheduled UCBs on March 31, 2007. Urban co-operative banks form a heterogeneous group in terms of geographical spread, area of operation, size and individual bank performance. In terms of geographical spread, UCBs are unevenly distributed across the states. As on March 31, 2007, the assets of urban co-operative banks constituted 2.7 per cent of the total assets of the financial system. However,



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being banks, UCBs are a part of the payments and settlement system and could have a significant contagion impact on financial stability. The sector is significantly compliant as regards Basel I capital adequacy norms with a minimum capital requirement of 9 per cent which is what is stipulated for commercial banks. However, these banks are not required to provide capital charge for market risk in line with Basel requirements. Moreover, provisioning norms are less stringent than internationally adopted best practices.

The business profile of UCBs at end-March 2006 and March 2007 is provided in Table 3.

The CRAR of 1496 out of a total of 1,813 UCBs was more than 9 per cent on March 31, 2007. The ratio of gross NPAs to gross advances of UCBs had declined from 18.9 per cent on March 31, 2006 to 17 per cent on March 31, 2007.

The ratio of net NPAs to net advances of UCBs also declined from 8.8 per cent on March 31, 2006 to 7.7 per cent on March 31, 2007. Net profit of scheduled UCBs decreased from Rs.514 crore during 2005-06 to Rs.442 crore during 2006-07. Their accumulated losses declined from Rs.2,032 crore during 2005-06 to Rs.1,996 crore during 2006-07. The performance of the sector thus leaves scope for further improvement.

#### 2.3.3 State Co-operative Banks/District Central Co-operative Banks

The rural financial sector comprises rural co-operative credit institutions and regional rural banks and has a wide outreach particularly among the rural and vulnerable sections of society. The rural co-operative credit institutions can be segregated further into long-term and short-term institutions. The long-term

**Table 3: Profile of Urban Co-operative Banks**

(Amount in Rs. crore)					
Item	No.	Assets	Deposits	Loans and Advances	Investments
1	2	3	4	5	6
<b>1. All UCBs</b>					
<i>As at end of Mar'06</i>	1,853	1,50,954(14.23)	1,14,060(8.61)	71,641(7.13)	50,395(7.52)
<i>As at end of Mar'07</i>	1813	1,59,851(5.89)	1,20,983(6.07)	78,660(9.80)	47,316(-6.11)
<b>2. Scheduled UCBs</b>					
<i>As at end of Mar'06</i>	55	64,702(15.09)	45,297(10.62)	27,960(11.57)	22,593(32.17)
<i>As at end of Mar'07</i>	53	71,562(10.60)	51,173(12.97)	32,884(17.61)	20,279(-10.24)
<b>3. Non-Scheduled</b>					
<i>As at end of Mar'06</i>	1,798	86,252(13.60)	68,763(7.32)	43,680(4.47)	27,802(-6.64 1)
<i>As at end of Mar'07</i>	1,760	88,290(2.36)	69,810(1.52)	45,776(4.80)	27,037(-2.757)

**Source:** Report on Trend and Progress of Banking 2006-07  
Figures in brackets indicate growth over previous year

Figures of Mar'07 are provisional

**Table 4: Profile of Rural Co-operatives**

(Amount in Rs. crore)				
Item	Assets	Deposits	Loans and Advances	Investments
1	2	3	4	5
<b>SCBs</b>	76,481 (6.48)	45,405 (2.41)	39,684 (6.24)	27,694 (18.84)
<b>DCCBs</b>	1,43,090 (7.28)	87,532 (6.57)	79,202 (8.32)	36,628 (1.92)

Figures in brackets indicate growth in % over the previous year

**Source:** Trend and Progress 2005-06 and 2006-07

institutions comprise state co-operative agriculture and rural development banks (SCARDB) and primary co-operative agriculture and rural development banks (PCARDB). The short-term institutions are state co-operative banks (StCBs), district central co-operative banks (DCCBs) and primary agricultural credit societies (PACS). The 31 StCBs and 371 DCCBs, falling under regulatory purview of the Reserve Bank are being covered for the purpose of the present assessment.

The StCBs and DCCBs comprise more than 4 per cent of the total financial sector assets. The profile of these entities on March 31, 2006 is shown in Table 4.

The rural financial sector has been a vulnerable link in the Indian financial landscape. There are a significant number of loss-making entities and the sector is plagued with very high NPA ratios. They are, however, an important component of the financial sector as they are ideally suited for achieving the objective of financial inclusion and together with commercial banks have played a major role in delivery of agricultural and rural credit.

### 2.3.4 Regional Rural Banks (RRBs)

Regional rural banks were conceived as institutions that combine the local feel and familiarity of co-operatives with the business organisation ability of commercial banks. In the multi-agency approach to agricultural and rural credit in India, RRBs have a special place. Being local institutions RRBs are ideally suited for achieving financial inclusion. The RRBs are jointly owned by the Central Government, State Government and the parent commercial bank. 88 RRBs falling under the regulatory purview of the Reserve Bank are being covered for the purpose of the present assessment.

The RRBs comprise more than 1.8 per cent of the total financial sector assets. The profile of these entities as on March 31, 2007 is shown in Table 5.

### 2.3.5 Non-Banking Financial Companies

Non-banking financial companies (NBFCs) play a crucial role in broadening access to financial services, enhancing competition and in diversification of the financial sector. They are

**Table 5: Profile of Regional Rural Banks**

(Amount in Rs. crore)				
Item	Assets	Deposits	Loans and Advances	Investments
1	2	3	4	5
<b>RRBs</b>	1,05,768(17.99)	83,147(16.57)	47,326(22.68)	25,307(1.53)

Figures in brackets indicate growth in % over the previous year

**Source:** Trend and Progress 2005-06 and 2006-07

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increasingly being recognised as complementary to the banking system, capable of absorbing shocks and spreading risks at times of financial distress. NBFCs provide some financial services provided by banks and as such compete with them, albeit not strongly, in so far as sources and application of funds are concerned-for garnering of deposits and in disbursement of loans, advances and investments. NBFCs in India are not permitted to accept demand deposits, are not required to maintain a cash reserve ratio with the Reserve Bank and are not part of the payment and settlement system.

NBFCs have been broadly classified into non-deposit taking NBFCs (NBFC-ND), deposit

taking NBFCs (NBFC-D) and residuary non-banking finance companies (RNBCs) which are NBFCs that accept deposits. There were 403 NBFCs-D, 12,617 NBFCs-ND and 3 RNBCs as on March 31, 2007. Since December 2006, NBFC-ND have been further bifurcated into NBFC-ND-Systematically Important (SI) and NBFC-ND-others. This segregation is based on an asset size of Rs.100 crore and above as such companies having public funds for their liabilities and exposure to financial markets are deemed as capable of posing systemic risks.

The profile of these NBFCs as on March 31, 2006 and 2007 is shown in the Table 6.

**Table 6: Profile of Non-Banking Financial Companies**

(Amount in Rs. crore)				
Item	Assets	Deposits	Loans and Advances	Investments
1	2	3	4	5
<b>NBFC-D</b>				
<i>As on March 31, 2006</i>	37,828 (5.1)	2,447 (37.7)	10,686 (-16.2)	4,326 (9.3)
<i>As on March 31, 2007</i>	47,999 (26.9)	2,042 (-16.5)	10,602 (-0.8)	7,508 (73.5)
<b>NBFC-ND-SI</b>				
<i>As on March 31, 2006</i>	2,50,765	–	1,46,116	47,482
<i>As on March 31, 2007</i>	3,17,898 (26.77)	–	1,84,507 (26.27)	63,980 (34.7)
<b>RNBC</b>				
<i>As on March 31, 2006</i>	21,891 (14.9)	20,175 (21.53)	–	19,671 (10.7)
<i>As on March 31, 2007</i>	23,172 (5.9)	22,622 (12.8)	–	21,777 (11.0)

Figures in brackets indicate growth in % over the previous year

**Source:** Trend and Progress 2006-07



The asset size of NBFCs has recorded a healthy increase (more than 25 per cent in 2006-07) in recent times primarily aided by the rapid growth in the NBFC-ND segment. At the end of March 2007, NBFCs accounted for around 8.5 per cent of the total assets of the financial system.

Though NBFCs are not part of the payment and settlement systems, their linkages to financial markets and institutions contain elements of contagion risks which are systemically relevant. The stipulated minimum capital adequacy ratio<sup>4</sup> for NBFC-ND-SI is 10 per cent. The CRAR as applicable to those NBFCs authorised to accept public deposits is:

- (i) Asset finance company (AFCs) with a minimum investment grade credit rating (MIGR) – 12 per cent
- (ii) AFC companies without MIGR and loan/investment companies – 15 per cent

It can be seen that the CRAR prescribed for NBFCs is higher than the norms prescribed for commercial banks in India at 9 per cent. However, income recognition, asset classification and provisioning norms applied to them are less stringent than international best practices and when compared to commercial banks. In view of the above, the assessment in their case has been attempted by identifying principles which are relevant to this sector, treating them as attainable points of reference. On this basis, action plans are delineated from a medium-term perspective.

The present assessment covers deposit-taking NBFCs (NBFCs-D) and non-deposit taking systemically important NBFCs (NBFCs-ND-SI).

### 2.3.6 Housing Finance Companies

Housing finance has grown rapidly in the last two decades and housing finance companies, commercial banks and co-operative banks are together actively involved in this growth. Despite the strong interest and growth shown by commercial as well as co-operative banks in the housing finance sector, housing finance companies remain a significant contributor to housing growth in the country. There are 43 housing finance companies, of which 23 are non-deposit taking. The 12 largest housing finance companies account for about 97 per cent of the outstanding housing loans, 99 per cent of the public deposits and 98 per cent of the total borrowings of the sector.

The profile of the housing finance companies is shown in the Table 7.

As on March 31, 2007, the asset size of the HFCs constituted 2 per cent of total assets of the financial system. Though systemically they constitute a very small component of the financial system, it has been decided to cover the scope of their activities as it is related to real estate which is witnessing a credit boom. Given the predominance of long-term assets in their balance sheets, HFCs could be significantly vulnerable to interest rate risk and adverse selection of assets which, in turn, could affect

**Table 7: Profile of Housing Finance Companies**

(Amount in Rs. crore)				
	Assets	Public deposits	Borrowings	Outstanding housing loans
1	2	3	4	5
As on March 31, 2006	1,15,600	11,700	87,200	74,800
As on March 31, 2007	1,36,700 (18.25%)	13,100 (11.96%)	1,01,600 (16.51%)	90,100 (20.45%)

<sup>4</sup> CRAR for NBFCs covers credit risk only

the financial system adversely. It is important, therefore, to assess the adequacy of the supervisory environment and its ability to effectively mitigate risks in the event of a cyclical downturn. Though Basel norms are not applicable to HFCs, a minimum capital ratio of 12 per cent (covering only credit risk) has been stipulated for them. The norms related to provisioning are less rigorous than the international standards.

### Section 3

#### Broad Issues

While the assessment of adherence to BCPs has been attempted separately for different categories of institutions, overall, the exercise has brought to the fore certain developmental issues meriting attention. The pros and cons related to such broad developmental issues are detailed in this chapter.

#### 3.1 Regulatory Accountability of the Reserve Bank

In terms of Section 53(2) of the RBI Act 1934, the Reserve Bank transmits to the Central Government a copy of its annual accounts together with a report by the Central Board on its working throughout the year. This annual report contains, *inter alia*, a chapter on regulation and supervision by the Reserve Bank. Conventionally, it is interpreted that the Reserve Bank is indirectly accountable to Parliament through the Ministry of Finance. The Panel feels that the Reserve Bank should be made accountable to the government for its supervisory functions through a more transparent framework of understanding.

#### 3.2 Ownership Issues

Public sector banks comprise 70 per cent of the assets of the banking sector. On the one hand, this bodes well for stability because of the implicit sovereign guarantee. On the other hand it leads to conflicts of interest as both the regulator and the regulated entities are owned by the government. Undue government influence can lead to poor governance, rendering regulation ineffectual. This has a direct bearing on the regulator's ability to enforce compliance with the Basel Core Principles. The Panel feels that in the interest of proper regulation and growth of the sector and to resolve the inherent conflict arising from the government owning a major portion of the banking system, the government should urgently consider giving up its role as majority shareholder in public sector banks.

#### 3.3 Implementation of Basel Norms in Respect of UCBs and Rural Financial Institutions

Urban co-operative banks, though compliant with the Basel I accord of 1988 in terms of risk-based capital requirements, have not implemented a capital charge for market risk in line with the BCBS amendment to the first capital accord in 1996. The Panel feels that as some of the scheduled UCBs are equivalent in size and systemic importance to medium-sized commercial banks, there is a need to assign duration-based capital charges for market risk for these entities.

Rural co-operative banks at present do not have any requirement of maintaining risk-based capital. The Panel is of the view that in respect

of rural co-operatives, the migration to Basel I can be considered with the implementation of the revival package based on the Vaidyanathan Committee recommendations.

Similarly, in respect of RRBs, implementation of Basel I norms relating to capital adequacy could be considered with the completion of the amalgamation and recapitalisation process of these entities. Also, given the varying status of RRBs and co-operative banks as regards financial health, computerisation, quality of governance, *etc.*, there is need for a selective approach for implementation of the Basel I prescription. The banks could be categorised and a differential time-frame and roadmap could be prescribed for implementation of the Basel I norms.

### 3.4 Duality in Regulation of Co-operatives

Co-operative banks are regulated and supervised by state registrars of co-operative societies, the central registrar of co-operative societies in case of multi-state co-operative banks and by the Reserve Bank. Rural financial institutions are supervised by NABARD.

Banking-related functions are regulated and supervised by the Reserve Bank and NABARD (as applicable) under the provisions of the Banking Regulation Act, 1949(AACS). This has resulted in RBI/NABARD having no powers to bring about changes in the composition of the Board, to address any prudential concerns, except to requisition the RCS to supersede the board. The Reserve Bank has put in place licensing guidelines and is also empowered to reject applications that do not meet the requisite criteria. The Reserve Bank has prescribed fit and proper criteria for election to the boards of the rural co-operative banks along with criterion for professionalisation of these boards and the CEOs of these banks. While the Reserve Bank has prescribed fit and proper criteria for CEOs of urban co-operative banks, no such criteria have been made applicable to the directors of UCBS.

The Reserve Bank does not have the power to determine the suitability of shareholders, though the registrar of co-operative societies can disqualify the directors. It cannot ensure that the board has sound knowledge of the activities

#### Box 3.2: Revival Package for Co-operative Credit Institutions

The revival package announced by the Central Government based on the Vaidyanathan Committee recommendations is aimed at reviving the short-term co-operative credit structure (STCCS) to make it a well-managed and vibrant medium to serve the credit needs of rural India, especially, small and marginal farmers. The proposed financial assistance is one time conditional and released only on the implementation of the recommendations for legal and institutional reforms. At the end-January 2008, 17 States which cover 90 per cent of the PACS and 87 per cent of the CCBs in the country have signed a MoU with the Central Government and NABARD.

Financial assistance is available for wiping out accumulated losses, covering invoked but unpaid guarantees given by State Governments and other dues to the CCS from them and increasing capital to a specified minimum level (of 7 per cent CRAR). In order to ensure that the CCS continues on sound financial, managerial and governance norms,

technical assistance will also be provided to upgrade institutional and human resources of the CCS. The liability for funding the financial package will be shared by the Central Government, the State Government and the CCS based on the origin of loss and existing commitments. The total financial assistance under the revival package has been estimated at Rs. 13600 crores.

On completion of the revival package, the co-operative credit institutions are expected to be transformed into institutions that (i) are democratic, well-governed, professionally managed and audited; (ii) have requisite autonomy in raising resources and deploying funds as also in other operational matters connected therewith; (iii) undertake financial activities as principal business and separately account for and fund other activities, if undertaken; and that (iv) the StCBs and DCCBs are effectively regulated on par with other entities accepting public deposits.

of the bank. The ability of shareholders to provide financial support cannot be assessed. The Reserve Bank needs to be given more powers to take action against erring management including forced mergers and liquidation.

The multiplicity of command centres coupled with the absence of a clear-cut demarcation between the functions of governments and the Reserve Bank/NABARD has been largely responsible for most of the difficulties in implementing regulatory measures with the required speed and urgency impeding effective supervision.

Pending extensive changes in various legislations, the Vision Document for the UCB sector provided for a two-track regulatory framework and an Memorandum of Understanding (MoU) between the Reserve Bank and other regulators, *viz.*, the State Governments and the central registrar of co-operative societies to ensure that the difficulties caused by dual control are addressed if not fully at least substantially through such MoU/s within the extant legal framework. The Task Force to look into the short-term rural co-operative credit institutions also recommends a similar MoU with State Governments in this regard. The efficacy of these MoUs is however, still to be established beyond doubts.

In respect of rural co-operatives, the Central Government had appointed a Task Force under the Chairmanship of Prof. A Vaidyanathan in 2004 to analyse the problems faced by rural co-operatives and to suggest an action plan for their revival. Based on the report of the Task Force (Vaidyanathan Committee), a revival package for the rural co-operative sector was formulated.

From the long-term perspective, the Panel suggests that government influence in the co-operative sector needs to be minimised and its regulation should be brought within the ambit of a single regulatory organisation. The Reserve Bank with its store of regulatory experience is best placed to be entrusted with this task. Till this is achieved, efforts to sign MoUs should continue with all State Governments and to chalk out a revival path for potentially viable institutions and a non-disruptive exit route for non-viable ones.

### 3.5 Licensing of Co-operative Institutions

Section 7 of the Banking Regulation Act, 1949 As applicable to Co-operative Societies (AACS), prohibits the use of the words 'bank', 'banker' or 'banking' by any co-operative society other than a co-operative bank as part of its name. However, this provision does not apply to primary agricultural credit society (PACS) or a primary credit society (PCS). The licensing criteria for banks which are consistent with ongoing supervision are laid down clearly in Section 22 of the Banking Regulation Act (AACS), 1949. The Act provides for automatic conversion of primary credit societies with banking as one of its main activities into primary (urban) co-operative banks. Although they are required to apply to the Reserve Bank within three months of attaining capital -plus reserves of Rs. 1 lakh for a licence under Section 22 of the Banking Regulation Act(AACS), 1949 , they can carry on banking business unless the licence application is refused. This has led to the presence of a large number of unlicensed banks.

There are around 309 StCBs and DCCBs and 79 UCBs which are currently operating without a banking license. The Panel expressed concern regarding the continuing existence of

### Box 3.3: Dual control and Progress in Streamlining the Dual Regulatory & Supervisory Control of UCBs

#### 1. Legislative framework

The issue of dual control has been cited as the single most important impediment to effective regulation and supervision. Urban Co-operative Banks (UCBs), being primarily co-operative societies, are governed by the provisions of respective State Co-operative Societies Acts and Multi-State Co-operative Societies Act, as the case may be, apart from the Banking Regulation Act, 1949(AACS). The powers in regard to incorporation, registration, management, amalgamation, reconstruction or liquidation are exercised by the Registrar of Co-operative Societies under the respective Co-operative Societies Act of the State or by the Central Registrar of Co-operative Societies in case of the multi-state urban co-operative banks. Banking related functions such as issue of licenses to start new banks/branches, matters relating to interest rates, loan policies, investments, prudential exposure norms, *etc.*, are regulated and supervised by the Reserve Bank under the provisions of the Banking Regulation Act, 1949(AACS).

#### 2. Problems in dual control

A few illustrations, indicating severity of the problem are given below:

- (i) The Reserve Bank has no authority to deal with delinquent management in a co-operative bank, this requires intervention of the RCS.
- (ii) In some states, UCBs are required to obtain a No Objection Certificate (NOC) from the RCS even after getting the branch license from the Reserve Bank.
- (iii) Making investments out of surplus resources needs the approval of the Registrar in some states.
- (iv) There are instances where on requests from the Reserve Bank, the Registrar superseded the Board of a co-operative bank. But, subsequently, the State Government in its wisdom annulled the Registrar's orders and restored the board.

#### 3. Recommendations of the High-Powered Committee

The High-Powered Committee on Urban Co-operative Banks recommended carrying out amendments in the State Co-operative Societies

Acts, Multi-state Co-operative Societies Act and also in the Banking Regulation Act, 1949(AACS), clearly demarcating the functions which are to be regulated solely by the Reserve Bank and those of the establishment of co-operative societies and their co-operative characteristics, which shall remain within the domain of the Registrar of Co-operative Societies of the concerned states. Accordingly, a draft legislative bill proposing certain amendments to the Banking Regulation Act, 1949, has been forwarded to the Central Government. The proposed amendments, *inter alia*, relate to:

- (i) preventing automatic conversion of primary credit societies to primary co-operative banks;
- (ii) empowering the Reserve Bank to cause special audit of UCBs whenever it is satisfied that it is necessary in the public interest or in the interests of the co-operative bank or its depositor, for such transactions or class of transactions or for such periods as may be specified in the order.

#### 4. Recent measures to overcome the complexities posed by dual control-'Vision Document' for the UCB Sector:

Against the above backdrop, the Vision Document for the UCB sector was formulated in March 2005 to address the issue of dual control within the existing legal framework. It provided a two-track regulatory framework and an MoU between the Reserve Bank and the other regulators, *viz.*, the State Governments and Central Registrar of Co-operative Societies (CRCS). As per the MoU, the Reserve Bank undertakes to constitute a State-Level Task Force for Urban Co-operative Banks (TAFUCB) having representatives from the Reserve Bank and the State Government. Moreover, it draws up a time-bound action plan for the revival of potentially viable UCBs and non-disruptive exit for non-viable UCBs and facilitates human resource development and IT initiatives in UCBs. Till date, the Reserve Bank had entered into MoU with 24 State Governments for supervisory and regulatory co-ordination. These MoU arrangements encompass 1,747 UCBs, *i.e.*, 98.7 per cent of the banks representing 99.3 per cent of the deposits and advances of the sector.

unlicensed co-operative institutions as these entities pose a risk to depositors' interests. There is a need to draw up a roadmap whereby "banks" which fail to obtain a license by 2012

will not be allowed to operate. This would expedite the process of consolidation and weeding out of non-viable entities from the co-operative space.



#### **3.6 Enhancement of Efficacy of Off-Site Monitoring through close co-ordination with On-Site Supervision**

The Reserve Bank monitors commercial banks and other financial institutions within its regulatory ambit through on-site inspection and off-site surveillance. Its powers are derived from the Banking Regulation Act, 1949. The Panel observed that there is need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.

#### **3.7 Regulatory Independence of NABARD and NHB**

Section 7(3) of the NABARD Act, 1981, states that the Central Government may, in consultation with the Reserve Bank remove the Chairman at any time before the expiry of his term of office. Section 8(2) of the NABARD Act, 1981 states that the Central Government may, in consultation with the Reserve Bank, remove the Managing Director or any whole-time director appointed under sub-section (3) of section 6, at any time before the expiry of his term of office, after giving him a reasonable opportunity of showing cause against the proposed removal. However, the Act is silent about the public disclosure of reasons for the removal of the head of supervisory authority. Similarly, there is no requirement for a public disclosure of the reasons for the removal of the head of NHB. Though Section 7 of NHB Act provides for terms of appointment of Chairman

of NHB, it states that Central Government can in consultation with the Reserve Bank remove the Chairman after giving him reasonable opportunity of showing cause against the proposed removal.

As NABARD and NHB are not independent regulators, but are being regulated by the Reserve Bank, the Panel feels that the present dispensation regarding removal of heads of these institutions may continue.

## **Section 4**

### **Commercial Banks**

#### **4.1 Legal Arrangements and Organisational set-up for Regulation and Supervision**

The Reserve Bank an autonomous body created under an act of the Indian Parliament, i.e., the RBI Act, 1934, is solely entrusted, *inter alia* with the responsibility of regulation and supervision of banks. The Banking Regulation Act, 1949, empowers it to inspect and supervise commercial banks. These powers are exercised through on-site inspection and off-site surveillance. The Banking Regulation Act, *inter alia*, which also defines banking activity, specifies licensing requirements and provides for winding-up of banking companies. In addition to inspection of banks, the Act empowers the Reserve Bank to issue directions and impose penalties. The Act is applicable to state-owned, private sector and foreign banks operating in India. In addition, public sector banks are subject to their respective statutes, the State Bank of India (SBI) Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959 and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980.

Within the Reserve Bank, a separate Board for Financial Supervision (BFS), a committee of the Bank's Central Board of Directors, is specifically entrusted with the responsibilities of financial supervision, including banking supervision. BFS has been constituted by the Bank's Central Board (RBI {BFS} Regulations, 1994 as a part of delegated legislation as per regulation under sub-section (i) of Section 58 of the RBI Act 1934). The Governor is the Chairman of the BFS. The BFS, which generally meets once a month, provides direction on a continuing basis on regulatory policies including governance issues and supervisory practices. It also provides direction on supervisory actions in specific cases. The BFS also ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban co-operatives banks and primary dealers. Some of the initiatives taken by BFS include restructuring of the system of bank inspections, introduction of off-site surveillance, strengthening of the role of statutory auditors and strengthening of the internal systems of supervised institutions.

#### **4.2 Summary Assessment of Commercial Banks**

For the purpose of this assessment, the 25 Basel Core Principles for regulation and supervision of institutions have been broadly categorised as under:

- (i) Objectives, autonomy and resources (Principle 1)
- (ii) Licensing criteria (Principles 2-5)
- (iii) Prudential requirements and risk management (Principles 6-18)
- (iv) Methods of ongoing supervision (Principles 19-21)
- (v) Accounting and disclosure (Principle 22)
- (vi) Corrective remedial powers (Principle 23)
- (vii) Consolidated and Cross border banking (Principles 24-25)

The summary assessment of adherence to Basel Core Principles in respect of regulation and supervision of commercial banks under the above mentioned broad categories is given below. The detailed principle-wise assessment of Basel Core Principles of commercial banks is furnished in **Appendix 4**.

##### **4.2.1 Objectives, Autonomy and Resources (Principle 1)**

All sub-components of the principle, except the one on independence, accountability and transparency, are fully compliant. The Reserve Bank which regulates and supervises commercial banks has clear responsibilities and objectives, transparent processes, sound governance and adequate resources. Over the years, by convention and practice, it has established its operational independence *de facto*, even though there are some legislative gaps in ensuring *de jure* independence inasmuch as the Central Government has powers to remove the head of the supervisory authority without specifying any reasons. It is only indirectly accountable to Parliament through the executive wing of the government. The accountability framework needs to be better delineated and made more transparent.

The responsibilities and objectives of the supervisory authority are clearly defined. It possesses sound governance and adequate resources to be accountable for the discharge of its duties. There is a suitable legal framework in place in the form of a Banking Regulation Act, 1949, which includes provisions relating to licensing of banks (Section 22), setting prudential rules and their ongoing supervision (Section 35). The extant legislation also empowers the supervisor to assess compliance with laws and regulations to ensure the safety and soundness of banks, to have access to banks' board, management, *etc.*, and to take action against banks indulging in unsound practices. Legal protection is provided for supervisors as per Section 54 of the Banking Regulation Act, 1949.



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The Reserve Bank has arrangements in place for sharing of information with domestic regulators. As the law does not empower it to enter into formal Memoranda of Understanding (MoUs), there are no formal MoUs with foreign

supervisory agencies. However, it shares information with overseas supervisors based on reciprocity and with clear understanding that the information will remain confidential and be used for the purpose for which it is sought.

#### Box 3.4: Risk-Based Supervision

The international banking scene has witnessed a strong trend towards globalisation and consolidation of the financial system. Supervisory processes have also evolved and acquired a certain level of robustness and sophistication with the adoption of the CAMELS/CALCS\* approach to supervisory risk assessments and rating. The Reserve Bank has been constantly endeavouring to enhance the sophistication and efficiency levels of its supervisory processes. Considering the growing diversities and complexities of banking business, the spate of product innovation with complex risk phenomena, the contagion effects that a crisis can spread and the consequential pressures on supervisory resources, the Reserve Bank issued guidelines on the adoption of the Risk-Based Supervision (RBS) approach in September 2002. Currently pilot runs in select banks are being undertaken.

The RBS approach essentially entails the allocation of supervisory resources and paying supervisory attention in accordance with the risk profile of each institution. It is expected to optimize utilisation of supervisory resources and minimize the impact of a crisis situation on the financial system. The RBS process involves continuous monitoring and evaluation of the risk profiles of the supervised institutions in relation to their business strategy and exposures. This assessment will be facilitated by the construction of a risk matrix for each institution.

The working will be by way of enhancement as well as refining of the supervisory tools over those traditionally employed under the CAMELS approach viz., on-site examination and off-site monitoring. The RBS processes and the outcomes will be forward-looking, focusing attention beyond the rectification

of deficiencies with reference to the on-site inspection date. The extent of on-site inspection would be largely determined by the quality and reliability of the off-site data, and the reliability of the risk profile built up by banks. The effectiveness of the RBS would clearly depend on banks' preparedness in certain critical areas, such as quality and reliability of data, soundness of systems and technology, appropriateness of risk control mechanisms, supporting human resources and organisational back-up. Currently, a comprehensive review of the CAMELS process and RBS system is on to evolve a typical framework for India which, while being risk-based, would also fulfil the statutory obligations on the part of the Reserve Bank to assess the real and exchangeable value of assets, and to ensure that the bank holds the minimum statutory and regulatory capital on the dates of assessments. At the same time, the supervisory framework, which as per the Core Principles, needs to follow certain objective mechanisms to ensure the allocation of resources as per the risk profiles of banks, will also have to be enabled to undertake the Supervisory Review and Evaluation Process (SREP) under Pillar 2 of Basel II. The said review attempts to integrate SREP with the ongoing regular supervisory framework.

In light of recent developments in the international arena, the Reserve Bank is reviewing its stance on RBS.

**Source:** RBI circular on Risk Based Supervision

\* **CAMELS** – Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems and Control

\* **CALCS** – Capital Adequacy, Asset Quality, Liquidity, Compliance and Systems and Control

#### **4.2.2 Licensing Criteria (Principles 2-5)**

All the principles relating to licensing criteria are compliant. The Banking Regulation Act, 1949 delineates the situations under which the word 'banking' can be used (Section 7) and permissible activities (Section 6) that can be undertaken by bank. The licensing criteria for banks which are consistent with ongoing supervision are laid down clearly in Section 22 of the Banking Regulation Act, 1949. The Reserve Bank has powers to reject an application if criteria set by it are not fulfilled by a bank. There are also guidelines in place for the fit and proper criteria in respect of directors and top management. The Reserve Bank has the power to review and reject any proposal to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties. Clear rules are laid down regarding major acquisitions by banks.

#### **4.2.3 Prudential Requirements and Risk Management (Principles 6-18)**

Some of these principles are aspirational in nature as full compliance can be achieved only post-implementation of Basel II. Of the 13 principles relating to prudential requirements and risk management, three principles relating to capital adequacy, large exposure limits and country and transfer risks are compliant; five principles relating to credit risk, problem assets, provisions and reserves, operational risk, internal control and abuse of financial services are largely compliant; four principles relating to risk management, exposure to related parties, market risk and liquidity risk are materially non-compliant; the principle relating to capture of interest rate risk in the banking book is non-compliant.

Detailed guidelines on capital adequacy covering both on and off-balance sheet items have been issued to banks. The Reserve Bank has issued detailed guidelines on risk management but there is no specific regulatory requirement of an internal capital adequacy assessment process, since Basel II norms have

not yet been implemented. (The Reserve Bank has since issued guidelines on the internal capital adequacy assessment process as part of the supervisory review process under Pillar II of Basel II which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009). Guidelines relating to stress testing have been issued and this has been made mandatory for banks from March 31, 2008. While explicit guidelines regarding information systems for addressing risks and segregation of duties have been issued to banks, the same have not been issued to banking groups.

The guidelines on credit management do not explicitly mention that the bank's credit risk management policies/strategies include counterparty risk that might arise through various financial instruments. Guidelines on income recognition, asset classification and provisioning do not require banks to make an assessment on an individual basis of large accounts which are substandard even if they are unsecured. There are guidelines on large exposures in place. The Reserve Bank has issued guidelines on related parties. However, the discipline of seeking prior approval of the Board does not apply to all transactions (other than lending) and there is no requirement of seeking prior approval of the Board for write-offs.

The Reserve Bank has issued detailed guidelines on country risk. Likewise, it has issued guidelines on market risk. However, the extant guidelines do not require banks' valuation methods to appropriately capture concentrations, less liquid positions and stale positions which, in turn, should be reflected in provisions held by banks. Liquidity risk is essentially a consequential risk typically triggered by a combination of several other risks, like loss of depositors' confidence, changes in counterparty risk, changes in economic conditions, fluctuations in interest rates *etc.* The guidelines on liquidity risk management do not

specifically mandate banks to assess the impact of other risks (*viz.*, credit, market and operational risks) on liquidity of the bank. Further, they are confined to rupee balance sheets of banks. Also, the increase in infrastructure financing and real estate exposure of banks has resulted in an increased Asset-Liability Management (ALM) mismatch. Though banks hold a significant portion of their assets in liquid instruments there is a growing dependence on purchased liquidity and an increase in illiquid assets. These require to be strictly factored into the prudential guidelines for liquidity management and, if considered necessary, in the capital requirement of banks. In the Indian context, since the Reserve Bank regulates and supervises banks and is also the LoLR, it is in a position to assess the solvency and liquidity position of banks, hence will be in a position to make judicious use of the LoLR. This helps the Reserve Bank in reducing the incidence of events that cause an aggregate shortage of liquidity and to intervene at the appropriate juncture.

The Reserve Bank has issued detailed guidelines on operational risk to banks.

The asset-liability framework and risk management guidelines include the management of interest-rate risk. However, no specific guidelines have been issued to banks for managing interest rate risk in banking book. (The Reserve Bank has since issued guidelines on interest rate risk in banking book as part of the supervisory review process under Pillar II of Basel II, currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009).

The guidelines on internal control issued by the Reserve Bank do not ensure that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office. They do not require that banks notify the Reserve Bank of any material information that negatively affects the fitness and propriety of a member or of the senior management.

#### Box 3.5: Operational Risk in Derivatives

Financial institutions are increasingly using complicated financial instruments. Many of these instruments do not trade through exchanges but as over the counter (OTC) transactions. This is of particular importance in respect of derivatives products. Operational risk in derivatives activities is particularly important, because of the complexity and rapidly evolving nature of some products. The nature of the controls in place to manage operational risk must be commensurate with the scale and complexity of derivatives activity being undertaken. Volume limits may be used to ensure that the number of transactions being undertaken does not outstrip the capacity of the support systems to handle them. A segregation of duties is

necessary to prevent unauthorised and fraudulent practices. A basic and essential safeguard against the abuse of trust by an individual is to insist that all staff should take a minimum continuous period of annual leave (say 2 weeks) each year. This makes it more difficult to conceal frauds in the absence of the individual concerned. Policies and procedures should be established and documented to cover the internal controls which apply at various stages in the work-flow of processing and monitoring trades. Apart from a segregation of duties, these include trade entry and transaction documentation, confirmation of trades, settlement and disbursement, reconciliation, revaluation, exception reports, accounting treatment and an audit trail.

The Reserve Bank is satisfied that banks have adequate policies and processes in place including strict KYC rules.

#### 4.2.4 Methods of Ongoing Supervision (Principles 19 -21)

The supervisory framework for commercial banks is largely in place. Of the three principles relating to methods of ongoing supervision two relating to supervisory techniques and supervisory reporting are largely compliant. The principle related to the supervisory approach is treated as materially

non-compliant as the present rating mechanism (CAMELS for domestic banks and CALCS for foreign banks) does not clearly reflect the risk profile of banks. There is no requirement of notifying the Reserve Bank of any substantive changes/ adverse developments in a bank.

The Reserve Bank employs both on-site and off-site supervision while conducting supervision. It has the means for collecting, reviewing and analysing prudential reports and statistical returns from banks both on a solo and consolidated basis.

### Box 3.6: Prompt Corrective Action

Banking failures across countries during 1980 and 1990s led to the search for appropriate supervisory strategies to avoid bank failures as they can have a destabilising effect on the economy. In both industrial and emerging market economies, bank rescues and mergers are more common than outright closure of banks. It is therefore essential that corrective action is taken well in time when the bank still has an adequate cushion of capital, to minimise the cost to the insurance fund / public exchequer in the event of a forced liquidation of the bank. In this context, supervisory action can be at two levels:

- \* early recognition of problems and corrective actions
- \* supervision and monitoring of troubled banks

Identifying problem banks early is one of the responsibilities of bank supervisors. The other responsibility is to initiate corrective action in an attempt either to prevent failure or to limit losses.

These objectives are sought to be achieved by establishing various trigger points and graded mandatory responses by supervisors. This represents partial replacement of regulatory discretion by rules, as the prescribed actions are generally likely to be a mix of mandatory and discretionary actions. The Financial Sector Assessment Programme (FSAP), jointly made by the International Monetary Fund and the World Bank team on India's compliance with the Basel Committee's Core Principles in 2001 highlighted that lack of explicit rules mitigating against supervisory forbearance is a major weakness and

that the time limit set by the Reserve Bank for taking remedial measures is too long.

The Reserve Bank has been taking bank-specific supervisory corrective actions where the financial position warrants such measures. These included directing banks to submit quarterly Monitorable Action Plans and progress reports on various targets set by the Reserve Bank, such as augmentation of capital, improvement in profitability, reduction of NPAs, reconciliation of entries in inter-branch, inter-bank and nostro accounts, review/renewal of borrowal accounts, *etc.* Though there are explicit provisions empowering the Reserve Bank to initiate appropriate corrective action against banks which show signs of distress, these are not properly structured and no time limit is set for a response to such actions in the case of definite weaknesses in banks. Accordingly, a prompt corrective action scheme was formulated in March 2001 which involved a schedule of corrective actions based on three parameters, i.e., CRAR, net NPAs and return on assets (RoA), which represent capital adequacy, asset quality and profitability.

There are triggers prescribed in respect of each of the three parameters and on hitting the trigger a set of mandatory and discretionary PCAs would be initiated against the bank that has hit the trigger. The rationale for classifying the rule-based action points into mandatory and discretionary action points is that some actions are essential to restore the financial health of banks while other actions will be taken at the discretion of the Reserve Bank depending on the profile of the bank.

**Source:** RBI Circular on Prompt Corrective Action

But it has no power to initiate inspections in respect of a banking group.

#### 4.2.5 Accounting and Disclosure (Principle 22)

The principle relating to accounting and disclosure is largely compliant. External experts are required to bring to the notice of the Reserve Bank any serious irregularities noticed by them in the working of a bank that requires immediate attention. The Reserve Bank ensures that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely acceptable internationally, and publishes on a regular basis information that fairly reflects its financial condition and profitability. The extant guidelines do not require banks to make qualitative disclosures on their risk management aspects. Banks at present do not have a formal board approved disclosure policy which would be applicable once Basel II guidelines come into effect from March 31, 2008 (The Indian banks with foreign operations and foreign banks are required to have a formal board-approved disclosure policy with effect from March 2008).

#### 4.2.6 Corrective Remedial Powers (Principle 23)

The principle relating to corrective remedial powers is largely compliant. The Reserve Bank has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. But it does not have the powers to impose penalties/ sanctions on the management and/or the board or individuals therein. Furthermore, there is no specified timetable for initiating actions under the Prompt Corrective Action (PCA) framework.

#### 4.2.7 Consolidated Supervision and Cross-Border Banking (Principle 24-25)

The principle relating to consolidated supervision is largely compliant while the principle relating to cross-border banking is materially non-compliant.

A concept of consolidated supervision is in place whereby banks that have subsidiaries are required to file consolidated financial statements and half-yearly consolidated prudential returns to the Reserve Bank. In India, the holding company of the banking group as per the current corporate structure is the bank itself. Hence, while reviewing the operations of a bank and evaluating its financial health, the supervisor, deriving the necessary powers from Section 35 of the Banking Regulation Act 1935, 'reviews' the 'overall activities' of the banking group, both domestic and cross-border. Specifically under Section 35 of the Banking Regulation Act, the Reserve Bank enjoys powers to inspect the banking companies of an Indian banking group incorporated abroad. Even otherwise, under the current financial conglomerate monitoring mechanism, banks which have been termed as 'designated entities', submits variety of information to the Reserve Bank on group level issues, and also in respect of individual entities of the Group. The on-site inspection reports of the banks include comments on the earning performance of the bank's subsidiaries and joint ventures. Though the Reserve Bank has the power to define the range of activities of the consolidated group and call for information in respect of any entity in the banking group, it does not have power to cause inspection of all entities in the banking group. There is a formal arrangement in place



for sharing information with domestic regulators. However, information exchange with foreign regulators takes place on an informal basis and there are no formal MoUs in place for exchange of information with foreign supervisors as there is no enabling provision in either the RBI Act or the BR Act regarding information sharing.

The Reserve Bank has mechanisms in place for sharing information among domestic regulators through the High-Level Co-ordination

Committee on Financial Markets (HLCCFM). Cross-border exchange of information of supervisory interest with host country supervisors is need-based and no formal MoUs exist. There is no formal arrangement with home / host supervisors to exchange information at periodic intervals.

In the absence of such arrangements, it is difficult to assess the adequacy of the information to be exchanged. For instance there is no formal mechanism at present for

### Box 3.7: Consolidated Supervision

Following the failure of large international banks triggered by the operations of their subsidiary ventures and the concerns arising out of the entry of banks into other lines of business, there has been renewed focus on empowering supervisors to undertake consolidated supervision of bank groups. The Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS) have underscored this requirement as an independent principle. Accordingly, a multi-disciplinary Working Group was set up in November 2000 by the Reserve Bank (RBI). The recommendations of the Working Group were examined in the Reserve Bank and it was decided to implement consolidated supervision in respect of banks.

The Working Group has identified the following three components of consolidated supervision:

- (a) Consolidated Financial Statements (CFS),
- (b) Consolidated Prudential Reports (CPR), and
- (c) Application of prudential regulations like capital adequacy and large exposures/risk concentration on a group basis.

All banks coming under the purview of consolidated supervision of the Reserve Bank, whether listed or unlisted were advised to prepare and disclose consolidated financial statements for the financial year commencing April 1, 2002 in addition to solo financial statements. Consolidated financial statements was required to be prepared in terms of Accounting Standard (AS) 21 and other related accounting standards prescribed by the Institute of Chartered Accountants of India (ICAI) viz., Accounting Standard 23 and Accounting Standard 27. For the purpose, the terms 'parent', 'subsidiary', 'associate', 'joint venture', 'control' and 'group' have the same meaning as ascribed to them

in the above Accounting Standards of the Institute of Chartered Accountants of India.

A parent presenting consolidated financial statements should consolidate all subsidiaries - domestic as well as foreign - except those specifically permitted to be excluded under Accounting Standard 21. These statements are called from groups where the apex entity is a commercial bank. Non-financial and insurance subsidiaries/associates/joint ventures of the apex bank are outside the ambit of the CFS/CPR. The reasons for not consolidating any other subsidiary should be disclosed in the consolidated financial statements. The responsibility of determining whether a particular entity should be included or not for consolidation would be that of the management of the parent entity; the statutory auditors should comment in this regard if they are of the opinion that an entity which ought to have been consolidated had been omitted.

Consolidated financial statements normally include a consolidated balance sheet, consolidated statement of profit and loss, principal accounting policies, notes on accounts, etc.

There are two specific supervisory processes in place to develop and maintain systems for thorough understanding of the operations of banking groups:

- Financial Conglomerate Monitoring (FCM)
- Consolidated Supervision (CPR & CFS)

The process of Financial Conglomerate Monitoring is being further fine tuned through a project under which various cross-country practices are being studied and typical Indian requirements are being assessed.

**Source:** RBI Circular on Consolidated Supervision

## Chapter III

### Assessment of Adherence to Basel Core Principles

inspection of bank branches abroad. In the Indian context, though there have been exchanges of supervisory information on specific issues between the Reserve Bank and a few other overseas banking supervisors/regulators. But no formal/ legal arrangement or Memorandum of Understanding (MoU) has so

far been entered into between the Reserve Bank and outside supervisory authorities for cross-border supervisory co-operation. This is partly because of legal impediments with regard to sharing of credit information and permitting an agency other than the Reserve Bank to inspect a bank in India.

**Table 8: Summary Assessment of Commercial Banks**

Sr. No.	Principle	C	LC	MNC	NC
	<b>Objectives, autonomy and resources</b>				
1.	Objectives independence, powers, transparency and co-operation		√		
	<b>Licensing criteria</b>				
2.	Permissible activities	√			
3.	Licensing criteria	√			
4.	Transfer of significant ownership	√			
5.	Major acquisitions	√			
	<b>Prudential requirements and risk management</b>				
6.	Capital adequacy	√			
7.	Risk management process			√	
8.	Credit risk		√		
9.	Problem assets, provisions and reserves		√		
10.	Large exposure limits	√			
11.	Exposure to related parties			√	
12.	Country and transfer risk	√			
13.	Market risk			√	
14.	Liquidity risk			√	
15.	Operational risk		√		
16.	Interest rate risk in banking book				√
17.	Internal control and audit		√		
18.	Abuse of financial services		√		
	<b>Methods of ongoing supervision</b>				
19.	Supervisory approach			√	
20.	Supervisory techniques		√		
21.	Supervisory reporting		√		
22.	<b>Accounting and disclosure</b>		√		
23.	<b>Corrective and remedial powers of supervisors</b>		√		
	<b>Consolidated supervision and cross-border banking</b>				
24.	Consolidated supervision		√		
25.	Home host relationship			√	
	<b>Total</b>	<b>7</b>	<b>11</b>	<b>6</b>	<b>1</b>

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant



### 4.3 Recommendations

In light of the gaps observed in its assessment of adherence to Basel Core Principles on the regulation of commercial banks, the Panel has made certain recommendations to strengthen the regulation and supervision of these entities. These are as under:

#### 4.3.1 Constitution of Bank Boards

As per Section 10A(2)(b) of the Banking Regulation Act, 1949, directors<sup>5</sup> on a bank's board should not have substantial interest in a company or firm. As per Section 5(ne) of the Banking Regulation Act, 1949, substantial interest<sup>6</sup> means a paid-up amount exceeding Rs. 5 lakh or 10 per cent of the paid-up capital of the company, whichever is less. The low amount of Rs. 5 lakh acts as a constraint for having directors with requisite expertise on banks' boards.

The Panel recommends that these guidelines need to be reviewed and the limits defining 'substantial interest' revised upwards so that banks can attract individuals with requisite expertise on their boards.

#### 4.3.2 Internal Capital Adequacy Assessment Process (ICAAP)

The Board of banks have been advised to have approved policy on the Internal Capital Adequacy Assessment Process (ICAAP) and to allocate capital as per the assessment. But progress in this regard is limited to a parallel run of the revised framework. The Internal Capital Adequacy Assessment Process is yet to be implemented.

The Panel expects that this would be implemented consequent to the full migration of commercial banks to the Revised International Capital Framework (Basel II) as stipulated by the Basel Committee on Banking Supervision (The Panel notes that the Reserve Bank has since issued guidelines on the internal

capital adequacy assessment process as part of the supervisory review process under Pillar II of Basel II which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009).

#### 4.3.3 Risk Modelling

In terms of the extant guidelines, the use of internal models for risk management is not specifically mandated. Consequently, there is no system of periodic validation and independent testing of models and systems in the banks.

The Panel feels that a rigorous model-building exercise is needed. This will enable them to adopt a more advanced Internal Rating Based (IRB) approach in respect of credit risk and an Advanced Measurement Approach (AMA) for operational risk. If a bank intends to take recourse to the IRB or AMA approach for assessing credit and operational risks respectively, it should have appropriate forward looking models in place which should be validated periodically. The Panel recognises the need for capacity building in respect of banks and the Reserve Bank as the prime precondition in this regard.

#### 4.3.4 Credit Risk

The Reserve Bank has issued detailed guidelines on credit risk management in October 2002 which includes putting in place policies and processes for identification, measurement, monitoring and control of credit risk. However, the guidelines do not require that banks' credit risk management policies / strategies should also include counterparty credit risk arising through various financial instruments.

The Panel recommends issuance of suitable guidelines on credit risk to include counterparty risk arising through various financial instruments.

<sup>5</sup> This is applicable to only 51 per cent directors having specialised qualification.

<sup>6</sup> Substantial interest in SSIs are excluded.

#### 4.3.5 Provisioning for Sub-standard Loans

(i) The Reserve Bank has issued detailed guidelines on income recognition and asset provisioning. As per extant guidelines, provisioning is not done on an individual basis in respect of the substandard category of NPAs.

The Panel feels that keeping in view the cost of compliance, the present stipulations could continue for the present. However, considering the very large number of low value NPAs which are substandard, if at all provisioning has to be done individual account-wise, a cut-off level should be set above which all accounts can be provided for individually. This cut-off level above which all substandard assets have to be provisioned for may be lowered in a phased manner.

(ii) As per extant guidelines on provisioning, banks are required to make up to two per cent provision on standard assets, while NBFCs do not need to make any provision on standard assets.

The Panel recommends a review of norms be made to reduce the possibility of regulatory arbitrage across categories of financial institutions.

#### 4.3.6 Exposure to the Capital Market

Globally, capital market exposure is measured based on risk and not quantitative limits. However, in India capital market exposure cannot exceed 40 per cent of the net worth, and the limit for lending to individuals is Rs.10 lakh (Rs.20 lakh in demat form) which appears to be low. Further, a uniform margin of 50 per cent is applied on all advances/financing of IPOs/ issue of guarantees on behalf of stockbrokers and market makers.

The Panel recommends a review of these limits periodically keeping in view the associated risks arising out of such exposures.

#### 4.3.7 Liquidity Risk

(i) The Reserve Bank has issued detailed guidelines on liquidity risk and banks have a liquidity management strategy in place. However, the effect of other risks on banks' overall liquidity strategy is not covered in the guidelines.

The Panel feels that the enhancement of knowledge and quantitative skills in the banking industry is an essential pre-requisite for analysing contagion risk. The banking sector is at a stage where it has initiated the implementation of simple and standardised risk management techniques. An impact analysis of other risks on liquidity at this juncture would therefore appear premature. The Panel also recognises the existence of diverse risk management techniques across the banking sector. It recommends that the implementation of contagion risk management techniques be undertaken in a phased manner. To begin with, it could be mandated for those banks that are in possession of appropriate skill sets. The Panel also recommends that banks should initially concentrate on knowledge and quantitative skill enhancement and fix a reasonable timeframe, say two years, before undertaking such forward-looking analysis of contagion risk.

(ii) The extant guidelines on liquidity risk issued by the Reserve Bank are confined to the rupee balance sheets of banks.

The Panel recommends that the Reserve Bank should consider issuing guidelines on liquidity risk which would also cover foreign exposures of banks.

#### **4.3.8 Operational Risk**

Though various aspects relating to operational risk are covered sufficiently in the Annual Financial Inspection reports for commercial banks, there is no reporting mechanism in place whereby the supervisor is kept informed of developments affecting operational risk in banks on an ongoing basis.

The Panel recommends that the Reserve Bank should put in place a mechanism whereby banks are required to report developments affecting operational risk to the supervisor.

#### **4.3.9 Interest rate risk in Banking Book**

Commercial banks have migrated to Basel II guidelines in phases beginning March 31, 2008. The identification, measurement, monitoring and control of interest rate risk in banking books is part of the stipulations mandated in Pillar II of the Revised Capital Framework and is not mandated at present.

The Panel recommends that the issuance of guidelines relating to the management of interest rate risk in banking books, post-migration to Basel II could be based on the modified duration approach for the measurement of interest rate risk in banking books as suggested by the Basel Committee (The Panel notes that Reserve Bank has since issued guidelines on interest rate risk in banking books as part of the supervisory review process under Pillar II of Basel II which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009).

#### **4.3.10 Notification of adverse information**

The Panel observes that there are no guidelines issued by the Reserve Bank which explicitly provide for the supervisor to ensure that banks notify the Reserve Bank as soon as they become aware of any material information which may negatively affect the fitness and propriety of a board member or a member of the senior management. At present this is being done on a voluntary basis.

The Panel recommends that the Reserve Bank issue specific guidelines in this regard that mandate banks to notify the Reserve Bank as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management.

#### **4.3.11 Appropriate skills in the back-office of the Bank Treasury**

Though the Reserve Bank has issued guidelines periodically on the segregation of duties and responsibilities in the front office, mid-office and back office for treasury operations, it is not being determined whether there is an appropriate balance of skills and resources in back office and control functions relative to the front office. Though this aspect is looked into during the on-site inspection of banks, there is no specific mandate in the inspection manual in this regard.

The Panel recommends that the Reserve Bank issue appropriate guidelines to banks stressing the maintenance of such a balance by banks. It also recommends the incorporation in the inspection manual of a suitable provision mandating on-site inspectors to specifically comment on this aspect in their reports.

#### **4.3.12 Risk-Based Supervision**

The current supervisory mechanism consists of monitoring banks through on-site inspections and off-site returns obtained from them, and through periodic meetings with bank officials. The on-site supervisory mechanism adopted by the Reserve Bank is CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems and Control) approach for domestic banks and CALCS (Capital Adequacy, Asset Quality, Liquidity, Compliance and Systems and Control) for foreign banks. These banks are rated on the CAMELS/CALCS model based on the on-site inspection by the Reserve Bank. However, the CAMELS/CALCS rating does not clearly reflect the risk profile of the bank, and does not pinpoint the risks where

the bank might be vulnerable or areas of risk where the bank has mitigating mechanisms to take care of the risks. Though a parallel run of Risk Based Supervision (RBS) is in progress for select banks, it is not yet mandated as a supervisory mechanism.

The Panel recommends a quicker adoption of the techniques and methodology of RBS. This will appropriately profile the bank, highlighting the risks and vulnerabilities it faces. Based on its assessment, the supervisory cycle for banks can then be determined. The Panel also recommends a further strengthening of off-site surveillance which is a pre-condition for the effective adoption of techniques and methodology of RBS.

#### **4.3.13 Qualitative Disclosure**

The Reserve Bank has issued detailed guidelines on accounting and disclosure norms and it is also satisfied that banks maintain adequate records drawn up in accordance with these accounting policies. However, though extant guidelines do require qualitative disclosure on risk management aspects, they are yet to be implemented.

The Panel recommends that there should be expeditious implementation of guidelines regarding qualitative disclosures, concurrent with full migration to Basel II. (The Panel notes that guidelines have since been issued mandating Indian banks with foreign operations and foreign banks to have formal Board approved disclosure policy from March 31, 2008 and for others from March 31, 2009).

#### **4.3.14 Prompt Corrective Action**

A concept Prompt Corrective Action (PCA) framework has been introduced by the Reserve Bank whereby it can initiate a set of actions

against banks based on trigger points relating to the CRAR, Net NPA Ratio and Return on Assets. While the PCA framework has prescribed broad triggers, there is no specified timetable for initiating the mandatory actions and the discretionary actions.

The Panel feels that the guidelines on the PCA framework should provide for an appropriate timeline for initiating mandatory and discretionary actions to follow the identified triggers. If necessary, this could be finalised in consultation with the Government.

#### **4.3.15 Consolidated Supervision**

The Reserve Bank has issued a circular in February 2003 on consolidated accounting to facilitate consolidated supervision. Accordingly, banks that have subsidiaries are required to file consolidated financial statements and half-yearly consolidated prudential returns to the Reserve Bank. Though the Reserve Bank has the power to define the range of activities of the consolidated group, it does not have the power to cause inspections of any entity within the banking group which is not under its regulatory purview. The Panel recognises that the insertion of Section 29(A) (Power in respect of associated enterprise) in the Banking Regulation Act (Amendment) Bill 2005 would empower the Reserve Bank to conduct consolidated supervision. The Panel recommends expeditious passage of the Amendment Bill in Parliament.

#### **4.3.16 Information sharing with Foreign Regulators**

The RBI Act does not explicitly provide for the Reserve Bank to enter into any agreement with corresponding home/host supervisors. Consequently, there is no formal Memorandum

of Understanding (MoU), and there is no agreed communication strategy between home/host regulators. Also the Banking Regulation Act empowers the Reserve Bank alone to inspect banks, and the overseas regulator is not permitted to inspect the Indian offices of the banks under their jurisdiction, share customer information (especially credit information) and inspection reports.

The Panel feels that there should be specific provisions in the RBI Act, 1934 and Banking Regulation Act, 1949 on lines of the SEBI Act, 1992 so that an MoU can be entered into with foreign supervisors establishing formal communication mechanisms. However, specifically empowering foreign entities to inspect domestic banks through amendment of an Act may not be feasible. There can be a clause in the MoU enabling the foreign regulators to inspect branches of foreign banks in India, subject to specific approval of the Reserve Bank and reciprocity.

## Section 5

### Urban Co-operative Banks

#### 5.1 Legal Arrangements and Organisational set-up for Regulation and Supervision

Urban co-operative banks (UCBs) form an important part of Indian banking. They supply the credit requirements of the middle and lower middle classes and the marginalised sections in specific regions.

There is dual control of UCBs, inasmuch as the regulatory and supervisory responsibilities are shared between state registrars of co-operative societies (central registrar of co-operative societies in case of multi-state co-operative banks) and the Reserve Bank. The Registrars at the state-level exercise powers under the respective co-operative societies acts of the states in regard to incorporation, registration, management, amalgamation, reconstruction or liquidation. In case of urban co-operative banks with a multi-state presence, the central registrar of co-operative societies (CRCS) exercises such powers.

Banking related functions, such as the issue of license to start new banks / branches, matters relating to interest rates, loan policies, investments, prudential exposure norms, *etc.*, are regulated and supervised by the Reserve Bank under the relevant provisions of the Banking Regulation Act, 1949 (as applicable to co-operative societies). While supervisory oversight of the Board for Financial Supervision (BFS) extends to UCBs, there is a multiplicity of command centres and an absence of clear-cut demarcation between the functions of State Governments and the Reserve Bank.

The "Vision Document for the UCB Sector" was formulated in March 2005 to address the issue of dual control within the existing legal framework. *Inter alia*, it provides for a two-track regulatory framework and a Memorandum of Understanding (MoU) between the Reserve Bank and the other regulators, *viz.*, the State Governments and CRCS. The MoU is a working arrangement between the Reserve Bank and the State Government/CRCS to ensure that the difficulties caused by dual control are suitably addressed. The Reserve Bank has till date entered into MoUs with 24 states for supervisory and regulatory co-ordination.

#### 5.2 Summary Assessment of Urban Co-operative Banks

Given the special features of UCBs in terms of their size and nature of their operations, some of the Basel Core Principles (BCPs) are not strictly applicable to them. These include:

- i. **Transfer of Significant Ownership (Principle 4):** There is no concept of controlling/significant ownership of an UCB. Each member has only one vote irrespective of the number of shares held by him/her.
- ii. **Country and Transfer Risk (Principle 12):** UCBs do not have exposure to foreign countries. Hence the question of country and transfer risk does not arise.



### Assessment of Adherence to Basel Core Principles

- iii. **Consolidated Supervision (Principle 24):** UCBs do not belong to any banking group. UCBs registered in states do not have subsidiaries. Hence the concept of consolidated supervision is not applicable.
- iv. **Home-host Relationship (Principle 25):** UCBs do not have foreign presence. Hence the question of a home-host relationship does not arise.

Also, the emphasis of other BCPs for UCBs may not carry equal significance vis-à-vis commercial banks.

The Panel recognises, therefore, that not all principles as encapsulated in the BCP are

applicable to UCBs. BCPs are not applicable to a significant proportion of these entities which are very small in size and conduct only rudimentary banking operations. This assessment, therefore, has been conducted with respect to larger and scheduled UCBs with public deposits above Rs.100 crore in whose case many of the principles are applicable.

The summary assessment of adherence to 25 BCPs in respect of regulation and supervision of UCBs under the broad categories is provided in this chapter. The detailed principle-wise assessment is furnished in **Appendix 5**.

#### Box 3.8: International Co-operative Bank Models

Across the globe, there are three main co-operative banking models: (i) the 'national' co-operative bank model, (ii) the 'federated' co-operative bank model; and (iii) the 'individual' co-operative bank model.

##### The National Co-operative Bank Model

Two or more co-operatives banks/credit unions merge their assets into a federal co-operative bank with a single identity or brand. The merging entities are allocated membership of the post-merger single identity, and shares in proportion to their assets. However, each member gets only one vote and may have one director to the bank's board. Profits and losses are allocated by the bank to the local co-operative banks/credit union members according to their number of shares. The co-operative bank is regulated as a single federal institution and produces consolidated financial statements.

##### The Federated Co-operative Bank Model

The federated structure in countries such as Netherlands (Rabobank Group), France (Credit Agricole Group), and Finland (OKO Group) lend financial strength to all the co-operative entities forming part of the structure. It revolves around a strong apex-level entity, which has even

supervisory powers and responsibility. All the local co-operative banks are generally members of the apex entity. Each member exercises its voting rights under the one-member-one-vote principle. The apex bank supports and advises individual member banks in areas such as customer services, ALM, IT, mutual funds, product development, *etc.* A significant characteristic of European co-operative banks is the existence of a mutual support system. In several co-operative banking groups in Austria, France and the Netherlands, legally binding cross-guarantees are in place, whereby if any bank within the group faces financial trouble, other members of the group support it; in effect each has joint and several liabilities for each other's commitments.

##### The Individual Co-operative Bank Model

Under this model, financial co-operatives function as individual co-operative banks with their own identities, brands, products, *etc.* UCBs in India come under this model. Such banks basically function on a stand-alone basis. Financial co-operatives especially in Asia function under this model.

The co-operative models of some countries are furnished in **Appendix 10**.

### 5.2.1 Objectives, Autonomy and Resources (Principle 1)

All sub-components of the principle except for the one on independence, accountability and transparency, are fully compliant. The Reserve Bank along with RCS which regulates and supervises urban co-operative banks, has clear responsibilities and objectives and possesses transparent processes, sound governance and adequate resources. Although, by convention, the Reserve Bank is operationally independent and accountable *de facto*, the Central Government has powers to remove the head of the supervisory authority without specifying any reasons. It is only indirectly accountable to Parliament, through the executive wing of the Government of India. The transparency of the accountability framework needs closer introspection.

There is a suitable legal framework in place which includes provisions relating to the licensing of urban co-operative banks, setting prudential rules and their ongoing supervision (as per sections 21, 22 and 35 of the Banking Regulation Act (AACS), 1949). The legal framework empowers supervisors to address compliance with laws, to ensure safety and soundness of banks, to have access to banks' boards, management, *etc.*, and to take action against banks indulging in unsound practices. Legal protection is provided for supervisors (as per Section 54 of the Banking Regulation Act (AACS), 1949). There are both formal and informal arrangements for sharing information and co-operation between domestic regulators. As these entities do not have overseas presence, the question of sharing information with foreign regulators does not arise.

### 5.2.2 Licensing Criteria (Principle 2-3 and 5)

While the principles relating to major acquisitions are fully compliant, there remain some minor lacunae in respect of full compliance of permissible activities, licensing criteria and transfer of significant ownership.

The activities that can be carried out by UCBs are clearly defined. Though the Banking Regulation Act (AACS), 1949, prohibits the use of the words 'bank', 'banker' or 'banking' other than by a co-operative bank as part of its name or in connection with its business, some primary credit societies (PCS), primary agriculture credit societies (PACS) and other entities call themselves banks and function as banks before a licence is granted by the Reserve Bank. The licensing criteria for banks which are consistent with ongoing supervision are laid down in Section 22 of the Banking Regulation Act (AACS), 1949. The Act provides for the automatic conversion of primary credit society with banking as one of its main activities to primary (urban) co-operative bank. Although they are required to apply to the Reserve Bank within three months of attaining capital plus reserves of Rs. 1 lakh for a licence under Section 22 of the Banking Regulation Act(AACS), 1949, they can conduct banking business till the licence application is refused. This has led to the presence of a large number of unlicensed banks (79 as of January 1, 2008).

The Reserve Bank does not have control over the managerial affairs or shareholding which is vested with the RCS. There are no fit and proper criteria for directors, as per the Memorandum of Understanding (MoU) with the State Governments. But fit and proper criteria have been prescribed for chief executive officers of UCBs.

UCBs do not have cross border operations. Acquisition by way of merger requires the prior approval of both the regulators, *viz.*, the Reserve Bank, and the registrar of co-operative societies/ central registrar of co-operative societies in case of multi-state UCBs.

### 5.2.3 Prudential Requirements and Risk Management (Principles 6-11, 13-18)

Of the 12 applicable principles relating to prudential requirements and risk management, three principles relating to capital adequacy,



problem assets and related parties are compliant; three principles relating to credit risk, large exposure limits and abuse of financial services are largely compliant; four principles relating to risk management, market risk, liquidity risk and internal control are materially non-compliant and two principles relating to operational risk and interest rate risk in banking books are non-compliant.

The Reserve Bank has issued capital adequacy guidelines which include both on and off-balance sheet items which are uniformly applicable to all urban co-operative banks. At present, UCBs are Basel I compliant, other than in relation to the capital charge for market risk. However, capital charge has been provided for market risk through the surrogate method<sup>7</sup>.

The Reserve Bank has issued guidelines on risk management which are mostly confined to credit risk. The Asset Liability Management (ALM) guidelines regarding structural liquidity and interest rate risk are applicable only to scheduled UCBs, *i.e.*, the larger entities. There is no system of confirmation by the supervisor regarding the adequacy of the risk management processes adopted by UCBs. The Reserve Bank does not determine whether the risk-taking function is segregated from the risk-evaluation/monitoring/control function.

The existing credit risk guidelines issued by the Reserve Bank do not require that banks' credit risk management policies/strategies should include the counterparty credit risk, except to certain sensitive sectors, arising through various financial instruments. The

Reserve Bank has not issued any guidelines regarding potential future exposures (*e.g.*, in forward contracts) and does not determine that UCBs have in place policies and processes to identify, measure, monitor and control counterparty credit risk exposures including potential future exposure. The Reserve Bank has issued detailed guidelines on income recognition, asset classification and provisioning. However, there is no effective mechanism for early identification of NPAs. The provisioning norms are not bank specific, but the supervisor has the power to prescribe these. The Reserve Bank has defined large exposure limits for banks. However, detailed risk management policies and practices to establish thresholds for acceptable concentration of credit are absent. The Reserve Bank has not issued detailed guidelines on market risk except for valuation norms for investments and asset-liability guidelines to scheduled UCBs.

The Reserve Bank has not issued detailed guidelines on liquidity risk except for ALM guidelines to scheduled UCBs. These guidelines do not take into account undrawn commitments and other off-balance sheet items. Though various guidelines for the prevention and reporting of frauds, internal/concurrent audit, balancing of books, *etc.*, have been issued, the Reserve Bank has not issued detailed guidelines on identification, measurement and monitoring of operational risk to UCBs. It has also not issued any guidelines to banks for management of interest rate risk in banking book.

The Reserve Bank has issued guidelines to banks asking them to put in place adequate

<sup>7</sup> The capital charge to market risk is being captured by assigning an additional risk weight of 2.5 per cent in respect of investments in addition to risk weights applicable for credit risk.

internal controls. A detailed evaluation of the internal audit function is, however, not undertaken. There is no system of reporting to the Reserve Bank of any adverse information on senior executives/members of the board. The Reserve Bank does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office. The Reserve Bank has issued guidelines in respect of KYC norms and fraud monitoring. There is no legal protection available to whistle blowers.

#### 5.2.4 Methods of Ongoing Supervision (Principles 19 to 21)

The supervisory framework for urban co-operative banks is largely in place. All the three principles relating to methods of ongoing supervision are largely compliant.

The main instrument of supervision of UCBs is the periodic on-site inspection of banks supplemented by off-site monitoring and surveillance. No forward looking view of the risk profile of banks is taken by the supervisor. It

**Table 9: Summary Assessment of Urban Co-operative Banks**

Sr. No.	Principle	C	LC	MNC	NC	NA
	<b>Objectives, autonomy and resources</b>					
1.	Objectives independence, powers, transparency and co-operation		√			
	<b>Licensing criteria</b>					
2.	Permissible activities		√			
3.	Licensing criteria		√			
4.	Transfer of significant ownership					√
5.	Major acquisitions	√				
	<b>Prudential requirements and risk management</b>					
6.	Capital adequacy	√				
7.	Risk management process			√		
8.	Credit risk		√			
9.	Problem assets, provisions and reserves	√				
10.	Large exposure limits		√			
11.	Exposure to related parties	√				
12.	Country and transfer risk					√
13.	Market risk			√		
14.	Liquidity risk			√		
15.	Operational risk				√	
16.	Interest rate risk in banking book				√	
17.	Internal control and audit			√		
18.	Abuse of financial services		√			
	<b>Methods of ongoing supervision</b>					
19.	Supervisory approach		√			
20.	Supervisory techniques		√			
21.	Supervisory reporting		√			
22.	<b>Accounting and disclosure</b>		√			
23.	<b>Corrective and remedial powers of supervisors</b>		√			
	<b>Consolidated supervision and cross-border banking</b>					
24.	Consolidated supervision					√
25.	Home host relationship					√
	<b>Total</b>	<b>4</b>	<b>11</b>	<b>4</b>	<b>2</b>	<b>4</b>

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant

does not evaluate the quality of the board/management on an ongoing basis as part of its supervisory duties.

Under Section 27 of Banking Regulation Act (AACS), 1949, the Reserve Bank has the power to call for information from UCBs. However, auditors are not required to bring to the notice of the Reserve Bank any material shortcomings identified during the course of the work undertaken by them.

#### **5.2.5 Accounting and Disclosure (Principle 22)**

The aforesaid principle is largely compliant in case of UCBs. The formats for preparation of financial statements are prescribed under Section 29 of the Banking Regulation Act (AACS) 1949. But, the Reserve Bank has no access to audit reports and it does not meet auditors during its conduct of on-site inspection. Laws/regulations do not require external auditors (not appointed for supervisory purpose) to report any significant adverse findings to the Reserve Bank.

#### **5.2.6 Corrective Remedial Powers (Principle 23)**

The aforesaid principle is largely compliant in case of UCBs. The Reserve Bank has at its disposal an adequate range of supervisory tools to bring about corrective action which includes the ability, where appropriate, to revoke the banking licence or recommend its revocation. While there is adequate corrective and remedial power vested in the Reserve Bank and RCS, dual control has led to slow supervisory response.

### **5.3 Recommendations**

For the reasons stated above and given that even scheduled UCBs do not have any

significant foreign presence at present - a position which is unlikely to change in a medium-term perspective-the Panel feels that migration to Basel II may not be feasible currently for the entire UCB sector.

In the opinion of the Panel, the single most important regulatory and supervisory hindrance that still exists in this sector is the problem of dual control.

#### **5.3.1 Memorandum of Understanding**

In order to mitigate regulatory disharmonies arising out of the system of dual control, MoUs have been entered into between the Reserve Bank, State Governments and the Central Registrar of Co-operative Societies. The Reserve Bank undertakes to constitute a state-level task force for urban co-operative banks with representatives from the Reserve Bank, State Governments and the sector for identification and drawing up of a time-bound action plan for the revival of potentially viable UCBs and the non-disruptive exit of non-viable UCBs and to facilitate human resources development and IT initiatives in UCBs. Till date, 24 State Governments and the Central Registrar of Co-operative Societies (CRCS) have entered into MoUs with the Reserve Bank.

The Panel is appreciative of the initiative and recommends that the Reserve Bank take immediate steps to sign MoUs with the remaining State Governments. At the same time, it also feels that while MoUs are appropriate from the medium-term perspective, in the interests of strengthening the sector, the regulatory and supervisory powers of UCBs should ultimately be vested with a single regulator which could be the Reserve Bank.

### 5.3.2 Capital Adequacy

The High-Powered Committee on UCBs constituted by the Reserve Bank in May 1999 observed that as UCBs perform the same banking functions as commercial banks and are exposed to similar risks in their operations, the non-application of capital adequacy norms to UCBs could undermine the stability of the whole banking system. Accordingly, based on the recommendations of the Committee, it was decided to make capital adequacy guidelines applicable to UCBs in a phased manner for scheduled and non-scheduled UCBs. So far, the capital adequacy norms for UCBs are as per Basel I norms, except for a capital charge for market risk. The capital charge for market risk in UCBs is in surrogate form where an additional 2.5 per cent risk weight is applied for market risk.

The Panel feels that it would be premature for the full migration of UCBs to Basel II norms at present. But given the increasing importance of interest rate risk in banks' balance sheets, there is a need to assign a capital charge for market risk through the application of the Basel approach of quantifying 'specific risk' and duration-based 'general risk' for banks' trading books at least for scheduled UCBs.

### 5.3.3 Risk Management

(i) The Reserve Bank does not review the system of corporate governance, risk management and internal control in UCBs.

The Panel recommends that the Reserve Bank needs to review the current system of corporate governance, risk management and internal control in place for UCBs and issue appropriate guidelines. If necessary, specific clauses could be inserted in the MoUs with State Governments.

(ii) Existing guidelines do not require UCBs to notify the Reserve Bank /registrar of co-operative societies as soon as they become aware of any material information which may negatively affect the fitness and propriety of any board member or member of the senior management.

The Panel recommends guidelines in this regard be issued.

### 5.3.4 Market Risk

Although, the Reserve Bank has powers under Section 35A of the Banking Regulation Act to impose specific limits and /or specific capital charges on market risk exposures on banks, no guidelines on market risk have been issued except for valuation norms for investments and ALM guidelines related to interest rate risk to scheduled UCBs. There are no guidelines on setting market risk limits commensurate with the size and complexity of the institution. No guidelines on stress testing, scenario analysis and contingency planning have been issued to UCBs.

The Panel recommends that the Reserve Bank issue guidelines on capital charges for market risk and usage of sensitivity and VaR limits as risk mitigation techniques to scheduled UCBs.

### 5.3.5 Liquidity Risk

Based on the recommendations of a Working Group constituted by the Reserve Bank, it was decided to make ALM guidelines on structural liquidity applicable to scheduled UCBs. However, these guidelines do not take into account undrawn commitments and other off-balance sheet items. Furthermore, UCBs do not have policies and processes in place for the ongoing measurement and monitoring of liquidity requirements.

The Panel recommends that the Reserve Bank needs to revise the ALM guidelines on structural liquidity issued to larger scheduled UCBs to take into account undrawn commitments and other off-balance sheet items. These entities should be also advised to adapt policies and processes for ongoing measurement and monitoring of liquidity risk.

The Panel also recommends that there is a need for extending the ALM guidelines to larger non-scheduled UCBs.

#### 5.3.6 Operational Risk

The Reserve Bank has issued guidelines on the prevention and reporting of frauds, internal/concurrent audit, balancing of books, *etc.* However, no guidelines have been issued on the operational risks to UCBs.

The Panel feels that given their size and the fact that they have not yet fully implemented Basel I, it would be premature to issue guidelines related to earmarking capital for operational risk based on the Basel II approach. However, basic guidelines on operational risk management can be considered to be issued to larger UCBs.

#### 5.3.7 Interest rate risk in Banking Book

No specific guidelines have been prescribed for the management of interest rate risk in banking book.

The Panel feels that given their size and the fact that they have not yet fully implemented Basel I, it would be premature to issue guidelines on interest rate risk in banking book to these entities.

#### 5.3.8 Balance of skills in the back and front offices of Treasury

The Reserve Bank does not determine whether there is an appropriate balance in skills and resources of the back office and control functions relative to the front office. It does not make an assessment of skills of employees of banks.

The Panel recommends that the Reserve Bank issue guidelines to the larger UCBs on the segregation of duties and responsibilities in the front office, mid office and back office for treasury operations related to scheduled UCBs.

Further, the Reserve Bank should make it necessary for its on-site inspection teams to look into this aspect in greater depth and comment about the same in their reports.

#### 5.3.9 Notification to Regulator of Substantive Changes

There is no requirement for UCBs to notify the Reserve Bank of any substantive changes in their activities, structure and overall condition or as soon as they become aware of any material adverse developments.

The Panel recommends that the Reserve Bank issue guidelines in this regard.

#### 5.3.10 Abuse of Financial Services

The Reserve Bank has issued detailed guidelines on Know-Your-Customer (KYC) to UCBs. However, there are no guidelines which give protection to bank staff who report suspicious activity in good faith either internally or directly to the relevant authority.

The Panel recommends that appropriate guidelines in this regard be issued.

#### 5.3.11 Appointment of Auditors

Currently the Reserve Bank does not have the power to appoint external experts including auditors to conduct supervisory tasks. Auditors are not required to bring to the notice of the Reserve Bank any material shortcoming identified during the course of their work. Aspects relating to audit are attended to by RCS. As per MoUs signed between the Reserve Bank and RCS, the State Governments are required to provide for a statutory audit by chartered accountants appointed in consultation with the Reserve Bank, for UCBs with deposits of over Rs.25 crore. The Reserve Bank has entered into



MoUs with 24 states and the Central Government till date.

The Panel urges the Reserve Bank to sign MoUs with the remaining State Governments. The Panel also recommends that the Reserve Bank in consultation with State Governments and ICAI explore the possibility of making it mandatory for external auditors to notify the Reserve Bank of any adverse developments that come to their notice during the course of their audit.

From a longer-term perspective, however, powers similar to those vested with the Reserve Bank under Section 30 of Banking Regulation Act, 1949, as applicable to commercial banks should form part of the MoU with State Governments, so as to alleviate the problems relating to auditors faced by the Reserve Bank (like appointment or removal of an auditor with the prior consent of the Reserve Bank, conducting a special audit of a bank if necessary in the interests of depositors, *etc.*)

### 5.3.12 Disclosures in Balance Sheet

As per existing guidelines, disclosures for UCBs in their balance sheets is limited to CRAR, investments, advances against real estate/shares/debentures/ directors/ relatives, cost of deposits, NPAs, profitability indicators and provisions.

The Panel recommends an enhancement in the disclosure norms for UCBs, which could include quantitative disclosures regarding Tier I and II capital, non-SLR investments, exposure to the capital market (direct and indirect exposure), loans subject to restructuring for larger UCBs, *etc.* Furthermore, given the fact that some of the larger scheduled UCBs have made forays into derivatives, there could be additional disclosure requirements on the reporting of derivatives and ALMs for these entities.

## Section 6

### State Co-operative Banks and District Central Co-operative Banks

#### 6.1 Legal Arrangement and Organisational set-up for Regulation and Supervision

The rural co-operative banking structure in India has two distinct structures: the short-term co-operative credit structure (STCCS) and the long term co-operative credit structure (LTCCS). The STCCS i.e., primary agricultural credit societies (PACS) at the village/base level, district central co-operative banks (DCCBs) at the intermediate level, and the state co-operative banks (StCBs) at the apex level, mostly provide crop and other working capital loans mainly for a short period to farmers and rural artisans. The long-term structure of rural co-operatives provide medium to long-term loans for investments in agriculture, rural industries and, of late, housing as well. Long-term co-operative credit institutions and PACS fall outside the ambit of the Banking Regulation Act, 1949, and so the Panel decided to cover as part of the assessment only StCBs and DCCBs. There are 31 StCBs (including 16 scheduled StCBs) of which 14 are licensed. Out of 366 DCCBs, 75 DCCBs are licensed as on 31 March 2007.

Like the urban co-operative sector, this sector is also subject to dual regulatory control. The Banking Regulation Act, 1949(AACS), provides the legal framework for regulation of these banks from the perspective of the Reserve Bank. The Reserve Bank exercises regulatory powers in relation to licensing, issue of directions and imposition of penalties, *etc.* The power of registering a co-operative society/bank, election and supersession of the board of directors, appointment of administrators, appointment/removal of the chief executive officer, winding up of a co-operative society, conduct of audit, *etc.*, are vested with the RCS<sup>8</sup>. Supervisory power is vested with

<sup>8</sup> The recommendations of the Vaidyanathan Committee seek to minimise the influence of the State Government in all such matters and it is expected that the recent Government of India package based on its recommendations, if implemented by the states, would solve these problems to a large extent.

NABARD and these institutions are not within the supervisory oversight of Board for Financial Supervision (BFS) constituted by the Reserve Bank.

There is, however, a Board of Supervision constituted independently by NABARD, which is kept abreast of the supervisory concerns that emanate from the functioning of rural co-operatives and other rural financial institutions. The board, in turn, provides direction on a continuing basis on regulatory policies and supervisory practices. While the supervisory function is carried out by NABARD, in the absence of powers to enforce satisfactory compliance by inspected banks on inspection observations, supervision is rendered less effective.

#### **6.2 Summary Assessment of State Co-Operative Banks and District Central Co-operative Banks**

Given the co-operative structure of StCBs and DCCBs and their scale of functioning, the Panel observes that the following principles as encapsulated in BCP are not applicable to StCBs/DCCBs:

- i. **Transfer of Significant Ownership (Principle 4):** There is no concept of controlling/significant ownership of a StCB/DCCB. Each member has only one vote irrespective of the number of shares held by the member.
- ii. **Country and Transfer Risk (Principle 12):** StCBs/DCCBs do not have exposure to foreign countries. Hence the question of country and transfer risk does not arise.
- iii. **Consolidated Supervision (Principle 24):** StCBs/DCCBs do not have any subsidiaries in the sense in which commercial banks have subsidiaries/associates. Hence the concept of consolidated supervision is not applicable.
- iv. **Home-host Relationship (Principle 25):** StCBs/DCCBs do not have a foreign presence. Hence the question of home-host relationship does not arise.

In spite of the non-applicability of some of the principles, the Panel feels that an assessment of the regulatory and supervisory structure of these entities would be useful for the following reasons:

- i) StCBs and DCCBs taken together form the largest segment in the co-operative banking sector and account for almost 50 per cent of its total assets.
- ii) These entities play a major role in credit delivery in the rural sector.
- iii) These entities are ideal conduits for financial inclusion.

The Basel norms have not yet been made applicable to the StCBs and DCCBs. As a result, there is no stipulated risk-based capital requirement in respect of these entities.

In order to revive the short-term co-operative credit structure, a task force was set up by the Government of India under Prof. A. Vaidyanathan. The package suggested by it includes the signing of an MoU between NABARD, relevant State Government and the Government of India to reform the institutional structure, legal reforms and bring



about a qualitative improvement in manpower. Capital augmentation of StCBs and DCCBs was a part of the package. The implementation of the Vaidyanathan Committee's recommendations is underway. The assessment has been conducted keeping in view the ground realities in the rural financial sector and is less rigorous than the assessment made of commercial banks. The summary assessment of adherence to the BCPs in respect of regulation and supervision of StCBs/DCCBs under the broad categories is provided in this chapter. The detailed principle-wise assessment is furnished in **Appendix 6**.

### **6.2.1 Objectives, Autonomy and Resources (Principle 1)**

All sub-components of the principle but for the one on independence, accountability and transparency are fully compliant. The responsibilities and objectives of the Reserve Bank and NABARD are clearly defined and both institutions possess sound governance practices and adequate resources to be accountable for the discharge of their duties. As per the existing statute, the Central Government is empowered to remove the head of the Reserve Bank without assigning any reason. Section 7(3) of NABARD Act, 1981, states that the Central Government may in consultation with the Reserve Bank remove the chairman at any time before the expiry of his term of office. Section 8(2) of NABARD Act, 1981 states that the Central Government may, in consultation with the Reserve Bank, remove the managing director or any whole-time director appointed under sub-Section (3) of section 6 any time before the expiry of his term of office, after giving him reasonable opportunity to show cause against the proposed removal. The Act is silent about the public disclosure of reasons for the removal of the head of the supervisory authority.

There is a suitable legal framework in place which includes provisions relating to the licensing of StCBs/DCCBs, the setting of prudential rules and their supervision. The

extant legislation empowers NABARD to assess compliance with laws, to ensure the safety and soundness of banks, to have access to banks' boards, management, *etc.*, and to take action against banks indulging in unsound practices. Legal protection is available for supervisors. Arrangements for the sharing of information between supervisors and protecting the confidentiality of such information are also in place.

### **6.2.2 Licensing Criteria (Principles-2, 3 and 5)**

While the principles relating to major acquisitions are fully compliant, there remain some gaps in respect of full compliance of permissible activities and licensing criteria. Section 6(1) of the Banking Regulation Act, 1949 (AACS) indicates the list of permissible activities that can be taken up by a banking company. However, the word "bank" can be legally used by unlicensed and unsupervised entities, e.g., PACS, state co-operative agriculture and rural development banks (SCARDBs) and primary co-operative agriculture and rural development banks (PCARDBs) which are outside the ambit of the Banking Regulation Act, 1949 (AACS). Though the Reserve Bank has set the criteria for granting licences for setting up of StCBs/DCCBs and has the power to reject applications which do not meet the standards based on the recommendations of NABARD, it does not have the power to determine the suitability of shareholders. The RCS can disqualify directors. The ability of shareholders to provide additional financial support also cannot be assessed. The acquisition of co-operative banks is allowed only by way of mergers/amalgamation, with the specific permission of the regulators. Co-operative banks do not have cross-border operations.

### **6.2.3 Prudential Requirements and Risk Management (Principles 6 to 11 and 13 to 18)**

The Basel norms have not been made applicable to StCBs and DCCBs. Broad

guidelines on risk management have been issued to StCBs/DCCBs. Of the 12 principles relating to prudential requirements and risk management, only two principles relating to large exposures and related parties are compliant; two principles relating to credit risk and problem assets, provisions and others are largely compliant; six principles relating to capital adequacy, risk management, market risk, liquidity risk, internal control and abuse of financial services are materially non-compliant; and two principles relating to operational risk and interest rate risk in banking book are non-compliant.

No risk-based capital adequacy guidelines to StCBs and DCCBs have been issued. The Reserve Bank has recently advised all co-operative banks to indicate the CRAR in their balance sheets as on 31 March 2008 and thereafter every year, as 'Notes on Accounts' to their balance sheets.

At present, risk management aspects are being reviewed by the boards of StCBs and DCCBs, based on the data placed before them on credit risk, liquidity risk and interest rate risk. Asset Liability Management (ALM) guidelines have been issued to five StCBs on a pilot basis. Sophisticated techniques of integrated risk management are not considered necessary for StCBs/DCCBs in view of the small size and volume of their operations.

Guidelines have been issued covering all the essential aspects required for the setting up of credit management measures in StCBs and DCCBs. Guidelines have also been issued to StCBs and DCCBs on income recognition, asset classification and provisioning, covering both on and off-balance sheet exposures. NABARD/ the

Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers to avoid concentration of credit, and has advised these banks to fix limits on their exposure to specific industries or sectors for ensuring better risk management. The concept of 'related party' is not strictly applicable to StCBs and DCCBs as there is no promoter holding a substantial shareholding as in the case of commercial banks. As per extant provisions of the Banking Regulation Act, banks are prohibited to grant loans and advances (other than for personal use) to any of its directors or their related parties.

NABARD/the Reserve Bank has not prescribed any guidelines for assessing market risk by StCBs and DCCBs except for valuation norms for investment. Since 1 April, 2007, Asset-Liabilities Management (ALM) has been introduced in five select StCBs on a pilot basis. No specific guidelines on the management of liquidity risk, operational risk and interest rate risk in banking books have been issued to StCBs and DCCBs.

Guidelines on various aspects of internal checks and control systems in co-operative banks have been issued. NABARD/ the Reserve Bank does not have any power to bring about changes in the composition of the board and senior management to address any prudential concerns. However, under the MoU signed by states for implementation of the Vaidyanathan Committee's recommendations, 'fit and proper criteria' for directors of the board and CEOs of banks are to be prescribed by the Reserve Bank. Further, as per the MoU, directors/CEO not fulfilling the 'fit and proper criteria' stipulated by the Reserve Bank can be removed at the request of the Reserve Bank/NABARD.

The Reserve Bank has issued KYC guidelines to StCBs and DCCBs wherein they have been advised to follow due procedure, including reporting of cash transactions to the Financial Intelligence Unit. The system to designate a compliance officer has not yet been made operational. NABARD/ the Reserve Bank do not have any authority to address criminal activities. Protection to whistle blowers is not legally available.

#### **6.2.4 Methods of Ongoing Supervision (Principles 19-21)**

The supervisory framework for StCBs and DCCBs is largely in place. All the three principles relating to methods of ongoing supervision *viz.*, supervisory approach, supervisory techniques and supervisory reporting are largely compliant.

NABARD employs a mix of on-site and off-site supervision to evaluate the condition of StCBs and DCCBs, their inherent risks, and the corrective measures necessary to address supervisory concerns and to supplement it with periodic discussions with the management. There is no requirement for StCBs and DCCBs to notify NABARD/ the Reserve Bank of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments. Supervisory work is not prioritised based on the risk profile.

NABARD has continuous interactions with the banks' boards/CEOs for understanding their risk perception, risk management systems and the risk mitigation measures in place. Under Section 27(2) of the Banking Regulation Act, 1949 (AACS), NABARD has powers to call for any information from a banking company relating to its affairs.

#### **6.2.5 Accounting and Disclosure (Principle 22)**

The aforesaid principle is largely compliant. NABARD can take recourse to the

provisions of the Banking Regulation Act, 1949 (AACS) for initiating action against StCBs and DCCBs which furnish wrong/incorrect information. All the financial statements published by StCBs and DCCBs are verified by co-operative auditors/ chartered accountants. The scope of external audits of individual banks and the standards to be followed in performing such audits is under the purview of the RCS. In the 25 states which have signed MoUs till December 2008, the States will have to make provisions in their state co-operative societies Acts for auditing of StCBs/DCCBs by chartered accountants approved by NABARD. In non-MoU states no such clause is there.

#### **6.2.6 Corrective Remedial Powers (Principle 23)**

The aforesaid principle is largely compliant. NABARD has framed a trigger point policy in consultation with the Reserve Bank in terms of which it recommends regulatory action to the Reserve Bank against those banks which fail to achieve a certain level of performance. However, the powers of corrective actions are vested with the Reserve Bank, and NABARD can play only a recommendatory role. The Reserve Bank also does not enjoy powers similar to Section 36AA of the Banking Regulation Act, 1949, to remove managerial and other persons from holding office in co-operative banks.

### **6.3 Recommendations**

In the opinion of the Panel, the single most important regulatory and supervisory hindrance that still exists in this sector is the problem of dual control by the RCS and the Reserve Bank /NABARD. Given the inadequate financial soundness of StCBs and DCCBs, the Panel feels that it would be premature to prescribe Basel norms for these entities before the revival package as recommended by the Vaidyanathan Committee is fully implemented. It is with

## Chapter III

### Assessment of Adherence to Basel Core Principles

this view that the Panel has assessed the adherence of StCBs/DCCBs to Basel Core Principles and observed some regulatory and supervisory gaps. The Panel has also made

recommendations which, if implemented, could ensure better compliance to Basel Core Principles and strengthen the regulation and supervision of StCBs and DCCBs.

**Table 10: Summary Assessment of State Co-operative Banks/  
District Central Co-operative Banks**

Sr. No.	Principle	C	LC	MNC	NC	NA
	<b>Objectives, autonomy and resources</b>					
1.	Objectives independence, powers, transparency and co-operation		√			
	<b>Licensing criteria</b>					
2.	Permissible activities		√			
3.	Licensing criteria		√			
4.	Transfer of significant ownership					√
5.	Major acquisitions	√				
	<b>Prudential requirements and risk management</b>					
6.	Capital adequacy			√		
7.	Risk management process			√		
8.	Credit risk		√			
9.	Problem assets, provisions and reserves		√			
10.	Large exposure limits	√				
11.	Exposure to related parties	√				
12.	Country and transfer risk					√
13.	Market risk			√		
14.	Liquidity risk			√		
15.	Operational risk				√	
16.	Interest rate risk in banking book				√	
17.	Internal control and audit			√		
18.	Abuse of financial services			√		
	<b>Methods of ongoing supervision</b>					
19.	Supervisory approach		√			
20.	Supervisory techniques		√			
21.	Supervisory reporting		√			
22.	<b>Accounting and disclosure</b>		√			
23.	<b>Corrective and remedial powers of supervisors</b>		√			
	<b>Consolidated supervision and cross-border banking</b>					
24.	Consolidated supervision					√
25.	Home host relationship					√
	<b>Total</b>	<b>3</b>	<b>10</b>	<b>6</b>	<b>2</b>	<b>4</b>

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant

### **6.3.1 Memorandum of Understanding**

In order to circumvent the regulatory disharmonies arising out of dual control of StCBs and DCCBs, MoUs have been entered into between NABARD, State Governments and the Central Registrar of Co-operative Societies. The Central Government has set up a National Implementing and Monitoring Committee under the Chairmanship of the Reserve Bank Governor to oversee the implementation and monitoring of the revival package for StCBs and DCCBs. Till December 2008, a total of 25 State Governments and the Central Registrar of Co-operative Societies have entered into MoUs with NABARD.

The Panel observed that NABARD has been discharging duties of supervision of StCBs and DCCBs, while the Reserve Bank has been regulating these entities. The Panel recommends that NABARD take steps to sign MoUs with the remaining State Governments. At the same time, it also feels that while MoUs are appropriate from the medium-term perspective, in the interest of strengthening the sector, the regulatory powers in respect of StCBs/DCCBs should be divested from the government and ultimately vest with a single regulator.

### **6.3.2 Capital Adequacy**

There is no concept of risk-based capital adequacy at present for StCBs/DCCBs.

The Panel observed that though these entities have adopted the concept of minimum capital requirements, it is not risk-based capital requirement. It recommends that, as suggested by the Vaidyanathan Committee, risk-based capital requirements of 7 per cent may be introduced for StCBs/DCCBs and increased in a phased manner to 9 per cent which is the stipulated minimum in case of commercial banks.

### **6.3.3 Risk Management**

The Reserve Bank /NABARD have not issued guidelines on risk management to StCBs/

DCCBs along the lines of commercial banks. There are no guidelines on market risk, liquidity risk, operational risk and interest rate risk in banking books.

The Panel recommends that once the concept of risk-based capital adequacy is introduced for StCBs/DCCBs, the issuance of guidelines on risk management along the lines of UCBs should be considered. It also recommends that some basic guidelines regarding management of market risk, operational risk and liquidity risk be stipulated. There is, however, no requirement for stipulating any capital charge for market risk, and operational risk. It is also premature to consider measurement and capital augmentation to mitigate interest rate risk in banking book.

### **6.3.4 Notification to Regulator of Substantive Changes**

There is no requirement for StCBs/DCCBs to notify the Reserve Bank /NABARD of any substantive changes in their activities, structure and overall condition or as soon as they become aware of any material adverse developments.

The Panel recommends that the Reserve Bank/NABARD issue requisite guidelines in this regard.

### **6.3.5 Abuse of Financial Services**

The Reserve Bank has issued detailed guidelines on Know-Your-Customer to StCBs and DCCBs. However, there are no guidelines which give protection to bank staff who report suspicious activity either internally or directly to the relevant authority.

The Panel recommends that appropriate guidelines be issued in this regard.

### **6.3.6 Appointment of Auditors**

Currently the Reserve Bank /NABARD do not have any power to appoint external experts including auditors to conduct supervisory tasks. Further, auditors auditing the accounts of StCBs



and DCCBs are not required to bring to the notice of the Reserve Bank /NABARD any material shortcomings. Aspects relating to audits are attended to by RCS. As per the MoUs signed between the Reserve Bank /NABARD and RCS, the State Governments are required to provide for a statutory audit by chartered accountants appointed in consultation with the Reserve Bank /NABARD for StCBs/DCCBs with deposits over Rs.25 crore. They are also required to provide for a special audit by chartered accountants, if required by the Reserve Bank /NABARD, for any StCB/DCCB. The Reserve Bank /NABARD have entered into MoUs with 25 states and the Central Government till December 2008.

The Panel strongly recommends that the Reserve Bank /NABARD in consultation with State Governments and ICAI explore the possibility of making it mandatory for external auditors to notify any adverse developments that have come to their notice during the course of their audit to the Reserve Bank /NABARD. From a longer-term perspective, however, powers similar to those vested with the Reserve Bank under Section 30 of the BR Act as applicable to commercial banks<sup>9</sup> should form part of the MoUs signed with State Governments so as to alleviate problems relating to audit functions faced by the Reserve Bank /NABARD.

## Section 7

### Regional Rural Banks

#### 7.1 Legal arrangement and Organisational set-up for Regulation and Supervision

Regional Rural Banks (RRBs) are a special category of banks formed by notification by the

Government of India under Section 3(a) (1) of the Regional Rural Banks (RRBs) Act, 1976. Section 6(2) of the RRBs Act, 1976, prescribes the ownership criteria for RRBs. The authorised capital of each RRB is Rs. 5 crore, which can be increased or reduced by the Central Government. However, the issued capital shall in no case be less than Rs.25 lakh. The capital issued by RRB is subscribed by the Central Government (50 per cent), the State Government (15 per cent) and a sponsor bank (35 per cent) which is generally a public sector commercial bank (with the exceptions of the Bank of Rajasthan, Jammu and Kashmir Bank and Uttar Pradesh State Co-operative Bank). In addition to the RRB Act of 1976, RRBs are governed by the Banking Regulation Act, 1949 and RBI Act, 1934.

RRBs' operations are limited to an area notified by the Central Government in the official gazette. While these entities may transact business of banking as defined in clause (b) of Section 5 of the Banking Regulation Act 1949, vide Chapter IV, Section 18 of the RRB Act 1976, they may, in particular undertake the following kinds of business:

- Granting of loans and advances particularly to small and marginal farmers and agricultural labourers; and
- Granting of loans and advances to artisans, small entrepreneurs and persons of small means engaged in trade, commerce or industry or other productive activities in the *notified area*.

Currently, RRBs are not required to be Basel I compliant. There is no stipulation for risk-

<sup>9</sup> Such as appointment or removal of a auditor with the prior consent of RBI/NABARD, carry out a special audit of a bank if necessary in the interest of depositors, etc.



based capital adequacy norms for these entities. These entities also do not have any international operations as their activities are limited in the *notified area*.

The regulation of RRBs is undertaken by the Reserve Bank. The supervision of RRBs is conducted by NABARD. RRBs are within the supervisory oversight of Board of Supervision constituted by NABARD. Powers to close/ amalgamate/merge RRBs rest with the Central Government.

## 7.2 Summary Assessment of Regional Rural Banks

Given the special features of RRBs, some of the Basel Core Principles are not strictly applicable to them. *viz.*,

- i. **Licensing Criteria (Principle 3):** The licensing authority for RRBs is the Government of India as they are licensed banks *ab initio*. The RRBs do not require a licence for their establishment under Section 22 of the Banking Regulation Act, 1949, and the Reserve Bank cannot withdraw it. However, RRBs have to apply for a licence to the Reserve Bank for opening branches. The Reserve Bank / NABARD does not have any power to reject the licence of an RRB since the powers to close/ amalgamate/ merge RRBs vest with the Government of India as per provision of Section 23 A(1) and Section 26 of the RRB Act, 1976.
- ii. **Transfer of Significant Ownership (Principle 4):** There is no concept of controlling/significant ownership for RRBs as the capital issued by an RRB is subscribed by the Central Government (50 per cent), concerned State Government (15 per cent) and sponsor bank (35 per cent).
- iii. **Country and Transfer Risk (Principle 12):** As RRBs do not have exposure to foreign countries, exposures to country and transfer risks do not arise.

iv. **Consolidated Supervision (Principle 24):** RRBs do not have subsidiaries. Hence the concept of consolidated supervision is not applicable.

v. **Home-host Relationship (Principle 25):** RRBs do not have foreign presence. Hence the concept of a home-host relationship does not arise.

The Panel recognises therefore that not all principles as delineated in BCP are applicable to RRBs. Also, as risk based capital stipulation is yet to be mandated for RRBs, the emphasis of other BCPs for RRBs may not carry equal significance vis-à-vis commercial banks. The summary assessment of adherence to BCPs as applicable in respect of regulation and supervision of RRBs under the broad categories is provided in this chapter. The detailed principle-wise assessment is furnished in **Appendix 7**.

### 7.2.1 Objectives, Autonomy and Resources (Principle 1)

All sub-components of the principle but for the one on independence, accountability and transparency are fully compliant. The Reserve Bank, along with NABARD, regulates and supervises RRBs. Both have clear responsibilities and objectives and possess transparent processes, sound governance practices and adequate resources. Conventionally, even though the Reserve Bank is operationally independent, the Central Government is empowered to remove the head of the Reserve Bank without assigning any reason. Similarly, the Central Government can, in consultation with the Reserve Bank, remove the NABARD Chairman or other directors at any time before the expiry of their term of office without the disclosure of reasons.

There is a suitable legal framework in place which includes provisions relating to setting prudential rules and ongoing supervision. Laws are in place for banking supervision which

empower NABARD to address compliance with laws, to ensure safety and soundness of banks, to have access to banks' boards, management, *etc.*, and to take action against banks indulging in unsound practices. Legal protection for supervisors is also available. There are formal and informal arrangements in place between the Reserve Bank and NABARD for co-operation and sharing of information pertaining to RRBs.

#### **7.2.2 Licensing Criteria (Principles 2 and 5)**

Both applicable principles, the one relating to permissible activities and other relating to major acquisitions are fully compliant. Section 5(b) of the Banking Regulation Act, 1949, defines "banking" clearly. The permissible activities of institutions that are licensed and subject to supervision are clearly defined. NABARD/ the Reserve Bank has specified the areas of investments that can be undertaken by RRBs. They are not permitted to enter into cross-border operations. There are no cases of acquisitions by RRBs, other than amalgamations approved by the Government of India, as of now.

#### **7.2.3 Prudential Requirements and Risk Management (Principles - 6 to 11 and 13 to 18)**

There is no concept of risk-based capital adequacy for RRBs and the risk management systems of RRBs are rudimentary. As RRBs are not required to be Basel I compliant, this assessment has been made keeping in view the current status. Of the 12 principles relating to prudential requirements and risk management, only two principles relating to credit risk and problem assets, provisions and others are compliant; two principles relating to large exposures and related parties are largely compliant; six principles relating to risk

management, market risk, liquidity risk, operational risk, internal control and abuse of financial services are materially non-compliant and two principles relating to capital adequacy and interest rate risk in banking book are non-compliant.

Broad guidelines on Risk Management Systems for RRBs were issued in 2004. Given their scale of operations the introduction of an Integrated Risk Management approach at present is not feasible because it entails huge investments in computerisation for the collection of necessary data. There is no stipulated capital charge for credit risk. NABARD determines, and periodically confirms, that senior management implements the credit risk strategy approved by the board. Guidelines to RRBs on income recognition, assets classification and provisioning have been issued. There are no specific guidelines in respect of management of market and interest rate risk in the banking books. Currently, most RRBs assess their liquidity positions, covering both on and off-balance sheet items without adopting the Asset Liability Management (ALM) methodology. ALM guidelines have been issued to begin with to 12 RRBs with effect from April 1, 2007. Illustrative guidelines on operational risk have been issued to RRBs.

Given the limited scope available in their area of operations, the exposure of RRBs to group borrowers is limited. The exposure of an RRB to a company cannot exceed 15 per cent of its owned funds. Sectoral exposures are not monitored by NABARD.

The RRB Act, 1976 clearly provides for duties and responsibilities of the Board, top management, *etc.*, which are scrupulously

followed by RRBs. Internal control measures are left to the individual management. However, uniform internal checks and control system manual for all RRBs have not been introduced. Though KYC guidelines have been issued, no whistle-blower policy is in place. NABARD has issued guidelines on the compliance function for RRBs including appointing a designated compliance officer.

#### **7.2.4 Methods of Ongoing Supervision (Principles 19-21)**

The supervisory framework for RRBs is largely in place. All the three principles relating to methods of ongoing supervision *viz.*, supervisory techniques, supervisory approach and supervisory reporting are largely compliant.

NABARD monitors RRBs through on-site inspections and off-site surveillance returns. It also has a system of collecting data by way of statistical and other returns from time to time from RRBs.

#### **7.2.5 Accounting and Disclosure (Principle 22)**

The aforesaid principle is largely compliant. Guidelines on accounting standards have been issued to RRBs. They have been granted an exemption, till March 31, 2008, relating to the publication of their balance sheets, profit and loss accounts and auditors' reports. Further, RRBs have been advised to display their balance sheet and profit and loss accounts in all their branches.

#### **7.2.6 Corrective and Remedial powers (Principle 23)**

The aforesaid principle is largely compliant. NABARD participates in deciding when and how to effect orderly resolution in case of a problem bank. It has at its disposal a range of supervisory tools for use when in its judgement, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise

threatened. NABARD has various instruments, processes and systems to bring about various timely corrections in respect of RRBs failing to come up to expected level of operational and financial efficiencies. It seeks to intervene at an early stage to prevent capital from falling below the minimum and has a range of options to address such scenarios. It applies penalties and sanctions not only to the bank but, when and if necessary, also to the management and/or the board, or individuals therein.

### **7.3 Recommendations**

In the light of the gaps observed in its assessment of adherence to the Basel Core Principles in respect to regulation of Regional Rural Banks (RRBs), the Panel has made the following recommendations to strengthen the regulation and supervision of these entities.

#### **7.3.1 Capital Adequacy**

Risk-based capital adequacy norms have not so far been made applicable to RRBs. The minimum capital requirement in absolute terms has been spelt out in the RRBs Act, 1976.

The Panel recommends introduction of minimum CRAR along with the recapitalisation of RRBs in a phased manner, after completion of a consolidation process of these entities.

#### **7.3.2 Risk Management Process**

RRBs have put in place risk management systems, but these do not cover all types of risks. The existing risk management guidelines cover broadly only the credit and liquidity risks. No specific guidelines have been issued in respect of operational risk and market risk to RRBs. They have not been permitted to use internal risk assessment models by NABARD. The concept of integrated risk management is also not recognised in the case of RRBs.

The Panel feels that once capital adequacy norms are made applicable to RRBs, guidelines on risk management related to market and operational risks should be introduced.

### Assessment of Adherence to Basel Core Principles

Table 11: Summary Assessment of Regional Rural Banks						
Sr. No.	Principle	C	LC	MNC	NC	NA
	<b>Objectives, autonomy and resources</b>					
1.	Objectives independence, powers, transparency and co-operation		√			
	<b>Licensing criteria</b>					
2.	Permissible activities	√				
3.	Licensing criteria					√
4.	Transfer of significant ownership					√
5.	Major acquisitions	√				
	<b>Prudential requirements and risk management</b>					
6.	Capital adequacy				√	
7.	Risk management process			√		
8.	Credit risk	√				
9.	Problem assets, provisions and reserves	√				
10.	Large exposure limits		√			
11.	Exposure to related parties		√			
12.	Country and transfer risk					√
13.	Market risk			√		
14.	Liquidity risk			√		
15.	Operational risk			√		
16.	Interest rate risk in banking book				√	
17.	Internal control and audit			√		
18.	Abuse of financial services			√		
	<b>Methods of ongoing supervision</b>					
19.	Supervisory approach		√			
20.	Supervisory techniques		√			
21.	Supervisory reporting		√			
22.	<b>Accounting and disclosure</b>		√			
23.	<b>Corrective and remedial powers of supervisors</b>		√			
	<b>Consolidated supervision and cross-border banking</b>					
24.	Consolidated supervision					√
25.	Home host relationship					√
	<b>Total</b>	<b>4</b>	<b>8</b>	<b>6</b>	<b>2</b>	<b>5</b>

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant

However, given the limited and rudimentary scale of operations of RRBs, capital charge for market risk and operational risk need not be mandated for some time. The Panel has come to the conclusion that while the current data

base of RRBs is not adequate for a sophisticated assessment of risk, the collection of required on-line data from branches would call for state-of-the-art technological upgradation and would involve huge investments, which the RRBs may

not be in a position to meet. Sophisticated techniques like internal risk assessment models and integrated risk management are not considered necessary at this stage, in view of size, volume and nature of business operations of RRBs.

### **7.3.3 Large Exposure Limits**

NABARD does not obtain information regularly that enables it to review the concentrations, including sectoral and geographical exposures, within a bank's portfolio.

The Panel observed that most lending by RRBs are under the priority sector segment and they have very limited exposure to other segments, both under lending and investments. Moreover, these exposures are reviewed at the time of on-site inspection with a broad-based approach to ascertain the sectoral and segment-wise credit disbursed by the banks. Hence, the Panel does not recommend calling for sectoral and geographical exposures from RRBs at present.

### **7.3.4 Market Risk, Liquidity risk and Operational Risk**

No guidelines have been prescribed for assessing market risk by RRBs. RRBs follow a methodology for assessing their liquidity position, but not on an ALM basis. ALM has been introduced in only 12 RRBs with effect from April 1, 2007. NABARD has been examining these aspects during the course of on-site inspections. Broad guidelines on all types of risks, as to identifying credit, market, interest rate and operational risks, and how they can be mitigated, have been issued to RRBs.

The Panel feels that given the fact that RRBs are currently in a non-Basel regime, the assessment of market risk can be implemented only after CRAR is introduced. This is envisaged along with the recapitalisation of RRBs. As commercial banks are stakeholders in RRBs, the Panel feels that it would be easier to implement

some of the guidelines issued by them on liquidity risk and operational risk.

Accordingly, the Panel recommends that as regards assessment of operational risk, guidelines on the lines applicable to commercial banks can be issued to RRBs. As regards liquidity risk, the Panel recommends that the concept of Asset Liability Management (ALM) be introduced for all RRBs along the lines for commercial banks. However, stipulating capital charges for such risks will be premature at this stage.

### **7.3.5 Interest Rate Risk in Banking Book**

No guidelines on interest rate risk in banking books have been issued to RRBs.

The concept of interest rate risk in banking books is part of the Basel II Accord. Since RRBs are yet to migrate to Basel I mode, the introduction of interest rate risk in banking would mean placing a significant burden on these entities. The Panel recommends that the concept of interest rate risk in banking books may not be considered for these entities at least over the medium-term.

### **7.3.6 Internal control and Audit**

(i) The Reserve Bank /NABARD do not have the power to require changes in the composition of the board and senior management of RRBs to address prudential concerns.

Since the composition of the board of RRBs is in accordance with the provisions of the RRBs Act, 1976, wherein nomination to the board is made with due approval from the Government of India (GoI), any change in this regard would require an amendment to the Act. However, the Panel feels that there is no need for any change at the current juncture.

(ii) Corporate governance in the strictest sense of the term has not so far been made applicable to RRBs as board members are generally nominated directors and not independent directors. Nor have they have been made accountable for all omissions and commissions.



The Panel observes that though directors are nominated to RRBs, it would be desirable to make them accountable. There should be a formal Board-approved policy in this regard. Further, it feels that over the medium-term, the Government could consider independent nominees on the boards of these banks.

(iii) While NABARD has issued guidelines regarding separation of functions in respect of the back office and front office, it does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

The Panel recommends that NABARD may comment on this aspect during the on-site examination of RRBs.

(iv) NABARD is in the process of preparing suitable guidelines on the 'Compliance Function' for RRBs in consultation with the Reserve Bank, on the lines of instructions issued to commercial banks. So far, NABARD has put in place a compliance system envisaging the submission of core compliance, full compliance, discussion on core compliance and rating of the compliance report with reference to observations made in the inspection report. Based on the nature of functions and size of RRBs, it has not been considered necessary to have a separate compliance function cell with them.

The Panel recommends that consequent to the amalgamation of RRBs, their business operations and size have grown, so the issue of guidelines to RRBs on the "compliance function" may be considered, specifying a separate compliance function cell for RRBs. NABARD has

since issued guidelines on the compliance function for RRBs including appointing a designated compliance officer. This is in consonance with the recommendations made by the Panel.

#### 7.3.7 Abuse of Financial Services

(i) The guidelines do not have elements like a customer acceptance policy, a customer identification, verification and due diligence programme; policies and processes to monitor and recognise unusual or potentially suspicious transactions, particularly of high-risk accounts; escalation to the senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk, and clear rules on what records must be kept on consumer identification and individual transactions and their retention period.

The Panel observes that the clientele of RRBs mainly comprise those under relaxed KYC norms. Hence, rigorous supervision may not be necessary. Given the size of operations, the Panel feels that they must continue with the existing practice, and once their operations grow in volume and coverage, detailed guidelines on the lines of those issued to commercial banks like customer acceptance policy, customer identification policy, *etc.*, could be considered.

(ii) NABARD does not determine whether banks have enhanced due diligence policies and processes regarding correspondent banking.

The Panel observes that due diligence policies and processes regarding correspondent



banking are yet to be put in place. This is because correspondent banking is in nascent stage in RRBs. The Panel recommends that once these banks enter into full-fledged correspondent banking, guidelines on due diligence policies could be considered.

(iii) The RRBs are yet to put in place measures for preventing, identifying and reporting of potential abuse of financial services including money-laundering.

The Panel recommends that guidelines should be issued advising RRBs to put in place measures for preventing, identifying and reporting of potential abuse of financial services, including money laundering.

(iv) NABARD does not determine whether RRBs have clear policies and processes for the staff to report problems related to the abuse of the banks' financial services either to local management or to the relevant dedicated officer or to both. There are also no laws and regulations which ensure that a member of a bank's staff who reports suspicious activity in good faith, either internally or directly to the relevant authority cannot be held liable.

The Panel recommends that NABARD should determine during on-site examination that banks have policies and processes whereby staff can report any problems relating to the abuse of banks' financial services either to local management or a relevant dedicated officer or to both. It also recommends that NABARD may in consultation with the Reserve Bank issue guidelines whereby staff who report suspicious activity are not held liable by the relevant authority.

### **7.3.8 Accounting and Disclosure**

RRBs had been granted exemption, till March 31, 2008, from the provisions of Section 31 of the Banking Regulation Act, 1949 relating to the publication of their balance sheets, profit and loss accounts together with auditors'

reports. Further, RRBs have been advised to display the B/S and P&L in all their branches.

The Panel recommends that NABARD may consider doing away with the exemption from year ending March 31, 2009 and require RRBs to publish balance sheets and profit and loss accounts together with auditors' reports.

## **Section 8**

### **Non-banking Financial Companies**

#### **8.1 Legal Arrangement and Organisational set-up for Regulation and Supervision**

Non-Banking Financial Companies (NBFCs) are an important component of the Indian financial services sector. Though they are not part of the payments and settlement system like banks, they provide some financial services similar to those of banks and compete with them albeit not significantly. They have efficiently intermediated and enhanced credit delivery to the dispersed, under-banked and under-serviced sections of the economy.

There are two broad categories of Non-Banking Financial Companies (NBFCs), viz. Non-Banking Financial Company–Deposit-Taking (NBFC-D), Non-Banking Financial Company – Non-Deposit-Taking (NBFC-ND). Residuary Non-Banking Financial Company (RNBC) is a type of a NBFC accepting deposits. NBFCs-ND - Systemically Important (NBFC-ND-SI) are non-deposit taking NBFCs with asset base greater than Rs.100 crore. This assessment covers the NBFCs-D and NBFCs-ND-SI which are being monitored more rigorously by the Reserve Bank.

While NBFCs-D have been regulated since 1963, an amendment to the RBI Act, 1934 in 1997 gave powers to the Reserve Bank to regulate and supervise all NBFCs more comprehensively. NBFCs-ND, till recently, were subject to minimal regulation as they were non-deposit taking bodies. Recognising the growing importance of this segment, and their linkages to banks and other financial institutions, capital

adequacy and exposure norms were made applicable to NBFCs-ND-SI from April 1, 2007.

The supervision of NBFCs falls within the ambit of the BFS. NBFCs are regulated and supervised by the Reserve Bank under the provisions of Chapter IIIB of the RBI Act, 1934. They are also governed by the Companies Act, 1956, and action taken for violation of the Companies Act falls within the jurisdiction of the Ministry of Corporate Affairs.

Though the Core Principles for Effective Banking Supervision are not applicable to NBFCs in the strictest sense of the term, the Panel feels the assessment of regulation and supervision of NBFCs based on the Core Principles would be useful for the following reasons:

- (i) NBFCs *inter alia* provide some services similar to banks.
- (ii) NBFCs are potential conduits in spreading systemic risk.
- (iii) The Reserve Bank has introduced risk-based capital requirements for NBFCs-D and NBFCs-ND-SI.
- (iv) There is scope for regulatory arbitrage between NBFCs and banks (of the same group) e.g., delinquency norms are more stringent in case of banks; NBFCs do not have to provide for standard assets in their portfolio while there are stipulated provisioning norms for banks in this regard.
- (v) The assessment would throw up developmental issues, which, if implemented could strengthen the regulation and supervision of NBFCs.

## 8.2 Summary Assessment of Non- Banking Financial Companies

The summary assessment of adherence to Basel Core Principles in respect of regulation and supervision of NBFCs under the broad categories are given below. The detailed principle-wise assessment of Basel Core Principles of NBFCs is furnished in **Appendix 8**.

### 8.2.1 Objectives, Autonomy and Resources (Principle 1)

All sub-components of the principle but for the one on independence, accountability and transparency are fully compliant. The Reserve Bank which regulates and supervises NBFCs has clear responsibilities and objectives and possesses transparent processes, sound governance and adequate resources.

Though conventionally, the Reserve Bank is perceived as an independent authority, the Central Government has powers to remove the Governor without disclosing reasons for removal. While the Reserve Bank is accountable to the Parliament through the Ministry of Finance, the transparency of the accountability framework needs closer re-examination.

Statutes, including provisions relating to the licensing of NBFCs, setting prudential rules and their ongoing supervision, *etc.*, are in place. The legal framework empowers the supervisor to address compliance with laws, to ensure the safety and the soundness of NBFCs, to have access to their boards, management, *etc.*, and to take action against those indulging in unsound practices. Legal protection for supervisors is available. As the law is silent on the Reserve Bank entering into a formal

Memorandum of Understanding (MoU), there are no formal MoUs with foreign supervisory agencies. However, the Reserve Bank has arrangements in place for sharing information with other domestic regulators.

### **8.2.2 Licensing Criteria (Principles 2 to 5)**

While the principles relating to permissible activities and licensing criteria<sup>10</sup> are largely compliant, there remain some gaps in respect of compliance of major acquisitions and transfer of significant ownership. Section 45I of the RBI Act clearly defines the term "Non-Banking Financial Company" as also the permissible activities of such entities. Section 45IA of the RBI Act empowers the Reserve Bank to set the criteria for licensing NBFCs and to reject an application if the criteria are not fulfilled or if the information provided is inadequate. The Reserve Bank however does not control branch expansion except for NBFCs-D where prescriptions in terms of Net Owned Funds (NOF) and credit ratings and requirements for notifying the Reserve Bank are laid down when the NBFC opens branches for collection of deposits.

The fit and proper test in the form of due diligence is carried out for directors only. The suitability of major shareholders is also not subject to detailed scrutiny. A detailed review of the strategic and operating plan, internal controls, risk management, *etc.*, is not taken into consideration at the time of approval of a Certificate of Registration for NBFCs. However, companies are required to submit a business plan at the time of obtaining Certificate of Registration which is examined in detail.

While the term 'substantial interest' is defined in prudential norms, there are no guidelines in place that define 'significant ownership' for NBFCs. There are no requirements to obtain supervisory approval or

provide immediate notification of proposed changes that would result in a change in ownership. The Reserve Bank cannot reverse or modify change of control that have taken place, but can cancel the Certificate of Registration of an NBFC if it is not in the public interest. No specific instructions have been issued by the Reserve Bank on major acquisitions or investments by an NBFC except for the exposure norms or policy for investments in specific sectors like insurance, *etc.*

### **8.2.3 Prudential Regulation and Risk Management (Principles 6 to 18)**

Though capital adequacy norms stipulated by BCBS are applicable to banking institutions, the Reserve Bank has specified a risk-based capital regime for NBFCs-D and NBFCs-ND-SI. The stipulation covers credit risk and has been set at a level higher than the 9 per cent capital requirement for banks. Of the thirteen principles relating to prudential requirements and risk management, the principle relating to capital adequacy is compliant and five principles relating to risk management, credit risk, problem assets, large exposures and abuse of financial services are largely compliant; two principles relating to liquidity risk and internal control is materially non-compliant and four principles relating to exposure to related parties, market risk, operational risk and interest rate risk in banking books are non-compliant; one principle relating to country risk is not applicable.

The Reserve Bank has issued guidelines on capital adequacy which include both on-and off-balance sheet items and are applicable to NBFC-D and NBFC-ND-SI. It has issued guidelines to NBFCs in respect of credit risk management. The credit risk management process takes into account the risk profile of the NBFC with prudent policies and processes to identify, measure, monitor and control credit risk.

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<sup>10</sup> Licensing is interpreted as grant of Certificate of Registration

There are regulatory norms for the management of problem assets of provisions and reserves. But there is no provisioning requirement for standard assets. Prudential limits to restrict exposures of NBFCs to single counterparties (or groups of connected parties) are in place. However, the Reserve Bank has not issued any instructions as regards the review and reporting of material concentration to the Board. Sectoral, geographical and currency exposures of NBFCs are not monitored.

Exposure to related counterparty is dealt with under Section 295 of the Companies Act, 1956. The Reserve Bank has issued ALM guidelines to a certain class of NBFCs<sup>11</sup> on an asset liability framework which includes the constitution of an Asset-Liability Committee (ALCO) and measuring future cash flows of NBFCs in different time buckets for the purpose of managing their liquidity and interest rate risk. However, the Reserve Bank has not issued guidelines for earmarking capital for operational risk to NBFCs. There is no bifurcation into trading book and banking book in the case of NBFCs.

The Reserve Bank has issued guidelines to NBFCs to put in place adequate internal controls. But it has not issued any directions assigning the responsibility for the control environment to the board and senior management of NBFCs. Furthermore, the Reserve Bank is not empowered to bring about changes in the composition of the Board and the senior management to address prudential concerns. The Reserve Bank does not determine whether

there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

Guidelines on KYC norms have been issued to NBFCs, but, the Reserve Bank has not put in place any due diligence policies. However, while granting permission for setting up a liaison office in India by a foreign NBFC, their operations from tax haven countries is accorded due cognizance.

There is no procedure for confirmation by the supervisor of money laundering prevention, the identification and the reporting of potential abuses. There is no mechanism to ensure compliance with KYC guidelines by non-deposit taking companies which are not inspected or subject to reporting exercise. There are no laws in place which give protection to NBFC staff who report suspicious activity in good faith either internally or directly to a relevant authority.

#### **8.2.4 Methods of Ongoing Supervision (Principles 19 to 21)**

There is a supervisory framework in place for NBFCs. All the three principles relating to methods of ongoing supervision, *viz.*, supervisory approach, supervisory techniques and supervisory reporting are largely compliant.

As regards the supervisory approach, a certain class of NBFCs has been advised to put in place a risk management committee to assess the risk it faces. Any change in the structures or failure to comply with prudential norms or any other prescriptions is to be reported by statutory

<sup>11</sup> NBFCs having Rs.20 crore deposits or Rs.100 crore assets

auditors through an exception report to the Reserve Bank. The system is yet to stabilise.

The Reserve Bank conducts both on-site (Section 45N of RBI Act) and off-site supervision (Section 45K and L of RBI Act) for the supervision of NBFCs. This supervision is limited to NBFCs-D and NBFCs-ND-SI. No interaction takes place with the senior management.

As part of the supervisory reporting mechanism, the Reserve Bank has been empowered under Section 45K and 45L of the RBI Act, 1934, to collect information from NBFCs and to issue directions. Under Section 45M of the RBI Act, 1934 it is the duty of every non-banking institution to furnish statements, information or particulars called for by the Reserve Bank.

#### **8.2.5 Accounting and Disclosure (Principle 22)**

The aforesaid principle is largely compliant. As regards accounting and disclosure, the Reserve Bank ensures that each NBFC maintains adequate records drawn up in accordance with accounting policies and practices that are widely acceptable and publishes on a regular basis information that fairly reflects its financial condition and profitability. The Reserve Bank has no power to reject and rescind the appointment of an external auditor that is deemed to have inadequate expertise or independence, or is not subject to or does not follow established professional standards.

#### **8.2.6 Corrective and Remedial Powers (Principle 23)**

The aforesaid principle is largely compliant. The Reserve Bank has at its disposal an adequate range of supervisory tools to bring about timely corrective actions which includes the ability to revoke the Certificate of Registration. There is no prompt corrective action framework stipulated for

NBFCs other than in cases where it has been specified at the time of granting of registration that such approval is required before undertaking the activity. The Reserve Bank does not have powers to withhold approval of new activities, other than while specifying at the time of granting registration, or acquisitions. It also is not empowered to restrict or suspend payments to shareholders or share repurchases, restrict asset transfers, bar individuals from operations, replace or restrict the powers of managers, board directors or controlling owners, facilitate a takeover or merger with a healthier institution, or provide for the interim management of the NBFC.

#### **8.2.7 Consolidated Supervision and Cross-border Banking (Principles 24 and 25)**

Both the principles relating to consolidated supervision and cross-border banking are non-compliant. As regards consolidated supervision, the Reserve Bank has no power to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, exposures to related parties and lending limits. It collects financial information for a group identified as a 'financial conglomerate'.

Of late, it has been observed that foreign entities have evinced interest in the NBFC sector. Policy initiatives have been taken to recognise the role of home-host regulators in this regard. Draft guidelines for a No-objection Certificate for opening of branches / joint venture abroad by NBFCs have been placed on the Reserve Bank website for comments / suggestions from public/stakeholders.

### **8.3 Recommendations**

The Panel observed that the NBFC sector is less closely regulated and supervised than the banks, and that not all Basel Core Principles (BCPs) can be made applicable to the sector



### Assessment of Adherence to Basel Core Principles

**Table 12: Summary Assessment of Non-Banking Financial Companies**

Sr. No.	Principle	C	LC	MNC	NC	NA
	<b>Objectives, autonomy and resources</b>					
1.	Objectives independence, powers, transparency and co-operation		√			
	<b>Licensing criteria</b>					
2.	Permissible activities		√			
3.	Licensing criteria		√			
4.	Transfer of significant ownership				√	
5.	Major acquisitions				√	
	<b>Prudential requirements and risk management</b>					
6.	Capital adequacy	√				
7.	Risk management process		√			
8.	Credit risk		√			
9.	Problem assets, provisions and reserves		√			
10.	Large exposure limits		√			
11.	Exposure to related parties				√	
12.	Country and transfer risk					√
13.	Market risk				√	
14.	Liquidity risk			√		
15.	Operational risk				√	
16.	Interest rate risk in banking book				√	
17.	Internal control and audit			√		
18.	Abuse of financial services		√			
	<b>Methods of ongoing supervision</b>					
19.	Supervisory approach		√			
20.	Supervisory techniques		√			
21.	Supervisory reporting		√			
22.	<b>Accounting and disclosure</b>		√			
23.	<b>Corrective and remedial powers of supervisors</b>		√			
	<b>Consolidated supervision and cross-border banking</b>					
24.	Consolidated supervision				√	
25.	Home host relationship				√	
	<b>Total</b>	<b>1</b>	<b>13</b>	<b>2</b>	<b>8</b>	<b>1</b>

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant

because many of these entities are very small in size and do not conduct banking operations in the strict sense. Given that the Reserve Bank has not fully stipulated Basel norms for this sector and given that these entities cannot

accept demand deposits, the Panel feels that migration to Basel II may not be feasible currently for these entities.

However, the key area of concern is the increasing interest shown by foreign NBFCs in



entering the country, raising a host of issues relating to mitigation of risks emanating from global exposure, information-sharing between home-host regulators, proper due diligence norms, *etc.*, for which adequate guidelines are not in place. Apart from the above, the Panel has observed some regulatory and supervisory gaps while assessing the adherence to Basel Core Principles (BCPs) in regulation and supervision of NBFCs. The Panel has made appropriate recommendations which, if implemented, could strengthen the regulation and supervision of NBFCs. The recommendations are detailed below:

### **8.3.1 Sharing of Information with Domestic and Foreign Regulators**

Of late, foreign entities have evinced growing interest in the NBFC sector. Also some domestic NBFCs are exploring global business opportunities. There are no formal arrangements in place for co-operation and information sharing with foreign financial sector supervisors of NBFCs.

The Panel recommends a formalisation of the relationship with foreign regulators. It should encapsulate a transparent method of information sharing. There should be specific provisions in the RBI Act, 1934 along the lines of the SEBI Act, 1992, so that MoUs can be entered into with foreign supervisors for establishing a formal communication mechanism for NBFCs.

The Panel acknowledges that policy initiatives have been taken to recognise the role of co-operation between home-host regulators. But no guidelines have yet been issued. The Panel recommends that the Reserve Bank expedite issuing guidelines in this regard.

### **8.3.2 Composition of the Board**

At present, the suitability of major shareholders and senior management is not subjected to detailed scrutiny. Due diligence is done only in respect of the directors.

The Panel recommends that the Reserve Bank needs to explore the option of examining the suitability of major shareholders and senior management of NBFCs.

### **8.3.3 Ownership Issues**

(i) The RBI Act does not delegate any powers under the Act to empower the Reserve Bank to bring about changes in the composition of the boards and senior management of NBFCs to address prudential concerns.

The Panel feels that the Reserve Bank should explore the option of acquiring legal powers in this regard.

(ii) The Reserve Bank does not obtain through periodic reporting or on-site examination, the names and holdings of all significant shareholders or those that exert a controlling influence, including the identities of beneficial owners of shares being held by nominees. However details of 'substantial interest' of promoters, the chairman, managing directors and CEO are part of the Certificate of Registration application form which is obtained by the Reserve Bank.

The Panel recommends that the Reserve Bank should explore the option of obtaining information on names and holdings of significant shareholders of NBFCs who exert a controlling influence, periodically through off-site returns.

### **8.3.4 Transfer of Significant Ownership**

The existing guidelines do not define 'significant ownership' or 'controlling interest' for NBFCs. A definition of 'substantial interest' has, however, been given in the prudential guidelines.

The Panel recommends that the Reserve Bank should explore the possibility of defining 'significant ownership' or 'controlling interest'. Further, it recommends that it should issue necessary guidelines to NBFCs advising them to intimate the Reserve Bank of any change in significant ownership.

#### 8.3.5 Major Acquisitions

Investments by NBFCs are governed by the Prudential Norms Directions, 2007. However, the Reserve Bank has no power to review major acquisitions by an NBFC against any prescribed criteria. Establishment of cross-border operations and corporate affiliations or structures which could expose the NBFC to undue risks or hinder effective supervision is also not reviewed.

The Panel feels that given NBFCs' developmental role in promoting new companies in the form of subsidiaries/associates, they should not be constrained by any specific mandated criteria regarding acquisition. But, the Reserve Bank could consider obtaining information relating to cross-border operations and corporate affiliations as part of the off-site surveillance.

#### 8.3.6 Reporting of Material Concentration to the Board

Though, the Reserve Bank has defined 'group of connected counterparties' and set prudent limits on large exposures to a single counterparty or a group of connected counterparties, it has not issued any instructions to NBFCs as regards review and reporting of material concentration to the Board.

The Panel feels that there is a need to issue guidelines for establishing thresholds depending on their respective scales of operation, and reporting exposures above the threshold to the board. This aspect can also be verified by the Reserve Bank during the on-site inspection of NBFCs.

#### 8.3.7 Exposure to Related Parties

The Reserve Bank has not issued any guidelines regarding related party exposures.

The Panel feels that the requirement of issuance of guidelines on arms-length relationships and stipulations on mitigating risks arising out of related party exposure be examined, keeping in view the developmental and supporting role played by NBFCs in the promotion of green field projects, which they often do through subsidiaries and associates.

#### 8.3.8 Market Risk and Liquidity Risk

The Reserve Bank has not issued any instructions to NBFCs to put in place policies and processes that accurately identify, measure, monitor and control market risks. The Reserve Bank has issued ALM guidelines which are applicable to NBFCs-D with deposits over Rs.20 crore or to NBFCs with an asset size of Rs 100 crore and above irrespective of whether they are accepting / holding deposits.

The Panel feels that NBFCs provide financial services similar to those of banks and, as such, compete with them. The non-deposit taking NBFCs' investment portfolio comprises a significant portion of their balance sheets. Also, their off-balance sheet exposures are susceptible to market risk. Therefore, the Panel recommends that the Reserve Bank consider the feasibility of implementing guidelines on market risk on the lines of commercial banks to deposit-taking NBFCs (with deposits above Rs.20 crore) and NBFCs-ND-SI.

The Panel recommends a phased and calibrated implementation of capital charges for market risk in respect of these entities.

However, it recommends that NBFCs not having any outstanding borrowing by way of public deposits or any other form of borrowing including preference shares could be considered for exemption from these guidelines. The Panel also feels that prudential norms for NBFCs particularly relating to ALM and liquidity risk management need to be strengthened in a non-disruptive manner.

### **8.3.9 Operational Risk**

The Reserve Bank has not issued any guidelines to NBFCs to have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk.

The Panel observes that capital adequacy requirements for NBFCs capture only credit risk. However, the capital adequacy requirements for NBFCs are higher than those for banks. The Panel feels that there is no need for issuing any guidelines on capital charges for operational risk for the present to NBFCs. However, guidelines on the management of operational risk without stipulating specific charges can be issued for NBFCs.

### **8.3.10 Balance of skills between front and back-office**

The Reserve Bank does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination of NBFCs.

The Panel recommends that the Reserve Bank needs to look into the same during the on-site inspection of NBFCs-D. Specific provisions in the NBFC inspection manual required to be made in this regard. For NBFCs-ND-SI, this could be done during on-site scrutiny.

### **8.3.11 Abuse of Financial Services**

(i) While granting permission for setting up a liaison office in India by a foreign NBFC,

their operation from a tax haven country is accorded due cognizance.

The Panel recommends that the Reserve Bank should have in place formal due diligence policies and formal processes regarding such activities. Suitable guidelines should be issued in this regard.

(ii) There is no procedure for confirmation by the Reserve Bank of money-laundering prevention, identification and reporting of potential abuse.

The Panel recommends that there can be confirmation that NBFCs have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services including money-laundering through on-site inspection.

(iii) The Reserve Bank has issued detailed guidelines on Know-Your-Customer (KYC) to NBFCs. However, there are no laws in place which give protection to NBFC staff who report suspicious activity in good faith, either internally or directly to the relevant authority.

The Panel recommends that appropriate guidelines be issued along the lines introduced for private sector banks and foreign banks (Introduction of 'Protected Disclosures Scheme for Private Sector and Foreign Banks').

### **8.3.12 Notification to Regulator of Substantive Changes**

The main instrument of supervision of NBFCs is the periodic on-site inspection that is supplemented by off-site monitoring and surveillance. However, there is no requirement to notify the Reserve Bank of any substantive changes in their activities, structure and overall condition or as soon as they become aware of any material adverse developments.

The Panel recommends that the Reserve Bank should issue requisite guidelines in this regard.

#### 8.3.13 Appointment of Auditors

The Reserve Bank has no power to recommend, reject and rescind the appointment of auditors.

The Panel recommends issuance of appropriate guidelines to empower the Reserve Bank regarding the appointment, rejection and rescinding the appointment of external auditors. This may be done in consultation with ICAI.

#### 8.3.14 Increased Disclosures

Disclosures made by NBFCs at present include both qualitative and quantitative information on financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies and basic business, management and governance. The Reserve Bank could consider increased disclosures in case of NBFCs in respect of ownership structure, significant holdings and nature and types of activities and products.

## Section 9

### Housing Finance Companies

#### 9.1 Legal Arrangement and Organisational set-up for Regulation and Supervision

Housing finance has grown rapidly in the last two decades. Apart from housing finance companies (HFCs), the credit boom witnessed in the housing sector has also been fuelled by commercial banks and co-operative banks. Along with commercial and co-operative banks, housing finance companies (HFCs) remain a significant contributor to the housing growth in the country. The buoyant state of housing

finance in India is evident from the fact that investment in housing as a proportion of GDP increased from 3.4 per cent in 2001 to 7.64 per cent in 2006. Further, the total disbursement of housing financed by HFCs and scheduled commercial banks increased from Rs.76,400 crore during 2004-05 to Rs.86,000 crore during 2005-06. Scheduled commercial banks were by far the most dominant, accounting for more than 65 per cent of total disbursement. Though, HFCs share in disbursement was lower at 34 per cent, the outstanding loan amount of housing loans was significant at Rs.89,400 crore at the end of March 2007. HFCs had public deposits to the tune of Rs.12,900 crore and borrowings of Rs.1,01,100 crore (of which borrowings from banks stood at Rs.48,800 crore) as on March 31, 2007 thereby establishing a systemic linkage. The largest HFC is also a financial conglomerate which has made a foray in several sectors including banking.

HFCs are regulated and supervised by the National Housing Bank (NHB) as per the provisions of the NHB Act, 1987 and Housing Finance Companies (NHB) Directions, 2001. They are also governed by the Companies Act, 1956, which falls within the jurisdiction of the Ministry of Corporate Affairs. Though the Core Principles for Effective Banking Supervision are not applicable to housing finance companies, the Panel feels the assessment of the regulation and supervision of HFCs based on the Core Principles would, nevertheless, be useful for the following reasons:

- (i) The potential of overheating of the housing sector and the regulatory and supervisory mechanism in place to address consequent risks needs to be assessed.

- (ii) Given the systemic linkages, HFCs are potential conduits for spreading systemic risk.
- (iii) NHB has introduced risk-based capital requirements for HFCs which are similar to the Basel-stipulated norms.
- (iv) As in the cases of NBFCs, there is scope for regulatory arbitrage between HFCs and banks, e.g., HFCs do not have to provide for standard assets in their housing loan portfolio while there are stipulated provisioning norms for banks in this regard.
- (v) The assessment would throw up developmental issues, which, if implemented could strengthen the regulation and supervision of HFCs.

There were 43 HFCs registered with NHB as on January 25, 2008. Of these, the 12 large ones account for more than 90 per cent of the asset base. Others are insignificant in size and undertake only rudimentary operations.

## **9.2 Summary Assessment of Housing Finance Companies**

The summary assessment of adherence to Basel Core Principles (BCPs) in respect of regulation and supervision of Housing Finance Companies (HFC) under the broad categories are given below. The detailed principle-wise assessment of Basel Core Principles for HFCs is furnished in **Appendix 9**.

### **9.2.1 Objectives, Autonomy and Resources (Principle 1)**

All sub-components of the principle except for the one on independence, accountability and transparency, are fully compliant. NHB, which regulates and supervises HFCs, has clear responsibilities and objectives and possesses transparent processes, sound governance, and adequate resources.

There is no requirement for the public disclosure of the reasons for the removal of the head of NHB. Though Section 7 of the NHB Act provides for terms of appointment of the chairman of NHB it states that the Central

Government can, in consultation with the Reserve Bank, remove the chairman after giving him a reasonable opportunity of showing cause against the proposed removal.

There is a suitable legal framework in place which include provisions relating to the licensing of HFCs, setting prudential rules and their ongoing supervision, empowering of supervisors to address compliance with laws to ensure the safety and soundness of HFCs, to have access to HFCs' boards, management, *etc.*, and to take action against HFCs indulging in unsound practices. Legal protection for supervisors is available under Section 46 of the NHB Act.

The NHB has arrangements in place for sharing of information with domestic regulators. There are no formal or informal arrangements in place for co-operation and information-sharing with foreign financial sector supervisors of HFCs and their companies which could be of material interest to the home or host supervisor.

### **9.2.2 Licensing Criteria (Principles 2 to 5)**

The principle relating to licensing criteria is largely compliant. But, there remain significant gaps in respect of full compliance of permissible activities, major acquisitions and transfer of significant ownership.

The definition of an HFC is not specific and clear. The permissible activities of HFCs are not clearly defined by supervisor, or in laws or regulations. Section 29A(4)(g) of the NHB Act empowers the licensing authority (NHB) to set criteria for licensing HFCs. It also has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate. NHB carries out fit and proper test for promoters and senior management, but an examination of the record of criminal activities is not part of the exercise. NHB does not obtain a no-objection certificate from the home supervisor before issuing a licence to foreign HFCs intending to establish a branch or subsidiary in India.



The regulation does not define 'significant ownership' and 'controlling interest'. NHB has no power to reject any proposal for a change in significant ownership if they do not meet criteria comparable to those used for approving new HFCs. NHB may, however, cancel a Certificate of Registration granted to an HFC if it is satisfied, *inter alia*, that the general character of the management or the proposed management of the housing finance institution shall be prejudicial to public interest or the interest of its depositors. NHB has no power to take appropriate action to modify, reverse or otherwise address a change of control of an HFC that has taken place without necessary notification or its approval. No specific instructions have been issued as regards major acquisitions or investments by an HFC which requires prior approval of the NHB.

#### **9.2.3 Prudential Requirements and Risk Management (Principles 6 to 18)**

HFCs are not required to implement Basel I guidelines. But NHB has stipulated a risk-based capital adequacy norm. Though the minimum capital requirement is related to credit risk, it is higher than the 9 per cent stipulated for banks. Of the 13 principles relating to prudential requirements and risk management, two relating to capital adequacy and problem assets are compliant; three relating to credit risk, large exposures and abuse of financial services are largely compliant; four relating to risk management, exposure to related parties, liquidity risk and internal control are materially non-compliant and four relating to market risk, country risk, operational risk and interest rate risk in banking book are non-compliant.

NHB has issued guidelines on capital adequacy which include both on and off-balance sheet items which are uniformly applicable to all the players in the housing finance sector. There is no blanket requirement for HFCs to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks,

As per the present regulatory framework, credit risk is generally being addressed to a significant extent. HFCs have a credit risk management process that takes into account the risk profile of the HFC with prudent policies and processes to identify, measure, monitor and control credit risk. NHB satisfies itself that HFCs establish and adhere to adequate policies and processes to manage problem assets and evaluates the adequacy of provisions and reserves.

NHB has powers under Section 30A of the NHB Act to require an HFC to increase its levels of provisions and reserves and/or its overall financial strength if it deems the level of problem assets to be a concern. NHB has to be satisfied that HFCs have policies and processes that enable the management to identify and manage concentrations within the portfolio, and it has set prudential limits to restrict HFCs' exposures to single counterparties or groups of connected parties. The large exposure limits are thereby defined.

NHB has not issued any directions and also does not monitor aggregate exposures to related parties at present. It does not determine whether the senior management and Board members of HFCs have an understanding of the nature and level of risk being undertaken by them and the relation of same to adequate



capital levels. Consolidated regulation is not in practice at present.

As per current practice, liquidity risk and interest rate risk are reported as a part of ALM returns. However, these ALM guidelines are applicable to only the larger HFCs. The capital charge for operational risk and market risk are yet to be considered as part of the required risk management structure for HFCs. No guidelines have been issued covering country or transfer risk.

NHB determines whether HFCs have in place internal controls which include the responsibilities of Boards and/or senior management and deal with organisational structure, accounting policies and processes, checks and balances, and safeguarding assets and investments. However, a detailed and rigorous assessment is not done. NHB has no power to bring about changes in the composition of boards and senior management to address prudential concerns.

As regards the abuse of financial services, NHB determines whether HFCs have adequate policies and processes in place, including strict KYC rules that promote high ethical and professional standards in HFCs and prevent them from being used for criminal activities. Though the Prevention of Money Laundering (PML) Act designates the Financial Intelligence Unit (FIU) as the appropriate authority for reporting such activities, HFCs are not required to report these to the supervisor. NHB does not determine whether adequate screening policies and processes are there when hiring staff. No whistle-blower policy is in place.

#### **9.2.4 Methods of Ongoing Supervision (Principles 19 to 21)**

The supervisory framework for HFCs is largely in place. All the three principles relating to methods of ongoing supervision *viz.*, supervisory approach, supervisory techniques and supervisory reporting are largely compliant.

As regards the supervisory approach, NHB has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. But there is no formal mechanism in place for HFCs to notify the NHB informally of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments. A breach of legal or prudential requirements is required to be reported under the off-site monitoring mechanism by HFCs as also by the statutory auditors of HFCs in terms of the Housing Finance Companies (NHB) Directions, 2001.

The supervisory techniques comprise on-site inspection and off-site surveillance. NHB evaluates the work of HFCs' internal audit functions, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk. But there is no structured mechanism in place. NHB is not legally empowered to obtain information from related non-financial companies.

#### **9.2.5 Accounting and Disclosure (Principle 22)**

The aforesaid principle is largely compliant. As regards accounting and disclosure, NHB ensures that each HFC maintains adequate records drawn up in accordance with accounting policies and practices that are widely acceptable internationally, and publishes on a regular basis information that fairly reflects its financial condition and profitability. Disclosures on risk management strategies and practices and risk exposures are not made in the balance sheets of HFCs.

#### **9.2.6 Corrective and Remedial Powers (Principle 23)**

The aforesaid principle is largely compliant. NHB has at its disposal a range of adequate supervisory tools to bring about timely corrective actions which include the ability (where appropriate) to revoke a licence or recommend its revocation. NHB participates in deciding when and how to effect the orderly

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resolution of a problem HFC situation. But there is no structured mechanism in place.

#### 9.2.7 Consolidated Supervision and Cross-Border Banking (Principles 24 to 25)

Both principles are non-compliant. Consolidated supervision is not done as

adequate powers are not there. No arrangement exists with foreign supervisory authorities to exchange information.

#### 9.3 Recommendations

The Panel finds that the HFC sector is less closely regulated and supervised than banks.

**Table 13: Summary Assessment of Housing Finance Companies**

Sr. No.	Principle	C	LC	MNC	NC	NA
	<b>Objectives, autonomy and resources</b>					
1.	Objectives independence, powers, transparency and co-operation		√			
	<b>Licensing criteria</b>					
2.	Permissible activities			√		
3.	Licensing criteria		√			
4.	Transfer of significant ownership				√	
5.	Major acquisitions				√	
	<b>Prudential requirements and risk management</b>					
6.	Capital adequacy	√				
7.	Risk management process			√		
8.	Credit risk		√			
9.	Problem assets, provisions and reserves	√				
10.	Large exposure limits		√			
11.	Exposure to related parties			√		
12.	Country and transfer risk				√	
13.	Market risk				√	
14.	Liquidity risk			√		
15.	Operational risk				√	
16.	Interest rate risk in banking book				√	
17.	Internal control and audit			√		
18.	Abuse of financial services		√			
	<b>Methods of ongoing supervision</b>					
19.	Supervisory approach		√			
20.	Supervisory techniques		√			
21.	Supervisory reporting		√			
22.	<b>Accounting and disclosure</b>		√			
23.	<b>Corrective and remedial powers of supervisors</b>		√			
	<b>Consolidated supervision and cross-border banking</b>					
24.	Consolidated supervision				√	
25.	Home host relationship				√	
	<b>Total</b>	<b>2</b>	<b>10</b>	<b>5</b>	<b>8</b>	<b>-</b>

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant

Given that HFCs have not fully migrated to Basel I, the Panel feels that migration to Basel II may not be immediately feasible for these entities. However, the Panel expresses concern at some serious lacunae in this sector as the NHB Act does not clearly define an HFC/HFI. This has resulted in a proliferation of many companies who use the word 'housing finance', but whose primary business is not that. It also observes that the NHB Act, 1987, does not define the permissible activities that can be taken up by HFCs. The Panel notes the growing interest shown by foreign HFCs to enter the country, but expresses the concern that the NHB does not obtain a No-objection-certificate from the home supervisor. The Panel recommends that remedial steps be taken immediately to plug this gap. Furthermore, with the largest HFC also being a financial conglomerate, the inability of the NHB to undertake consolidated regulation and supervision raises serious concerns.

In addition, the Panel has observed some regulatory and supervisory gaps while assessing adherence to Basel Core Principles in regulation and supervision of HFCs. The Panel has also made appropriate recommendations which, if implemented, could ensure better compliance to Basel Core Principles and further strengthen regulation and supervision of HFCs. The recommendations are delineated below:

### **9.3.1 Information sharing with Regulators and Due Diligence of Foreign HFCs entering the Country**

There are no formal arrangements in place for co-operation with foreign authorities. In light of the increased interest shown by foreign investors in the Indian housing finance market, NHB needs to assess foreign shareholding in the HFC sector. While assessing foreign shareholding of HFCs, only foreign direct investment (FDI) is taken into account. There is no practice at present of obtaining a no-objection-certificate from the home supervisor for foreign HFCs intending to open a branch in India. In respect of HFCs which are wholly/significantly owned by foreign entities, NHB

does not assess whether the home supervisor practices global consolidated supervision.

The Panel feels that in the backdrop of the growing foreign interest in the housing finance sector, home-host relationships and cross-border co-operation among supervisors are increasingly important. Thus, there is a need for co-ordination and information exchange between home supervisors and the NHB. The Panel believes that a formalisation of the relationship with foreign regulators is necessary. This should encapsulate a transparent method of information-sharing. There should be specific provisions in the NHB Act, 1987 on the lines of SEBI Act, 1992, so that MoUs can be entered into with foreign supervisors for establishing a formal communication mechanism.

The Panel also recommends that NHB obtain a no-objection-certificate from the home supervisor before issuing a Certificate of Registration to a foreign HFC to establish branches in India. Further, they should also assess whether the home supervisor practices global consolidated supervision.

As regards foreign ownership of HFCs, the Panel recommends the reckoning of FIIs as a part of the foreign shareholding of HFCs.

### **9.3.2 Permissible Activities**

A lot of builders/construction companies use the word 'housing' in their names even though they are not licensed and registered with NHB. This practice of companies using the term Housing Finance Company (HFC) or Housing Finance Institution (HFI) is not desirable and needs to be stopped forthwith. The problem arises because the National Housing Bank Act does not clearly define what is a housing finance company or a housing finance institution. Likewise, the Act also does not specify the activities that can be taken up by HFCs/HFIs.

The Panel feels that builders/construction companies should not be permitted to use the term 'housing finance' in their names, and

accordingly recommends that the Ministry of Corporate Affairs to issue necessary guidelines to the Registrars of Companies in this regard. Furthermore, the Panel also recommends that the activities that can be taken up by HFC/HFI needs to be clearly defined in the NHB Act.

#### 9.3.3 Composition of the Board

(i) NHB has not issued any guidelines that establish the responsibilities of the boards and senior management with respect to corporate governance, to ensure that there is effective control over a HFC's entire business.

The Panel recommends that NHB issue appropriate guidelines in this regard.

(ii) NHB conducts the 'fit and proper test' for promoters and senior management. However, an examination of the record of criminal activities is not part of the exercise. It also does not ensure that the Board collectively have a sound knowledge of each of activity that each HFC intends to pursue and the associated risks therein.

The Panel recommends that the scope of the 'fit and proper test' should be expanded to cover a record of criminal activities. Further, it recommends that NHB formulate guidelines to ensure that Board of HFC collectively has sound knowledge of each type of activity undertaken by them.

(iii) NHB does not have the power to bring about changes in the composition of the Board and senior management to address any prudential concerns.

The Panel recommends that NHB consider amending the Act or issue appropriate guidelines whereby it would be empowered to initiate such action if necessary.

#### 9.3.4 Ownership

There is no clear definition of 'significant ownership' or 'controlling interest' in the case of HFCs.

The Panel recommends that NHB may in consultation with the Reserve Bank examine this issue and provide for a clear definition of 'significant ownership' or 'controlling interest'. Based on an approved definition of ownership and control it may be explored whether NHB's powers regarding requirements of obtaining supervisory approval for change in ownership, reporting of significant shareholders *etc.*, can be enhanced.

#### 9.3.5 Major Acquisitions

NHB does not have the power to review major acquisitions or investments by an HFC and confirming that corporate affiliations or structures do not expose the HFC to undue risks or hinder effective supervision.

The Panel feels that NHB needs to lay down norms for the acquisition or investment by an HFC, taking into account the entity's financial and organisational resources and the risks that could emanate from such acquisition. Accordingly the Panel recommends that NHB should issue appropriate guidelines.

#### 9.3.6 Provisioning of Off Balance Sheet Items

There is no asset classification and provisioning norm specified for off-balance sheet items.

The Panel recommends that off-balance sheet items should also be covered under the Income Recognition and Asset Classification norms.

### **9.3.7 Large Exposure Limits**

Though NHB has prescribed ceilings for different kinds of concentrations for HFCs, it has not said that HFCs should establish thresholds for acceptable concentration of credit.

The Panel recommends that NHB should issue necessary guidelines to HFCs in this regard.

### **9.3.8 Exposure to Related Parties**

NHB does not obtain and review information on aggregate exposures to related parties.

The Panel feels it is desirable for NHB to monitor related party exposures to avoid conflicts of interest. Furthermore, NHB needs to take steps to mitigate the risks arising from exposure to related parties. The Panel recommends that the first step in this direction would be for NHB to define and capture information on related parties from HFCs and also put in place a mechanism to review the same. On the basis of the review, the potential risk areas may be identified and suitable guidelines may be contemplated to mitigate such risks.

### **9.3.9 Market Risk**

NHB has not issued any guidelines relating to market risk to HFCs except for ALM guidelines.

The Panel recommends that NHB issue guidelines on market risk on lines of commercial banks for HFCs. This can be done in a phased manner. At the outset surrogate risk weights can be stipulated for instruments susceptible to market risk. In the second stage, the assets can be segregated into banking book and trading book. Capital charge on market risk for items in the trading book may be considered.

### **9.3.10 Liquidity risk**

NHB has not issued any detailed liquidity risk management guidelines other than ALM guidelines for larger HFCs.

The Panel recommends that the guidelines should be more exhaustive and should cover aspects like the existence of a contingent plan for handling liquidity problems *etc.* It should also obtain information for identifying those institutions carrying out significant liquidity transformations.

### **9.3.11 Operational Risk and Interest rate Risk in Banking Book**

NHB has not issued any guidelines to HFCs to have in place risk management policies and processes to identify, assess, monitor and control/ mitigate operational risk. Likewise, it has not issued any instructions to HFCs to have effective systems in place to identify, measure, monitor and control interest rate risk in their banking book.

The Panel believes that capital adequacy requirements for HFCs capture credit risk. Furthermore, the minimum stipulated risk-based capital requirement for HFCs is higher than that for banks. The Panel feels that NHB could consider the issuance of management of operational risk guidelines to HFCs, though capital charge for operational risk need not be earmarked at this stage. The Panel feels that to issue guidelines relating to measurement and mitigation of interest rate risk in the banking books of HFCs may be premature at this stage.

### **9.3.12 Internal Control and Audit**

(i) NHB does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

The Panel feels that considering the level of operations of most of HFCs, such a prescription may not be warranted. However, they feel that feasibility of introduction of such practice be explored by NHB.

(ii) NHB does not determine whether HFCs have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the HFC. It also does not determine whether the



Board exercises oversight on the management of the compliance function.

The Panel recommends that introduction of such practice be explored by NHB.

#### 9.3.13 Abuse of Financial Services

(i) NHB does not satisfy itself that HFCs have adequate screening policies and processes to ensure high ethical and professional standards when hiring staff.

The Panel recommends that NHB needs to introduce appropriate guidelines in this regard.

(ii) NHB does not determine whether the HFCs have clear policies and processes for staff to report any problems related to the abuse of the HFCs' financial services to either local management or the relevant dedicated officer or to both.

The Panel feels that NHB needs to explore the feasibility of introducing such a policy.

(iii) NHB has issued detailed guidelines on Know Your Customer (KYC) to HFCs. However, there are no laws in place which give protection to HFC staff who report suspicious activity in good faith either internally or directly to relevant authority.

The Panel recommends that appropriate guidelines in this regard be issued.

(iv) NHB does not determine whether the system of risk management & internal controls & detection/prevention of criminal activities & oversight of outsourced functions is in place in HFCs.

The Panel recommends that the NHB ensure that the system of risk management & internal controls & detection/prevention of criminal activities is in place by issuance of suitable guidelines.

#### 9.3.14 Supervisory Approach

At present the HFCs are not required to notify NHB of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.

The Panel recommends that NHB needs to put in place a structured mechanism in this regard.

#### 9.3.15 Accounting and Disclosure

Though NHB requires that HFCs rotate partners of audit firms, it does not have power to reject and rescind appointment of external auditor.

The Panel recommends the issuance of appropriate guidelines to empower NHB regarding the appointment, rejection and rescinding appointment of external auditors. This may be done in consultation with ICAI.

#### 9.3.16 Consolidated Regulation/Supervision

Currently, NHB is not empowered to undertake consolidated supervision. The HFCs are not required to submit consolidated financial statements to NHB. Though the largest HFC is a financial conglomerate, NHB is a part of the regulatory body to look into the affairs of the financial conglomerate.

The Panel recommends that the issuance of guidelines is needed (i) mandating the housing finance companies to submit consolidated financial statements and consolidated prudential returns; and (ii)empowering NHB to conduct consolidated supervision through appropriate amendment to the NHB Act, 1987.



## Appendix 1

### Assessment of Basel Core Principles Assessment in respect of Commercial Banks - FSAP-2001

The Financial Sector Assessment Program- 2001(FSAP-2001) conducted by IMF/World Bank had done an assessment of adherence to Basel Core Principles in respect of regulation and supervision of commercial banks. This was based on the then extant Principles which were issued in October 1999.

Basel Core Principle	Description (as per Core Principles methodology - October 1999)	FSAP-2001 assessment
1	2	3
1.	Objectives, autonomy, powers and resources	C
2.	Permissible activities	C
3.	Licensing	C
4.	Ownership	C
5.	Investment criteria	C
6.	Capital adequacy	LC
7.	Credit policy	C
8.	Loan evaluation	LC
9.	Large exposures	LC
10.	Connected lending	C
11.	Country risk	MNC
12.	Market risk	LC
13.	Bank's overall risks	C
14.	Internal control and audit	C
15.	Money Laundering	LC
16.	On-site and off-site supervision	C
17.	Bank Management	C
18.	Off-site data	C
19.	Validation of data	C
20.	Consolidated supervision	MNC
21.	Accounting	LC
22.	Remedial measures	LC
23.	Globally consolidated supervision	C
24.	Host country supervision	LC
25.	Supervision over foreign bank's establishments	C

C-compliant, LC-Largely compliant, MNC- Materially Non-Compliant, NC-Non-compliant

## Appendix 2

### Recommendations of the Advisory Group constituted by the Standing Committee on International Financial Standards and Codes (2001-02)

#### (i) Operational Independence of the Supervisor

In the interest of proper public perception of the Reserve Bank's independence, it would be desirable to consider suitable amendments to the relevant provisions of law making it obligatory on the part of the government to make public the reasons for removal of the Governor/Deputy Governors from office.

#### (ii) Licensing and Structure

- Though the Reserve Bank has the powers to prescribe and vary requirements in respect of capital to exercise necessary entry level controls, the Group feels that such powers to decide requirement of capital on case-by-case basis would need to be clearly defined in law.
- Banks seeking licence should be asked to state in detail their operational standards and procedures, internal control procedures and arrangements facilitating oversight of banks' various activities by the supervisor.
- The Reserve Bank should apply stricter norms for the 'fit and proper' test while evaluating directors and the quality of the board.

#### (iii) Capital Adequacy

- Though regulations require all banks to calculate and maintain minimum capital adequacy ratios, the Reserve Bank is constrained and has shown forbearance in its measures against banks that fail to meet

these requirements because of their government ownership. Such forbearance cannot be long-term and specific measures against banks failing to meet capital adequacy requirement need to be stipulated in the interest of the overall soundness of the system.

- Currently, capital adequacy is calculated for banks on a solo basis without taking into consideration the risks emanating from their subsidiaries. The current stipulation of deducting the value of any equity investment in a subsidiary from the Tier I capital of the parent does not satisfactorily ensure risk-based capital adequacy on a consolidated basis.

#### (iv) Management of Credit Risk

- Banks in India are yet to acquire adequate expertise in sophisticated credit risk mitigation techniques. Until banks improve their expertise, properly controlled credit risk environment will not be established. The Reserve Bank has to guide banks in this regard and enable them to enhance their expertise.
- Because of the existence of prescribed norms for loan loss provisioning, banks do not generally undertake an independent exercise for assessment of loan loss provisions and requirement of write-off. Banks have not developed sophisticated models and statistical tools for assessment

of provisioning requirement that would reflect realistic repayment expectations. They are, however, moving towards that and once they acquire the expertise, the supervisor will no more be required to give structured provisioning norms.

**(v) Connected Lending**

- A comprehensive definition of 'connected' or 'related parties' and 'large shareholdings' needs to be provided by law/regulator.
- The definition of connected lending also needs to be made more broad-based to include all types of connected parties irrespective of whether the banks and counterparties are in the public sector.

**(vi) Management of Other Risks**

- Though there is now an appreciation of the existence of liquidity, interest rate and operational risks, there is lack of expertise for their proper management. MIS, in most cases, continues to be not fully aligned to the requirements of proper risk management with the consequence that advanced practices like stress testing and contingency planning are still not in place.
- A risk management oriented approach to supervision has been adopted by the Reserve Bank in the last two years, i.e., since April 1999. Banks, however, as yet do not have in place highly developed and sophisticated risk management systems notwithstanding the fact that risk identification, measurement and mitigation is being attempted on a more systematic basis. The Reserve Bank may assist banks in hastening introduction of the more scientific and sophisticated risk management systems.

**(vii) Functioning of the Board of Directors**

- It is recommended that risk management should be a specifically stipulated item for being covered in the directors' responsibility

statement. The present laws relating to the responsibilities of the Board of Directors are mostly in general terms.

- While, in the course of the on-site inspection of banks, some assessment is made of the boards' and senior management's performance, such assessment rarely results in measures being taken by the regulator for improvement/change even where a case for such improvement/change seems strong. It is, therefore, suggested that a more formal and rigorous assessment of the boards' performance be undertaken by the regulator.
- As the Reserve Bank itself is moving towards "Risk-Based Supervision", internal audit at individual banks' level would also now have to be modified suitably so that their systems and MIS match the changing supervisory focus. Only a co-ordinated effort on the part of banks as well as the Reserve Bank can result in a quick and smooth transition to "Risk-Based Supervision".

**(viii) "Know Your Customer" Procedures**

From time to time, the Reserve Bank has issued guidelines in regard to 'Know Your Customer' policies and practices. In the context of ever-increasing domestic and cross-border flows of funds, the implementation of these guidelines should be ensured by the supervisor and adherence thereto made more stringent as a part of a conscious anti-money laundering policy.

**(ix) Methods of Ongoing Banking Supervision**

- Since the financial condition of individual banks can change drastically depending on their risk profile, the Reserve Bank should consider moving over fully to a risk-based approach to supervision as early as possible.
- At present, the supervisor does not generally meet with the banks' board of directors or the external auditors. The Reserve Bank may consider introducing

such meetings in the interest of greater involvement of the banks' boards with supervisory concerns and actions in order to enrich the scope of examination of banks. The practice of the Reserve Bank meeting with external (statutory) auditors could also be introduced.

- The Reserve Bank may consider using independent and well qualified external auditors to examine specific aspects of banks' operations.
- The laws and regulations in India do not establish the principles and norms for consolidated reporting of accounts. The move towards consolidated accounting and supervision needs to be expedited.
- A formal framework for co-ordination between different regulators is essential. The Reserve Bank may consider taking necessary steps to impress upon the government the need and urgency of achieving and maintaining a high level of co-ordination among different regulators.

#### **(x) Legal and other Measures of support for the Supervisor**

- The Reserve Bank has powers to apply penalties and sanctions not only on banks but also on the management or Board of Directors. The Reserve Bank should consider introduction of measures by which clear accountability can be fixed on individual directors and/or the board of directors for non-performance and/or negligence of their duties.
- As of now, laws and regulations do not mitigate undue delays on the part of the

supervisors in initiating appropriate corrective actions. However, a Prompt Corrective Action (PCA) framework is now being evolved with triggers identified for a range of mandatory and discretionary actions could be extended further and clear limits defined of forbearance that can be shown by the supervisor in any situation.

- The Reserve Bank may consider having more interactions with the external auditors of banks.

#### **(xi) Supervision of Internationally Active Banking Organisations**

- The Reserve Bank should practice consolidated supervision over internationally active banking organisations of which it is the home country supervisor.
- The Reserve Bank should look at the management's local oversight of foreign operations and ensure that it is particularly close when the foreign activities differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the locations where the principal activities are conducted.
- The supervisor should visit the offshore locations periodically and exchange information with the host country authorities during such visits.
- It would be preferable to have formal arrangements between home and host country supervisors for sharing of information and supervisory concerns rather than having only informal arrangements as at present.

## Appendix 3

### Recommendation of Committee on International Financial Standards and Codes – Report on the Progress Agenda Ahead

Sr. No.	Recommendation of Committee on International Financial Standards and Codes - September 2000	Recommendation of Committee on International Financial Standards and Codes - Report on the Progress and Agenda Ahead - December 2004
1	2	3
1	Powers of the Reserve Bank to decide on capital requirements on a case-by-case basis needs to be clearly defined in law.	The issue of revision of minimum capital requirement and the supervisory process is under review. The Reserve Bank could consider its legal, institutional and regulatory aspects in the context of discriminatory capital charge for proper risk management.
2	A stricter view about objectives, philosophy and internal controls at pre-licensing stage, evaluating Directors on Board and making individual Directors accountable.	The Reserve Bank is implementing this recommendation of the Consultative Group of Directors of Banks and FIs (2002) (Ganguly Committee) as per the circular issued by the Reserve Bank in June 2002.
3	Banks should obtain prior approval of supervisor for any proposed changes in ownership or exercise of voting rights over the threshold.	Guidelines issued in February 2004 provide for "acknowledgement" from the Reserve Bank for acquisition/ transfer of shares. Such acknowledgement would be required for all cases of acquisition of shares which will take the aggregate holding of an individual or group to equivalent of 5 per cent or more of the paid-up capital of the bank. The Reserve Bank while granting acknowledgement may require such acknowledgement to be obtained for subsequent acquisition at any higher threshold as may be specified. Incorporation of this aspect in the Banking Regulation Act, 1949 through appropriate amendment is under active consideration.
4	Forbearance on capital requirements cannot be long-term. The Reserve Bank had introduced Prompt Corrective Action (PCA) in December 2002 to address this issue.	The scheme, where one of the trigger points is minimum CRAR, was reviewed in December 2003 and it has been decided to continue with PCA in its present form.
5	The Reserve Bank should gradually move to setting bank-specific capital ratios based on their individual risk profiles; the Reserve Bank may assist and guide banks on risk management.	The Reserve Bank will address this issue during the course of implementation of Basel II norms. The Reserve Bank has already issued comprehensive guidelines on ALM and other risk management systems and guidance notes on credit

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		risk and market risk management. Implementation of these guidelines is being monitored closely through quarterly reports and Annual Financial Inspections (AFI) reports. The Reserve Bank has also introduced Risk Based Supervision (RBS) on a pilot basis.
6	Banks' risk management policies and procedures should be provided in publicly available documents.	Disclosure under Pillar 3 – Market discipline which provide for qualitative disclosures on management of risks will be considered at the time of Basel II implementation
7	The Reserve Bank may issue suitable instructions for continued assessment of guarantees and strength of collateral.	The Reserve Bank has already issued necessary instructions.
8	A system of classification of off-balance sheet items on the lines of extant system of classification of funded exposure should be put in place.	Income Recognition and Asset Classification norms are being applied to off-balance sheet items, when they get crystallised. Even otherwise, risk weights as per the Basel Committee norms are applicable.
9	'Closely related groups' need to be defined. Banks should monitor loans to connected and related parties. Such loans that are not fully collateralised should be deducted from bank's capital to that extent.	In terms of Section 20 of the Banking Regulation Act, 1949, there are restrictions on banks granting loans and advances to its Directors, to any Company where Director of the bank is also a Director of the company, to individuals where the Director is a partner or a guarantor. As regards monitoring of loans to related parties, the Reserve Bank has issued guidelines to banks on Accounting Standard (AS)-18 'Related Party Disclosures'. The guidelines require that the name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.
10	Adopt rating of Board performance.	The evaluation of the performance of the Board is undertaken while arriving at supervisory rating under the component of 'Management' in the CAMELS approach. The Reserve Bank could also consider further appropriate action, if necessary.



Sr. No.	Recommendation of Committee on International Financial Standards and Codes - September 2000	Recommendation of Committee on International Financial Standards and Codes - Report on the Progress and Agenda Ahead - December 2004
11	'Know Your Customer (KYC)' guidelines should be verified by supervisor.	Guidelines have already been issued by the Reserve Bank and IBA. Instructions have been issued to the Inspecting Officers of DBS to check the compliance by the banks with regard to 'KYC' norms during the AFIs and comment on the quality of compliance. In cases where violation of KYC guidelines has come to the Reserve Bank's notice, the Reserve Bank has taken action against errant banks and even imposed penalty.
12	The Reserve Bank may consider introducing meetings with banks' boards and external auditors. It should enhance the role of external auditors.	Exit level discussions are held by inspectors with the bank management. Further, in the case of private sector banks, the inspection findings are invariably discussed with the Chief Executive Officer and a few prominent Directors of the bank. The Banking Regulation Act provides for the role of the external auditors and the same has been enhanced by the BFS.
13	Move towards consolidated accounting and supervision. In case of internationally active banks, MOUs with host country supervisors should be considered.	The Reserve Bank has issued a circular in February 2003 on consolidated accounting to facilitate consolidated supervision. Accordingly, banks which have subsidiaries are required to file consolidated financial statements and half yearly consolidated prudential returns to the Reserve Bank. Exchange of information of supervisory interest with host country supervisors is need-based, though no formal MOUs exist.
14	Co-ordination among regulators. High Level Co-ordination Committee on Financial Markets (HLCCFM) already exists.	Recently three sub-committees have also been constituted, viz., Sub-Committee on the Reserve Bank Regulated Entities, Sub-Committee on SEBI Regulated Entities and Sub-Committee on IRDA Regulated Entities. On the basis of recommendation made by JPC, a joint Reserve Bank and SEBI group was constituted to put in place an integrated system of alerts which would piece together disparate signals from different elements of the market. Accordingly, as recommended by the group, the process of exchange of alerts and information has been set in motion.
15	Imposition of conservatorship to enable banks in difficulty to gain time.	Provision for moratorium for up to six months already exists under the Banking Regulation Act. In the recent past, there have been three cases of moratorium. Nedungadi Bank Ltd. was put under

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Sr. No.	Recommendation of Committee on International Financial Standards and Codes - September 2000	Recommendation of Committee on International Financial Standards and Codes - Report on the Progress and Agenda Ahead - December 2004
		moratorium and later on was merged with Punjab National Bank. South Gujarat Local Area Bank was placed under moratorium and later merged with Bank of Baroda. Recently, Global Trust Bank was placed under moratorium and later amalgamated with the Oriental Bank of Commerce.
16	Quality of corporate governance should be same for all types of banks; make Boards accountable and streamline process of induction of Directors; steps for percolation of strategic objectives and values.	Recommendations of the Consultative Group of Directors of Banks and FIs (2002) (Ganguly Committee) are being implemented.
17	Establishment of compensation committees to link remuneration/ rewards to contribution.	A few newly set up private sector banks have such Committees, though for public sector banks pay structures are based on negotiation at industry level.
18	Prohibiting loans and advances to Directors/ connected parties.	Statutory restrictions on loans and advances to Directors and connected parties are already in place. However, making these norms applicable to major shareholders would require legal amendments. The Reserve Bank could consult Government of India on this for effecting appropriate legal changes.
19	Overlap between the Reserve Bank as owner and Reserve Bank as regulator/ supervisor.	The proportion of the Reserve Bank shareholding in SBI has come down from 97.8 per cent to 59.73 per cent. Nominees on the Boards of banks are not posted from Supervisory Departments such as DBS and DBOD. The Reserve Bank is also in the process of off-loading its stake in IDFC Ltd. A view on offloading of the Reserve Bank's stake on NABARD and NHB is yet to be firmed up.
20	Government ownership not conducive for urgent corrective action by regulator.	PCA regime does not discriminate on the basis of ownership. Government of India has concurred with the actions proposed under PCA.

Sr. No.	Recommendation of Committee on International Financial Standards and Codes - September 2000	Recommendation of Committee on International Financial Standards and Codes - Report on the Progress and Agenda Ahead - December 2004
21	Institutionalise discussion between Board and management on quality of internal control systems; improve risk management.	The Reserve Bank issued risk-based internal audit guidelines in December 2002. These guidelines provide for the Board to approve policy for undertaking risk-based internal audit covering risk assessment methodology on which the audit plan could be based. The policy should lay down the maximum time period beyond which low risk business activities/location is not to remain unaudited. The Board of Directors has been made responsible for an effective risk based internal audit system and the internal audit head is required to report to the Board in this respect.
22	Promote greater awareness in regard to security, risk and controls in computerised environment.	Recommendations as contained in the Report of Committee on Internet Banking and Working Group Report on Information System on Security for Banking and Financial Sectors have been forwarded to banks. Banks have also been given detailed checklist for computer audit. In continuation of these efforts towards sensitising the banks regarding information system security, detailed guidelines / instructions relating to Information System Audit have been issued to the banks for implementation during the current financial year.
23	The Reserve Bank should engage external auditors for area audit/ inspection of banks.	The statute provides for engagement of external auditors. There are instances where the Reserve Bank engaged external auditors for specific assignments.
24	The gaps with regard to monitoring of credit risk relate to the formulae-based determination of loan-loss provisions, a somewhat lenient approach to off-balance sheet activities and inadequate attention to economic factors. Banks need to improve credit risk management.	The Reserve Bank is, however, pursuing a standardised approach for implementation under Basel II. As such, at this point of time, these are not very relevant for most of the banks. However, banks could consider process of building up necessary MIS in this regard for future purposes.
25	Banks should capture elements of risk like probability of default (PD), loss given default (LGD) and exposure at the time of default (EAD).	The Reserve Bank is, however, pursuing a standardised approach for implementation under Basel II. As such, at this point of time, these are not very relevant for most of the banks. However, banks could consider process of building up necessary MIS in this regard for future purposes.

## Chapter III

### Assessment of Adherence to Basel Core Principles

Sr. No.	Recommendation of Committee on International Financial Standards and Codes - September 2000	Recommendation of Committee on International Financial Standards and Codes - Report on the Progress and Agenda Ahead - December 2004
26	Banks should build historical database on portfolio quantity and provisioning/charge-off.	This has already been made part of guidelines on risk management systems. The Reserve Bank is monitoring implementation.
27	Guidelines in respect of dealing with Highly Leveraged Institutions (HLI) should be put in place.	Banks are not allowed to lend to HLIs.
28	As per extant guidelines, if a loan under doubtful category does not migrate to loss category, the account remains under-provided as after three years only a maximum of 50 per cent provision is created under the secured portion.	The Reserve Bank has advised banks not to go through various stages of classification in case of serious credit impairment. The Reserve Bank has also been impressing upon the banks to make adequate provisions to take care of impairment in assets. The Reserve Bank has also announced graded provisions to be made in case of doubtful assets of more than three years from March, 2005 and to provide for fully in respect of fresh additions after this date.
29	Increasing provision on the secured portion of doubtful debts beyond 50 per cent.	As part of the Annual Policy Statement for the year 2004-05, an announcement has been made for introduction of a graded higher provisioning requirement (for secured portion) according to the age of NPAs, which are included under 'doubtful assets' for more than three years. This graded provisioning has been made applicable since end-March 2005.
30	Level of disclosures to be gradually improved. Detailed discussions on operational, legal and strategic risks may be made mandatory in director's report to shareholders.	The Reserve Bank has stipulated standards of disclosure from time to time. It will work out guidelines for operational risk, legal risk and strategic risk in due course. The Reserve Bank is monitoring implementation of disclosures stipulated.
31	Mechanisms for detecting and providing for double gearing problems with financial conglomerates.	The Reserve Bank circular of February 2003 provides for half-yearly consolidated prudential returns in respect of banks which have

Sr. No.	Recommendation of Committee on International Financial Standards and Codes - September 2000	Recommendation of Committee on International Financial Standards and Codes - Report on the Progress and Agenda Ahead - December 2004
		subsidiaries. The Reserve Bank is monitoring implementation. For computation of capital adequacy, double gearing has been addressed by providing for deduction of capital of the subsidiary.
32	The Reserve Bank should ensure fitness for directors/ managers of the unregulated entities in a conglomerate.	The Reserve Bank does not have jurisdiction over unregulated entities in a conglomerate. As such, it needs to be considered what further action can be implemented in this regard.
33	Make arrangements for applying fit and proper tests on all shareholders with shareholding beyond a specified threshold.	The Reserve Bank has issued circular specifying the relevant factors which are taken into account for determining whether the applicant (including all entities connected with the applicant) is 'fit and proper' to hold position of a shareholder. Amendment to Banking Regulation Act is also being considered to empower the Reserve Bank to permit/ reject transfer of shares in a banking company above a threshold.
34	The Reserve Bank may consider introduction of the concept of primary supervisor.	The new framework for monitoring of financial conglomerate envisages a complementary strand to the already existing regulatory structure, wherein the concept of principal regulator has been addressed. The new framework provides for: (i) identification of financial conglomerate that would be subjected to focused regulatory oversight, (ii) capturing intra-group transactions and exposures, (iii) identifying designated entity within each group for collating data for all other group entities and furnishing the same to principal regulator and (iv) formalised mechanism for exchange of information.
35	Risk control guidelines including appropriate controls in up-stream and downstream units, material risk concentrations, Intra-group Transactions and Exposures (ITEs).	The Reserve Bank has issued comprehensive guidelines on risk management systems. Accounting Standard 18 takes into account disclosures related to ITEs. As a pro-active stance to address the issue of monitoring of conglomerates, the Reserve Bank had constituted a Working Group on Financial Conglomerates. The Group has set criteria and identified 24 financial conglomerates. It has also evolved a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-regulatory exchange of information in respect of conglomerates. The first report based on the format recommended by the Group is under preparation.

## Chapter III

### Assessment of Adherence to Basel Core Principles

Sr. No.	Recommendation of Committee on International Financial Standards and Codes - September 2000	Recommendation of Committee on International Financial Standards and Codes - Report on the Progress and Agenda Ahead - December 2004
36	A country-wise analysis should be undertaken to identify constraints in countries where local laws do not permit home supervisor to conduct on-site inspection.	There is no system of regular on-site inspection of foreign branches of Indian banks by the Reserve Bank. In case of specific situations, matter is taken up with the respective host country supervisor.
37	Separate approvals of home country supervisors of foreign banks should be insisted for their new branches.	Approval is sought from the home country supervisors of foreign banks for opening of their maiden branch. The Reserve Bank could consider further action in this regard.
38	Periodic review of supervisory systems and standards of host countries where Indian banks have presence.	The Reserve Bank accepts standards as evolved by the Basel Committee. Periodical reviews of performance of overseas offices including regulatory environment in those countries are done.
39	Information sharing on parent bank's difficulties. Information on parent bank's difficulties is not being obtained.	However, the functioning of the branches of foreign bank is monitored independently. The Reserve Bank could consider necessary follow-up on this.



## Appendix 4

### Detailed Assessment (Principle-by-Principle)- Commercial Banks

**Principle 1: Objectives, independence, powers, transparency and co-operation**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 1(1): Responsibilities and objectives**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

**Description :**

The Reserve Bank ("RBI") is an autonomous body created under an act of the Indian parliament i.e. The RBI Act, 1934. The Banking Regulation Act, 1949 (BR Act), lays down the laws relating to banking regulation and supervision of banks in India. The Reserve Bank is entrusted, *inter alia*, with the sole responsibility of regulation and supervision of banks under the BR Act, 1949. The responsibilities and the objectives of the Reserve Bank are clearly delineated in the aforesaid Acts. Laws and regulations are in place that provide framework of minimum prudential standards which banks are required to meet. The banking laws are reviewed and updated from time to time. The BR Act was last amended in 2007. The detailed information on financial strength and performance of the industry is available publicly through various Reserve Bank publications like Annual Report, fortnightly statements, Report on Currency and Finance, Banking Statistics, Report on Trends and Progress of Banking in India *etc.* The Reserve Bank monitors banks through both off-site returns and on-site examinations.

**Assessment: Compliant****Principle 1(2): Independence, accountability and transparency**

Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.

**Description :**

The RBI Act provides the basis for its independence, accountability and governance structure. The Reserve Bank is solely responsible for the regulation and supervision of banks and it derives its powers and mandates from the BR Act, 1949. Various provisions of the RBI Act, 1934 and the BR Act, 1949 provide for operational independence to the Reserve Bank on matters relating to bank supervision. Though as per convention, the Reserve Bank enjoys independence vis-à-vis the executive arm of the State, by way of technical statutory position there is potential for loss of the Reserve Bank's independence. Inasmuch as the Central Government has powers to remove the Governor of the Reserve Bank (as per Section 11 of RBI Act, 1934) without specifying any reasons in this regard and without publicly disclosing the reasons for removal of the head of

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supervisory authority. Further, as per Section 30 of RBI Act, 1934, the Central Government can supersede the Central Board and thereafter general superintendence and direction of affairs of bank shall be entrusted to such agency as Central Government may determine. While the Reserve Bank is accountable to the Parliament through Ministry of Finance, the transparency of the accountability framework needs closer introspection.

There is no indication of industry interference in its functioning and the Reserve Bank suffers from no limitation in obtaining and deploying the resources needed for carrying out its mandate. The Department of Banking Supervision of the Reserve Bank which is entrusted with job of supervision of banks submits half-yearly and annual review notes on its performance to the Board for Financial Supervision (BFS) and the Central Board of the Reserve Bank. An annual report on the working of the Reserve Bank with detailed analysis of its annual accounts and an assessment of Indian economy is also submitted to the Central Government under Section 53(2) of the RBI Act, 1934. The Reserve Bank and its staff have clearly established their credibility purely on the basis of their professionalism and integrity. The Reserve Bank is financed by its own budget and does not receive any financial support from any entity, including the Central Government. The Reserve Bank equips its officers with latest techniques of supervision through on going training programmes organised at its own staff colleges. The Governor of the Reserve Bank is appointed by the Central Government for a term not exceeding five years and is eligible for re-appointment.

**Assessment: Materially Non-Compliant**

**Comments:** The reasons for removal of head of supervisory agency during his term are not specified in law. Though the Reserve Bank is accountable indirectly to Parliament through Ministry of Finance, it is not accountable through a transparent framework for discharge of its duties in relation to its objectives. Hence, a more formalised and transparent framework of understanding with the Government of India regarding the way the Reserve Bank is made accountable for its supervisory functions would be desirable.

**Principle 1(3): Legal framework**

A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.

**Description:**

The Reserve Bank is vested with the powers to issue licence to a company for commencing and carrying on the business of banking (Section 22(1) of the BR Act, 1949) and the powers to revoke licence (Section 22(4) of the BR Act, 1949). It is also vested with powers to issue directions/ guidelines on any aspect of banking vide Section 35A of the BR Act, 1949 without the need for amending the law each time that it sets the prudential rules. Further, it is also empowered under Section 27 of the Banking Regulation Act, 1949 to call for any information from banking companies in the form and frequency it deems necessary.

<b>Assessment: Compliant</b>
<b>Principle 1(4): Legal powers</b>
A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
<b>Description:</b>
The BR Act, 1949 vests the Reserve Bank with powers to address any issue relating to compliance with laws as also safety and soundness of the banks under its supervision. It has also access to all the records/staff of a bank. The Reserve Bank has powers to issue directions to banks in general or in particular under section 35A of the BR Act, 1949 in the public interest; or in the interest of banking policy; or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or to secure the proper management of any banking company generally. It is thus empowered to take remedial actions and/or impose a range of sanctions as warranted by the situation. Further Section 22(4) of BR Act, 1949 empowers the Reserve Bank to cancel licence granted to a banking company under certain conditions.
<b>Assessment: Compliant</b>
<b>Principle 1(5): Legal protection</b>
A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
<b>Description:</b>
Section 54 of BR Act, 1949 provides for explicit protection to the supervisors. No suit or other legal proceeding shall lie against the Reserve Bank or any of its officers for anything or any damage caused or likely to be caused by anything done in good faith or intended to be done in pursuance of the BR Act. The cost of legal action arising out of the discharge of official duties is met by Reserve Bank.
<b>Assessment: Compliant</b>
<b>Principle 1(6): Co-operation</b>
Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
<b>Description:</b>
Information sharing between various entities involved with responsibility of soundness of financial system is in place. The Reserve Bank shares information with overseas supervisors based on reciprocity and with clear understanding that the information will remain confidential and will be used for the purpose for which it is sought. However there are no formal Memoranda of Understanding (MoU) with foreign supervisory agencies, since the law does not empower the Reserve Bank to enter into formal MoUs. The information that the Reserve Bank receives from other supervisors is invariably used only for supervisory purposes and the information received is treated as confidential though this is not required due to any provision of law.
<b>Assessment: Compliant</b>

**Principle 2: Permissible activities**

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

**Description:**

The term banking is clearly defined in the Section 7 of the BR Act, 1949. It also prescribes the permissible activities (Section 6 of the BR Act, 1949) that can be taken up by these entities that are licensed and subject to supervision by the Reserve Bank. Besides banks, there are some other entities like Development Financial Institutions (DFIs) and Non-Banking Financial Companies (NBFCs) who accept deposits of money that are not repayable on demand which cannot be withdrawn by cheques, also under the supervisory ambit of the Reserve Bank. Further, there are corporate bodies other than banks which can also accept retail deposits but are not covered under supervisory ambit of the Reserve Bank. The Reserve Bank publishes directory of commercial banks indicating the addresses of each of their branch office from time to time with a time lag of about one year. The Reserve Bank also maintains an upto date list of the licensed banks which are in the Second Schedule of RBI Act, 1934 on its website.

**Assessment: Compliant**

**Principle 3: Licensing criteria**

The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

**Description:**

The supervisor is also the licensing authority in the country. The criteria for licensing of banks are laid down in the Section 22 of the BR Act, 1949 which are consistent with criteria applied for ongoing supervision. The supervisor has power to reject application for setting up a bank if licensing criteria is not fulfilled by the entity. The Reserve Bank before granting any licence satisfies itself by an inspection of the books of the bank or otherwise that certain conditions as to solvency, management, corporate governance, capital, operational plans are met. The minimum requirement for paid up capital and reserves and transfer to reserve fund have also been prescribed in the Act. The Reserve Bank also closely looks at the promoters of new banks and their sources of finance to establish that these are genuine promoters of the bank. It also evaluates the general character of the proposed management to ensure that it would not be prejudicial to the interests

of present or future depositors. Fit and proper test is applied to evaluate the directors and the Chief Executives. Further, there is a fit and proper test for elected directors which have been implemented through amendment of Bank Nationalisation Act in 1970 and Bank (Second) Nationalisation Act in 1980 and State Bank of India (Subsidiaries Banks) Act and also through issue of guidelines by the Reserve Bank. Section 10A(2) of the BR Act, 1949 prescribes that the members of the Board of the bank should have special knowledge or practical experience in specialised areas or any other matter the special knowledge of, and practical experience in, which would, in the opinion of the Reserve Bank, be useful to the banking company.

The proposed strategies and operating plans are reviewed with a view to ensuring that the business strategy of banks is sound and that the proposed bank would be viable in the normal course under reasonable assumptions. In terms of Rule 11 of the Banking Regulation (Companies) Rules, 1949 applications for a proposed bank are required to be submitted in the prescribed form (Form III). At present, foreign banks are operating through branches only. The 'tests of entry' criteria are also applied to foreign banks when they submit their proposals to establish the first branch in India. The Reserve Bank is vested with powers under section 22(4) of the BR Act, 1949 to cancel a licence granted to a banking company provided the company ceases to carry on banking business in India; or it fails to comply with any of the conditions imposed under Section 22(1), Section 22(3) or Section 22(3A). The BR Act, 1949 prescribes the members of the Board are having special knowledge or practical experience.

**Assessment: Compliant**

**Principle 4: Transfer of significant ownership**

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

**Description :**

As per the Reserve Bank guidelines, any transfer of shares in a banking company, which exceeds 5 per cent of the paid-up capital of the bank requires acknowledgement by the Reserve Bank before the registration of the transfer in their books. The Reserve Bank has requisite powers to reject/prevent any proposal for a change in significant ownership or controlling interest in a bank. Further, the Reserve Bank receives a half-yearly return on 'ownership and control' from all domestic banks which contains details of top ten shareholders. Any significant change in ownership is also examined during on-site inspection.

As per Section 10(A)(2)(b) of the BR Act, 1949, directors on the bank's Board should not have substantial interest in a company or a firm. As per Section 5(ne) of the BR Act, 1949, substantial interest means an amount paid-up exceeding Rs. 5 lakh or ten per cent of the paid-up capital of the company, whichever is less. The low amount of Rs. 5 lakh acts as a constraint for having directors with requisite expertise on banks' boards.

**Assessment: Compliant**

**Comments:** Guidelines need to be reviewed and the limits defining 'substantial interest' revised upwards so that the banks can attract individuals with requisite expertise on their Boards.

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**Principle 5: Major acquisitions**

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

**Description:**

The BR Act, 1949 lays down aspects relating to major acquisitions. It provides the procedure to be followed for merger/acquisition/amalgamation of banking companies (private sector banks) including the provisions requiring prior approval of the Reserve Bank.

The banks are allowed to set up subsidiaries and make significant investment only in companies that are undertaking business authorised under section 19(1) of the BR Act, 1949. All proposals for major acquisitions are looked into from the point of view of their impact on the bank and its ability to manage the investment/ acquisition well. All acquisitions/ investments that are made for strategic purposes need the prior approval of the Reserve Bank. The bank's investments in equity shares of companies done with a trading intent do not need the prior approval of the Reserve Bank provided the acquisition is in accordance with the legal/ prudential requirements. Under Section 19(1) of the BR Act, 1949, any foreign banking operations of a bank situated in India require prior permission of the Reserve Bank.

**Assessment: Compliant**

**Principle 6: Capital adequacy**

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

**Description :**

The Reserve Bank has mandated capital adequacy requirements for all commercial banks which are on par with the International Convergence of Capital Measurement and Capital Standards, July 1988 (Basel Accord). The banks are required to maintain a Capital Adequacy Ratio (CAR) of at least 9 per cent of the risk weighted assets as per Basel methodology, covering both on and off-balance sheet items. It captures banks' exposures to credit risk in the entire balance sheet and market risks in banks' trading book exposures. All banks are treated at par for the purpose of capital adequacy. In event of banks falling below minimum capital ratio a concept of Prompt Corrective Action (PCA) framework is in place whereby structured and discretionary actions can be initiated by the Reserve Bank. The Reserve Bank does not permit banks to use internal assessments of risk as inputs for the calculation of regulatory capital.

**Assessment: Compliant**



**Principle 7: Risk management process**

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

**Description :**

In October 1999, the Reserve Bank had issued detailed guidelines on risk management to banks. It had also issued guidelines on credit risk, market risk and operational risk. The internal capital adequacy assessment process is only being undertaken parallelly and as of date, there is no specific regulatory requirement in this regard. The primary responsibility of laying down risk parameters and establishing risk management and control system was assigned to the Board of Directors. The progress made by banks in implementation of the guidelines on Risk Management Systems, Risk Based Supervision and Risk Based Internal Audit are monitored on a quarterly basis. Further, a review of the risk management framework is undertaken during Annual Financial Inspections (AFIs) of banks. The bank's Board has to ensure that the directors are kept abreast of the latest managerial techniques, technological developments, financial markets, risk management systems *etc.*, through training programmes, seminars, workshops *etc.* As a part of migration of banks to Basel II regime, those with international operations and foreign banks beginning from March 31, 2008 and others from March 31, 2009 would be using standardised approach for credit risk and basic indicator approach for operational risk. The use of internal models is not specifically stipulated. However, as banks progress towards more sophisticated methodologies, the skills at banks as well as supervisory levels needs to be enhanced to conduct periodic independent validation testing. Guidelines on stress testing have been made mandatory from March 31, 2008.

**Assessment: Materially Non-Compliant**

**Comments:** The banks need to put in place appropriate Internal Capital Adequacy Assessment Processes (ICAAPs). The regulations should mandate such ICAAP and the AFIs need to ensure that these processes are operational.

The AFIs need to determine the effectiveness of the ICAAPs in place in banks as a part of Basel II preparedness initially and thereafter as a part of Basel II compliance. Though banks are at present required to adopt standardised approach as prescribed by the regulator, however, as and when they move to internal models for measurement of risk, the AFI needs to comment on the independent validation and testing of models by the banks. (The Reserve Bank has since issued guidelines on internal capital adequacy assessment process as part of supervisory review process under Pillar II of Basel II which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009. However, AFIs have not yet been conducted in this regard).

The fact that risk reports reflect the capital needs with reference to the economic capital needs is not explicitly determined in the AFIs. The determination of risk management aspects at group level is not explicit in AFIs.

While explicit guidelines regarding information systems for addressing risks and segregation of duties have been issued to banks, the same have not been issued to banking groups.

In terms of the extant guidelines the use of internal models for risk management is not specifically mandated. Consequently, there is no system of periodic validation and independent testing of models and systems in the banks. A rigorous model building exercise is consequential to the banks adopting more advanced Internal Rating Based (IRB) approach in respect of credit risk and Advanced Measurement Approach (AMA) in respect of operational risk. If a bank intends to take recourse to IRB or AMA approach for assessing credit and operational risks respectively, it should have appropriate forward looking models in place which should be validated periodically. There is a need for capacity building in respect of banks and the Reserve Bank, as the prime precondition in this regard.

**Principle 8: Credit risk**

Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

**Description:**

The Reserve Bank has issued guidelines on credit risk management. These guidelines require that the Board of Directors of each bank is responsible for putting in place an appropriate credit risk management framework, approving and periodically reviewing the credit risk policy, strategy, procedures and processes. These regulations require the banks to have in place well documented and appropriate policies/processes that establish a properly controlled credit risk environment that is appropriate to each bank's size and credit risk appetite. These aspects are periodically confirmed by the Reserve Bank on the basis of the quality of the credit portfolio of banks through the AFIs, periodical off-site reports and informal discussions with the top management of banks. Any shortcomings in these areas are highlighted in the AFIs and later pursued through informal discussions as also through a formal follow-up of the AFI findings.

**Assessment: Largely Compliant**

**Comments:** Guidelines on credit risk need to explicitly mention that the bank's credit risk management policies/strategies should also include counterparty credit risk arising through various financial instruments.

**Principle 9: Problem assets, provisions and reserves**

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

**Description :**

The Reserve Bank has issued detailed guidelines on income recognition, asset classification and provisioning pertaining to advances portfolio and classification & valuation of investment portfolio including off-balance sheet exposures. The Reserve Bank has issued guidelines on early

identification of problem assets. The banks are also required to place periodical reviews of Non-Performing Assets (NPAs) to their Board/senior management and pursue effective means and methodologies for recovering / managing the NPAs. The on-site inspection by the Reserve Bank comments on asset quality as also impairment in the value of assets. The quality of assets is also monitored on quarterly basis through off-site monitoring returns. The Reserve Bank has been empowered to issue directions which may include, among many other things, higher provisioning, and higher capital level. It has prescribed calendar of reviews which are to be submitted by the banks to their respective Boards. Among other things, the banks are required to present to its board a report giving details of level of NPAs and recovery thereof, *etc.*, on a monthly basis.

**Assessment: Largely Compliant**

**Comments:** The guidelines do not require provisioning on an individual basis for large accounts which are classified as substandard if they are unsecured.

Keeping in view the cost of compliance, the present stipulations may continue for the present. However, considering the very large number of low value NPAs which are sub-standard, if at all provisioning has to be done individual account-wise, a cut-off level should be set above which all accounts can be provided for individually. This cut-off level above which all substandard assets have to be provisioned for may be lowered in a phased manner.

As per extant guidelines on provisioning, the banks are required to make up to two per cent provision on standard assets, while NBFCs need not make any provision on standard assets. There is a need to review the norms to reduce the possibility of regulatory arbitrage across categories of financial institutions.

Globally, the capital market exposure is measured based on risk and not quantitative limits. In India capital market exposure cannot exceed forty per cent of the net worth and the limit for lending to individuals at Rs.10 lakh (Rs.20 lakh in demat form) appears to be low. Further, a uniform margin of fifty per cent shall be applied on all advances /financing of IPOs/ issue of guarantees on behalf of stock brokers and market makers. There is a need to review the limits from time to time keeping in view the associated risks arising out of such exposures.

**Principle 10: Large exposure limits**

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

**Description:**

The Reserve Bank has prescribed prudential credit exposure limits for 'single borrower' and 'group borrowers' at fifteen per cent and forty per cent respectively of the bank's capital funds. Further, to encourage flow of funds to the infrastructure sector, these limits can be exceeded by five per cent and ten per cent respectively. The banks have in place Management Information System (MIS) to monitor their counterparty exposures across the portfolios including counterparty credit exposures arising out of derivative contracts. These exposures are compiled and monitored for individual counterparties as well as for groups of connected counterparties. The integrity of the MIS is verified during the on-site examination. In addition to the aforesaid prudential credit exposure limits, the Reserve Bank has prescribed prudential limits for capital market exposures. This however should be reviewed periodically. The information on concentration of exposures is obtained regularly by the Reserve Bank through off-site returns.

**Assessment: Compliant**

**Principle 11: Exposures to related parties**

In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

**Description :**

The regulations issued by the Reserve Bank clearly define related parties. Section 20 of the BR Act prohibits loans and advances (other than for personal use) to directors or to any firm or company in which directors are interested or individuals in respect of whom any of its directors is a partner or guarantor. While there are restrictions on lending to directors, lending to relatives of directors, subsidiaries/associates/joint ventures require the prior approval of the Board or are reported to the Board. The banks' investments in instruments which qualify for inclusion as capital funds in their subsidiaries are deducted from the investing bank's Tier 1 capital for capital adequacy purposes. Further, the Reserve Bank has set a limit of ten per cent of the capital funds of the investing bank for its investment in all capital instruments of other banks. The guidelines issued by the Reserve Bank on credit risk management stipulates a credit review mechanism, however in many banks, it is not done by independent units. The detailed exposure norms addressing the concentration risk of the loan portfolio of the banks are in place. The discipline of seeking prior approval of the Board does not apply to all transactions (other than lending) which need to be bridged explicitly. Further, the requirement of seeking the prior approval of the Board for write-offs needs to be specified in the guidelines. The supervisory requirement that banks have policies and processes in place to prevent persons benefiting from the exposure and/or persons related to such a person from being part of the process of granting and managing the exposure are not part of the guidelines.

**Assessment: Materially Non-Compliant**

**Comments:** The guidelines do not require specific approval of Board for any transactions other than lending and it also does not require approval of Board for write-off. It also does not require that banks have policies and processes in place to prevent persons benefiting from the exposure and/or related to such a person from being part of the process of granting and managing the exposure.

**Principle 12: Country and transfer risks**

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

<p><b>Description :</b></p> <p>The Reserve Bank has issued detailed guidelines on the issues of identifying, measuring, monitoring and controlling country exposure risks. All banks have put in place appropriate information systems to track their exposures to countries in various risk categories. They are required to report to the Reserve Bank on a quarterly basis, their exposures to all those countries where the exposures to each of those countries are in excess of one percent of its total assets. The Reserve Bank has prescribed provisioning requirement on the net funded country exposures on a graded scale ranging from 0.25 to hundred per cent. The banks are required to report details of their country-wise exposures to the Reserve Bank as a part of their off-site returns along with the details of the provisions held thereof.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 13: Market risk</b></p> <p>Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.</p>
<p><b>Description :</b></p> <p>The Reserve Bank has powers under Section 35A of the BR Act, 1949 to impose specific limits and /or specific capital charge on market risk exposures as part of the general powers to issue directions to banks on any aspect of their functioning. It has issued guidelines to banks in 2002 on market risk stating therein that the Boards of the banks should clearly articulate market risk management policies, procedures, prudential risk limits, review mechanisms and reporting and auditing systems. The Risk Policy Committee is required to submit requests for market risk limits annually for approval to the Board. The usage of Sensitivity and Value at Risk limits for trading portfolios and limits for accrual portfolios (as prescribed for Asset Liability Management) are required to be measured daily. These aspects are looked into during on-site inspections by the Reserve Bank. All banks are required to have a contingency funding plan in place. The Reserve Bank has issued guidelines on capital charge for market risk in June 2004 required to be maintained by the banks. The banks have operationalised formal stress testing framework in accordance with guidelines from March 31, 2008. The guidelines do not explicitly require banks' valuation methods to appropriately capture concentrations, less liquid positions, and stale positions.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> The guidelines on market risk need to explicitly state that banks valuation methods appropriately capture less liquid positions and stale positions which in turn should be reflected in provisions held by the banks.</p> <p>Instructions relating to stress testing need to be dovetailed into the bank's risk management strategy. The Reserve Bank should look into these aspects and explicitly confirm the adoption of such approaches by the banks.</p>
<p><b>Principle 14: Liquidity risk</b></p> <p>Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>

**Description :**

The Reserve Bank has issued guidelines on Asset-liability framework and Risk management systems to banks in 1999. The Board is required to undertake overall responsibility for management of risks and decide the risk management policy of the bank and set limits for liquidity risks. The banks management has been advised to measure not only the liquidity positions of banks on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. The banks are required to fix aggregate and individual gap limits for each currency with the approval of the Reserve Bank. They are required to adopt Value at Risk approach to measure the risk associated with forward exposures. The Reserve Bank monitors currency risk through a monthly return on maturity and positions for on- and off-balance sheet items in foreign exchange. The banks have been advised to prepare contingency plans to measure their ability to withstand bank-specific or market crisis scenario. The top management is involved in fixing and monitoring of limits on foreign exchange positions. Stress testing of foreign currency liquidity for large banks active in foreign exchange market has been prescribed. The assessment of impact of other risks on liquidity as well is yet to be mandated for banks explicitly in the guidelines. The current guidelines on liquidity management are confined to the domestic balance sheet of banks.

Liquidity risk is essentially a consequential risk typically triggered by a combination of several other risks like loss of depositors' confidence, changes in counterparty risk, changes in economic conditions, fluctuations of interest rates *etc.* The increase in infrastructure financing and real estate exposure of banks has resulted in increased ALM mismatch. Though the banks hold a significant portion of their assets in liquid instruments a trend analysis has indicated a growing dependence of the banks on purchased funds and an increase in illiquid assets. These require to be suitably factored in the capital requirement of banks.

**Assessment: Materially Non-Compliant**

**Comments:** The assessment of impact of other risks (credit, market and operational risks) on liquidity is yet to be mandated for the banks explicitly in the guidelines.

The current guidelines on liquidity management are confined to the rupee balance sheet of the banks. The overseas operations are subject to a separate set of guidelines which does not capture the assets/liabilities in the same currency across overseas branches as well as domestic branches.

Section 17 of the RBI Act, 1934 empowers the Reserve Bank to grant advance to scheduled banks by rediscounting the bills of exchange as also granting advance to various entities as notified by Central Government. Further, Section 18 of the RBI Act, 1934 empowers the Reserve Bank to purchase, sell or discount any bill of exchange or promissory note though the same may not be entitled for purchase or discount and also make loans or advances to any entity in case of a special occasion. However recent events like sub-prime crisis in USA and Northern Rock in UK have highlighted the need for more careful management of liquidity risk.



The Panel feels that the recent global financial turmoil has necessitated the need to have a re-look at the conventional role of Lender of Last Resort (LoLR). The existing provisions in RBI Act, 1934, empower the Reserve Bank to provide liquidity in times of crisis. Given the increasing integration of global markets as also innovations that are taking place, conventional methods of LoLR may not be sufficient, as is evident from the recent crisis. Accordingly, it recommends that the Reserve Bank may consider constituting a Working Group to look into the whole gamut of issues relating to liquidity with a specific mandate to look into (i) the powers available as per extant provisions with the Reserve Bank as regards its role of LoLR (ii) the scope for putting in place a mechanism whereby the same can be activated at the shortest possible notice and (iii) the scope for expanding the instruments that can be permitted for providing liquidity.

**Principle 15: Operational risk**

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

**Description :**

The Reserve Bank has issued guidelines on management of operational risk in 2005 which are to be observed by banks in India while formulating their operational risk strategy. The Board of Directors of a bank is primarily responsible for ensuring effective management of operational risks. The adequacy of the Operational Risk Management (ORM) framework in each bank is assessed during the AFIs by the Reserve Bank. The AFIs also assess the strategy and significant policies/processes as also their implementation. The banks should have in place contingency and business continuity plans to enable them to operate on an ongoing basis and limit losses in the event of severe business disruption. These plans need to be stress tested annually and the plans are required to be revised to appropriately address any new or previously unaddressed parameters for these plans. The ORM guidelines issued to banks require banks to include legal risks in their ORM framework. The Reserve Bank has issued comprehensive guidelines on outsourcing. The Reserve Bank reviews during on-site inspections of banks the implementation of these guidelines to assess the quality of related risk management systems particularly in respect of material outsourcing. Guidelines have been issued in April 2005 and February 2006 whereby the supervisor is required to comment in its Annual Financial Inspection report on the implementation of Business Continuity Management in the banks. Though aspects relating to implementation of policies to address operational risk are commented upon by the Reserve Bank at the time of conducting supervision, the guidelines regarding putting in place appropriate reporting mechanism are required.

Operational risk in derivatives activities is particularly important, because of the complexity and rapidly evolving nature of some of the products. The nature of the controls in place to manage operational risk must be commensurate with the scale and complexity of the derivatives activity being undertaken. The volume limits may be used to ensure that the number of transactions being undertaken does not outstrip the capacity of the support systems to handle them.

Segregation of duties is necessary to prevent unauthorised and fraudulent practices. A basic and essential safeguard against abuse of trust by an individual is to insist that all staff should take a minimum continuous period of annual leave (say two weeks) each year. This makes it more difficult to conceal frauds in the absence of the individual concerned. Policies and procedures should be established and documented to cover the internal controls which apply at various

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<p>stages in the work flow of processing and monitoring trades. Apart from segregation of duties, these include trade entry and transaction documentation, confirmation of trades, settlement and disbursement, reconciliation, revaluation, exception reports, accounting treatment and audit trail.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> The banks need to be advised about putting in place appropriate reporting mechanism to apprise Reserve Bank of developments that take place in this regard.</p>
<p><b>Principle 16: Interest rate risk in the banking book</b> Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.</p>
<p><b>Description :</b> No specific guidelines have been issued by the Reserve Bank on interest rate risk in banking book to the banks. The Reserve Bank has issued guidelines on Asset-liability framework and Risk management systems in banks in 1999. These guidelines also focus on management of interest rate risk. The bank Boards are required to undertake overall responsibility for management of risks and decides the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks. The adequacy of banks' risk management processes with respect to interest rate risk is verified through on-site and off-site review. The AFIs by the Reserve Bank state the status of interest rate risk management in banks, especially with reference to the role of Board and senior management. The present guidelines to banks approach interest rate risk measurement from the 'earnings perspective' using the Traditional Gap Analysis (TGA). The Reserve Bank intends to move over to modern techniques of interest rate risk measurement like Duration Gap Analysis, Simulation and Value at Risk in near future. The Reserve Bank collects data from banks through off-site returns and periodically conducts stress tests in order to gauge the impact of interest rate movements on banks' assets and liabilities. The banks are required to submit a monthly return on interest rate sensitivity for exposures in Rupee as well as in foreign currencies to the Reserve Bank. The Reserve Bank has prescribed clear-cut and well-defined division of responsibility between front, middle and back offices. This largely addresses Interest Rate Risk in the trading book i.e., as market risk. The banks should measure their vulnerability to loss in stressed market conditions, including the breakdown of key assumptions, and consider these results when establishing and reviewing their limits and policies in respect of Interest Rate Risk. The Reserve Bank has prescribed framework for measurement of capital adequacy and has not allowed banks to use internal capital measurement systems.</p>
<p><b>Assessment: Non-Compliant</b></p>
<p><b>Comments:</b> No specific guidelines have been issued by the Reserve Bank on interest rate risk in banking book to the banks. The issuance of guidelines in this regard post migration to Basel II</p>

could be based on the modified duration approach for measurement of interest rate risk in the banking book as suggested by the Basel Committee. (The Reserve Bank has since issued guidelines on interest rate risk in banking book as part of supervisory review process under Pillar II of Basel II which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009.).

**Principle 17: Internal control and audit**

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

**Description:**

As per the Consultative Group of Directors from banks and Financial Institutions (Ganguly Committee) set up by the Reserve Bank in 2002, to review the supervisory role of bank Boards, the responsibilities of the Board of Directors are well-defined and every director should be familiarised on the functioning of the bank before his induction. They should be familiarised on the functioning of the bank before his induction, covering the following essential areas: delegation of powers to various authorities by the Board, strategic plan of the institution, organisational structure, financial and other controls and systems *etc.*

The adequacy and effectiveness of internal control system in banks forms a part of the on-site inspection by the Reserve Bank. Further, a number of instructions/guidelines have been issued to banks to streamline their inspection and audit machinery, introduce concurrent audit, monitor treasury operations, introduce internal control system for prevention of frauds, *etc.* A concept of Risk Based Supervision and Risk Based Internal Audit have been introduced by the Reserve Bank from 2003 and assessment of control functions is an important input in drawing up of risk matrix of the bank/branch.

The Reserve Bank is vested with powers to remove managerial and other persons from the office of a banking company and appoint additional directors on the Board of a bank to secure proper management of the banking company in public interest as per Section 36-AA and 36-AB of the BR Act, 1949. The Reserve Bank has issued guidelines from time to time on segregation of duties and responsibilities in front office, mid-office and back-office for treasury operations. However, it is not being 'determined' whether there is an appropriate balance in the skills and resources of the back-office and control functions relative to the front office/business origination.

The compliance function in banks has to be adequately enabled and made sufficiently independent. The banks in India already have certain compliance processes in place in accordance with the recommendations of the Ghosh Committee report of 1992. These processes and the organisational structures through which they operate have been primarily shaped by the Reserve Bank guidelines to banks as also by the banks' own standards of internal governance. In 2007, the banks were advised to introduce certain principles, standards and procedures relating to compliance function consistent with the BCBS document and keeping in view the operating environment in India. The banks were advised to formulate a comprehensive policy document for internal inspection/audit, and get the same approved by their Board of Directors/Audit

Committee of the Board. This policy document was thereafter to be reviewed periodically, keeping in view the changing environment, directives/guidelines of the Reserve Bank and other legal requirements under advice to the Reserve Bank.

The banks have been advised by the Reserve Bank to have in place organisational structure of Inspection/Audit Department at Head Office/Zonal Office/Regional Office level, total number of branches of the bank, the number of branches in the inspection jurisdiction of each inspectorate, functional chart showing the reporting lines, periodicity of internal inspection/audit of branches/controlling offices *etc.*

**Assessment: Largely Compliant**

**Comments:** Though, the Reserve Bank has issued guidelines from time to time on segregation of duties and responsibilities in front office, mid-office and back-office for treasury operations, however, it is not being 'determined' whether there is an appropriate balance in the skills and resources of the back-office and control functions relative to the front office/business origination. The Annual Financial Inspections can review the skills/resources of back-office *vis-à-vis* front office.

Though, there are no laws or regulations in place that provide for the Reserve Bank to ensure that banks notify it as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management, but the same is being done on voluntary basis.

Likewise, though instructions have been issued to banks placing the responsibility for the control environment on the Board but not on the senior management of the bank.

**Principle 18: Abuse of Financial Services**

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know your customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

**Description :**

The Reserve Bank has issued guidelines to all banks whereby they were advised to prepare and put in place a proper policy framework on Know Your Customer (KYC) and become fully compliant by end of December 2005. The Chairmen/ CEOs of these banks were required to personally monitor the progress and ensure that the instructions percolated to the operational level. The banks were also required to put in place appropriate system for fixing accountability to penalise serious lapses and intentional circumvention of KYC/ Anti Money Laundering (AML) guidelines. The suspicious transactions are reported by banks only to Financial Intelligence Unit -IND. There

are systems in place for reporting of frauds by banks. The Reserve Bank maintains a database of frauds and their modus operandi and this information is shared with banks to enable them to prevent occurrences of such frauds.

Shell banks are not permitted to operate in India. The banks' internal audit and compliance functions have an important role in evaluating and ensuring adherence to the KYC policies and procedures. The banks are also required to ensure that their audit machinery is staffed adequately with individuals who are well versed in such policies and procedures. Concurrent / Internal Auditors are specifically required to check and verify the application of KYC procedures at the branches and comment on the lapses observed in this regard. The compliance has to be put up before the Audit Committee of the Board on quarterly intervals. The KYC / AML guidelines have been issued by the Reserve Bank under Section 35A of the BR Act, 1949 and any contravention of or non-compliance of these guidelines would attract penalties under relevant provisions of the Act. The KYC/AML guidelines require the Reserve Bank to sample check the accounts and is not exhaustive.

**Assessment: Largely Compliant**

**Comments:** The sustenance of KYC/AML compliance by banks needs to be strengthened.

**Principle 19: Supervisory Approach**

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

**Description:**

The Reserve Bank has developed and maintains systems for a thorough understanding of the operations of individual banks and also of banking system as a whole focusing on safety and soundness and the stability of the banking system. There are two specific supervisory processes in place to develop and maintain systems for thorough understanding of the operations of banking groups: Financial Conglomerate Monitoring (FCM) and Consolidated Supervision. The process of FCM is being further fine-tuned through a project under which various cross-country practices are being studied and typical Indian requirements are being assessed. In the Mid Term Review October 2007, it was announced that FCM and Consolidated Supervision processes would be integrated. The work is in progress.

The Reserve Bank looks at all major risks confronting the bank during its on-site inspection through CAMELS rating approach for domestic banks and CALCS approach for foreign banks operating in India. The basic objective of supervision of banks is to assess the solvency, liquidity and operational health of banks. The risk profile of banks is also analysed based on their off-site returns. The supervisory work is prioritised based on the inspection findings and also from the inputs received in the off-site returns. The Reserve Bank uses on-site and off-site information to generate periodic reviews.

Several initiatives have been taken for a gradual rollout of the Risk Based Supervision (RBS) process. The new methodology for risk assessment enables the supervisors to separately assess the risk for inherent/control risk areas and domestic/overseas operations in respect of all the business risk areas, thereby providing important inputs for area-specific supervisory action. The

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Reserve Bank also confirms banks' and banking groups' compliance with prudential regulations and other legal requirements through on-site inspection and off-site monitoring of banks. A quicker adoption of techniques and methodology of RBS which will appropriately profile the bank, highlighting the risks and vulnerability faced by the entity. Based on its assessment, the supervisory cycle for the banks can be determined. There is a need for further strengthening of off-site surveillance which is a pre-condition for effective adoption of techniques and methodology of RBS.

In order to monitor the health and the stability of financial system in India, the Reserve Bank has been compiling macro-prudential indicators (MPIs) from March 2000 onwards. The MPIs comprise both aggregated micro-prudential indicators of the health of individual financial institutions and macroeconomic indicators associated with financial system soundness. India is one of the countries which volunteered to participate in the co-ordinated compilation exercise of the Financial Soundness Indicators for December 2005 under the aegis of the International Monetary Fund (IMF); the requisite data was forwarded to the IMF on July 31, 2006.

The banks are required to notify to the supervisor any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.

**Assessment: Materially Non-Compliant**

**Comments:**

The Reserve Bank has no power to cause inspection of banking group. The CAMELS rating does not clearly reflect the risk profile of the bank and does not pinpoint the risks where the bank might be vulnerable or areas of high risk where the bank might be well in control. Appropriate risk profiling of banks for optimisation of supervisory resources is necessary.

A quicker adoption of techniques and methodology of RBS which will appropriately profile the bank, highlighting the risks and vulnerability faced by the entity. Based on its assessment, the supervisory cycle for the banks can be determined. There is a need for further strengthening of off-site surveillance which is a pre-condition for effective adoption of techniques and methodology of RBS.

**Principle 20: Supervisory Techniques**

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

**Description:**

A supervisory rating model based on CAMELS concept (CALCS for foreign banks) is in place, combining both qualitative and quantitative elements to summarise the performance of individual banks and also to assess the aggregate strength and soundness of the banking system. The on-site inspections aim at achieving the following objectives *viz.* evaluation of bank's safety and



soundness, appraisal of the quality of Board and top management, ensuring compliance with prudential regulations, identifying the areas where corrective action is required to strengthen the bank, appraisal of soundness of bank's assets, analysis of key financial factors such as capital, earnings, and liquidity and determine bank's solvency, assessment of the quality of its management team and evaluation of the bank's policies, management, internal operations and control and review of compliance with banking laws and regulations as well as supervisory guidance conveyed on specific policies. The statute provides for engagement of external auditors. There are instances where the Reserve Bank engaged external auditors for specific assignments.

An Off-site Monitoring and Surveillance (OSMOS) system has been set up in 1995 with the primary objective of analysing the financial position of the banks in between on-site inspections. The returns received from the banks cover a wide range of data pertaining to assets, liabilities and off-balance sheet exposures, exposure to sensitive sectors, exposure of banks to interest rate and liquidity risks (both in domestic and foreign currencies), operations of subsidiaries *etc.* This helps the policy makers to refine their regulatory as well as monetary policy stance so as to achieve a fine balance between growth and financial stability. Regular reviews and periodic reporting to Board of Financial Supervision ensures effective co-ordination between on-site and off-site wings of the Department.

There are mechanisms in place for periodical monitoring of banks apart from on-site inspection and off-site monitoring, meeting to discuss issues of supervisory concerns with bank management, if any, like meetings for various purposes like discussions on Resource Management, consultation with banks before introduction of major reporting changes *etc.* There are the Reserve Bank Nominee Directors on the Boards of banks who are also required to report bi-monthly on the important policy decisions taken by the bank in particular highlighting supervisory issues, if any.

**Assessment: Largely Compliant**

**Comments:** There is need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.

**Principle 21: Supervisory reporting**

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

**Description:**

The Department of Banking Supervision in the Reserve Bank has formulated and put in place a supervisory strategy which, besides retaining the importance of on-site inspections which has been the main plank of banking supervision, also focuses on three other areas: off-site monitoring through introduction of a set of returns; strengthening of the internal control systems in banks and increased use of external auditors in banking supervision.

The financial statements are prepared by banks based on Accounting Standards prescribed by Institute of Chartered Accountants of India (ICAI) except those that have been specifically modified by the Reserve Bank in consultation with ICAI keeping in view the nature of banking industry. The formats for preparation of financial statements are prescribed under Section 29 of the BR

Act. The banks are mandated to disclose additional information as part of annual financial statements *viz.* CRAR, Tier I ratio, percentage of shareholding of Government of India in nationalised banks, Net NPL ratios, operating profit as percentage to working funds, Return on Assets, lending to sensitive sectors *etc.* The banks submit 22 Off-site returns electronically as part of the off-site monitoring mechanism whose periodicity varies from monthly or quarterly or half yearly or annually.

The Reserve Bank does not have jurisdiction over entities in a conglomerate which are outside the purview of its regulatory domain. However, there is an informal information sharing arrangement with other regulators in place. The Reserve Bank is vested with powers to issue directions under the BR Act, 1949 where necessary in the interest of banking policy, in public interest or where the affairs of the banking company are being conducted in a manner detrimental to the interest of the depositors. The Act also empowers the Reserve Bank to obtain any information from the supervised institutions (Section 27), issue directions on any aspect of their business (Section 35A), appoint nominees on their boards, cause change of management (Section 36AA and 36AB), cancel their licence (Section 22(4)), take monetary and non-monetary penal measures (Section 46 and 47A), cause merger / amalgamations, impose restrictions or even close the bank. Any inconsistency or inaccuracy in reporting is taken up with top management of the bank. Submission of any wrong information to the Reserve Bank can invite imposition of penalties specified in Section 46(1) of the BR Act, 1949. The external auditors look into bank's books and at times also look at specific issues.

**Assessment: Largely Compliant**

**Comments:** The power to call for information pertaining to any entity of the banking group is being sought through the introduction of a new Section 29A in the B R Act, 1949. Till then we will be non-compliant with regard to the information pertaining to associates/ related entities.

The letters appointing the external experts needs to specifically require them to promptly bring to notice of the Reserve Bank any material shortcomings identified by them during the work.

**Principle 22: Accounting and disclosure**

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

**Description :**

The Reserve Bank has laid down asset classification and provisioning norms which have to be adhered to by the banks. The banks are required to follow norms for valuation of collateral and value of collateral is not reduced from non-performing loans. The financial statements are prepared based on accounting standards prescribed by the ICAI except those that have been specifically

modified by the Reserve Bank in consultation with the ICAI keeping in view the nature of banking industry. It is mandatory for all banks to get their annual accounts audited every year by external auditors who are appointed with the prior approval of the Reserve Bank under Section 30(1-A) of BR Act, 1949. The auditors are required to report specifically whether the financial statements exhibit a true and fair view of the affairs of the bank under section 30(3) of BR Act, 1949. The scope of statutory audit is defined in Section 30 of the BR Act, 1949.

The banks incorporated in India are required to publish their balance sheet and profit and loss account together with the auditor's report in a newspaper in circulation at the place where the bank has its principal office. To ensure disclosure on par with international standards, banks are mandated to disclose certain additional information as part of annual financial statements. The disclosure standards are reviewed by the Reserve Bank by critically analysing the balance sheet formats, accounting policies and disclosures forming part of financial statements. The AFIs conducted by the Reserve Bank also examine compliance with the disclosure standards.

The Reserve Bank does not interact with the external auditors of banks individually. The senior member(s) of the audit profession are represented on the Central Board of the Reserve Bank. This provides for interaction and communication with the auditing fraternity. The statutory auditors have the responsibility of highlighting matters of material significance in their report to the annual accounts as per Companies Act.

Under the existing laws, no legal responsibility devolves on the auditors to report directly to the Reserve Bank matters of material significance observed by them in the audit of banks. However external experts are required to bring to notice of the Reserve Bank any serious irregularities noticed by them in the working of the bank that requires immediate attention. As per the Reserve Bank guidelines, a firm of Chartered Accountants appointed as statutory central auditors in public sector banks and associated continuously for three years is required to be rested for a period of at least two years. The branch statutory auditors of public sector banks are also rested for a minimum period of 2 years after continuous association for 4 years only in respect of 33 centres. Further, in respect of private sector banks and foreign banks, the statutory auditors are approved to continue for a period of 4 years, after which they are replaced. The Reserve Bank has developed a set of disclosure requirements for banks which allow the market participants to assess key pieces of information on capital adequacy, risk exposures, risk assessment processes and key business parameters which provide a consistent and understandable disclosure framework that enhances comparability. Under the existing framework Reserve Bank does not have explicit powers to have access to external auditors' working papers. The guidelines requiring qualitative disclosure on risk management aspects have been mandated as part of Basel II implementation which is yet to be implemented. The frequency of disclosures could be increased.

**Assessment: Largely Compliant**

**Comments:** Though, the guidelines relating to qualitative disclosures on risk management aspects have been mandated, they are yet to be implemented. The disclosures on aggregate data on balance sheet indicators and other statistical parameters need to be done more frequently. The banks at present do not have formal Board approved disclosure policy which would be applicable once Basel II guidelines come into effect from March 31, 2008 (The Indian banks with foreign operations and foreign banks are required to have a formal Board approved disclosure policy from March 2008).

**Principle 23: Corrective and remedial powers of supervisors**

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

**Description:**

The Department of Banking Supervision of Reserve Bank is in continuous dialogue with the senior management of the Bank both at Central office and at Regional office level.

The Reserve Bank has sufficient powers in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution). The Reserve Bank has sufficient powers under Section 35A of BR Act, 1949 to issue directions to banks in public interest, in interest of banking policy, to prevent affairs of the bank being conducted in manner detrimental to interests of depositors. The BR Act, 1949 also gives the Reserve Bank wide powers to obtain any information from the supervised institutions (Section 27), issue directions on any aspect of their business (Section 35A), appoint nominees on their boards, cause change of management (Section 36AA and 36AB), cancel their licence (Section 22(4)), take monetary and non-monetary penal measures (Section 46 and 47A), cause merger / amalgamations, impose restrictions or even close the bank.

The supervisor has a concept of Prompt Corrective Action (PCA) in place whereby it has powers to take measures should a bank fall below the minimum capital ratio, intervene at an early stage to prevent capital from falling below the minimum and also prescribe a set of actions that need to be taken by the banks.

In the case of banks which do not meet capital adequacy regulations, restrictions on branch expansion, assets expansion and setting up of subsidiaries are imposed. The Reserve Bank also has the authority to restrict declaration of dividend by private banks to bring about corrective action.

**Assessment: Largely Compliant**

**Comments:** While the PCA framework has prescribed broad triggers, there is no specified timetable for initiating the mandatory actions and the discretionary actions. The Reserve Bank has at its disposal an adequate range of supervisory tools to bring about timely corrective actions; however, it does not have the powers to impose penalties/ sanctions on the management and/or the Board or individuals therein.

**Principle 24: Consolidated Supervision**

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

**Description:**

The Reserve Bank has issued a circular in February 2003 on consolidated accounting to facilitate consolidated supervision. Accordingly, banks that have subsidiaries are required to file consolidated financial statements and half-yearly consolidated prudential returns to the Reserve Bank. Exchange of information of supervisory interest with host country supervisors is need-based, though no formal MoUs exist.

In India, the holding company of the banking group as per the current corporate structure is the bank itself. Hence, while reviewing the operations of a bank and evaluating its financial health, the Reserve Bank, deriving the necessary powers from Section 35 of the BR Act 1949, 'reviews' the 'overall activities' of the banking group, both domestic and cross border. Specifically under section 35 of the BR Act, the Reserve Bank enjoys powers to inspect the banking companies of Indian banking group incorporated abroad.

The present format of the Annual Financial Inspection (AFI) of banks does provide for the 'review' of the 'overall activities' on a group-wide basis in respect of the banking group. The reports invariably contain, observations on the following 2 aspects: -

1. Group Risk
2. Functioning of subsidiaries

Even otherwise, under the current financial conglomerate monitoring mechanism, the banks which have been termed as 'designated entities', submit varieties of information to the Department of Banking Supervision (DBS) on Group level issues, and also in respect of individual entities of the Group. Some of the Group-level information submitted to DBS relate to: -

- Intra Group Transactions and Exposures
- Capital adequacy

The on-site inspection reports of the banks include comments on earning performance of the bank's subsidiaries and joint ventures. In addition, the Reserve Bank conducts inspection of merchant banking subsidiaries of banks. The banks are required to conduct internal audit/inspection of their subsidiaries as a measure of control over them. The periodical review notes on these subsidiaries put up to the banks' Board are sent to the Reserve Bank.

The High Level Co-ordination Committee on Financial Markets (HLCCFM) already exists. Recently three sub-committees have also been constituted, viz., Sub-Committee on Reserve Bank Regulated Entities, Sub-Committee on Securities and Exchange Board of India (SEBI), Regulated Entities and Sub-Committee on Insurance Regulatory Development Authority (IRDA) Regulated Entities. On the basis of recommendation made by Joint Parliamentary Committee (JPC), a joint Reserve Bank and SEBI group was constituted to put in place an integrated system of alerts which would piece together disparate signals from different elements of the market. Accordingly, as recommended by the group, the process of exchange of alerts and information has been set in motion. Cross Border Exchange of information of supervisory interest with host country supervisors is need-based, though no formal MoUs exist.

In the Indian context, though there have been exchange of supervisory information on specific issues between the Reserve Bank and few other overseas banking supervisors/ regulators, no formal/ legal arrangement or MoU has so far been entered into between the Reserve Bank and outside supervisory authorities for cross-border supervisory co-operation. This is partly because of the legal impediments with regard to sharing of credit information and permitting an agency other than the Reserve Bank to inspect a bank in India.

With Indian banks expanding their scope and scale of operations abroad through their branch network or through their subsidiary, there is a need to subject such operations to comprehensive on-site inspection, in order to discharge the Reserve Bank's statutory responsibility as well as to meet the demands of Consolidated Supervision. This need gains even further emphasis in respect of banking conglomerates having overseas offices, subsidiaries, associates *etc.* as such conglomeration in the financial sector calls for comprehensive collaboration among the national supervisors and also the respective sovereign governments to effectively address crisis prevention and resolution.

Further, with the implementation of Basel II norms, Indian banks operating abroad/ foreign banks operating in India would be subjected to dual (home/host) country regulatory & supervisory prescriptions for all the three Pillars. This would necessitate the following: -

- (i) Dialogue between the Reserve Bank and other overseas regulators for harmonisation / reconciliation.
- (ii) Exchange of critical /sensitive supervisory information between Reserve Bank and other overseas regulators.
- (iii) Formal visits / information sharing by local supervisors to the overseas branches/offices of Indian banks and vice versa. This would need to be formally enabled for each other and hence would primarily need to be legally mandated.

Under Pillar 2 of Basel II, in order to make a supervisory assessment of the ICAAP of banks, there would be a need for formal dialogue between home and host country supervisors in order to make a subjective and qualitative assessment. Potentially there could be significant conflicts between rules/regulations as well as supervisory assessments of home/host country supervisors. Such conflicts would need to be resolved/reconciled expeditiously.

It is with these issues in mind that the the Reserve Bank in October 2007 had announced the constitution of a Working Group to lay down the road-map for adoption of a suitable framework for cross-border supervision and supervisory co-operation with overseas regulators, consistent with the framework envisaged in the Basel Committee on Banking Supervision (BCBS). The Panel encourages this effort by the Reserve Bank in strengthening cross-border supervision and exchange of information.

The Reserve Bank determines during on-site inspection of banks that management is maintaining proper oversight of the bank's foreign operations, including branches, joint ventures and subsidiaries. It also reviews at time of on-site inspection that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) includes information reporting on its foreign operations that is adequate in scope and frequency to manage their overall risk profile and is periodically verified, assessing in an appropriate manner compliance with internal controls; and ensuring effective local oversight



of foreign operations. It confirms during on-site inspections that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is particularly close when the foreign activities have a higher risk profile or when the operations are conducted in jurisdictions or under supervisory regimes differing fundamentally from those of the bank's home country.

The Reserve Bank has the requisite power to close branches (including foreign branches) of banks operating in India under its jurisdiction.

**Assessment: Largely Compliant**

**Comments:** The present supervisory framework allows for review of the activities of the Group at a broad level. It is expected that the financial conglomerates monitoring mechanism would further be strengthened in this regard.

Though the Reserve Bank has powers to define the range of activities of the consolidated group, it does not have the power to cause inspections of any entity of the banking group, which is being sought through the introduction of a new Section 29A in the B R Act.

The co-operation and co-ordination between domestic regulators need to be strengthened through strengthening of the HLCCFM.

No formal mechanism of inspection in bank branches abroad exist. But the Reserve Bank can and has in the past, in consultation with other country supervisors, conducted special inspections of foreign branches of Indian banks.

**Principle 25; Home host relationship**

Cross-border consolidated supervision requires co-operation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

**Description:**

There are formal systems for information exchange with other regulators on sharing of supervisory information at present in India. The Reserve Bank maintains regular contact with overseas supervisors and also serves on important international forums connected with bank supervision. It was one of the non-G 10 member countries consulted in the Core Principles formulation exercise and is now represented on the Core Principles Liaison Group set up by the BCBS. It has also been represented on key international forums of Central Bankers / Bank Supervisors such as the Working Group on Strengthening Financial Systems. As of now, there are no formal arrangements in place for sharing of such information with other overseas regulators but as and when the Reserve Bank receives such requests from overseas regulators/supervisors, information relating to supervisory ratings, inspection findings *etc.*, is shared with host regulators. However, in such cases, an undertaking on confidentiality is obtained from the host regulator seeking the information that the information so received, would not be shared by the overseas regulator with any entity other than its Central Bank, unless compelled to do so by the law or courts in that overseas country, in which event, the overseas regulator would notify the Reserve Bank in writing, prior to the release of such information.

The home supervisors do not, at present, provide information on banks proactively. However, these issues are discussed during periodical meetings / interactions with the home supervisors. The Reserve Bank accepts standards as evolved by the Basel Committee. The periodical reviews of performance of overseas offices including regulatory environment in those countries are done. The country of origin does not confer any special status on foreign banks operating in India. They are generally subject to the same legislation and regulatory requirements as applicable to domestic banks. The Reserve Bank has the necessary powers to share information with overseas supervisors.

The overseas segment of a bank is targeted for annual appraisal by the Reserve Bank based on off-site records maintained at Head Office, to ensure that they comply with regulations and prudential norms framed by the home and host countries. Besides, the foreign branches of Indian banks are subjected to inspection by the Reserve Bank when deemed necessary and by the bank itself regularly. As indicated earlier, the Reserve Bank is examining the question of putting in place a prudential reporting system on global consolidated basis. A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action. This is being done on informal basis.

**Assessment: Materially Non-Compliant**

**Comments:** There is no formal arrangement with the home / host supervisors to exchange information at periodical intervals. The Reserve Bank is currently exploring the possibility of exchanging supervisory letters with other regulators. The home supervisors do not, at present, provide this information proactively. However, these issues are discussed during periodical meetings / interactions with the home supervisors.

The RBI Act does not explicitly provide for the Reserve Bank to enter into any agreement with corresponding home/host supervisors. Consequently, there is no formal MoU, and there is no agreed communication strategy between home/host regulators. Keeping in mind the need for an enhanced and well structured, supervisory co-operation system, particularly for internationally active banks. A Working Group has been constituted by the Reserve Bank to lay down the road-map for adoption of a suitable framework for cross-border supervision and supervisory co-operation with overseas regulators, consistent with the framework envisaged in the BCBS.

## Appendix 5

### Detailed Assessment (Principle-by-Principle)- Urban Co-operative Banks

<p><b>Principle 1: Objectives, independence, powers, transparency and co-operation</b></p> <p>An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>
<p><b>Principle 1(1): Responsibilities and objectives:</b></p> <p>An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks</p>
<p><b>Description:</b></p> <p>The responsibilities and objectives of the various regulators are delineated as per law.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Comments :</b> –</p>
<p><b>Principle 1(2): Independence, accountability and transparency</b></p> <p>Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.</p>
<p><b>Description:</b></p> <p>The operational independence, accountability and governance structures of supervisory authority are prescribed by law. It has adequate budget and has salary scales to attract and retain qualified staff.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> The reasons for removal of the head of the supervisory authority not specified in law. There is no transparent public disclosure of objectives and framework for discharge of duties by supervisor.</p>
<p><b>Principle 1(3): Legal Framework</b></p> <p>A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.</p>
<p><b>Description:</b></p> <p>The legal framework for banking supervision including provisions relating to authorisation of banking establishments and their ongoing supervision are provided under BR Act (As Applicable to Co-operative Societies), 1949.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Comments:</b> No perceived gap.</p>

## Chapter III

### Assessment of Adherence to Basel Core Principles

<b>Principle 1(4): Legal Powers</b> A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
<b>Description :</b> The supervisor has adequate powers given under BR Act (As Applicable to Co-operative Societies), 1949
<b>Assessment: Compliant</b>
<b>Comments:</b> The Reserve Bank together with the joint supervisor i.e. Registrar of Co-operative Societies has the necessary powers
<b>Principle 1(5): Legal Protection</b> A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
<b>Description:</b> Legal structure including protection of supervisors is given in Section 54 of the BR Act (As Applicable to Co-operative Societies), 1949.
<b>Assessment: Compliant</b>
<b>Comments:</b> No perceived gap.
<b>Principle 1(6): Co-operation</b> Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
<b>Description :</b> A Vision Document for the Urban Co-operative Banks (UCBs) was formulated in March 2005 to address the issue of dual control within the existing legal framework .It provides for a two track regulatory framework and MoU between the Reserve Bank and the other regulators viz. the State Governments and Central Registrar of Co-operative Societies (CRCS). The MoU is a working arrangement in the form of Memorandum of Understanding (MoU) between the Reserve Bank and the State Government/CRCS to ensure that the difficulties caused by dual control are suitably addressed through such MoUs. As per the MoU the Reserve Bank has constituted a State level Task Force for Urban Co-operative Banks (TAFUCB) having representatives from the Reserve Bank, State Government and the sector for identification and drawing up of a time-bound action plan for the revival of potentially viable UCBs and non disruptive exit for non-viable UCBs and to facilitate human resources development and IT initiatives in UCBs. Till date the Reserve Bank has entered into MoUs with 24 states. The inspection findings are shared with the State Registrar of Co-operative Societies. The supervisory issues are discussed at TAFUCB and State Level Review Rehabilitation Committee in non-MoU States.

<b>Assessment: Compliant</b>
<b>Comments:</b> No perceived gap.
<p><b>Principle 2: Permissible Activities</b></p> <p>The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.</p>
<p><b>Description:</b></p> <p>The permissible activities of a banking company are listed in Section 6(1) of the BR Act, 1949. Section 6(2) specifically prohibits a banking company from carrying on any form of business other than those referred to in Section 6(1). Section 7 prohibits the use of the words 'bank', 'banker' or 'banking' by any co-operative society other than a co-operative bank as part of its name or in connection with its business. However, it does not apply among others, to a primary credit society (PCS) or to a primary agriculture credit society (PACS).</p>
<b>Assessment: Largely Compliant</b>
<p><b>Comments:</b> The word "bank" can be legally used by unlicensed and unsupervised entities e.g. Primary Agriculture Credit Society (PACS), Land Development Bank (LDB). However, their number is not very large. The Banking Regulation (as Applicable to Co-operative Societies (AACS)) Act came into effect in 1966 and many of the co-operative societies were in existence prior to this Act coming into existence. These entities had since applied for licence from the Reserve Bank and continued to operate as co-operative society as their application was neither accepted nor rejected by Reserve Bank.</p> <p>There are around 79 UCBs which are currently operating without a banking license. As the continuing existence of unlicensed co-operative institutions poses a risk to the depositors' interests, there is a need to draw up a roadmap whereby "banks" which fail to obtain license by 2012 would not be allowed to operate. This would expedite the process of consolidation and weeding out non-viable entities from the co-operative space.</p>
<p><b>Principle 3: Licensing Criteria</b></p> <p>The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, and internal controls and risk management and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>
<p><b>Description :</b></p> <p>For commencing banking business, a primary (urban) co-operative bank, as in the case of commercial bank, is required to obtain a licence from the Reserve Bank, under the provisions of Section 22 of the BR Act, 1949 (as Applicable to Co-operative Societies). The Reserve Bank has set the criteria for granting license for setting up of new UCBs and also has the power to reject applications which do not meet the standards. The criteria are in line with those specified under the Core Principles. However, there are certain shortcomings as the Reserve Bank does not have</p>

**Assessment of Adherence to  
Basel Core Principles**

control over managerial affairs or shareholding. Fit and proper criteria for directors of All Primary (Urban) Co-operative Banks are non-existent.

Moreover, the Act provides for automatic conversion of primary credit societies registered with banking as one of its main activities to become primary (urban) co-operative banks once it attains capital and reserves of rupees 1 lakh. Although they are required to apply to the Reserve Bank within three months of attaining capital plus reserves of Rs.1 lakh for a licence under Section 22, they can carry on banking business till the licence application is refused. This has led to coming into existence of a large number of unlicensed banks. The Reserve Bank has advised all State Governments not to register societies with banking as one of its activities without prior approval of the Reserve Bank. The proposed amendments to the Banking Regulation Act (AACS), 1949 contain provisions to plug this backdoor entry.

**Assessment: Largely Compliant**

**Comments:**

- The Reserve Bank does not have powers to determine suitability of shareholders. The Registrar of Co-operative Societies can disqualify directors.
- There are no fit & proper criteria for Directors, however, fit & proper criteria for CEOs prescribed under MoU
- The Reserve Bank cannot ensure that the Board has sound knowledge of activities of the bank.
- The ability of shareholders to provide additional financial support cannot be assessed.
- Progress of new entrants largely monitored.

**Principle 4: Transfer of significant ownership**

The supervisors has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly in existing banks to other places.

**Description:**

There is no concept of controlling/significant ownership of an UCB. Each member has only one vote irrespective of number of shares held by the member. This principle is not applicable to UCBs.

**Assessment: Not Applicable**

**Comments:** Concepts of significant ownership and controlling interest absent; democratic institutions with one member one vote principle; law puts limit on individual shareholding.



**Principle 5: Major acquisition**

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

**Description:**

UCBs do not have cross-border operations. Investment by UCBs is limited to SLR/non-SLR holding and not in equities save a few all India Financial Institutions. Acquisition by way of merger requires the prior approval of both the regulators *viz.* the Reserve Bank and Registrar of Co-operative Societies/Central Registrar of Co-operative Societies in case on multi-state UCBs.

**Assessment: Compliant**

**Comments:** Acquisition only by way of merger is permissible with prior approval of the regulators. Large non-SLR investments not permissible under current regulations.

**Principle 6: Capital adequacy**

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

**Description:**

A minimum Capital Adequacy Ratio (CRAR) of 9 per cent to be maintained by UCBs on a solo basis, as per Basel I norms, covering both on and off-balance sheet items. The capital charge for market risk capital is maintained in surrogate way i.e. by having 2.5 per cent additional risk weights for certain types of investment exposures. The market risk as per Basel norms has not been made applicable. The UCBs are not internationally active banks. Minimum capital requirement in absolute terms has also been prescribed for setting up new UCBs

**Assessment: Compliant****Comments:**

- UCBs are not internationally active. Capital adequacy norms are largely as per Basel I.
- UCBs not permitted to use internal risk assessment models.
- Capital adequacy norms based largely on Basel I.
- Concept of holding company not applicable.
- Concept of banking group not applicable.
- Bank-wise capital not prescribed.
- Duration based capital charge for market risk need to be made applicable instead of surrogate method.

**Principle 7: Risk management process**

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

<p><b>Description:</b> The Reserve Bank has a system of on-site inspection of UCBs supplemented by off-site monitoring system to examine various risk management aspects in the banks that mostly pertain to CAMELS. Admittedly, risk management process is weak in smaller banks. Presently, Asset Liability Management (ALM) guidelines are applicable only to Scheduled UCBs, <i>i.e.</i>, the larger entities. It is proposed to extend the ALM guidelines to non-scheduled UCBs also with deposits above Rs. 100 crore.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> Risk management policies are mostly confined to credit risk. No system of confirmation by supervisor regarding adequacy of risk management processes adopted by UCBs. Risk management and capital requirement prescribed mostly for credit risk. Models are not used. Risk taking function not segregated from risk evaluation/monitoring/control function. Standards issued mostly for credit risk. No guidelines for setting up dedicated risk management unit have been issued. No guidelines for stress testing issued. No guidelines issued for reputational and strategic risks.</p>
<p><b>Principle 8: Credit risk</b> Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.</p>
<p><b>Description:</b> The banks are required to have documented credit policy approved by the Board. Quality of assets and erosion in their value are assessed during on-site inspection. Compliance with the prudential norms on income recognition, asset classification, provisions for erosion in value of assets and adequacy of credit appraisal and recovery policy are also seen during on-site inspection. Significant divergence, if any, noticed in asset classification is taken up with the bank management. Monitoring of the quality of assets is also done on quarterly basis through off-site returns. Off-site surveillance also helps in monitoring the top non performing loans (NPLs) and provisioning therefor.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b></p> <ul style="list-style-type: none"> <li>● No guidelines have been issued regarding potential future exposures (e.g. in derivatives)</li> <li>● Guidelines on credit risk need to explicitly mention that the bank's credit risk management policies / strategies should also include the counterparty credit risk arising through various financial instruments.</li> </ul>

<p><b>Principle 9: Problem assets, provisions and reserves</b></p> <p>Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.</p>
<p><b>Description:</b></p> <p>Detailed guidelines as per international norms have been laid down by the Reserve Bank on income recognition, asset classification and provisioning covering both on and off-balance sheet exposures. Depending on the time span of non-performing assets (NPAs), the latter has to be classified into sub-standard, doubtful and loss assets. As per the Reserve Bank norms, provisions are to be made for NPAs based on potential threat to realisability of the assets. During the course of on-site inspections, the efficacy of classification of NPAs by the banks is examined and in case of significant divergence in NPA figures as assessed by the supervisor <i>vis-à-vis</i> that assessed by the bank, the latter is advised to initiate remedial measures. The compliance of provisioning requirement as per the prudential norms laid by the Reserve Bank is the sole responsibility of the bank management. The adequacy of provisions as per the Reserve Bank norms is to be certified by the statutory auditors of the bank. However, credit risk management process is weaker in smaller banks. The amount of provisioning required and extent of provisioning done are also monitored through on-site inspection and off-site returns. The off-site return statements are designed to monitor compliance and obtain information in the areas of prudential interest, including information on balance sheet and off-balance sheet exposures, profitability, asset quality, sector/segment-wise concentration of advances, connected or related lending and capital adequacy.</p> <p>Adequate legal avenues are available for recovery of problem assets through co-operative courts, civil courts and application of SARFAESI Act, 2002.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Comments:</b> No effective mechanism for early identification of NPAs. Provisioning norms are not bank specific, but supervisor has the powers to do so.</p>
<p><b>Principle 10: Large exposure limits</b></p> <p>Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.</p>
<p><b>Description:</b></p> <p>The Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers (presently 15 per cent and 40 per cent respectively of capital funds) to avoid concentration of credit, and has advised the banks to fix limits on their exposure to specific industries or sectors (real estate, capital market, <i>etc.</i>) for ensuring better risk management. The banks are required to report top 20 borrowers with balances outstanding exceeding 15 per cent of their capital funds.</p>
<p><b>Assessment: Largely compliant</b></p>
<p><b>Comments</b></p>

**Principle 11: Exposures to related parties**

In order to prevent abuses arising from exposures (both on balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

**Description:**

The concept of 'related party' is strictly not applicable to UCBs as there is no promoter having substantial share holding as in the case of commercial banks. Limit on individual shareholding is generally provided in the State Co-operative Societies Acts and in any case a member has one vote only irrespective of his shareholding. 'Related parties' in case of UCBs can be interpreted as director related entities only. As per Section 20 of the BR Act, banks are prohibited to grant loans and advances (other than for personal use) to any of its directors or to any firms or private companies in which any of its directors are interested as partner or managing agent or guarantor or to individuals in cases where any of its directors is a guarantor, with certain exceptions. In respect of non-fund based facilities, which are not regarded as loans and advances within the meaning of Section 20 of the BR Act, any devolvement on the bank resulting in creditor-debtor relationship between the bank and the director, *etc.* shall attract Section 20 of the BR Act. Section 20 A of the Act *ibid* says that any remission of debt to directors or company in which any of its directors is interested as director, partner, managing agent or guarantor, *etc* require the Reserve Bank's prior permission.

Further, the Reserve Bank monitors loan to directors/relatives as part of on-site inspection and through an off-site return on quarterly basis.

**Assessment: Compliant**

**Comments:** The related party means only directors, their relatives and firms and companies in which they are interested; there are no significant shareholders (one member one vote principle); subsidiaries non-existent except for a few in case of multi-state banks. The regulations prohibit loans to directors/relatives and firms in which they have an interest. The write-off of director related loans require the Reserve Bank approval under the Act. The banks are required to submit a quarterly statement on loans to directors/relatives, *etc.*

**Principle 12:Country and transfer risks**

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

<p><b>Description:</b> UCBs do not have exposure to foreign countries.</p>
<p><b>Assessment: Not Applicable</b></p>
<p><b>Comments:</b> Not applicable.</p>
<p><b>Principle 13: Market risks</b> Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.</p>
<p><b>Description:</b> The Reserve Bank has powers under Section 35A of the BR Act to impose specific limits and /or specific capital charge on market risk exposures as part of the general powers to issue directions to banks on any aspect of their functioning. The primary (urban) co-operative banks are required to classify their entire investment portfolio (including SLR and non-SLR securities) under three categories <i>viz.</i> -(i) Held to Maturity (HTM) (ii) Available for Sale (AFS) and (iii) Held for Trading (HFT). Guidelines have been specified for valuation. Primary (urban) co-operative banks are not permitted to invest in bonds and debentures of private sector companies. Their investments in bonds of PSUs and shares (as permitted by the Reserve Bank) should be classified under 'Held to Maturity' category, limit under HTM category, shifting of securities under each category <i>etc.</i></p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> Detailed guidelines on market risk have not been issued except valuation norms for investments and asset-liability guidelines to scheduled banks.</p>
<p><b>Principle 14: Liquidity risk</b> Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>
<p><b>Description:</b> All Scheduled UCBs are required to maintain Cash Reserve Ratio (CRR) as per section 42(1) of RBI Act, 1934 and non-Scheduled UCBs as per Section 18 of the BR Act (AACS). Both Scheduled and Non-Scheduled UCBs are required to maintain Statutory Liquidity Ratio (SLR) as per Section 24 of the BR Act, 1949 (AACS) respectively. Presently, Asset Liability Management (ALM) guidelines are applicable only to Scheduled UCBs, <i>i.e.</i>, the larger entities.</p>
<p><b>Assessment: Materially Non-Compliant.</b></p>
<p><b>Comments:</b> Liquidity maintained as required by statute. No detailed guidelines issued as envisaged. The ALM guidelines issued to scheduled banks do not take into account undrawn commitments and other off-balance sheet items. The UCBs do not have policies and processes in place for ongoing measurement and monitoring of liquidity requirements.</p>

<p><b>Principle 15: Operational risk</b></p> <p>Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
<p><b>Description:</b></p> <p>The Reserve Bank has a system of on-site inspection of UCBs that looks into the risk management policies and processes in the bank. However, capital charge for operational risk has not been prescribed for UCBs.</p>
<p><b>Assessment: Non-Compliant</b></p>
<p><b>Comments:</b> Various guidelines for prevention and reporting of frauds, internal/concurrent audit, balancing of books, <i>etc.</i> have been issued. No guidelines have been issued covering operational risk.</p>
<p><b>Principle 16: Interest rate risk in the banking book</b></p> <p>Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.</p>
<p><b>Description:</b></p> <p>No specific guidelines have been prescribed for management of interest rate risk other than ALM guidelines</p>
<p><b>Assessment: Non-Compliant</b></p>
<p><b>Comments:</b> No guidelines have been issued.</p>
<p><b>Principle 17: Internal control and audit</b></p> <p>Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.</p>
<p><b>Description:</b></p> <p>The Reserve Bank has issued a number of instructions/guidelines to banks to streamline their inspection and audit machinery, introduce concurrent audit, monitor treasury operations, introduce internal control system for prevention of frauds, monitor cash flows in accounts, promptly reconcile inter-branch accounts, and balance books periodically.</p>



Each bank has an internal audit department that undertakes audit of bank's operations periodically. The on-site inspection of the banks includes examination and evaluation of the adequacy and effectiveness of the Internal Control System in the banks.

**Assessment: Materially Non-Compliant**

**Comments:** The Reserve Bank has no powers except to requisition RCS to supersede the Board. The Reserve Bank does not make assessment of skills of employees of banks. Chief Executive Officer of the bank is responsible for compliance. Detailed evaluation of internal audit function not done. No system of reporting to the Reserve Bank adverse information on senior executives/members of Board. The Reserve Bank does not determine that there is an appropriate balance in skills and resources of back office and control functions relative to the front office. It does not make assessment of skills of employees of banks.

**Principle 18: Abuse of financial services**

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict 'know your customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

**Description:**

The Know Your Customer' Rules for UCBs are in place. There are specific directions for obtaining proper introduction while opening Deposit Accounts. A number of instructions have been issued by the Reserve Bank and the Government of India to prevent money laundering. The Anti Money Laundering Act has been enacted.

A system of reporting frauds in banks to the Reserve Bank on a case-by-case basis is in place. The cases of frauds involving amounts of less than Rs 1 lakh are to be submitted to the Reserve Bank in a consolidated quarterly statement. The cases of individual frauds involving amounts of Rs.1 lakh and above but less than Rs.25 lakh should be reported to the Regional Office of Urban Banks Department of the Reserve Bank , under whose jurisdiction the Head Office of the bank falls. The cases of individual frauds involving amounts of Rs.25 lakh and above should be reported to Frauds Monitoring Cell, Department of Banking Supervision, the Reserve Bank, within three weeks from the date of detection. In addition to the requirement given above, banks may report the fraud by means of letter to the Chief General Manager-in-Charge of the Department of Banking Supervision, Reserve Bank, Central Office, within a week of such fraud coming to the notice of the bank's Head Office. In order to have uniformity in reporting, frauds have been classified as under, based mainly on the provisions of the Indian Penal Code:(a) Misappropriation and criminal breach of trust (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property (c) Unauthorised credit facilities extended for reward or for illegal gratification (d) Negligence and cash shortages (e) Cheating and forgery (f) Irregularities in foreign exchange transactions (g) Any other type of fraud not coming under the specific heads as above.

**Assessment: Largely Compliant**

**Comments:** Protection to whistle blowers not legally available.

<p><b>Principle 19: Supervisory approach:</b></p> <p>An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.</p>
<p><b>Description:</b></p> <p>The main instrument of supervision of UCBs is the periodical on-site inspection of banks that is supplemented by off-site monitoring and surveillance. The CAMELS rating framework was made applicable to scheduled UCBs from the inspection cycle beginning March 2003. Further, a system of grading has been adopted under which UCBs are being classified into four categories (Grade I/II/III/IV). The supervisory response is taken as per the gradation of the banks. Further, an Off-Site Surveillance (OSS) system has been implemented in all Scheduled UCBs as well as in Non-Scheduled UCBs (with deposit base of Rs. 100 crore and above). The banks that are not covered under OSS continue to submit periodic reports. The above tools have enabled the Reserve Bank to supervise and take remedial measures as deemed appropriate.</p>
<p><b>Assessment: Largely Compliant.</b></p>
<p><b>Comments:</b></p> <ul style="list-style-type: none"><li>● OSS system being used to monitor risks of individual banks on an ongoing basis.</li><li>● No system of reporting to the Reserve Bank of any material adverse development by banks.</li><li>● Methodology adopted by supervisor does not take forward looking view of risk profile of banks.</li></ul>
<p><b>Principle 20: Supervisory techniques</b></p> <p>An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.</p>
<p><b>Description:</b></p> <p>The Reserve Bank has understanding of operations of individual banks through on-site inspection, OSS returns and periodic meeting with the management. Deeper understanding of the problems faced by the sector has been facilitated by the formation of TAFUCBs in states which have signed MOU with the Reserve Bank.</p>
<p><b>Assessment: Largely Compliant.</b></p>
<p><b>Comments:</b> Supervisor does not evaluate quality of Board/management on an ongoing basis. There is need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.</p>

**Principle 21: Supervisory reporting**

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis and a means of independent verification of these reports, through either on-site examinations or use of external experts.

**Description:**

The Reserve Bank has powers under Section 27 of the BR Act, to call for any information at any time from a banking company relating to its affairs. Presently, the Reserve Bank receives prudential reports and statistical returns from banks on a solo basis only. The off-site supervisory returns received by the Reserve Bank are used to prepare various reports. Any inconsistency or inaccuracy in reporting is taken up with top management of the bank. Submission of any wrong information to the Reserve Bank can invite imposition of penalties specified in Section 46(1) of the BR Act. Further, State Governments appoint statutory auditors who are government auditors or professional CAs. As per MoU, State Governments are required to introduce long form audit report for statutory audit and modify audit rating models in alignment with the gradation system adopted by the Bank for all UCBs and provide for statutory audit by Chartered Accountants (CAs) appointed in consultation with the Bank for UCBs with deposit over Rs.25 crore and special audit by CAs, if required by the Reserve Bank, for any UCB.

**Assessment: Largely Compliant****Comments:**

- UCBs mostly do not have group entities.
- Largely compliant taking into account the powers of the joint regulator i.e. RCS.
- No requirement for external auditors to report adverse findings to the supervisor promptly.

**Principle 22: Accounting and disclosure**

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

**Description:**

The Reserve Bank is committed to enhance and improve the levels of transparency and disclosure in the annual accounts of banks. The formats for preparation of financial statements are prescribed under Section 29 of the BR Act. The Reserve Bank has also laid disclosure norms in the balance sheet. Powers with regard to appointment of auditors *etc.* vests with the State Government.

Currently the Reserve Bank does not have any power to appoint external experts including auditors to conduct supervisory task and these auditors are not required to bring to notice of the Reserve Bank any material shortcoming identified during the course of the work undertaken by them. Aspects relating to audit are attended to by RCS. As per MoU signed between the Reserve Bank and RCS, the State Governments among other things, are required to provide for statutory audit by Chartered Accountants (CAs) appointed in consultation with the Reserve Bank for UCBs with deposit over Rs.25 crore. The Reserve Bank has entered into MoU with 18 states and the Central Government.

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As per extant guidelines, the disclosures for UCBs in their balance sheet is limited to CRAR, investments, advances against real estate/ shares/debentures/ directors/ relatives, cost of deposits, NPAs, profitability indicators and provisions.

**Assessment: Largely Compliant**

**Comments:**

- The Reserve Bank has no powers to have external audit conducted on banks. Such powers are with the RCS. Co-ordination between regulators has been facilitated through MoU.
- The Reserve Bank does not meet external auditors.
- Laws/regulations do not require external auditors (not appointed for supervisory purpose) to report to supervisors significant adverse findings.
- Supervisors do not have powers to access auditor's working papers.

**Principle 23: Corrective and remedial powers of supervisors**

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.

**Description:**

UCBs do not have global presence. The Reserve Bank is vested with powers to issue directions under the BR Act where necessary in the interest of banking policy, in public interest or where the affairs of the banking company are being conducted in a manner detrimental to the interest of the depositors. The BR Act also gives the Reserve Bank wide powers to obtain any information from the supervised institutions (Section 27), issue directions on any aspect of their business (Section 35A), cause change of management, cancel their license, take monetary and non-monetary penal measures (Section 46 to 48), impose restrictions or even close the bank. The regulatory violations in complying with prudential requirements could lead to imposition of monetary penalties and issue of letters of displeasure to the bank's management. The RCS can be advised to conduct enquiry under the provisions of the State Co-operative Societies Acts and recover the amount of penalty imposed by the Reserve Bank from the concerned directors/executives who are responsible. In extreme cases, the concerned Registrar of co-operative society is requested to supersede the board of directors. In the case of banks which do not meet capital adequacy regulations, restrictions on branch expansion, assets expansion *etc.*, is imposed.

**Assessment: Largely Compliant**

**Comments:** The present supervisory tools are adequate. However, dual control of UCBs has led to slow supervisory responses. The Reserve Bank may like to have more powers against erring management including forced merger and liquidation. This has been partially redressed through MoUs. Penalties/sanctions against management/ Board through RCS.

<p><b>Principle 24: Consolidated supervision</b></p> <p>An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.</p>
<p><b>Description:</b></p> <p>UCBs do not have global presence.</p>
<p><b>Assessment: Not Applicable</b></p>
<p><b>Comments:</b> UCBs do not belong to any banking group. UCBs registered in States do not have subsidiaries. Multi-state UCBs are permitted to set up subsidiaries, but only one subsidiary has been set up by a bank so far.</p>
<p><b>Principle 25: Home-host relationships</b></p> <p>Cross-border consolidated supervision requires co-operation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.</p>
<p><b>Description:</b></p> <p>UCBs do not have global presence.</p>
<p><b>Assessment: Not Applicable</b></p>
<p><b>Comments:</b> Not applicable.</p>

## Appendix 6

**Detailed Assessment (Principle-by-Principle)-State Co-operative Banks/  
District Central Co-operative Banks****Principle 1: Objectives, independence, powers, transparency and co-operation**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 1(1): Responsibilities and objectives**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

**Description :**

The Laws *viz.* the RBI Act, 1934, BR Act, 1949 (As Applicable to Co-operative Societies - AACS), State Co-operative Societies Act/Rules as applicable to State Co-operative Banks (SCBs) and District Central Co-operative Banks (DCCBs) are in place for regulation and supervision of StCBs/DCCBs. The responsibilities and objectives of various regulators *viz.* the Reserve Bank, NABARD and RCS are delineated as per law. The co-operatives are regulated by the Reserve Bank as well as Registrar of Co-operative Societies leading to duality of control which gives rise to supervisory related issues. The laws and supporting regulations provide a framework of minimum prudential standards that StCBs/DCCBs must meet. The banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to the changing industry and regulatory practices. As per the provisions of Section 31 of the BR Act, 1949 (AACS), both StCBs and DCCBs publish their annual financial statements in the newspapers for the benefit of their shareholders.

**Assessment: Compliant****Principle 1(2): Independence, accountability and transparency**

Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.



<p><b>Description:</b> The National Bank for Agriculture and Rural Development (NABARD) exercises the powers of inspection over the StCBs and DCCBs under Section 35(6) of the BR Act, 1949 (AACS). It has been undertaking its supervisory responsibilities within the overall policy frame-work and guidelines issued from time to time by the Reserve Bank (Regulator) on matters pertaining to the affairs of StCBs/DCCBs. It has total operational independence in deciding the framework for undertaking supervisory responsibilities.</p> <p>There is no provision for public disclosure for removal of the head(s) of the supervisory authorities for the reasons specified in law. Though, there is no transparent public disclosure of objectives and framework for discharge of duties by NABARD, supervisory findings are sent to the supervised entities and State Governments for initiating appropriate remedial action under intimation to the Regulator (the Reserve Bank).</p> <p>The NABARD recruits staff and the personnel with high qualification, competence and integrity. The entire supervisory work is being attended to by NABARD out of its own funding and there is no external assistance for the purpose. NABARD is having exclusive training budget for capacity building of its supervisory officials. Adequate number of computers and other equipments are in place to carry on the supervisory functions more effectively.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> The reasons for removal of head of supervisory authority during his term are not specified in Law.</p>
<p><b>Principle 1(3): Legal framework</b> A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.</p>
<p><b>Description:</b> Both StCBs and DCCBs are primarily registered as co-operative societies under the respective State Co-operative Societies Act. All the co-operative banks can commence banking business without obtaining licence. The DCCBs do not require licences for opening branches within their areas of operation, while the StCBs do require licences for their branch expansion from the Reserve Bank. The Reserve Bank is the authority responsible for granting and withdrawing banking licences to StCBs/DCCBs on the basis of the recommendations of NABARD. In case of amalgamation and liquidation of the StCBs and DCCBs, the permission of the Registrar of Co-operative Societies (RCS) of the concerned State is necessary. The supervised entities are submitting a copy of statutory returns prescribed by the Reserve Bank as also submitting Off-Site Surveillance Returns (OSS Returns) to NABARD which are prescribed under Section 27(2) of the BR Act, 1949 (AACS).</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(4): Legal powers</b> A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.</p>
<p><b>Description:</b> NABARD exercises the powers of supervision over the co-operative banks under Section 35(6) of the BR Act, 1949 (AACS). It ensures safety and soundness of these banks through on-site</p>

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<p>inspections and off-site returns. NABARD does not have any power to ensure effective compliance from the StCBs/DCCBs on the supervisory findings. Section 35A of the BR Act, 1949 (AACS) empowers the Reserve Bank to give directions to the StCBs/DCCBs and impose sanctions through the intervention of the RCS of the concerned States. The revocation of banking licence is possible for the Reserve Bank in respect of StCBs/DCCBs.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(5): Legal protection</b> A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.</p>
<p><b>Description:</b> The law provides protection to NABARD and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. NABARD and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(6): Co-operation</b> Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>
<p><b>Description:</b> There are formal and informal arrangements in place between the Reserve Bank, RCS and NABARD for co-operation and sharing of information pertaining to the StCBs/DCCBs.  The copy of the inspection report is shared with the State RCS. The supervisory issues/concerns in respect of the StCBs/DCCBs are discussed at the State Level Review and Monitoring Committee/ State Level Coordination Committees which is also shared with the Parliament. The Reserve Bank, NABARD and RCS can provide to each other, with necessary safeguards, confidential information relating to the StCBs/DCCBs. NABARD is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 2: Permissible activities</b> The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.</p>
<p><b>Description:</b> Section 6(1) of the BR Act, 1949 (AACS) indicates the list of the permissible activities that can be taken up by a banking company. Section 7 of the Act prohibits the use of the words "bank",</p>

'banker', or 'banking' by any co-operative society other than a co-operative bank as part of its name or in connection with its business. However, this provision does not apply to a Primary Credit Society (PCS) or to a Primary Agricultural Credit Society (PACS). The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by NABARD, or in laws or regulations. The word "bank" can be legally used by unlicensed and unsupervised entities, e.g. PCS, PACS and Land Development Bank (LDB), whose numbers are not large. The list of co-operative banks is kept current and updated by NABARD.

**Assessment: Largely Compliant**

**Comments:** As the co-operative credit structure is largely dependent on the primary agricultural credit societies for their grass-root level purveying of rural credit, they have been permitted to accept deposits from other than members for the sake of enlarging their capital base which is taken into consideration for deciding the eligibility and quantum of borrowing from the higher financing agencies like SCBs and DCCBs.

There are around 309 StCBs and DCCBs which are currently operating without a banking license. As the continuing existence of unlicensed co-operative institutions poses a risk to the depositors' interests, there is a need to draw up a roadmap whereby "banks" which fail to obtain license by 2012 would not be allowed to operate. This would expedite the process of consolidation and weeding out non-viable entities from the co-operative space.

**Principle 3: Licensing criteria**

The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

**Description:**

A co-operative bank for commencing business is required to obtain a licence from the Reserve Bank, under the provisions of Section 22 of the BR Act, 1949 (AACS). As per Section 11(1) of the BR Act (AACS) the capital requirement is Rs. 1 lakh for non-scheduled co-operative banks and cannot exceed Rs. 5 lakh in respect of scheduled Banks as per Section 42(6)(a)(i) of the RBI Act, 1934. The Reserve Bank has set the criteria for granting license for setting up of new co-operative banks. It has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate. It determines that the proposed legal, managerial, operational and ownership structures of the bank will not hinder effective supervision. It reviews proforma financial statements and projections for the proposed bank which includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank. The co-operative Banks not permitted to operate in foreign countries.

However, there are certain limitations as the Reserve Bank does not have control over managerial affairs or shareholding. There are no fit and proper criteria for directors/Chief Executive Officers of co-operative banks at present, though they are going to be implemented with the proposed Co-

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<p>operative Reforms Package as per Vaidyanathan Committee-I Report. The Reserve Bank has issued guidelines to NABARD for implementation in this regard. The Reserve Bank does not have powers to determine suitability of shareholders. RCS can disqualify directors.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> There are no fit and proper criteria for directors/Chief Executive Officers of co-operative banks at present. The Reserve Bank does not have powers to determine suitability of shareholders.</p>
<p><b>Principle: 4 Transfer of significant ownership</b></p> <p>The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.</p>
<p><b>Description:</b></p> <p>There is no concept of controlling/significant ownership of a co-operative bank. Each member has only one vote irrespective of number of shares held by the member.</p>
<p><b>Assessment: Not Applicable</b></p>
<p><b>Comments:</b> Concept of significant ownership and controlling interest absent.</p>
<p><b>Principle 5: Major acquisitions</b></p> <p>The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>
<p><b>Description:</b></p> <p>The acquisition of StCBs/DCCBs is only by way of merger/amalgamation with the specific permission of the Reserve Bank /NABARD/RCS. They are not permitted to make large non-Statutory Liquidity Ratio (non-SLR) investments as per current regulations. Laws or regulations provide criteria by which to judge individual proposals. NABARD determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment. The StCBs/DCCBs do not have cross-border operations. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 6: Capital adequacy</b></p> <p>Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.</p>

<p><b>Description:</b> The capital adequacy guidelines have not been issued to StCBs/DCCBs. The Government of India Reform Package under implementation envisages stipulation of minimum 7 per cent CRAR within MoU period. As StCBs/DCCBs are not internationally active banks, Basel norms have not been made applicable so far. Providing capital charges to various material risk exposures have not been prescribed so far. The Reserve Bank has recently advised all co-operative banks to indicate the CRAR in their balance sheet as on March 31, 2008 and thereafter every year as 'Notes on Accounts' to their Balance Sheets.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> The position can be examined once the instructions on CRAR are issued to them by the Reserve Bank. The Vaidyanathan Committee set up for reviving the Short-Term Co-operative Credit Structure (STCCS), has suggested that risk based capital requirements of 7 per cent may be introduced for StCBs/DCCBs and increased in phased manner to 9 per cent as in case of commercial banks.</p>
<p><b>Principle 7: Risk management process</b> Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.</p>
<p><b>Description:</b> StCBs/DCCBs are having risk management mechanism in rudimentary fashion. The risk management policies are mostly confined to credit risk. The banks are yet to put in place sophisticated risk management systems and risk mitigant measures. NABARD, during the course of its on-site inspection of StCBs/DCCBs, examines in detail the risk management policies, processes and other aspects like documentation, <i>etc.</i> Wherever deviations are noticed, such instances are being brought to the notice of the banks concerned for initiating appropriate remedial measures. The need for having sophisticated techniques of Integrated Risk Management is not considered necessary in view of their size and volume of business operations. At present, risk management aspects are being reviewed by the Boards of StCBs/DCCBs in a routine manner, based on the data placed before them on credit risk, liquidity risk, and interest rate risk areas.</p> <p>As StCBs/DCCBs being small business entities, introduction of Integrated Risk Management approach would require huge investments on computerisation for collection of necessary data. Admittedly, risk management process is weak in smaller banks. Presently, Asset Liability Management (ALM) guidelines are applicable only to five StCBs, on a pilot basis. It has been made obligatory for the co-operatives to get their Board's approval before implementing suitable risk management measures.</p> <p>There are no models used for various kinds of risks. The risk taking function is not segregated from risk evaluation/monitoring/control function. No detailed guidelines for setting up dedicated risk management unit have been issued. No guidelines for stress testing issued. No comprehensive guidelines issued for reputational and strategic risks. The concept of holding company and banking group is not applicable to StCBs/DCCBs.</p>

<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> There are no models used for various kinds of risks. No detailed guidelines for setting up dedicated risk management unit have been issued. No guidelines for stress testing issued. No comprehensive guidelines issued for reputational and strategic risks. The concept of holding company and banking group is not applicable to StCBs/DCCBs.</p>
<p><b>Principle 8: Credit risk</b></p> <p>Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.</p>
<p><b>Description:</b></p> <p>The StCBs/DCCBs are required to have documented credit policy approved by the respective Boards. Compliance with the prudential norms on income recognition, asset classification, provisions for erosion in value of assets and adequacy of credit appraisal and recovery policy are also seen during on-site inspection. Significant divergence, if any, noticed in asset classification is taken up with the bank management.</p> <p>The StCBs/DCCBs have credit appraisal mechanism in place as also it has delegated powers to bank functionaries for sanction of credit. NABARD has been ensuring to scrutinise all such loan proposals during on-site inspections and bring out deficiencies/lapses in non- adherence to the well established appraisal norms by the Branch Managers / Loan Committee accordingly. NABARD has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> Co-operative Banks generally comply with the supervisor's guidelines in this regard. Violations in exercise of the delegated powers, over concentration in a particular sector/segment/activity, interference in loan decision making by any Director are brought out in the on-site inspection reports on an ongoing basis.</p>
<p><b>Principle 9: Problem assets, provisions and reserves</b></p> <p>Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.</p>
<p><b>Description:</b></p> <p>The Reserve Bank has issued detailed guidelines to StCBs/DCCBs on income recognition, asset classification and provisioning covering both on and off-balance sheet exposures. During the</p>



course of on-site inspections, the efficacy of asset classification by the banks is examined and in case of significant divergence in NPA figures as assessed by NABARD vis-a- vis that assessed by the banks, the banks are advised to initiate remedial measures. Adequacy of provisions as per the Reserve Bank norms is to be certified by the Departmental auditors who conduct the statutory audit of the banks. The amount of provisioning required, extent of provisioning done are also monitored through on-site inspection and off-site surveillance returns.

NABARD determines that banks have appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations. It also determines that banks have appropriate policies and processes, and organisational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting past due obligations.

NABARD has the power to require a bank to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern. It requires banks to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. The valuation of collateral is required to reflect the net realisable value.

**Assessment: Largely Compliant**

**Comments:** This is being done by giving a divergence statement whereby the supervised banks are made to know the improper classification of assets and provisioning there against during the course of on-site inspections.

**Principle 10: Large exposure limits**

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

**Description:**

NABARD/ Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers (presently 15 per cent and 40 per cent respectively of capital funds) to avoid concentration of credit, and has advised the banks to fix limits on their exposure to specific industries or sectors (real estate, capital market, *etc.*) for ensuring better risk management. Further, NABARD has recently linked the individual and group exposure limits based on inspection ratings assigned by it to the banks. The banks are required to report in off-site returns top 20 borrowers with outstanding balances exceeding 15 per cent of their capital funds.

NABARD confirms that a bank's risk management policies and processes establish thresholds for acceptable concentrations of credit and require that all material concentrations be reviewed and reported periodically to the Board.

The banks are required to submit periodical Credit Monitoring Arrangements (CMA) returns towards their exposure to various segments/sectors/parties/units to NABARD. On the basis of information furnished, wherever violations are observed, such banks are being advised to bring down their level of exposure from time to time by the supervisor.

**Assessment: Compliant**

**Comments:** Detailed risk management policies and practices are absent. Definition of large exposure not prescribed and no uniformity among banks. Limit of 20 per cent not adhered to for group exposure.

**Principle 11: Exposures to related parties**

In order to prevent abuses arising from exposures (both on balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

**Description:**

The concept of 'related party' is strictly not applicable to StCBs/ DCCBs as there is no promoter having substantial share holding as in the case of commercial banks. Limit on individual shareholding is generally provided in the State Co-operative Societies Acts and in any case a member has one vote only irrespective of his shareholding. 'Related parties' in case of Co-operative Banks can be interpreted as director related entities only. As per Section 20 of the BR Act, banks are prohibited to grant loans and advances (other than for personal use) to any of its directors or to any firms or private companies in which any of its directors are interested as partner or managing agent or guarantor or to individuals in cases where any of its directors is a guarantor, with certain exceptions. In respect of non-fund based facilities, which are not regarded as loans and advances within the meaning of Section 20 of the BR Act, any devolvement on the bank resulting in creditor-debtor relationship between the bank and the director, *etc.*, shall attract Section 20 of the BR Act. Section 20 A of the Act *ibid* says that any remission of debt to directors or company in which any of its directors is interested as director, partner, managing agent or guarantor, *etc.*, require the Reserve Bank's prior permission. Further, NABARD monitor loan to directors/relatives as part of on-site inspection and through off-site returns on a quarterly basis.

**Assessment: Compliant**

**Comments:** Related party means only directors, their relatives and firms and companies in which they are interested; no significant shareholders (one member one vote principle); subsidiaries non-existent except for a few in case of multi-state banks. Loans to directors/relatives and firms in which they are interested prohibited by regulation. Write-off of director related loans require the Reserve Bank approval under the Act. Banks are required to submit a quarterly statement on loans to directors/relatives, *etc.*

**Principle 12: Country and transfer risks**

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

<p><b>Description:</b> They do not have overseas presence and are not engaged in lending under foreign currencies.</p>
<p><b>Assessment: Not Applicable</b></p>
<p><b>Comments:</b> Co-operative Banks are not permitted to take country and transfer risks as they are not engaged in lending under foreign currencies.</p>
<p><b>Principle 13: Market risk</b> Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.</p>
<p><b>Description :</b> No guidelines have been issued for assessing market risk by the StCBs/DCCBs. The Reserve Bank has issued prudential guidelines on investment, both Statutory Liquidity Ratio (SLR) and non-SLR investments. The investment guidelines of the bank are approved by the Board which has to be in consonance with the Reserve Bank guidelines.  During the course of on-site inspections, a broad analysis is made about the extent to which these banks are exposed to market risk on the basis of their investment portfolio and attention of the supervised banks is drawn towards this. No guidelines have been issued so far imposing any market risk limits to StCBs/DCCBs and similarly these banks have also not framed any policy guidelines in this regard.  Stress testing, validation, <i>etc.</i> which are the pre-requisites of Integrated Risk Management measures have not been made applicable to StCBs/DCCBs so far by the Regulator (the Reserve Bank). Besides, this requires advanced Information Technology arrangements in these banks that require huge capital cost. At present, the necessity for such an advanced approach of Integrated Risk Management system is not considered necessary for StCBs/DCCBs in view of their low volume of investment operations.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> Since CRAR which is a pre-requisite for assessing the market risk, <i>etc.</i> has not been introduced to StCBs/DCCBs, no guidelines on market risk has been issued and made applicable to them.</p>
<p><b>Principle 14: Liquidity risk</b> Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>
<p><b>Description :</b> All the Scheduled Co-operative Banks are required to maintain Cash Reserve Ratio as per Section 42(1) of the RBI Act, 1934 and non-Scheduled Co-operative Banks as per Section 18 of the BR Act, 1949 (AACS). Both Scheduled and Non-Scheduled Co-operative Banks are required to maintain SLR as per Sec. 24 of the Act <i>ibid.</i> Presently, ALM guidelines have been issued and made applicable to only 5 StCBs with effect from 1<sup>st</sup> April 2007, on a pilot basis.</p>

At present, the Risk Management systems followed by the StCBs and DCCBs are on traditional lines and not on advanced approach basis, like adopting stress testing, *etc.* However, all these banks do necessarily measure, analyse and monitor the various risks to which they are exposed to and take appropriate steps to mitigate such risks. No contingency plans for handling liquidity problems including informing NABARD.

**Assessment: Materially Non-Compliant**

**Comments:** All the StCBs and DCCBs have put in place suitable systems for assessing their liquidity position covering both on and off-balance sheet items. Although no supervisory guidelines on preparation of contingency plans for handling liquidity problems have been issued, StCBS/DCCBs, on their own, do take care of this unforeseen eventuality by their own internal measures. Advanced Risk Management measures and Stress Testing may not be necessary at this juncture.

**Principle 15: Operational risk**

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

**Description:**

Illustrative guidelines on all types of risks including operational risk have been issued to StCBs/DCCBs. They have been advised to suitably modify these guidelines, based on the size and complexity of the banks' operations and put in place suitable systems for mitigation of such risks.

StCBs/DCCBs have been advised to get their Risk Management Systems, policies and procedures prepared and get them approved by the respective Boards. NABARD also suggested to the Boards of these banks to ensure that these policies and processes are implemented effectively.

StCBs/DCCBs do follow the rudimentary system of assessing the risks, minimising losses arising out of business disruption and preparing contingency plans to take care of them.

Information Technology is in various stages in co-operative banks. Information Technology is yet to be fully developed/ adopted in other areas of banks' business. The banks do provide certain basic information through CMA, OSS, *etc.*, returns to the NABARD.

NABARD/ Reserve Bank has not so far suggested to StCBs/DCCBs for outsourcing risk management programme. This is an area which is left to the discretion and decision of the respective Board of Directors of banks.

**Assessment: Non-Compliant**

**Comments:** As and when the business operations of the co-operative banks expand, much sophisticated risk management measures including those for operational risk will be issued in consultation with the Reserve Bank. Capital charge for operational risk has not been prescribed for the co-operative banks.

Various guidelines for prevention and reporting of frauds, internal/concurrent audit, balancing of books, *etc.* have been issued to co-operative banks by NABARD. They are not as detailed as prescribed under operational risk as part of Basel Core Principles. No supervisory guidelines for preparation of systematic contingency plans have been suggested to the StCBs/DCCBs. Supervisor has not issued any detailed guidelines on Information Technology so far in view of their limited size and volume of business operations.

**Principle 16: Interest rate risk in the banking book**

Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

**Description:**

The Boards of StCBs/DCCBs do not have appropriate review mechanism in this regard. However, ALM System has been introduced only in 5 StCBs with effect from 1<sup>st</sup> April 2007, on a pilot basis. The StCBs/DCCBs may need some more time to get the full advantage of ALM system.

**Assessment: Non-Compliant**

**Comments:** DCCBs by and large follow the interest rates on deposits and advances as being followed by their StCBs, while StCBs fixes the interest rates, based on the trends followed by the commercial banks in their areas of operation. Since their investment portfolio is very small in size as compared to commercial banks, detailed guidelines on interest rate risk have not been considered necessary at this stage.

**Principle 17: Internal control and audit**

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

**Description:**

The existing State Co-operative Societies Act and Bank's own bye-laws clearly provides for duties and responsibilities of the Board, top management, *etc.* which are being followed by the StCBs/DCCBs. Further, the general principles of corporate governance are also in vogue. However, 'fit and proper' criteria for selection of Board members and their responsibilities have been framed for them by the NABARD in consultation with the Reserve Bank. Corporate Governance in the strictest sense of the term has not so far been made applicable to StCBs/DCCBs as the Board members are generally nominated/elected Directors and they have not been made accountable for all the omissions and commissions.

NABARD had already issued general circulars giving essential guidelines on various aspects of internal checks and control systems in co-operative banks. Further, NABARD had already circulated the manual on internal checks and branch control systems in co-operative banks. These guidelines help in streamlining the inspection and audit machinery, introduction of concurrent audit, monitoring of treasury operations, measures for prevention of frauds, reconciliation of inter-branch and inter-bank accounts promptly, book balancing, *etc.* Each bank has an internal audit department that undertakes audit of bank's operations regularly. Examination and evaluation of adequacy and effectiveness of the internal control system in the banks form one of the important aspects during on-site inspections conducted by NABARD.

NABARD has issued detailed guidelines to all the StCBs/DCCBs to segregate the front office and back office functions. However, wherever deviations are noticed in the extant guidelines on investment issued by the Reserve Bank /NABARD including the segregation of functions, such cases are being taken up with the banks concerned for appropriate remedial measures.

NABARD is in the process of preparing suitable guidelines on 'Compliance Function' to co-operative banks in consultation with the Reserve Bank, on the lines of instructions issued to commercial banks for adoption. The compliance on NABARD's inspection report must be placed before the Board for approval before being sent to NABARD by the banks concerned. This system ensures the oversight of the Board of the management of the compliance function.

**Assessment: Materially Non-Compliant**

**Comments:** There are no powers provided in the BR Act, 1949 (AACS) to the Reserve Bank for appointing additional directors on the Boards of co-operative banks. Similarly, no powers to remove managerial and other persons from holding office in the co-operative banks are vested with the Reserve Bank. NABARD does not have any powers to bring about changes in composition of Board and senior management to address prudential concerns.

Looking to the very nature of functions and size of co-operative banks, no guidelines to have a separate Compliance Function Cell has been issued to them. However, with their business operations likely to grow with the implementation of the Co-operative Reforms Package as per Vaidyanathan Committee I report, NABARD has recently approached the Reserve Bank for approval of guidelines on "Compliance Function" to co-operative banks as well on the lines of the instructions issued to the commercial banks to facilitate issue of the same by the Supervisor.

**Principle 18: Abuse of Financial Services**

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict 'know your customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.



**Description:**

At present, NABARD has been conducting the statutory inspections of StCBs/DCCBs under Section 35(6) of the BR Act, 1949 (AACs). Necessary enforcement powers vest with the Regulator, *i.e.* the Reserve Bank, Registrar of Co-operative Societies and Government of India.

KYC guidelines are in place in StCBs/DCCBs. Various instructions have been issued by the Reserve Bank and Government of India to prevent money laundering. The Anti-Money Laundering Act which has been enacted has been made applicable to StCBs/DCCBs.

A system of reporting of frauds in banks to NABARD on a case-by-case basis is in place. NABARD had prepared and supplied the Compendium on Prevention of Frauds in StCBs/DCCBs wherein measures required to be taken by the banks for prevention of frauds/embezzlements/misappropriations, *etc.* are delineated in detail. However, as regards criminal activities in the banks, no specific guidelines are issued by NABARD/ the Reserve Bank in this regard so far. Protection to whistle blowers not legally available. Suspicious activities are not reported by the banks.

As per the KYC guidelines, the StCBs/DCCBs have strictly been advised to follow the due procedure including reporting to Financial Intelligence Unit. This is being verified during the course of on-site inspections. As the clientele of StCBs/DCCBs mainly comprise those under relaxed KYC norms, such rigorous supervision may not be necessary. StCBs/DCCBs have been recently permitted by the Reserve Bank to undertake correspondent banking activities, which are still in nascent stage.

The guidelines issued by the Reserve Bank in this regard are being followed by the co-operative banks and verified during the course of on-site inspections.

The system to designate Compliance Officer has not yet been made operational in co-operative banks, as in the case of commercial banks.

At present, co-operative banks are reporting CTR and STR involving cash transactions of Rs.10 lakh and above to the Financial Intelligence Units as required by KYC norms.

**Assessment: Materially Non-Compliant**

**Comments:** Once the compliance function circular is issued to the StCBs/DCCBs in consultation with the Reserve Bank, the Compliance Officer concept will be introduced by them thereafter. As regards criminal activities in the banks, no specific guidelines are issued by NABARD/ the Reserve Bank in this regard so far. Protection to whistle blowers not legally available.

**Principle 19: Supervisory Approach**

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

**Description:**

At present, NABARD's supervisory assessment is on the CAMELSC pattern (Capital Adequacy, Asset Quality, Management Efficiency, Earnings, Liquidity, Systems and Procedures and Compliance) on the basis of which on-site inspections of StCBs/DCCBs are being conducted. The main focus of NABARD's supervisory role by way of on-site inspection is to ensure safety and security of present and future depositors' interests, to ensure that the business conducted by

the StCBs/DCCBs is in conformity with the provisions of the relevant Acts, Rules and Regulations, ensure observance of Rules, Regulations, guidelines, *etc.*, issued by NABARD/ the Reserve Bank/ Government and examine the financial, operational and managerial soundness of StCBs/DCCBs.

NABARD monitors and assesses trends, developments and risks for the banking system as a whole. It has been assessing operations of individual banks through on-site inspections, off-site returns and periodic discussions with the management. Deeper understanding of the problems faced by the sector has been facilitated through SLCC/State Level Monitoring and Implementation Committee set up for monitoring the performance of weak banks.

NABARD/ Reserve Bank does not requires banks to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements. It has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.

**Assessment: Largely Compliant**

**Comments:** Supervisory work is not prioritised based on the results of these assessments. However, the weak banks are being inspected annually.

**Principle 20: Supervisory Techniques**

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

**Description**

NABARD employs an appropriate mix of on-site and off-site supervision to evaluate the condition of banks, their inherent risks, and the corrective measures necessary to address supervisory concerns. The specific mix may be determined by the particular conditions and circumstances of the country. NABARD has policies and processes in place to assess the quality, effectiveness and integration of on-site and off-site functions, and to address any weaknesses that are identified. There is full co-ordination and sharing of information between the on-site and off-site functions undertaken by NABARD. On-site work is entirely being conducted with NABARD's own staff and no external experts are engaged for the purpose.

NABARD has been in constant interaction with the banks' Boards/CEOs for understanding their risk perception, risk management systems and risk mitigant measures putting in place. Detailed comments are made in the on-site inspection report about the quality of the Board and management.

NABARD evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk. It has

circulated the manual on internal checks and branch control to co-operative banks for adoption. NABARD communicates to the bank the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.

**Assessment: Largely Compliant**

**Comments:** There is need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.

**Principle 21: Supervisory Reporting**

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

**Description:**

Under Section 27(2) of the BR Act, 1949 (AACS), NABARD has powers to call for any information at any time from a banking company relating to its affairs. Presently, NABARD and the Reserve Bank receive prudential reports and statistical returns from banks on solo basis only. The off-site surveillance returns prescribed and received by NABARD are used to prepare various reports. Any inconsistency or inaccuracy in reporting is taken up with the top management of the bank. Submission of any wrong information to the Reserve Bank /NABARD can invite imposition of penalties specified in terms of Sec. 46(1) of the Act *ibid*. StCBs/DCCBS generally follow the double entry book-keeping system as per the instructions of RCS. They follow the valuation norms as per the Reserve Bank /NABARD's instructions issued from time to time in respect of their investments and assets.

NABARD collects and analyses information from banks at a frequency (e.g. monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.

There are no banking groups in co-operative banks. Similarly, consolidated supervision has not been introduced for them.

NABARD has full access to all bank records for the furtherance of supervisory work. It also has similar access to the bank's Board, management and staff, when required. Validation of data is done through on-site inspections and off-site surveillance mechanism by the supervisor's own staff. However, no external experts are engaged for the purpose.

**Assessment: Largely Compliant**

**Comments:** –

**Principle 22: Accounting and disclosure**

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

**Description:** NABARD can take recourse to the provisions of the BR Act, 1949 (AACS) for initiating action against the co-operative banks which furnish wrong/incorrect information.

Assessment of Adherence to  
Basel Core Principles

All the financial statements published by the co-operative banks are getting verified by the co-operative auditors and in a few cases by the chartered accountants who conduct the statutory audit of these banks. With the implementation of the Co-operative Reforms Package under the Vaidyanathan Committee I Report, (VC-I report) in respect of co-operative banks that fall in the 17 States (as on 31.10.2007) which had executed MoU, auditing would hence forth be done by the Chartered Accountants.

Generally, audit and accounting norms are prescribed by the State Government (RCS) for the co-operative banks. NABARD has also prescribed Long Form Audit Report format for adoption by the co-operative auditors.

NABARD/ Reserve Bank has not spelt out the scope of external audits of individual banks and the standards to be followed in performing such audits which continued to be under the RCS. Neither NABARD nor the Reserve Bank has powers to have external audit conducted on banks. Co-ordination between Regulators/Supervisor has been facilitated through MoU under VC-I report. Broad guidelines like LFAR, audit classification norms, *etc.*, have been issued by NABARD. Laws/regulations do not require external auditors (not appointed for supervisory purpose) to report to supervisors significant adverse findings. NABARD does not have powers to access auditor's working papers.

NABARD has been taking up the matter wherever the co-operative auditors failed to adhere to its prudential guidelines with the RCS and request that suitable action should be taken against such recalcitrant auditors.

The formats for preparation of financial statements are prescribed under Section 29 of the B.R. Act, 1949 (AACS). The Reserve Bank, in consultation with NABARD, has laid down 'Notes on Account' to co-operative banks' balance sheets with effect from 31 March 2006.

NABARD has been publishing 'Statistical Tables relating to Co-operative Movement' which contain individual as also aggregate data on balance sheet indicators, statistical parameters, *etc.*

**Assessment: Largely Compliant**

**Comments:** –

**Principle 23: Corrective and remedial powers of supervisors**

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

**Description:**

During the course of on-site inspections, Inspecting Officers of NABARD are discussing the major supervisory findings with the Board of Directors on the concluding day which is followed

up by written communication from its Regional Offices. The co-operative banks are also advised to submit their compliance in writing in respect of core areas of Inspection findings within 45 days and full compliance within 90 days from the date of issue of inspection reports.

NABARD participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution). It has framed a trigger point policy in consultation with the Reserve Bank in terms of which regulatory action is initiated against those banks which fail to achieve certain level of performance which includes, among others, cancellation of licence or rejection of licence application, supersession of Boards, *etc.*

Based on the recommendations of NABARD, the Reserve Bank has been issuing directions restricting the mobilisation of new deposits, grant of advances, supersession of the Boards, *etc.* Further, the Reserve Bank has been vested with powers to issue directions under the BR Act, 1949 (AACS) where necessary in the interest of banking policy, public interest or where the affairs of banking company are being conducted in a manner detrimental to the interest of the depositors. Sec.35A of the Act *ibid* provides necessary powers for issue directions on any other aspect of their business, cause change of management, cancel their license, take monetary and non-monetary penal measures (Sec.46 to 48 of the Act *ibid*), impose restrictions or even close the bank. Regulatory violations in complying with prudential requirements could lead to imposition of monetary penalties and issue of letters of displeasure to the bank's management. RCS can be advised to conduct enquiry under the provisions of the State Co-operative Societies Acts and recover the amount of penalty imposed by the Reserve Bank from the concerned directors/executives who are responsible. In case of those banks which do not meet the prudential regulations, restrictions on branch expansion, assets expansion, *etc.*, is imposed.

**Assessment: Largely Compliant**

**Comments:** NABARD has evolved and is implementing the trigger point policy for regulatory action. Based on the same, it has been recommending such regulatory measures to be initiated against recalcitrant banks to the Reserve Bank and wherever necessary, the Reserve Bank has taken such regulatory action against the erring co-operative banks. At present, penalties/sanctions against management/ Board are recommended by the Reserve Bank to the concerned RCS who has been vested with such powers as per the provisions of the State Co-operative Societies Act. However, the Reserve Bank does not enjoy powers under Section 36AA of the BR Act, 1949 to remove managerial and other persons from holding office in co-operative banks.

**Principle 24: Consolidated supervision**

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

**Description:**

Concept of consolidated supervision is not applicable

**Assessment: Not Applicable**

## Chapter III

### Assessment of Adherence to Basel Core Principles

**Comments:** The concept of Consolidated Supervision has not so far been made applicable to the on-site Inspections of co-operative banks. Co-operative banks do not belong to any banking group. They are registered in states and do not have subsidiaries.

**Principle 25: Home-host relationships**

Cross-border consolidated supervision requires co-operation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

**Description:**

Co-operative banks do not have global presence.

**Assessment: Not Applicable**

**Comments:** Since co-operative banks do not have global presence, this does not arise.



## Appendix 7

### Detailed Assessment (Principle-by-Principle) – Regional Rural Banks

**Principle 1: Objectives, independence, powers, transparency and co-operation**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 1(1): Responsibilities and objectives**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

**Description:**

There are laws, viz. the RBI Act, 1934, BR Act, 1949 and Regional Rural Banks (RRBs) Act, 1976 in place for regulation and supervision of Regional Rural Banks (RRBs). The banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

**Assessment: Compliant**

**Comments:** Pending the Reserve Bank's decision regarding publication of balance sheets, profit and loss accounts together with audit reports by the RRBs, NABARD will continue to publish the selected financial indicators for the use of public as hitherto.

**Principle 1(2): Independence, accountability and transparency**

Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.

**Description:**

The powers of inspection over RRBs are exercised by NABARD under Section 35 (6) of the BR Act, 1949. The entire supervisory work is being attended to by NABARD out of its own funding and there is no external assistance for the purpose. Though, NABARD has been undertaking its supervisory responsibilities within the overall policy frame-work and guidelines issued from time to time by the Reserve Bank, it has total operational independence in deciding the framework for undertaking supervisory responsibilities. Further, though Central Government and State Government are stakeholders in RRBs, there has been no interference from these entities in the way NABARD undertakes its supervisory role in respect of RRBs.

NABARD recruits staff in transparent and open competitive examination and the personnel with high qualification, competence and integrity are only placed in NABARD's services. There are no special pay scales for staff undertaking supervisory work. The officers are given adequate opportunities for participating in training programmes on supervision in its own training establishments and other select institutions. Adequate number of computers and other equipments are in place to carry on the supervisory functions more effectively. The reasons for removal of the head of the supervisory authorities are not publicly disclosed.

<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> The reasons for removal of head of supervisory authority are not publicly disclosed. Though supervisor is accountable to Ministry of Finance there is no transparent framework for discharge of duties in relation to its objectives.</p>
<p><b>Principle 1(3): Legal framework</b> A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.</p>
<p><b>Description:</b> As the RRBs are formed by notification by Government of India under Section 3(a) (1) of RRB Act, 1976, they do not require licence for their establishment under Section 22 of the BR Act, 1949. However, the provisions of Section 23A (1) and Section 26 of RRB Act, 1976, empowers the Central Government to amalgamate and liquidate RRBs respectively. The NABARD has been constantly in touch with the Reserve Bank and also with the supervised entities to know the efficacy of its supervisory processes, instruments and systems by holding frequent interactions with them. Thus, there is a process of mutual consultation in place. The supervised entities are monitored through various statutory returns prescribed by the Reserve Bank as also off site returns prescribed by NABARD under Section 27(2) of the BR Act, 1949.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(4): Legal powers</b> A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.</p>
<p><b>Description:</b> The NABARD exercises the powers of supervision over RRBs under Section 35 (6) of the BR Act, 1976. It has full access to banks' Board, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations. The Reserve Bank has powers under Section 35-A of the BR Act, 1949, to give directions to RRBs and impose sanctions. The licence issued to RRBs cannot be revoked as they are formed by notification by Government of India under Section 3(a) (1) of RRB Act, 1976.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(5): Legal protection</b> A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.</p>

<p><b>Description:</b> NABARD and its staff are protected against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. NABARD and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(6): Co-operation</b> Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>
<p><b>Description:</b> There are formal and informal arrangements in place between the Reserve Bank and NABARD for co-operation and information sharing pertaining to RRBs. The Reserve Bank and NABARD can provide to each other, with necessary safeguards, confidential information relating to RRBs. NABARD is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Comments:</b> At present, RRBs are not permitted to deal with foreign financial institutions. Hence, there is no question of co-operation and sharing of information with the foreign financial sector supervisors of banks.</p>
<p><b>Principle 2: Permissible activities</b> The permissible activities of institutions that are licensed and subject to supervision as banks must be defined and the use of the word "bank" in names should be controlled as far as possible.</p>
<p><b>Description:</b> The word "banking" has been clearly defined under Section 5(b) of the BR Act, 1949. The permissible activities of the institutions that are licensed and subject to supervision as banks are also clearly defined either by supervisors, or in laws or regulations. The use of the word "bank" and any derivations such as "banking" in a name is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled. The taking of deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks. The list of RRBs is kept current and updated.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 3: Licensing criteria</b> The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>

**Description:**

The ownership structure of RRBs are decided by the Government of India and provided for in the Regional Rural Banks Act, 1976 itself. The authorised capital of each RRB is Rs.5 crore, which can be increased or reduced by the Central Government. However, the issued capital shall in no case be less than Rs.25 lakh. The capital issued by an RRB is subscribed by the Central Government (50 per cent), concerned State Government (15 per cent) and sponsor bank (35 per cent). As per provision of Section 23 A(1) and Section 26 of the Regional Rural Banks Act, 1976, the Reserve Bank /NABARD does not have any power to reject the licence of RRB since the powers to close/amalgamate/merge the RRBs vest with the Government of India. Detailed guidelines have been issued to RRBs on risk- management systems which are to be put in place in the banks. The Boards of RRB are having adequate and strong knowledge of the various types of activities which the banks intend to pursue and the associated risks. NABARD has also recently prepared the draft Manual on internal checks and controls for RRBs. RRBs are not permitted to deal in cross-border banking.

**Assessment: Not Applicable**

**Comments:** For RRBs, the licensing authority is the Government of India as the RRBs are licensed banks ab-initio. However, RRBs have to apply to the Reserve Bank for licence for opening their branches. Looking to the size and nature of business operations handled by the RRBs, it has not been considered desirable to introduce integrated risk management measures at this juncture. Similarly, guidelines on detection and prevention of criminal activities and oversight of proposed outsourced functions are yet to be introduced for RRBs. These would be introduced in a phased manner.

**Principle: 4 Transfer of significant ownership**

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

**Description:**

Since the RRB Act, 1976 specifically prescribed the ownership structure and controlling interest there is no other separate law or regulation. In view of the extant provisions specified under the RRB Act, 1976, NABARD does not have any powers to reject any proposal for a change in significant ownership as of now. In view of the specification of ownership structure spelt out in the RRB Act, 1976, such a situation does not arise.

**Assessment: Not Applicable**

**Comments:** NABARD has no such powers in this regard as of now as the ownership structure of RRBs is decided by the Government of India, in consultation with the Reserve Bank and NABARD.

**Principle 5: Major acquisitions**

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

**Description:**

The areas of investments have been specified to the RRBs. The investments by RRBs are limited to SLR/Non-SLR holding and not in equities save a few all India Financial Institutions. Large non-SLR investments not permissible under current regulations. There are no cases of acquisitions by the RRBs, other than amalgamation approved by the Government of India, as of now. The RRBs are not permitted to enter into acquisitions and make investments in foreign subsidiaries including establishing foreign branches. Consolidated supervision has not been made applicable to RRBs.

**Assessment: Compliant****Principle 6: Capital adequacy**

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

**Description:**

Capital adequacy norms have not so far been made applicable to RRBs. The minimum capital requirement in absolute terms has also been spelt out in the RRB Act, 1976. However, the time-frame for introduction of Capital to Risk Weighted Assets Ratio (CRAR) to RRBs will be decided by the Regulator.

**Assessment: Non-Compliant****Comments:** Capital adequacy norms and providing of regulatory capital to various risks including market risk as per Basel norms have not been made applicable to RRBs at present.**Principle 7: Risk management process**

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

**Description:**

Detailed guidelines on risk management systems to be put in place have been issued to RRBs and there is a periodical review by the respective Boards. All the banks have been advised to prepare suitable risk management policies with the approval of their boards and implement the same. The boards are expected to identify, evaluate, monitor and control all material risks to which the banks are exposed to generally commensurate with the size and complexity of the institutions. It has been made obligatory for the RRBs to get their Board's approval before implementing

suitable risk-management measures. The RRBs are having risk management mechanism in rudimentary fashion. The banks are yet to put in place sophisticated risk management systems and risk mitigant measures.

The RRBs being small business entities, introduction of integrated risk management approach would require huge investments on computerisation for collection of necessary data. Hence, this is not being reviewed. At present, risk management aspects are being reviewed by the boards of RRBs in a routine manner based on the data placed before them on credit risk, liquidity risk, and interest rate risk areas.

NABARD, during the course of its on-site inspection of RRBs, examines in detail the risk management policies, processes and other aspects like documentation, *etc.*, in addition to the delegation of powers at various levels as obtaining in the supervisory entities. Wherever deviations are noticed, such instances are being brought to the notice of the RRBs concerned for initiating appropriate remedial measures. NABARD has an inbuilt system of holding wrap-up discussion on the concluding day of the on-site inspection wherein the various risks afflicting the bank are being brought to the notice of the Board of Directors and other senior management of the banks concerned.

**Assessment: Materially Non-Compliant**

**Comments:** The RRBs are yet to put in place sophisticated risk management systems and risk mitigant measures. The RRBs being small business entities, introduction of integrated risk management approach would require huge investments on computerisation for collection of necessary data. Hence, this is not being reviewed. No guidelines for stress testing as also for reputational and strategic risks issued by the supervisor. The concept of holding company and banking group not applicable to RRBs.

**Principle 8: Credit risk**

Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

**Description:**

Detailed guidelines for risk management measures have been issued to RRBs which covers all the essential aspects required for setting up of credit risk management measures in RRBs. It determines, and periodically confirms, that a bank's Board approves, and periodically reviews, the credit risk management strategy and significant policies and processes for assuming, identifying, measuring, controlling and reporting on credit risk. It also determines, and periodically confirms, that senior management implements the credit risk strategy approved by the Board



and develops the aforementioned policies and processes. The efficacy of these measures initiated by the banks concerned is being verified by NABARD during on-site inspection of these entities. The loans are sanctioned by RRBs after thorough appraisal and on the basis of the recommendations of the Credit/Loan Committee. NABARD scrutinises loan proposals during on-site inspections and brings out deficiencies/lapses in non-adherence to established appraisal norms by the Branch Managers/Loan Committee accordingly. NABARD has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.

**Assessment: Compliant**

**Principle 9: Problem assets, provisions and reserves**

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

**Description:**

Detailed guidelines have been issued to RRBs on income recognition, assets classification and provisioning which includes off-balance sheet exposures. These aspects are examined during the course of on-site inspections of RRBs and wherever deviations/shortcomings are observed, they are brought to the notice of the banks through their inspection reports for rectification and making adequate provisioning as per extant guidelines. NABARD has been issuing suitable model guidelines to RRBs for resorting to One-Time Settlement (OTS) scheme/write-off which are required to be fine-tuned by the banks concerned suiting their requirements and with the approval of their Boards.

Each RRB has a well set procedure for proper and periodical review of its recovery portfolio, NPAs and appropriate policies for recovery of their dues from problem assets. All banks have put in place suitable mechanism for review of bigger loan accounts and monitor them very closely wherever they are showing/have started showing signs of loan delinquencies. The information on NPAs is obtained from all the RRBs as at the close of each financial year (March 31) through off-site surveillance returns. Based on this information, NABARD does a bank-wise analysis and a memorandum is placed before the Board of Supervision, a Committee constituted by the Board of Directors of NABARD, to provide necessary policy guidelines on matters of supervisory nature.

The RRBs ensure that their loans are fully secured and have sufficient collaterals so that they do not pose any credit risk. However, wherever shortage in the value of collateral is noticed by the NABARD's inspection team during the course of on-site inspections, the banks concerned are advised suitably to ensure that their loans are fully secured with adequate value of collaterals.

The attention of the Boards of RRBs concerned is drawn whenever the banks' credit risks are enormous and showing serious signs of sickness so as to enable them to take timely and appropriate remedial measures to arrest this trend. Similarly, the major deviations in the assets classification and provisioning requirements are also being brought to the notice of the Board of Directors by way of Inspection Reports of NABARD, compliance on which has necessarily to be approved by the Board.

**Assessment: Compliant**

**Principle 10: Large exposure limits**

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

**Description:**

The loans granted to a company together with investments made in its shares by the RRBs should not exceed 15 per cent of owned funds (capital funds) of the RRBs concerned as per the extant the Reserve Bank's instructions. The RRBs exposure to group borrowers is very limited in view of the limited scope available in their areas of operation. Hence, the scope for financing to group borrowers (other than under Government sponsored programmes) gets limited. However, with the amalgamation of RRBs, their exposure limit gets enlarged because of increased in their capital funds and wider area of operation. NABARD confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.

The credit portfolio together with segment-wise distribution of credit purveyed by the RRBs is being reviewed by the boards of RRBs regularly. No data on sectoral exposures is being obtained by NABARD, excepting the consolidated position of total exposure through off-site surveillance returns. However, this is being reviewed at the time of on-site inspections with a broad-based approach to ascertain the sectoral and segment-wise credit disbursed by the banks. Further, RRBs have not been permitted to deal in lending involving foreign exchange, except by way of deposit accounts. Hence, they have not been allowed to take currency exposure risks.

**Assessment: Largely Compliant**

**Comments:** Since most of the lending by the RRBs are under the priority sector segment and in view of their limited exposure to various segments both under lending and investment as stipulated by the Reserve Bank, such information are not being called for by NABARD.

NABARD does not obtain information regularly that enables them to review the concentrations within a bank's portfolio, including sectoral and geographical exposures.

**Principle 11: Exposures to related parties**

In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

**Description:**

The Reserve Bank has power to define related parties. It is assessed during the course of inspection of RRBs that the exposure to related parties is not granted at favourable terms than corresponding exposures to unrelated parties.

**Assessment: Largely Compliant**

<p><b>Principle 12: Country and transfer risks</b></p> <p>Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.</p>
<p><b>Description:</b></p> <p>RRBs are not permitted to take country and transfer risks as they are not engaged in lending in foreign currency.</p>
<p><b>Assessment: Not applicable</b></p>
<p><b>Comments: –</b></p>
<p><b>Principle 13: Market risk</b></p> <p>Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.</p>
<p><b>Description:</b></p> <p>No guidelines for assessing market risk have been issued to the RRBs. The RRBs are in a nascent stage for adopting the integrated risk management systems. However, during the course of on-site inspection of RRBs, a broad analysis is made about the extent to which the banks are exposed to market risk on the basis of their investment portfolio. No market risk limits have been prescribed for RRBs and similarly the RRBs have also not framed any policy guidelines in this regard. Stress testing, validation, <i>etc.</i>, which are the pre-requisites of integrated risk management measures have not been made applicable to RRBs so far by the Reserve Bank. Besides, this requires advanced information technology arrangements in the RRBs which require huge capital cost. At present, the necessity for such an advanced approach of integrated risk management system is not considered necessary for RRBs in view of their low volume of operations.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> Since CRAR which is a pre-requisite for assessing the market risk, has not been introduced for RRBs, no guidelines on market risk has been issued and made applicable to them. Applicability of capital adequacy norms is a pre-requisite before introducing integrated risk management measures to RRBs.</p>
<p><b>Principle 14: Liquidity risk</b></p> <p>Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>
<p><b>Description:</b></p> <p>RRBs do follow a methodology for assessing their liquidity position, though not on ALM basis, on a regular basis by covering both on and off-balance sheet items. NABARD has been examining these aspects during the course of on-site inspection more critically. Asset Liability Management (ALM) has since been introduced in 12 RRBs with effect from 1 April 2007. Although no supervisory guidelines on preparation of contingency plans for handling liquidity problems has been issued, RRBs on their own do take care of this unforeseen eventuality by their own internal measures.</p>

NABARD determines that a bank's senior management has defined (or established) appropriate policies and processes to monitor, control and limit liquidity risk; implements effectively such policies and processes; and understands the nature and level of liquidity risk being taken by the bank. All the RRBs have put in place policies, procedures and systems in this regard. At present, the risk management systems followed by the RRBs are on traditional lines and not on advanced approach basis, like adopting stress testing, *etc.* However, all the RRBs do necessarily measure, analyse and monitor the various risks to which they are exposed to and take appropriate steps to mitigate such risks. As indicated earlier, broad guidelines were already issued by the supervisor for putting in place suitable risk management systems in RRBs.

**Assessment: Materially Non-Compliant**

**Comments:** ALM has since been introduced in 12 RRBs with effect from 1st April 2007. Nevertheless, all the RRBs have put in place suitable systems for assessing their liquidity position covering both on and off-balance sheet items. Although no supervisory guidelines on preparation of contingency plans for handling liquidity problems has been issued, RRBs on their own do take care of this unforeseen eventuality by their own internal measures.

Advanced risk management measures and stress testing may not be necessary at this juncture. No detailed guidelines in regard to contingency plans for ensuring liquidity management have been issued to RRBs.

**Principle 15: Operational risk**

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

**Description:**

Broad guidelines on all types of risks including operational risk have been issued to RRBs. They have been advised to suitably modify these guidelines based on the size and complexity of the banks' operations and put in place suitable systems for mitigation of such risks. RRBs have been advised to get their risk management systems policies and procedures prepared and get them approved by the respective boards. It has also been suggested to the boards of supervised banks to ensure that these policies and processes are implemented effectively. NABARD is satisfied that the approved strategy and significant policies and processes for operational risk are implemented effectively by management. This is being examined during the course of on-site inspection more critically. Information Technology is in various stages in RRBs. However, only a few RRBs have fully computerised their entire operations whereas most of the banks had computerised their banking and accounting aspects.

**Assessment: Materially Non-Compliant**

**Comments:** RRBs on their own have gone in for computerisation of their banking operations, of course with the guidance of their sponsor banks, only with a view to providing better and efficient

banking services and products to their clientele and to tackle the stiff competition of private technology-driven banks entering into rural arena. No specific guidelines on information technology have been issued so far in view of their limited size and volume of business operations. Since the level and type of information technology requirement is bank-specific, it is desirable that IT policy may be better left to the RRBs concerned as the present boards are quite conscious of the needs of making available technological-driven banking services and products to their clientele.

**Principle 16: Interest rate risk in the banking book**

Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

**Description:**

No guidelines have been issued on interest rate risk in banking book.

**Assessment: Non-Compliant**

**Comments: –**

**Principle 17: Internal control and audit**

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

**Description:** The existing RRB Act, 1976 clearly provides for duties and responsibilities of the Board, top management, *etc.*, which are being scrupulously followed by the RRBs. Though, the general principles of corporate governance are also in vogue, in the strictest sense of the term it has not so far been made applicable to RRBs as the board members are generally nominated directors and not independent directors and they have not been made accountable for all the omissions and commissions. NABARD had already issued guidelines on various aspects of internal checks and control systems in RRBs. The Task Force on empowering RRB boards for operational efficiency constituted by the Reserve Bank had also emphasised the need for toning up the internal control and check systems in RRBs.

The risk perception and risk assessment and analysis at the level of RRBs are in incipient stage. There has not been any occasion to change the composition of the Board so far in any of the RRBs. NABARD has issued detailed guidelines to all the RRBs to segregate the front office and back office functions. However, wherever deviations are noticed in the extant guidelines on investment issued by the Reserve Bank /NABARD including the segregation of functions, such cases are being taken up with the banks concerned for appropriate remedial measures.

NABARD has issued guidelines on compliance function in RRBs which stipulate creation of compliance function cell and compliance officer. The compliance on NABARD's inspection report must be placed before the board for approval before being sent to NABARD by the banks concerned. This system ensures the oversight of the Board of the management of the compliance function.

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<p>All the RRBs are having their internal, independent and permanent audit and inspection wings to take care of all the aspects relating to internal control. The audit staff is having full access to and communication with any member of staff as also full access to records, files, data, <i>etc.</i>, of the bank. However, this audit and inspection function has not been outsourced so far by any of the RRBs, except conduct of statutory audit by the Chartered Accountants.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> The Reserve Bank /NABARD does not have powers to bring about changes in composition of board and senior management of RRBs to address any prudential concerns. Corporate governance in strictest sense of term has not so far been made applicable to RRBs.</p> <p>NABARD does not determine that there is an appropriate balance in skills and resources of the back office and control functions relative to the front office/business origination.</p> <p>Uniform internal checks and control system manual for all RRBs has not been introduced.</p>
<p><b>Principle 18: Abuse of Financial Services</b></p> <p>Supervisors must be satisfied that banks have adequate policies and processes in place, including strict 'know your customer' (KYC) rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.</p>
<p><b>Description:</b></p> <p>Though, NABARD has been conducting the statutory inspections of RRBs under Section 35(6) of the BR Act, 1949, the necessary enforcement powers vest with the Reserve Bank /GoI. NABARD had prepared and supplied the compendium on prevention of frauds in RRBs wherein measures required to be taken by the banks for prevention of frauds/ embezzlements/ misappropriations, <i>etc.</i>, are detailed. However, as regards criminal activities in the banks, no specific guidelines are issued to RRBs.</p> <p>As per the KYC guidelines, the RRBs have been advised to follow the due procedure. As the clientele of RRBs mainly comprise those under relaxed KYC norms, rigorous supervision may not be necessary. Presently, they are only having Cash Transactions Report (CTR) and Suspicious Transactions Report (STR) to be sent to Financial Intelligence Units as advised by the Reserve Bank. So far NABARD has not prescribed any 'due diligence' guidelines for adoption by the RRBs. All regulatory powers vest with the Reserve Bank and NABARD does not have any regulatory powers to initiate action against RRBs. The system to designate compliance officer has been introduced in RRBs, as in the case of commercial banks. NABARD does not have any authority for addressing criminal activities.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>



**Comments:** The RRBs are implementing KYC norms as applicable to their rural clients. They do not have an advanced approach like customer acceptance policy, a customer identification, verification and due diligence programme; policies and processes to monitor and recognise unusual or potentially suspicious transactions; particularly of high risk accounts; escalation to senior management level of decisions on entering into business relationship with high risk accounts, such as those for politically exposed persons or maintaining such relationships when an existing relationship becomes high risk; and clear rules on what records must be kept on consumer identification and individual transactions and their retention period, which would be put in place once their operations grow in size (area) and volume. Due diligence policies and processes regarding correspondent banking are yet to be put in place since the correspondent banking is in nascent stage in RRBs.

The RRBs are yet to take due precautions to put in place for preventing, identifying and reporting of potential abuse of financial services including money-laundering. But for reporting cash transactions to FIU, no other measures have been adopted by the RRBs.

NABARD does not determine that RRBs have clear policies and processes for staff to report any problems related to abuse of banks' financial services to either local management or relevant dedicated officer or to the both. There are no laws and regulations which ensure that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to relevant authority cannot be held liable.

#### **Principle 19: Supervisory Approach**

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

#### **Description:**

At present, NABARD's supervisory assessment is on the CAMELSC pattern (Capital Adequacy, Asset Quality, Management Efficiency, Earnings, Liquidity, Systems and Procedures and Compliance) on the basis of which on-site inspections of RRBs are being conducted. The main focus of NABARD's supervisory role by way of on-site inspection is to ensure safety and security of present and future depositors' interests, to ensure that the business conducted by the RRBs is in conformity with the provisions of the relevant acts, rules and regulations, ensure observance of rules, regulations, guidelines, *etc.*, issued by NABARD/ the Reserve Bank /Government and examine the financial, operational and managerial soundness of RRBs. The present supervisory approach adopted takes adequate care of the risk profile of RRBs which are primarily involved in priority sector segment. NABARD takes adequate care of the risk profiles of RRBs and furnishing reports to the Reserve Bank from time to time on the affairs of RRBs for initiating appropriate measures.

The RRBs are adopting prudential regulations and other legal requirements as may be advised by the Reserve Bank from time to time. Broader guidelines with regard to the types of business to be handled, clientele to be served, areas of business operations as also business diversification/ avenues of RRBs are being finalised by the Reserve Bank after due consultation with them and their sponsor banks.

**Assessment: Largely Compliant**

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**Comments:** The present supervisory approach adopted takes adequate care of the risk profile of RRBs which are primarily involved in priority sector segment. As and when their operations grow in volume and size, further refinement in the risk management policies will be thought of. The RRBs cannot on their own take up any new business activity.

**Principle 20: Supervisory Techniques**

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

**Description:**

As a part of its supervisory techniques, NABARD has been following both on-site inspections and off-site surveillance system. On the concluding day of on-site inspection, a wrap-up discussion is held with the Board of Directors where the major findings of inspection are being brought to the notice of the top management for immediate intervention. Besides, NABARD has also a system of discussing the core issues on the findings of on-site inspection with the CEO of the bank subsequent to the receipt of core compliance report which the supervised entity is expected to submit within 45 days from the date of issue of NABARD's inspection report. Thus, there has been regular interaction with the bank management. Under off-site surveillance system information by way of periodical returns are being called for from the RRBs and analysed at NABARD's Regional Offices. Wherever considered necessary, suitable warning signals are issued to the concerned RRBs by these Regional Offices. NABARD communicates to the bank the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.

**Assessment: Largely Compliant**

**Comments:** The existing on-site and off-site surveillance systems adopted by the NABARD are being constantly upgraded so as to ensure greater amount of quality assessment, effectiveness and integration so that the weaknesses noticed in the working of RRBs are addressed forthwith and expeditiously.

There is need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.

**Principle 21: Supervisory Reporting**

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

**Description:**

NABARD has a system of collecting various data by way of statistical and other returns prescribed in consultation with the Reserve Bank from time to time from the RRBs and periodical reviews are undertaken both on solo and a consolidated basis, even sponsor bank-wise as well. The efficacy of the information furnished by the RRBs is also being verified during the on-site inspections. Various control returns are prescribed by NABARD and the Reserve Bank to know the size, activities and risk profile of RRBs which are considered to be quite exhaustive and adequate.

Information Technology has been getting the due focus in RRBs only very recently. As such, the data are being compiled manually and sent to NABARD by the RRBs. However, in the post-amalgamation scenario of RRBs, the information technology is getting momentum and networking will be taking place in due course. During the course of on-site inspection, NABARD reviews the Management Information System (MIS) obtaining in the RRBs and suggestions/ comments are made for integration of returns, *etc.*, with a view to making them more user-friendly and cost-effective.

NABARD has the full access to all RRBs' records, bank's Board, management and staff during the discharge of supervisory responsibilities. This system has been enforced in respect of off-site surveillance system returns where the RRBs have nominated one senior officer who will be responsible for correctness and accuracy of information furnished to NABARD.

**Assessment: Largely Compliant**

**Comments:** At present, obtaining of data and validation are done manually while analysing of data is done through computer. The system is working well. However, NABARD would be focusing to get the same on on-line in due course.

**Principle 22: Accounting and disclosure**

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

**Description:**

NABARD has powers to take recourse to the provisions of the Banking Regulation Act, 1949 for initiating action against the RRBs which furnish wrong/incorrect information. The RRBs do follow the accounting principles and norms for appropriation of profits after making appropriate provisions as per the guidelines issued by the Reserve Bank. All the financial statements published by the RRBs are getting verified and certified by the Chartered Accountants who perform the duties of the statutory auditors. Similarly, the Reserve Bank has been prescribing the types of financial statements together with schedules for adoption by the RRBs in consultation with the ICAI. The Reserve Bank has been ensuring proper accounting procedures to be followed by the RRBs in accordance with the ICAI standards. Formats of balance sheets, profit and loss accounts together with the auditors' reports are prescribed by the Reserve Bank in consultation with ICAI to RRBs. These guidelines are being scrupulously followed by the RRBs.

NABARD has been prescribing the audit norms for statutory auditors auditing the RRBs in consultation with the Reserve Bank and Government of India. The auditing practices and standards are prescribed by NABARD in consultation with the Reserve Bank and Government of India which are on par with the ICAI standards.

## Chapter III

### Assessment of Adherence to Basel Core Principles

RRBs had been granted exemption, till March 31, 2008 from the provisions of Section 31 of the BR Act, 1949 relating to publication of their balance sheets, profit and loss accounts together with the auditors' reports. Further, RRBs have been advised to display the B/S and P&L in all their branches. NABARD publishes the major financial indicators based on audited figures on a yearly basis. This facilitates NABARD to undertake an in-depth analysis on the performance of individual RRB vis-à-vis the peer group and RRBs in the country as a whole.

**Assessment: Largely Compliant**

**Comments:** Exemption has further been granted till March 31, 2008. Further, RRBs have been advised to display the Balance Sheet and Profit & Loss Account in all their branches.

#### **Principle 23: Corrective and remedial powers of supervisors**

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

#### **Description:**

During the course of on-site inspections, officers of NABARD are able to access the Long Form Audit Reports (LFAR) of the auditors and make use of the same while firming up their observations. NABARD is having various instruments, processes and systems to bring about various corrections timely in respect of RRBs failing to come up to the expected levels of operational and financial efficiencies.

**Assessment: Largely Compliant**

**Comments:** –

#### **Principle 24: Consolidated supervision**

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

#### **Description:**

The concept of consolidated supervision has not so far been made applicable to the RRBs.

**Assessment: Not Applicable**

**Comments:** The concept of consolidated supervision has not so far been made applicable to the RRBs.

**Principle 25: Home-host relationships**

Cross-border consolidated supervision requires co-operation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

**Description:**

RRBs cannot have global presence. Hence, this does not apply.

**Assessment: Not Applicable**

**Comments:** RRBs cannot have global presence. Hence, this does not apply.

## Appendix 8

Detailed Assessment (Principle-by-Principle)–Non-Banking Financial Companies<sup>12</sup>**Principle 1: Objectives, independence, powers, transparency and co-operation**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 1(1): Responsibilities and objectives**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

**Description :**

The Reserve Bank ("Reserve Bank"), is an autonomous body created under an Act of the Indian Parliament i.e. The RBI Act, 1934 and is responsible for regulation and supervision of NBFCs. This Act lays down the laws relating to regulation and supervision of NBFCs. The responsibilities and the objectives of the Reserve Bank are clearly delineated in the aforesaid Acts. Laws and regulations are in place that provide framework of minimum prudential standards which NBFCs are required to meet. The Reserve Bank Act has been amended in 1997 by consolidating and collating the provisions of Chapters IIIB, IIIC and V of RBI Act insofar as they relate to NBFCs and unincorporated bodies.

The detailed information on financial strength and performance of the industry is available publicly through various Reserve Bank publications like Annual Report, fortnightly statements, Report on Currency and Finance, *etc.* However, no periodic and exclusive updates are made available on website / publication *etc.* The Reserve Bank monitors NBFCs through both on-site inspections and off-site surveillance.

**Assessment: Compliant****Principle 1(2): Independence, accountability and transparency**

Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.

<sup>12</sup> The assessment is in respect of NBFC-D and NBFC-ND-SI



<p><b>Description :</b></p> <p>The RBI Act provides the basis for its independence, accountability and governance structure. The Reserve Bank is solely responsible for the regulation and supervision of NBFCs and it derives its powers and mandates from the RBI Act, 1934. Various provisions of the RBI Act, 1934 provide for operational independence to the Reserve Bank on matters relating to supervision of NBFCs. An Annual Report on the working of the Reserve Bank with detailed analysis of its annual accounts and an assessment of Indian economy is also submitted to the Central Government under Section 53(2) of the RBI Act, 1934. The Reserve Bank and its staff have clearly established their credibility on the basis of their professionalism and integrity. The Reserve Bank is financed by its own budget and does not receive any financial support from any entity, including the Central Government. The Reserve Bank equips its officers with latest techniques of supervision through ongoing training programmes organised at its own staff colleges. The Governor of the Reserve Bank is appointed by the Central Government for a term not exceeding five years and is eligible for reappointment.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> The reasons for removal of head of supervisory agency during his term are not specified in law.</p>
<p><b>Principle 1(3): Legal framework</b></p> <p>A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.</p>
<p><b>Description:</b></p> <p>The Reserve Bank is vested with the powers to issue licence to a NBFC for commencing and carrying on the business of non-banking financial institution (Section 45IA of the RBI Act, 1934). It is also vested with powers to issue directions/ guidelines on any aspect of non-banking business vide Section 45K, 45L, 45JA of the RBI Act, 1934. Further, it is also empowered under Section 45K and 45L of the RBI Act, 1934 to call for any information from non-banking financial companies in the form and frequency it deems necessary.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(4): Legal powers</b></p> <p>A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.</p>
<p><b>Description:</b></p> <p>The Reserve Bank is vested with powers under RBI Act to address any issue relating to compliance with laws as also safety and soundness of the NBFCs under its supervision. It also has access to all the records of a NBFC. The Reserve Bank has powers to issue directions to NBFCs in general or in particular under section 45K and 45JA of the RBI Act, 1934 in the public interest; or to prevent the affairs of any NBFC being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the NBFC; or to secure the proper management of any NBFC generally. It is thus empowered to take remedial actions and/or impose a range of sanctions as warranted by the situation. Further Section 45IA of RBI Act, 1934 empowers Reserve Bank to cancel licence granted to a NBFC under certain conditions.</p>
<p><b>Assessment: Compliant</b></p>

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**Principle 1(5): Legal protection**

A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.

**Description:**

Section 58A of RBI Act, 1934 provides for explicit protection to the supervisors. No suit or other legal proceeding shall lie against Reserve Bank or any of its officers for anything or any damage caused or likely to be caused by anything done in good faith or intended to be done in pursuance of the Banking Regulation Act. The cost of legal action arising out of the discharge of official duties is met by Reserve Bank.

**Assessment: Compliant**

**Principle 1(6): Co-operation**

Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Description:**

Information sharing between various entities involved with responsibility of soundness of financial system is in place. The Reserve Bank shares information with overseas supervisors based on reciprocity and with clear understanding that the information will remain confidential and will be used for the purpose for which it is sought. However there are no formal Memoranda of Understanding (MoU) with foreign supervisory agencies, since the law does not empower the Reserve Bank to enter into formal MoUs. The information that the Reserve Bank receives from other supervisors is invariably used only for supervisory purposes and the information received is treated as confidential though this is not required due to any provision of law.

**Assessment: Compliant**

**Principle 2: Permissible activities**

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

**Description:**

The term "Non-Banking Financial Company" (NBFC) is clearly defined in Section 45I(f) of the RBI Act, 1934. The definition is generic in nature qualified by the principal business definition which states that a company will be treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets should be more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company. The permissible activities of institutions that are licensed and subject to supervision as NBFCs are clearly defined in Section 45I of RBI Act. The principal business definition states what a Non-Banking Financial Institution (NBFI) is

but it does not limit the activities permitted. An NBFI can do any activity which is defined in its Memorandum of Association. The Reserve Bank publishes, and keeps current, a list of licensed NBFCs operating within its jurisdiction.

**Assessment: Largely Compliant**

**Comments:** The definition NBFC is generic in nature qualified by the principal business definition which states that a company will be treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets should be more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company. Principal business definition states what an NBFI is but does not limit the activities permitted. An NBFI can do any activity which is defined in its Memorandum of Association.

**Principle 3: Licensing criteria**

The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

**Description:**

The Reserve Bank is the licensing<sup>13</sup> authority for NBFCs. It has the power to set criteria for granting Certificate of Registration of NBFCs. Reserve Bank has powers to cancel certificate of registration if it is obtained based on false information provided by NBFC. The powers pertaining to requirement of registration and net owned fund are drawn in terms of Section 45-IA of RBI Act, 1934. The NBFC has to fulfill certain conditions for obtaining CoR from the Bank. These conditions are position of the NBFC to pay its present or future depositors in full as and when their claims accrue; that the affairs of the non-banking financial company are not being or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors; that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the public interest or the interests of its depositors; that the non-banking financial company has adequate capital structure and earning prospects; that the public interest shall be served by the grant of certificate of registration to the non-banking financial company to commence or to carry on the business in India; that the grant of certificate of registration shall not be prejudicial to the operation and consolidation of the financial sector consistent with monetary stability and economic growth considering such other relevant factors which the Bank may, by notification in the Official Gazette, specify. It determines that the proposed legal, managerial, operational and ownership structures of the NBFC and its wider group will not hinder effective supervision on both a solo and a consolidated basis. In the case of NBFC and its group, the activities are varied and may be non-financial in nature; hence the supervision on a consolidated basis is not feasible under the current statute.

The Reserve Bank has stipulated a minimum initial capital amount for all NBFCs. The Reserve Bank identifies and determines the suitability of major shareholders of NBFC, including the

<sup>13</sup> Licensing is interpreted to mean granting Certificate of Registration

ultimate beneficial owners, and others that may exert significant influence. However, the suitability of major shareholders is not subjected to detailed scrutiny and the due diligence exercise is done in respect of directors only. The senior management is not considered for such due diligence. The due diligence on directors is undertaken at the time of grant of Certificate of Registration/ change in management to ensure that the Board, collectively, must have a sound knowledge of each of the types of activities the NBFC intends to pursue and the associated risks. The Board, collectively, must have a sound knowledge of the activities the NBFC intends to pursue and the associated risks.

The Reserve Bank does not carry out a detailed review of strategic and operating plan, internal control, risk management *etc.*, at the time of approval of Certificate of Registration. The Reserve Bank reviews pro forma financial statements and projections for the proposed NBFC. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the NBFC.

There is no formal arrangement in place for obtaining No Objection Certificate by the Reserve Bank from the home supervisor in the case of foreign NBFCs. However, a reference is made to the home regulator and its views are obtained before issue of certificate of Registration. Further, the Reserve Bank has not worked out any arrangements to ascertain whether the home supervisor practices global consolidated supervision.

#### **Assessment: Largely Compliant**

**Comments:** In the case of NBFC and its group, the activities are varied and may be non-financial in nature. The supervision on a consolidated basis is not feasible under the current statute.

The suitability of major shareholders is not subjected to a detailed scrutiny. Only the due diligence exercise is done in respect of directors. The fit and proper test is carried out for directors only. The senior management is not considered for such due diligence.

The companies are required to submit business plan at the time of obtention of CoR. The detailed review of strategic and operating plan, internal control, risk management *etc.*, is not taken into consideration at the time of approval of Certificate of Registration.

In the case of foreign NBFCs establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection from the home supervisor has been received. No such formal arrangements/ agreements have so far been worked out with other regulators outside the country.

#### **Principle: 4 Transfer of significant ownership**

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

**Description :**

While substantial interest has been defined in prudential norms, there are no guidelines in place that define significant ownership or controlling interest in NBFCs. The NBFCs are companies under Section 3 of Companies Act, 1956 and may be listed on stock exchange. The shares of listed NBFC may be traded and the Reserve Bank has not devised any guidelines for change in controlling interest or ownership or exercise of voting rights. There are no requirements to obtain approval from the Reserve Bank or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest. The NBFCs have been directed to give one month's prior public notice of the intention of sale or transfer of the ownership by sale of shares or transfer of control whether with or without sale of shares in one leading national and another leading local vernacular newspaper. A no objection from each of the depositors has to be taken in respect of their willingness to continue with their deposits under a new management.

The Reserve Bank obtains details of the substantial interest of promoters, chairman, managing directors and CEO as part of the Certificate of Registration application form. However, it does not obtain from NBFCs, through periodic reporting or on-site inspection, the names and holdings of all significant shareholders or those that exert controlling influence.

**Assessment: Non-Compliant**

**Comments:** The Reserve Bank has no power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing NBFCs by other parties.

**Principle 5: Major acquisitions**

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

**Description:**

Investments by NBFCs are governed by Prudential Norms Directions, 2007. However, the Reserve Bank has no power to review major acquisitions by an NBFC, against any prescribed criteria. Establishment of cross-border operations, and corporate affiliations or structures which could expose the NBFC to undue risks or hinder effective supervision is also not reviewed.

The Reserve Bank is aware of the risks that non-banking activities can pose to a banking group and has the means to take action to mitigate those risks. It takes necessary preventive steps within the ambit of the RBI Act, 1934 to mitigate the risks that non-banking activities may pose to a banking group.

**Assessment: Non-Compliant**

**Comments:** NBFCs do not have cross border operations. However, many foreign companies have set up NBFCs in India. Investments by NBFCs are governed by Prudential Norms Directions, 2007. No specific instructions have been issued by the Reserve Bank as regards major acquisition or investments by an NBFC.

A definition of substantial interest has been given in prudential guidelines. Establishment of cross-border operations and corporate affiliation or structures which could expose the NBFC to undue risks or hinder effective supervision is also not reviewed.

**Principle 6: Capital adequacy**

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

**Description :**

NBFC-D and NBFC-ND-SI have risk based capital requirements which are higher than those prescribed for the banks. Both on-balance sheet and off-balance sheet risks are included as part of capital adequacy ratio<sup>14</sup>. The Reserve Bank has the power to impose a specific capital charge and/or limits on all material risk exposures. The required capital ratio<sup>1</sup> reflects the risk profile of such individual NBFCs. The laws or regulations clearly give the Reserve Bank power to take measures should such an NBFC's CRAR fall below the minimum capital ratio<sup>1</sup>.

**Assessment: Compliant**

**Comments: –**

**Principle 7: Risk management process**

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

**Description:**

Though, the Reserve Bank has issued segmented risk management guidelines they do not specifically stipulate that individual NBFCs should have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. It has power to require NBFCs to strengthen their risk management process but the same cannot be prescribed for all group entities. The Reserve Bank has advised NBFCs to form an Audit Committee of Board, to monitor Asset Liability Management (ALM), structural and dynamic liquidity. The Board of the NBFC decides on the ALM and the monitoring is done at the Board level.

The Reserve Bank determines whether senior management ensures that the risk management policies and processes are appropriate in the light of the NBFC's risk profile. The Reserve Bank has prescribed CRAR for Non-Banking Financial Company – Deposit Taking (NBFC-D) and (Non-Banking Financial Company – Non Deposit Taking – Systemically Important (NBFC-ND-SI). However, the nature and specific methodology is not related to size, complexity and business strategy. NBFC do not have option of qualitative approach to capital planning.

<sup>14</sup> CRAR captures credit risk only



NBFCs (engaged in and classified as equipment leasing, hire purchase finance, loan, investment and residuary non-banking companies) meeting the criteria of asset base of Rs.100 crore (whether accepting / holding public deposits or not) or holding public deposits of Rs. 20 crore or more (irrespective of their asset size) as per their audited balance sheet as of 31 March 2001 are required to put in place the ALM System. The systems in place are also verified during the course of inspection.

The Reserve Bank determines that NBFCs have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board. The NBFCs have been advised as part of corporate governance to constitute Risk Management Committee (RMC) which is a Board Committee to oversee the risk aspects of its business along with Asset Liability Committee (ALCO). Instructions on major integrated risk management initiatives have not been issued.

The Reserve Bank has in place a system of half yearly reporting of ALM returns and the returns comprise of three parts i.e. Statement of structural liquidity in format ALM –Annexure I, Statement of short-term dynamic liquidity in format ALM – Annexure II and Statement of Interest Rate Sensitivity in format ALM – Annexure III which are obtained from NBFCs. As regards NBFCs, the credit risk mitigation is through exposure norms, concentration mix / appraisal system. The liquidity and interest risk are taken care through ALM. The issue of operational risk and market risk are required to be addressed per se in details.

**Assessment: Materially Non-Compliant (Largely Compliant for Deposit taking NBFCs)**

**Comments:** The Reserve Bank has not prescribed any risk management guidelines for group entities. Comprehensive risk management guidelines have not been prescribed to NBFCs till date. Instructions on major integrated risk management initiatives have not been issued. The issue of operational risk and market risk are required to be addressed per se in details.

**Principle 8: Credit risk**

Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

**Description :**

The NBFC's Board is required to approve a loan and credit policy. During the course of inspection of NBFCs, it is confirmed that NBFC has a well documented credit policy and it is confirmed that senior management implements the credit risk strategy approved by the Board and develops the policies and processes for assuming, identifying, measuring, controlling and reporting on credit risk. Powers are delegated in this regard by the Board.

The Reserve Bank requires, and periodically confirms, that NBFCs make credit decisions free of conflicts of interest and on an arm's length basis. During the course of on-site supervision of NBFCs, it is confirmed that there is no excess investments by NBFCs in shares, securities and debentures of subsidiaries and companies belonging to the same group and other NBFCs. It is also verified that there are no loans and advances and other credit exposures to subsidiaries and companies belonging to the same group and entities in which the company's directors or major shareholders hold substantial interest. The particulars of such advances are required to be

furnished by the company in its half yearly return. However the bank does not have access to NBFC officer though interaction takes place with Managing Directors / Directors.

**Assessment: Largely Compliant**

**Comments:** A large segment of NBFC's sector constituted non-deposit taking NBFCs which are not subject to inspections hence they are not compliant in respect of credit risk. The bank does not have access to NBFC officer though interactions take place with Managing Directors/ Directors.

**Principle 9: Problem assets, provisions and reserves**

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

**Description:**

The Reserve Bank has issued guidelines on asset classification and provisioning norms to NBFCs and it confirms the implementation of the same during the course of inspection of NBFCs. The Prudential Norms applicable to NBFCs provide for valuation, classification and provisioning for large exposures on an individual item basis. The statutory auditors of NBFCs also look into adherence of the aforesaid instructions. Though, the system for classification and provisioning is applicable to contingent credit exposures, other off-balance sheet exposures like derivatives, financial structured instruments *etc.*, are not provided for.

The Reserve Bank obtains information on asset classification and provisioning on periodic basis from NBFCs. It has the power to require an NBFC to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern or if it is found during the course of inspection or from analysis of balance sheet or from report submitted by the Statutory Auditors that the level of problem assets is of concern.

The Reserve Bank has prescribed prudential norms which includes instructions about NBFCs to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. Valuation of collateral is done only on yearly interval for deposit taking NBFCs.

The Reserve Bank determines that the Board receives timely and appropriate information on the condition of the NBFC's asset portfolio, including classification of credits, the level of provisioning and major problem assets.

**Assessment: Largely Compliant**

**Comments:** Though, the system for classification and provisioning is applicable to contingent credit exposures, other off-balance sheet exposures like derivatives, financial structured instruments *etc.*, are not provided for.

**Principle 10: Large exposure limits**

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparty or groups of connected counterparties.

**Description:**

The Reserve Bank has set prudent limits on large exposures to a single counterparty or a group of connected counterparties which includes on-balance sheet as well as off-balance sheet items. It also confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.

The Reserve Bank determines that an NBFC's Management Information Systems identify and aggregate on a timely basis exposure to individual counterparty and groups of connected counterparties. The Reserve Bank has not issued any guidelines which require that all material concentrations be reviewed and reported periodically by NBFCs to the Board. However, the NBFCs are required to devise its own benchmarks in this regard.

The Reserve Bank regularly obtains information on sectoral and capital market exposure. It has the power to require NBFCs to take remedial actions in cases where concentrations appear to present significant risks.

**Assessment: Largely Compliant**

**Comments:** The Reserve Bank has not issued any instructions to NBFCs as regards review and reporting of material concentration to the Board and NBFCs are required to devise their own benchmarks in this regard. The Reserve Bank has not issued any instructions as regards review and reporting of material concentration to the Board. Sectoral, geographical and currency exposures of the NBFCs are not monitored.

**Principle 11: Exposures to related parties**

In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

**Description:**

The Reserve Bank so far has not addressed the issue. However the issue is dealt under Section 295 of the Companies Act, 1956.

**Assessment: Non-Compliant**

**Comments:** The Reserve Bank so far has not addressed the issue. However the issue is dealt under Section 295 of the Companies Act, 1956.

**Principle 12: Country and transfer risks**

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

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<p><b>Description:</b> Most of the NBFCs are small size domestic NBFCs with no international presence. As such criterion is not applicable.</p>
<p><b>Assessment: Not Applicable</b></p>
<p><b>Comments:</b> Most of the NBFCs are small size domestic NBFCs with no international presence. As such criterion is not applicable.</p>
<p><b>Principle 13: Market risk</b> Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.</p>
<p><b>Description:</b> The supervisor has not issued any guidelines for assessment of market risk. However, the NBFCs have been advised to follow the guidelines laid down in accounting standards by the Institute of Chartered accountants of India as regards long-term investments.</p>
<p><b>Assessment: Non-Compliant</b></p>
<p><b>Comments:</b> The supervisor has not issued any guidelines for assessment of market risk. The Reserve Bank may consider feasibility of implementing guidelines on market risk on lines of commercial banks to deposit taking NBFCs (having deposits above Rs.20 crore) and NBFCs-ND-SI. A phased and calibrated implementation of capital charge for market risk in respect of these entities may be considered. However, NBFCs not having any outstanding borrowing by way of deposits or by any other form of borrowing including preference shares could be considered to be exempted from these guidelines.</p>
<p><b>Principle 14: Liquidity risk</b> Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>
<p><b>Description:</b> The Reserve Bank has prescribed the ALM guidelines applicable to a certain class of NBFCs<sup>15</sup> which includes constitution of ALCO and measuring the future cash flows of NBFCs in different time buckets. Further, the Reserve Bank obtains ALM statements through off-site returns from those NBFCs to whom ALM guidelines are applicable. During the course of inspection of such NBFCs, the Reserve Bank confirms that they have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board.</p>

<sup>15</sup> NBFCs with deposits of Rs.20 crore or asset size of Rs.100 crore irrespective of whether they accept/hold deposits.

<b>Assessment: Materially Non-Compliant</b>
<b>Comments:</b> The Bank has prescribed the ALM guidelines applicable to NBFCs-D. The prudential norms for NBFCs particularly relating to ALM and liquidity risk management need to be strengthened, albeit, in a non-disruptive manner.
<b>Principle 15: Operational risk</b> Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.
<b>Description :</b> The Reserve Bank has not issued any instructions as regards management of operational risk to NBFCs.
<b>Assessment: Non-Compliant</b>
<b>Comments:</b> The Reserve Bank has not issued any instructions as regards operational risk to NBFCs.
<b>Principle 16: Interest rate risk in the banking book</b> Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
<b>Description:</b> The Reserve Bank does not distinguish between banking book and trading book. No guidelines regarding management of interest rate risk in banking book have been issued. Available for sale category has not been defined in case of NBFCs.
<b>Assessment: Non-Compliant</b>
<b>Comments:</b> There is no bifurcation into trading book and banking book in case of NBFCs.
<b>Principle 17: Internal control and audit</b> Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
<b>Description:</b> The Reserve Bank has made applicable the corporate governance guidelines to a certain class of NBFCs <sup>16</sup> . Further, listed NBFC are required to comply with the Clause 49 of the listing agreement which lays down the principles of corporate governance. However, the Reserve Bank has not addressed the issue of connected lending at present.  The Reserve Bank determines that NBFCs have in place internal controls that are adequate for the nature and scale of their business which are the responsibility of the Board and/or senior management. Internal control is one of the areas which is looked into by the Reserve Bank during the course of inspection.

<sup>16</sup> NBFCs with deposits of Rs.20 crore or asset size of Rs.100 crore

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No instructions have been issued to the effect that the Reserve Bank determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

The Reserve Bank determines that NBFCs have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the NBFC. However, the Reserve Bank has not issued any instructions for compliance review by the senior management on regular basis.

The Reserve Bank determines that NBFCs have an independent, permanent and effective internal audit function charged with (i) ensuring that policies and processes are complied with and (ii) reviewing whether the existing policies, processes and controls remain sufficient and appropriate for the NBFC's business. The NBFCs are required to have an Audit Sub Committee to ensure compliance as regards internal audit and control.

The Reserve Bank determines that the internal audit function has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing. It also determines that internal audit function has appropriate independence, including reporting lines to the Board. It also determines that it has full access to and communication with any member of staff as well as full access to records, files or data of the NBFC and its affiliates.

**Assessment: Materially Non-Compliant**

**Comments:** The Reserve Bank has not issued any instructions regarding clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the NBFC, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the NBFC's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations. Further, the Reserve Bank is not empowered to bring about changes in the composition of the Board and senior management to address any prudential concerns.

**Principle 18: Abuse of Financial Services**

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know your customer" (KYC) rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

**Description:**

NBFCs have been advised of the reporting requirements under the Prevention of Money Laundering Act, 2002. In addition to reporting to the Financial Intelligence Unit or other designated authorities, NBFCs report to the Reserve Bank suspicious activities and incidents of fraud when they are material to the safety, soundness or reputation of the NBFC. The Reserve Bank can



initiate criminal action against the directors of the NBFC indulging in the financial misappropriation by reporting the same to the appropriate authorities. Though the guidelines for KYC have been put in place there is no mechanism to ensure compliance with KYC guidelines by non-deposit taking companies.

The Reserve Bank satisfies that NBFCs have enhanced due diligence policies and processes regarding correspondent banking. The Reserve Bank has not prescribed any due diligence requirements. However, while granting permission to setting up a liaison office in India by a foreign NBFC their operations from tax haven countries is accorded due cognizance before grant of permission.

The Reserve Bank periodically confirms that NBFCs have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering. There is no procedure for confirmation by supervisor of money laundering prevention, identification and reporting of potential abuses. However, Financial Intelligence Unit-India (FIU-Ind) is the designated authority overseeing compliance with money laundering aspect.

The Reserve Bank determines that NBFCs have clear policies and processes for staff to report any problems related to the abuse of the NBFCs' financial services to either local management or the relevant dedicated officer or to both. There are no instructions in place to ensure that a member of a NBFC's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.

The Reserve Bank is able, directly or indirectly, to co-operate with the relevant domestic and foreign financial sector supervisory authorities or share with them information related to suspected or actual criminal activities where this information is for supervisory purposes.

**Assessment: Largely Compliant**

**Comments:** The Reserve Bank has not put in place any due diligence policies. However, while granting permission to setting up a liaison office in India by a foreign NBFC their operation from a tax haven countries is accorded due cognizance before grant of permission.

There is no procedure for confirmation by supervisor of money laundering prevention, identification and reporting of potential abuses. Though the guidelines for KYC have been put in place there is no mechanism to ensure compliance with KYC guidelines by non-deposit taking companies. However, FIU is the designated authority overseeing compliance with money laundering aspects.

There are no instructions in place to ensure that a member of a NBFC's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.

**Principle 19: Supervisory Approach**

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

**Description:**

A certain class of NBFCs<sup>17</sup> has been advised to put in place Risk Management Committee to assess the risk faced by NBFCs. To take care of determining and assessing on an ongoing basis the

<sup>17</sup> NBFCs with deposits of Rs.20 crore or assets of Rs.100 crore

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nature, importance and scope of the risks to which individual NBFCs and their groups are exposed, a reporting requirement under the financial conglomerate regulated by other regulator namely Securities and Exchange Board of India (SEBI), and Insurance Regulatory Development Authority (IRDA) has been put in place.

The Reserve Bank has put in place a system of reporting by an NBFC, duly certified by statutory auditors. Any change in the structure, failure to comply with prudential norms standards is to be reported by statutory auditors through exception report to the Reserve Bank. However, the system is yet to be stabilised in this regard. The Reserve Bank has an adequate information system which facilitates the processing, monitoring and analysis of prudential information.

**Assessment: Largely Compliant**

**Comments:** The Reserve Bank has put in place a system of reporting by an NBFC, duly certified by statutory auditors. Any change in the structure, failure to comply with Prudential Norms Standards is to be reported by statutory auditors through exception report to the Reserve Bank. However, the system is yet to be stabilised in this regard.

**Principle 20: Supervisory Techniques**

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

**Description:**

The Reserve Bank employs an appropriate mix of on-site (Section 45N of RBI Act) and off-site supervision (Section 45L and 45K of RBI Act) to evaluate the condition of NBFCs, their inherent risks, and the corrective measures necessary to address supervisory concerns.

The on-site inspection carried out by the Reserve Bank is used as a tool to assess corporate governance in NBFCs; determine that information provided by NBFCs is reliable; obtain additional information on the NBFC and its related companies needed for the assessment of the condition of the NBFC; the evaluation of material risks, and the identification of necessary remedial actions and supervisory actions, including enhanced off-site monitoring; and monitor the NBFC's follow-up on supervisory concerns. Off-site work is used as a tool to regularly review and analyse the financial condition of individual NBFCs using prudential reports, statistical returns and other appropriate information and help determine the priorities and scope of on-site work. The Reserve Bank communicates to the NBFC the findings of its on- and off-site supervisory analyses by means of supervisory letter containing adverse inspection findings or through discussions or meetings with management.

The Reserve Bank maintains sufficiently frequent contacts as appropriate with the NBFC's Board, directors and Audit Committee to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality and risk management systems. The requirement of regular meeting with newly registered NBFCs

to assess their compliance with regulatory / supervisory framework has been put in place. The Reserve Bank limits itself to interaction with the Managing Director/Chairman of NBFC. No interaction takes place with the senior or middle management. The Reserve Bank reviews on an ongoing basis the quality of the Board and management.

The Reserve Bank evaluates the work of the NBFC's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk. The Reserve Bank has put in place the requirement of Audit Sub Committee to a certain class of NBFCs<sup>18</sup> to review the internal audit function, the position is also commented while undertaking inspection of deposit taking NBFCs.

**Assessment: Largely Compliant**

**Comments:** The requirement of regular meeting with newly registered NBFCs to assess their compliance with regulatory / supervisory framework has been put in place. The Reserve Bank limits itself to interaction with the Managing Director / Chairman of NBFC. No interaction takes place with the senior or middle management. There is need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.

**Principle 21: Supervisory reporting**

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

**Description:**

The Reserve Bank has been empowered under Sections 45K and 45L of the RBI Act, 1934 to call for information from NBFCs and to give directions to them. It has the power to require NBFCs to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. The Reserve Bank provides instructions that clearly describe the accounting standards to be used in preparing supervisory reports.

Financial Conglomerates have been identified and data is analysed. However, consolidated supervision on a comparable basis is not attempted for NBFCs.

The Reserve Bank has the power to request and receive any relevant information from NBFCs, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the NBFC or its group, or to the assessment of the risks of the NBFC or its group. This includes internal management information.

The Reserve Bank has the power of full access to all NBFC records for the furtherance of supervisory work. It also has similar access to the NBFC's Board, management and staff, when required.

The Reserve Bank clearly defines and documents the roles and responsibilities of external experts, including the scope of the work, when they are appointed to conduct supervisory tasks and monitors the quality of the work. External experts may be utilised for routine validation or to examine specific aspects of NBFCs' operations.

The Reserve Bank requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.

<sup>18</sup> NBFCs with deposits of Rs.20 crore or assets of Rs.100 crore

<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> Financial Conglomerates have been identified and data is analysed. However, consolidated supervision on a comparable basis is not attempted.</p>
<p><b>Principle 22: Accounting and disclosure</b></p> <p>Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.</p>
<p><b>Description:</b></p> <p>The Reserve Bank has the power under Section 45K of the RBI Act, 1934 to call for any statements, information or particulars relating to or connected with acceptance of deposits.</p> <p>The Reserve Bank requires NBFCs to utilise valuation norms that are consistent, realistic and prudent, taking account of current values where relevant, and to show profits net of appropriate provisions.</p> <p>The Reserve Bank has the power, in appropriate circumstances, to establish the scope of external audits of individual NBFCs and the standards to be followed in performing such audits. It has no power to reject and rescind the appointment of an external auditor that is deemed to have inadequate expertise or independence, or not to be subject to or not to follow established professional standards. However, the Reserve Bank can refer such instances to the ICAI.</p> <p>The disclosures made by NBFCs include both qualitative and quantitative information on its financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies and basic business, management and governance.</p> <p>The Reserve Bank publishes aggregate information on the system to facilitate public understanding of the system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of NBFCs' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles). Statistics on risk profile parameter is neither obtained nor published by the Reserve Bank in respect of individual companies.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> The Reserve Bank has power to call for information from NBFCs under the provisions of RBI Act. However, corporate governance guidelines are not applicable to all the NBFCs but a certain class of NBFCs. Statistics on risk profile parameter is neither obtained nor published by the Reserve Bank in respect of individual companies. The Reserve Bank has no power to reject or rescind the appointment of external auditors in response to any observed shortcomings. However, the Reserve Bank can refer such instances to the Institute of Chartered Accountants of India (ICAI). There is a need for increased disclosures in case of NBFCs like structure of their holdings <i>etc.</i></p>

**Principle 23: Corrective and remedial powers of supervisors**

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

**Description:**

The Reserve Bank raises supervisory concerns with management or, where appropriate, the Board, at an early stage, and requires that these concerns are addressed in a timely manner. Where the Reserve Bank requires the NBFC to take significant remedial actions, these are addressed in a written document to the Board. The Reserve Bank requires the NBFC to submit regular written progress reports and checks that remedial actions are completed satisfactorily.

The problem NBFCs are supervised on regular basis by the Reserve Bank. Section 45MC of the RBI Act empowers the Reserve Bank to file winding up petition in case of problem NBFCs.

The Reserve Bank has made available an appropriate range of supervisory tools for use when, in its judgment, an NBFC is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened. These tools include the ability to require an NBFC to take prompt remedial action and to impose penalties. In practice, the range of tools is applied in accordance with the gravity of a situation.

There is no prompt corrective action framework stipulated for NBFCs other than in cases where it has been specified at the time of granting of registration that such approval is required before undertaking the activity. The Reserve Bank does not have powers to withhold approval of new activities or acquisitions. It is also not empowered to restrict or suspend payments to shareholders or share repurchases, restrict asset transfers, bar individuals from operations, replace or restrict the powers of managers, Board directors or controlling owners, facilitate a takeover or merger with a healthier institution, provide for the interim management of the NBFC. However, depending upon the circumstances of the case it has power to revoke the Certificate of Registration granted to an NBFC.

The Reserve Bank has the power to take measures should a NBFC fall below the minimum capital ratio, and seeks to intervene at an early stage to prevent capital from falling below the minimum. The Reserve Bank, however, has not put in place a prompt corrective action framework.

The Reserve Bank applies penalties and sanctions not only to the NBFC but, when and if necessary, also to management and/or the board, or individuals therein. The Reserve Bank has power to impose penalties on the NBFCs for non-compliance with the provisions of RBI Act. It can also impose specific penalties on persons who, at the time the contravention or default was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company.

**Assessment: Largely Compliant**

**Comments:** The Reserve Bank does not have powers of withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from operations, replacing or restricting the powers of managers, Board directors or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the NBFC. However, depending upon the circumstances of the case it has power to revoke the Certificate of Registration granted to an NBFC.

**Principle 24: Consolidated Supervision**

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

**Description:**

Most of the NBFCs have no global presence. To understand the activities of the groups, financial conglomerate reporting in respect of financial activities of domestic NBFCs is in place. The Reserve Bank has no powers to limit the range of activities the consolidated group may conduct and the locations in which activities can be conducted. No system is in place to supervise the foreign operations of NBFCs.

**Assessment: Non-Compliant**

**Comments:** The Reserve Bank has no power to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, exposures to related parties and lending limits. Consolidated supervision is not undertaken if NBFC is the parent.

**Principle 25: Home-host relationship**

Cross-border consolidated supervision requires co-operation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

**Description:**

Of late, it has been observed that foreign entities have evinced interest in NBFC Sector. Policy initiatives have been taken to recognise role of home-host regulator in this regard. However, guidelines are yet to be announced in public domain. There is no formal arrangement of sharing information with foreign supervisors. However, as and when information is requested by host country regulator information is provided.

The presence of domestic NBFCs abroad in the form of subsidiaries is not significant as at present only a few large companies have opened branches / subsidiaries abroad. Only those NBFCs which do not pose any supervisory concerns are permitted.

Home country supervisors are given on-site access to local offices and subsidiaries of a group in order to facilitate their assessment of the group's safety and soundness and compliance with KYC requirements. Home supervisors should inform host supervisors of intended visits to local offices and subsidiaries of groups. FIU-Ind is designated authority for Prevention of Money Laundering Act, 2002 (PMLA Act). For adhering to requirement of Anti-Money Laundering Act, NBFCs have been advised to report to FIU-Ind in this regard. As a different nodal agency has been



identified the role of regulator is limited to issue of regulations and monitoring reporting requirement in this regard.

**Assessment: Non-Compliant**

**Comments:** Of late it has been observed that foreign entities have evinced interest in NBFC sector. Some of the domestic NBFCs have also started looking abroad for business opportunities. Policy initiatives have been taken to recognise role of home-host regulator in this regard. Draft guidelines for NOC for opening of branches /joint venture abroad by NBFCs have been placed for comments / suggestions from public/stakeholders on the [www.rbi.org.in](http://www.rbi.org.in). The regulations for the operations of foreign NBFCs in India are at par with domestic NBFCs and they are subjected to prudential, inspection and regulatory reporting requirements similar to those for domestic NBFCs.

## Appendix 9

**Detailed Assessment (Principle-by-Principle) – Housing Finance Companies****Principle 1: Objectives, independence, powers, transparency and co-operation**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 1(1): Responsibilities and objectives**

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

**Description :**

The National Housing Bank ("NHB"), is an autonomous body created under an act of the Indian parliament i.e. The National Housing Bank Act, 1987 is responsible for regulation and supervision of HFCs. This Act lays down the laws relating to regulation and supervision of HFCs. The responsibilities and the objectives of the NHB are clearly delineated in the aforesaid Act. Laws and regulations are in place that provide framework of minimum prudential standards which HFCs are required to meet. The National Housing Bank Act, 1987 (the Act) was amended extensively in year 2001. The Directions are amended from time to time as necessary. Although annual reports/ accounts are published, there is no specific requirement for publishing the financial strength indicators

**Assessment: Compliant**

**Comments:** Requirement for publishing further financial strength indicators being considered.

**Principle 1(2): Independence, accountability and transparency**

Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.

**Description :**

The supervisory objectives are as per the National Housing Bank Act, 1987. The issue of operational independence and reasons of removal of the head of the NHB are not publicly disclosed inasmuch as Section 7 of NHB Act states that Central Government in consultation with Reserve Bank shall

<p>have the right to terminate the term of office of the Chairman or Managing Director as the case may be at any time before expiry of term of his office. Being a public institution, NHB is accountable to the Parliament. The staff at NHB is selected in a transparent manner subject to satisfying certain level of professionalism and integrity. NHB is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight which includes adequate budget, salary scales to retain staff, adequate training budget, budget for computers and other equipments <i>etc.</i></p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> The issue of operational independence and reasons of removal of the head of NHB are not publicly disclosed.</p>
<p><b>Principle 1(3): Legal framework</b> A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.</p>
<p><b>Description:</b> Section 29A of the National Housing Bank Act, 1987 identifies the authority responsible for granting and withdrawing Certificate of Registration granted to Housing Finance Companies (HFCs). The National Housing Bank (NHB) is empowered to set prudential rules (without changing laws) and a process of public consultation on proposed changes is there. The NHB is empowered to obtain information from the HFCs and their groups in the form and frequency it deems necessary.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(4): Legal powers</b> A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.</p>
<p><b>Description:</b> The law empowers NHB to supervise through off-site and on-site monitoring. The NHB has powers to cancel Certificate of Registration/ invoke penal provisions. It has full access to HFCs' Board, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations.</p>
<p><b>Assessment: Compliant</b></p>
<p><b>Principle 1(5): Legal protection</b> A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.</p>
<p><b>Description:</b> Section 46 of the National Housing Bank Act, 1987 provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. Under the provisions of this Act, the staff is adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.</p>
<p><b>Assessment: Compliant</b></p>

<p><b>Principle 1(6): Co-operation</b> Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>
<p><b>Description:</b> NHB has arrangements with other regulators /supervisors to share information e.g. the Reserve Bank (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory Development Authority (IRDA), Registrar of Companies (RoC), High Level Co-ordination Committee (HLCC) for co-ordination between Government and other regulators at the state level. However, the arrangements are informal in nature and are not binding on either of the parties. There are no formal or informal arrangements in place for co-operation and information sharing with foreign supervisors of HFCs and their groups. However, NHB is able to share any confidential information with any supervisor subject to confidentiality of such information being ensured by the latter. It is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession as per the Section 44 of the National Housing Bank Act, 1987.</p>
<p><b>Assessment: Largely Compliant</b></p>
<p><b>Comments:</b> There is no formal or informal arrangement for sharing information with foreign regulators.</p>
<p><b>Principle 2: Permissible activities</b> The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.</p>
<p><b>Description:</b> The NHB Act does not clearly define HFI/HFC. It also does not define the permissible activities of the HFCs. All HFCs are regulated by NHB and it has discretion to grant permission to accept deposits to HFCs. The list of registered HFCs is available on NHB's website.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> The definition of Housing Finance Institution (HFI)/ Housing Finance Company (HFC) to be made specific and clear. The possibility of defining the permissible activities of HFCs needs to be explored</p>
<p><b>Principle 3: Licensing criteria</b> The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition,</p>

including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

**Description:**

Section 29A of the National Housing Bank Act, 1987 empowers NHB to set criteria for licensing of HFCs. It also empowers NHB to reject an application if the licensing criteria are not fulfilled or the information provided is inadequate.

While NHB determines the proposed legal, managerial, operational and ownership structures of the HFC, it does not do so taking into account the wider group of the HFC on a consolidated basis. Section 29A of NHB Act has prescribed minimum initial capital for all HFCs. There is fit and proper test for promoters. As per Section 29A of NHB Act, if the NHB determines that the license was based on false information, the license can be revoked.

NHB reviews the proposed strategic and operating plans of the HFC which includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, is in place.

NHB reviews pro forma financial statements and projections for the proposed HFC which includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the HFC.

In case of foreign HFC establishing office in our country, there is no practice of NHB obtaining no objection from the home supervisor. NHB also does not have a practice of ascertaining from the home supervisor as part of the licensing process, as well as ongoing supervision of cross-border operations in its country as to whether the home supervisor practices global consolidated supervision.

**Assessment: Largely Compliant**

**Comments:** Assessment of HFCs from the group perspective needs to be explored. Assessment of transparency of the ownership structure, sources of initial capital and identification and determination of ultimate beneficial owners needs improvement. Expanding the scope and coverage of fit and proper test to include record of criminal activities needs to be examined. Scope for requirements to put in place for appropriate system of corporate governance, risk management and internal controls needs to be examined.

The issue of home-host relationship has gained importance. Before issuing Certificate of Registration (CoR), No objection Certificate (NOC) from home supervisor may be obtained. Also, it may be assessed whether home supervisor practices global consolidated supervision.

There is no specific provision that the Board should collectively have sound knowledge of each of the types of activities the HFC intends to pursue and the associated risks and the same needs to be examined.

**Principle: 4 Transfer of significant ownership**

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

**Description :**

NHB has not defined "significant" ownership and "controlling interest" for HFCs. There are no requirements to obtain approval or provide immediate notification to NHB of proposed changes

that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest. NHB has no power to reject any proposal for a change in significant ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new HFCs. NHB obtains on case-to-case basis through on-site examination the names and holdings of all significant shareholders of HFCs. NHB has no power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to it or its approval.

**Assessment: Non-Compliant**

**Comments:** Clear definitions of "significant ownership" and "controlling interest" to be provided in consultation with the Reserve Bank. The need for requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest needs to be examined.

NHB has no power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new HFCs. The scope to include this power needs to be examined.

NHB does not obtain from HFCs, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles which might be used to disguise ownership.

NHB does not have the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.

**Principle 5: Major acquisitions**

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

**Description:**

There are no laws or regulations in place which define what types and amounts (absolute and/or in relation to a HFC's capital) of acquisitions and investments need prior approval of NHB. There are no specific provisions whereby NHB can prohibit HFCs from making major acquisitions/investments (including the establishment of foreign branches or subsidiaries) in countries with secrecy laws or other regulations prohibiting information flows deemed necessary for adequate consolidated supervision.



NHB does not determine that the HFC has, from the outset, adequate financial and organisational resources to handle the acquisition/investment. It does not, at present, have the practice of determining the risks that other (group) activities can pose to an HFC.

**Assessment: Non-Compliant**

**Comments:** None of the principles relating to major acquisition are delineated at present to HFCs and feasibility of all such requirements enshrined in the principles needs to be explored.

**Principle 6: Capital adequacy**

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

**Description:**

NHB has prescribed Capital Adequacy Ratio (CAR) for HFCs and it is more than that for banks. The prescribed CAR requirement is above the applicable Basel requirement. The CAR covers both on and off-balance sheet items. NHB has the powers to take measures should CAR of an HFC fall below the minimum capital adequacy ratio. HFCs are subjected to uniform capital adequacy computation methods and risk weight standards.

**Assessment: Compliant**

**Principle 7: Risk management process**

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

**Description:**

Though there is no blanket requirement for HFCs to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks, but the bigger HFCs are subjected to Asset Liability Management (ALM) systems and ALM guidelines. As per the present regulatory framework, credit risk is addressed to an extent in general and liquidity risk and interest rate risk are to be reported as part of ALM returns but operational risk and market risk is yet to consider being part of required risk management structure for HFCs. Further, the consolidated regulation is not in practice at present.

The HFCs are required to submit half yearly ALM returns, wherever applicable, and their ALM systems are reviewed during the on-site inspections by NHB. As per the ALM guidelines, wherever applicable, Asset-Liability Committee (ALCO) has to consist of people from senior management. However, understanding of the nature and level of risk being taken by the HFC and relation of same to adequate capital levels by senior management and the Board of HFC is not determined by NHB.

The HFCs are subjected to uniform capital adequacy computation methods and risk weight standards. The HFCs do not use models for measurement of component of various risks.

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NHB does not determine that HFCs and their groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. It is also does not satisfy itself that these reports are provided on a timely basis to the board or senior management and reflect the HFC's risk profile and capital needs.

NHB determines on case-to-case basis that HFCs have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board. It does not determine that HFCs and their groups have risk evaluation, monitoring, and control or mitigation functions with duties clearly segregated from risk-taking functions in the HFC, and which report on risk exposures directly to senior management and the Board.

**Assessment: Materially Non-Compliant**

**Comments:** There is no blanket requirement for HFCs to have in place comprehensive risk management policies and processes and the bigger HFCs are subjected to ALM systems and ALM guidelines. Operational risk and market risk are yet to be considered as part of risk management structure of HFCs. Consolidated regulation in respect of HFCs is not there are present. The understanding of the nature and level of risk being taken by the HFC and relation of such to adequate capital levels by senior management and the Board of HFC is not determined by NHB.

HFCs are subjected to uniform capital adequacy computation methods and risk weight standards. The HFCs do not use models for measuring various components of risk.

NHB does not determine that HFCs and their groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. It also does not determine in respect of all HFCs that they have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board. It is done on select basis. Further, it also does not determine that HFCs have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board.

**Principle 8: Credit risk**

Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

**Description:**

Though during the inspections, credit policy of HFCs is reviewed but since HFCs are granulated in different sizes, the degree of review varies from HFC to HFC. They take credit risk measures as they also serve the sub-prime market and evaluate their customers by personal contacts and

other verifications. The size of most of HFCs presently may not warrant more sophisticated and complex risk model. An indirect check is kept on the issue of HFCs by making credit decisions free of conflict of interest and at arms length by deducting from Net Owned Funds (NOF) the exposure of HFCs in group companies in excess of 10 per cent. NHB has full access to information in the credit and investment portfolios.

**Assessment: Largely Compliant**

**Comments:** Feasibility of introduction of risk based model for credit to be considered in due course.

**Principle 9: Problem assets, provisions and reserves**

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

**Description:**

NHB has issued guidelines to HFCs on asset classification and provisioning norms. The adequacy of the classification and provisioning policies is confirmed by on-site inspection and statutory auditors. The Board of HFCs is kept apprised of the condition of the HFC's asset portfolio. The valuation, classification and provisioning for large exposures are conducted on individual item basis. Any deviations observed in asset classification and provisioning norms have to be reported by statutory auditors to NHB. Further NHB monitors the asset portfolio of HFCs during on-site inspection as well through off-site returns. However, there are no asset classification and provisioning norms for off-balance sheet items.

NHB determines that HFCs have appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations. It also determines during on-site inspection that HFCs have appropriate policies and processes, and organisational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations.

NHB is informed on a periodic basis, and in relevant detail, or has access to information concerning the classification of credits and assets and provisioning.

Section 30A (I) of National Housing Bank Act, 1987 empowers the NHB to require an HFC to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern. NHB has powers under Section 30A of NHB Act to suggest additional provisions or to impose other remedial measures to HFCs.

NHB determines that the Board receives timely and appropriate information on the condition of the HFC's asset portfolio, including classification of credits, the level of provisioning and major problem assets. It requires that valuation, classification and provisioning for large exposures are conducted on an individual item basis.

**Assessment: Compliant**

**Comments:** –

**Principle 10: Large exposure limits**

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparty or groups of connected counterparties.

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**Description:**

NHB has the power to define, a "group of connected counterparties" to reflect actual risk exposure which also includes off-balance sheet items. It also sets prudent limits on large exposures to a single counterparty or a group of connected counterparties. It confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.

NHB determines that an HFC's management information systems identify and aggregate on a timely basis exposure to individual counterparties and group of connected counterparties. It regularly obtains information on concentrations within an HFC's portfolio, including sectoral, geographical and currency exposures, that enables it to be reviewed. NHB has the power to require HFCs to take remedial actions in cases where concentrations appear to present significant risks.

**Assessment: Largely Compliant**

**Comments:** Though ceilings of different kind of concentrations have been prescribed by NHB, but there is no practice of determining thresholds for concentration of credit internally acceptable to the HFCs.

**Principle 11: Exposures to related parties**

In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

**Description:**

NHB has power to provide, a comprehensive definition of "related parties". There are no specific requirements that require the exposures to related parties may not be granted on more favourable terms than corresponding exposures to non-related counterparties. However they can be verified on case-to-case basis during on-site inspections.

There are no requirements to the effect that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the HFC's Board. Further, there are no requirements to ascertain that HFCs have policies and processes in place to prevent persons benefiting from the exposure and/or persons related to such a person from being part of the process of granting and managing the exposure.

NHB has the power to set on a general or case-by-case basis, limits for exposures to related parties, and to deduct such exposures from capital when assessing capital adequacy, or to require collateralisation of such exposures. There is no requirement to the effect that HFCs have policies

and processes to identify individual exposures to related parties as well as the total amount of such exposures, and to monitor and report on them through an independent credit review process. Further, the exceptions to policies, processes and limits are not required to be reported to the appropriate level of senior management and, if necessary, to the Board.

NHB does not obtain and review information on aggregate exposures to related parties.

**Assessment: Materially Non-Compliant**

**Comments:** NHB does not obtain and review information on aggregate exposures to related parties.

**Principle 12: Country and transfer risks**

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

**Description:**

There is no such requirement that HFCs have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

**Assessment: Non-Compliant**

**Comments:** There are no guidelines for country risk and transfer risk in respect of HFCs.

**Principle 13: Market risk**

Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

**Description :**

There are no specific provision for market risk as regards HFCs.

**Assessment: Non-Compliant**

**Comments:** No guidelines for market risk in respect of HFCs.

**Principle 14: Liquidity risk**

Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

**Description:**

NHB has addressed the aspect relating to liquidity risk management in the ALM guidelines issued by them. These guidelines also take into consideration undrawn commitments and other off-balance sheet liabilities, as well as existing on-balance sheet liabilities. These ALM guidelines are applicable to only larger HFCs.

<p>NHB does not obtain sufficient information to identify those institutions carrying out significant foreign currency liquidity transformation. It also does not determine that HFCs have contingency plans in place for handling liquidity problems, including informing the supervisor.</p>
<p><b>Assessment: Materially Non-Compliant</b></p>
<p><b>Comments:</b> There are no detailed guidelines on liquidity risk for all HFCs as it is restricted to larger HFCs. The guidelines issued to larger HFCs are not exhaustive as laid down in the principle. Further, the supervisor does not obtain sufficient information to identify those institutions carrying out significant foreign currency liquidity transformation. It also does not monitor that HFCs have contingency plans in place for handling liquidity problems, including informing the supervisor.</p>
<p><b>Principle 15: Operational risk</b></p> <p>Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
<p><b>Description :</b></p> <p>There are no guidelines on operational risk in place for HFCs.</p>
<p><b>Assessment: Non-Compliant</b></p>
<p><b>Comments:</b> Feasibility of introduction of risk management policies and processes to identify, assess, monitor and control/ mitigate operational risk to be explored</p>
<p><b>Principle 16: Interest rate risk in the banking book</b></p> <p>Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.</p>
<p><b>Description :</b></p> <p>There are no guidelines on interest rate risk in the banking book in place for HFCs.</p>
<p><b>Assessment: Non-Compliant</b></p>
<p><b>Comments:</b> Feasibility of options to be explored for introduction of risk management policies and processes to ensure that effective systems are in place to identify, measure, monitor and control interest rate risk in the banking books of HFCs.</p>



**Principle 17: Internal control and audit**

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

**Description:**

NHB has not issued any guidelines that establish the responsibilities of the board and senior management with respect to corporate governance to ensure that there is effective control over a HFC's entire business. NHB monitors through off-site returns that HFCs have in place internal controls and deal with organisational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments, but it is not in so much detail.

There is no requirement that the Board and senior management understand the underlying risks in their business and are committed to a strong control environment, but the management's role in this regard is monitored.

NHB has no power to require changes in the composition of the board and senior management to address any prudential concerns related to the satisfaction of these criteria. It does not determine that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination. It also does not require that HFCs have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the HFC.

Though not specifically prescribed, NHB ascertains that HFCs have an independent, permanent and effective internal audit function charged with ensuring that policies and processes are complied with and reviewing whether the existing policies, processes and controls remain sufficient and appropriate for the HFC's business. NHB does not prescribe that the internal audit function has sufficient resources, and staff that are suitably trained; has appropriate independence; has full access to and communication with any member of staff as well as full access to records, files or data of the HFC and its affiliates; *etc.*

**Assessment: Materially Non-Compliant**

**Comments:** Introduction of guidelines on corporate governance to establish the responsibilities of the board and senior management. No detailed prescription as regards HFCs to have in place internal controls that is adequate for the nature and scale of their business. There is no requirement of placing the responsibility for the control environment on the board and senior management of the HFC. NHB does not have the power to require changes in the composition of the board and senior management to address any prudential concerns related to the satisfaction of these criteria. NHB does not have power to ensure that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination in respect of HFCs. There is no requirement for HFCs to have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the HFC. NHB does not require that HFCs have an independent, permanent and effective internal audit function. Most of the above prescriptions are not considered necessary given the scale of operations of HFCs.

**Principle 18: Abuse of Financial Services**

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know your customer" (KYC) rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

**Description:**

NHB has powers to ensure that HFCs have adequate policies and processes in place, including strict KYC rules that promote high ethical and professional standards in the financial sector. KYC guidelines have been issued and adopted by HFCs.

NHB has ensured reporting system to Financial Intelligence Unit (FIU) through principal officers. However, policies and processes in this regard are checked during inspections on case-to-case basis.

Though Prevention of Money Laundering (PML) Act designates FIU as the appropriate authority for reporting incidences of suspicious activities and fraud when they are material to the safety, soundness or reputation of the HFC, but HFCs are not required to report these to NHB.

The correspondent banking does not exist among HFCs. NHB periodically confirms that HFCs have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering.

NHB does not have adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a HFC that does not comply with its obligations related to criminal activities. It does not determine that adequate screening policies and processes are there when hiring staff. No whistle-blower policy in place.

Laws and regulations ensure that a member of a HFC's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.

**Assessment: Largely Compliant**

**Comments:** Regarding criminal activities, no such power prescribed for supervisor. Though PML Act designates FIU as the appropriate authority for reporting such incidences but HFCs are not required to report these to the supervisor. NHB has adequate enforcement powers to take action against a HFC that does not comply with its obligations related to criminal activities. NHB does not determine that adequate screening policies and processes are there when hiring staff. No whistle-blower policy in place. HFCs are required to inform the Financial Intelligence Unit and, if applicable, other designated authority of any suspicious transactions directly without routing the same through NHB.

NHB does not determine that the system of risk management & internal controls & detection/prevention of criminal activities & oversight of outsourced functions is in place in HFCs.

**Principle 19: Supervisory Approach**

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

**Description:**

NHB has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual HFCs and their groups. It also monitors and assesses trends, developments and risks for the system as a whole. It also takes into account developments in other financial institutions through frequent contact with their regulators. However, no structured mechanism is there in place.

No structured mechanism is there in place for the supervisor to use a methodology for determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual HFCs and their groups are exposed. NHB confirms HFCs' and their groups' compliance with prudential regulations and other legal requirements.

There is no structured mechanism in place which requires the HFCs to notify the supervisor of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.

NHB has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.

**Assessment: Largely Compliant**

**Comments:** NHB has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual HFCs and their groups. It monitors and assesses trends, developments and risks for the system as a whole. It also takes into account developments in non-bank financial institutions through frequent contact with their regulators. It uses a methodology for determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual HFCs and their groups are exposed. It requires HFCs to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements. All the aforesaid things are done but there is no structured mechanism in place.

**Principle 20: Supervisory Techniques**

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

**Description:**

NHB employs an appropriate mix of on-site (Section 34 of NHB Act) and off-site supervision (Section 31 of NHB Act) to evaluate the condition of HFCs, their inherent risks, and the corrective measures necessary to address supervisory concerns. The on-site inspection is used as a tool to provide independent verification about adequate corporate governance, determine the reliability of information provided by HFCs, obtention of additional information on the HFC and its related companies needed for the assessment of the condition of the HFC, and monitor the HFC's follow-up on supervisory concerns.

The off-site returns are used as a tool to regularly review and analyse the financial condition of individual HFCs using prudential reports, statistical returns and other appropriate information, including publicly available information; followup on matters requiring further attention, evaluate developing risks and help identify the priorities and scope of further work.

Based on the risk profile of individual HFCs, the supervisor maintains sufficiently frequent contacts as appropriate with the HFC's Board, non-executive directors, Audit Committee and senior and middle management to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality and risk management systems. Though contact is there but no structured mechanism is in place.

NHB evaluates the work of the HFC's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk. The supervisor monitors this through on-site examination but no structured mechanism is in place. It communicates to the HFC the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.

**Assessment: Largely Compliant**

**Comments:** Based on the risk profile of individual HFCs, NHB maintains sufficiently frequent contacts as appropriate with the HFC's Board, non-executive directors, Audit Committee and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality and risk management systems. NHB evaluates the work of the HFC's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk. The aforesaid things are there but there is no structured mechanism in place in this regard.

There is need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervisions. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.

**Principle 21: Supervisory reporting**

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

**Description:**

NHB has the power to call for information from HFCs both on a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. The accounting Standards issued by ICAI are to be followed by HFCs for preparation of supervisory report. NHB collects and

analyses information from HFCs at a frequency commensurate with the nature of the information, the size, activities and risk profile of the individual HFC. However, details on entities other than HFCs are not collected. It has power to request and receive any relevant information from HFCs. However, assessment of risk to the HFC's group as a whole is not done.

NHB has the power of full access to all HFC records for the furtherance of supervisory work. It also has similar access to the HFC's Board, management and staff, when required. It utilises policies and processes to confirm the validity and integrity of supervisory information. NHB clearly defines and documents the roles and responsibilities of external experts, including the scope of the work, when they are appointed to conduct supervisory tasks and monitors the quality of the work.

NHB requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes. Such requirement is there for the auditors but does not cover external experts like consultants.

**Assessment: Largely Compliant**

**Comments.** In order to make meaningful comparison between HFCs and their groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and period (flow data). In this connection, details on entities other than HFCs are not collected.

The supervisor has power to request and receive any relevant information from HFCs. However, assessment of risk to the HFC's group as a whole is not done.

NHB requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes. Such requirement is there for the auditors but does not cover external experts like consultants.

**Principle 22: Accounting and disclosure**

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

**Description:**

NHB has powers under Section 49 of the National Housing Bank Act, 1987 to hold HFC's management and the HFC's Board responsible for ensuring that financial record-keeping system and the data they produce are reliable. It has also got powers to hold HFC's management and the HFC's Board responsible for ensuring that the financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion. It requires HFCs to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and to show profits net of appropriate provisions. The NHB has powers under Section 34 of Act, in appropriate circumstances, to establish, the scope of external audits of individual HFCs and the standards to be followed in performing such audits.

The audits cover areas such as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting. All these aspects are covered as per accounting standards issued by ICAI.

NHB does not have power to reject and rescind the appointment of an external auditor.

## Chapter III

### Assessment of Adherence to Basel Core Principles

The required disclosures include both qualitative and quantitative information on a HFC's financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies, and basic business, management and governance but not risk management strategies and risk exposures.

NHB does not publish aggregate information on the system to facilitate public understanding of the system and the exercise of market discipline.

**Assessment: Largely Compliant**

**Comments:** NHB does not have power to reject and rescind the appointment of an external auditor. Risk management strategies and practices, risk exposures not there as part of disclosures in the balance sheet of HFCs. NHB does not publish aggregate information on the system to facilitate public understanding of the system and the exercise of market discipline.

**Principle 23: Corrective and remedial powers of supervisors**

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

**Description:**

NHB raises supervisory concerns with management or, where appropriate, the Board, at an early stage, and requires that these concerns are addressed in a timely manner. Where it requires the HFC to take significant remedial actions, these are addressed in a written document to the Board. NHB requires the HFC to submit regular written progress reports and checks that remedial actions are completed satisfactorily.

NHB participates in deciding when and how to effect the orderly resolution of a problem HFC situation. Though this has been done in some cases there is no structured mechanism in place.

The National Housing Bank Act, 1987 empowers the supervisor with appropriate range of supervisory tools like restricting the current activities of the HFC, revoking of the license, for use when, in the supervisor's judgment, an HFC is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened.

NHB has the power to take measures should the capital adequacy ratio of an HFC fall below the minimum prescribed level, and seeks to intervene at an early stage to prevent capital from falling below the minimum. It has a range of options to address such scenarios. NHB applies penalties and sanctions not only to the HFC but, when and if necessary, also to management and/or the Board, or individuals therein.

**Assessment: Largely Compliant**

**Comments:** There is no structured mechanism in place as regards participation by NHB in when and how to effect the orderly resolution of a problem HFC situation.



The National Housing Bank Act, 1987 empowers NHB with appropriate range of supervisory tools like restricting the current activities of the HFC, revoking of the license, for use when, in the supervisor's judgment, an HFC is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened.

**Principle 24: Consolidated Supervision**

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

**Description:**

Consolidated supervision is not done as adequate powers are not there. The HFCs are not required to submit consolidated financial statements to NHB. Though the largest HFC is a financial conglomerate, NHB is a part of the regulatory body to look into the affairs of the financial conglomerate.

**Assessment: Non-Compliant**

**Comments:** Consolidated supervision is not done.

**Principle 25; Home host relationship**

Cross-border consolidated supervision requires co-operation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

**Description:**

There are no formal arrangements in place for co-operation with foreign authorities. In the wake of increased interest shown by the foreign investors in the Indian housing finance market, NHB needs to assess the foreign shareholding in the HFC sector. While assessing foreign shareholding of HFCs, only Foreign Direct Investment (FDI) is taken into account. There is no practice at present of obtaining no objection certificate from home supervisor in case of foreign HFCs intending to open a branch in India. In respect of HFCs which are wholly/significantly owned by foreign entities, NHB does not assess whether the home supervisor practices global consolidated supervision.

**Assessment: Non-Compliant**

**Comments:** Feasibility of introduction of such arrangements to be explored.

## Appendix 10

### Co-operative Models in Some Countries

**(A) Rabobank Group (Netherlands):**

- (i) **Group Structure:** Rabobank Group is the largest financial services provider in Netherlands and has an extensive network worldwide. Rabobank Group is a co-operative banking organisation comprising Rabobank Netherlands (central co-operative of Local banks), Rabobank Netherlands' local member credit institutions (Local Banks) and numerous other subsidiaries like Rabobank International. While Rabobank Netherlands is a legal entity, the Rabobank Group is not a legal entity. Both Rabobank Netherlands and all the local Rabo banks have the legal form of a co-operative. There is however significant difference between the two type of co-operatives. In principal, all customers of the local bank can become members of local banks, with membership bringing certain rights. But in Rabobank Netherlands only local Rabobanks that have a co-operative structure and whose Article of Association have been approved in advance by Rabobank Netherlands can become members. It is therefore a closed co-operative. The co-operative structure and local involvement have been the cornerstones of the Group for more than a century. In case of Local Banks, members exercise influence on the co-operative through the general

meetings. In the case of Rabobank Netherlands members are from local banks who are its shareholders and exercise influence. While Rabobank Netherlands is a subsidiary of the local Rabobanks, it is in fact at the head of an inverted pyramid. It is important to recognise that the Rabobank Netherlands relationship with the member banks is that it is 'daughter' to many parents. At the same time it is itself the 'parent' of many subsidiaries including Rabobank International.

- (ii) **Supervisory/Regulatory Structure:** The Local Banks serve their customers with the support of Rabobank Netherlands and not vice versa. The latter provides managerial, operational and advisory services, which include credit approvals, cost sharing and other centralised functions such as IT, human resource management, liquidity, capital and risk management, *etc.* Further, in accordance with the Credit System Supervision Act, 1992, it is responsible for supervising the financial health and professionalism of the Local Rabobanks. It also acts as treasurer to the Group and a holding company of a large number of subsidiaries.
- (iii) **Deregulated Supervision:** In the Netherlands, licensing of banks and subsequent supervision is carried out by Dutch Central Bank (DNB). The local Rabobank has its own banking license,

but at a local level they do not need to comply with all the licensing conditions specified in law. The law gives DNB power to set aside certain elements of the licensing application, and certain terms and conditions attached to the licensing power if the bank in question is affiliated to a central credit institution. Considering that the local Rabobanks are members of Rabobank Netherlands, supervision of the solvency, the liquidity and the administrative organisation of the member banks has been assigned to Rabobank Netherlands instead to DNB. Rabobank Group is treated as a consolidated entity for regulatory and supervisory purposes.

- (iv) **Shareholding:** Local Rabobanks do not have any shareholders and as such do not pay dividends. Hence they retain all profits after net payments on trust-preferred securities and membership certificates. It is understood that some form of concessions is given to such securities holder in interest payments, customer service *etc.* Local banks which are members of Rabobank Nederland are also its shareholders. In the past these Local banks have committed to taking shares of Rabobank Nederland in proportion to their balance sheet so as to ensure that Rabobank Nederland has sufficient capital.
- (v) **Mutual Support System:** In accordance with the Credit System Supervision Act, 1992 an internal Cross-Guarantee System is in place whereby certain entities within the Rabobank Group are liable for the other participants' financial obligations in case of a shortfall of funds. Participating entities within the Rabobank Group include Rabobank Netherlands and the Local

Rabobanks. This cross guarantee system, in a way, provides, to any bank within the structure, access to the resources of the entire Group, facilitating support in times of need. In effect they all have joint and several liability for each other's commitment. In order to be part of the system banks have to comply with certain rules. The compliance with these rules is monitored and supervised from a central level.

- (B) **Raiffeisen Bank Group (Austria):** Raiffeisen Bank (RZB) is an international co-operative bank based and founded in Austria in 1927. It is currently one of the largest banks in the country. It provides the full range of commercial and investment banking services in Austria and ranks among the leading banks in Central and Eastern Europe.
  - (i) **Group Structure:** The Raiffeisen Banking Group has a 3-tier structure:
    - a) The first tier is formed by around 570 independent and locally active Raiffeisen banks (credit co-operatives) and their more than 1,600 branches.
    - b) The second tier consists of eight central provincial banks called Raiffesenlandesbanks owned by the Raiffeisen banks of the respective federal province. The second tier is either organised in the form of co-operatives or joint stock banks.
    - c) Raiffeisen Zentralbank Österreich AG (RZB) is organised as a joint-stock company, 88 per cent of which owned by regional Raiffesenlandesbanks.
  - (ii) The local banks with a business profile similar to savings banks concentrate on retail customers and small businesses. Since 1960s there was a wave of

mergers between tiny regional co-operatives to form banks which were of a sufficient size for modern banking. Regional Raiffeisenlandesbanks function as bankers for the regional savings and credit co-operatives. They provide services that cannot be carried out by local banks. RZB was founded after the First World War and acts as the central institution of the sector, the liquidity centre for the Raiffeisenlandesbanks and also operates as a commercial bank. RZB is a leading corporate and investment bank in Austria. RZB owns 70 per cent of Raiffeisen International. RZB is the central institute of the RZB group and the founder of Raiffeisen International. RZB has specialised subsidiaries for leasing, insurance, building and loan association, investment banking, investment funds, private banking, private equity management

- (iv) **Mutual Assistance Features:** Similar to Rabo Bank Group, individual Raiffeisen banks, the raiffeisen regional banks, and the RZB provide mutual assistance to protect the interests of creditors and ensure the continued existence of the troubled institution. Any financial assistance provided is accompanied by conditions such as changing management to remedy the underlying cause of the financial problem. The Group also has cross Guarantee System (Haftungsverbund). Voluntary membership commits participating savings banks to be jointly and severally

liable for all deposits and liabilities of member banks, up to a limit established by a formula. Member banks are required to provide support for other member banks facing financial distress, which could include provision of liquidity, granting of loans, provision of guarantees, capital injections as well as intervention in business policy and changes in management. A unique feature of the arrangement is that the provisions are implemented by a company that is empowered to establish and monitor risk management policies and systems for member banks, and to intervene and make executive management decisions in a troubled savings bank.

#### (C) Credit Agricole Group (France)

- (i) **Structure:** Originally, the Credit Agricole Group was the banker of the French agricultural sector and farming communities. However, it has evolved and broadened its activities to service all sectors of the economy and all types of clients: The organisation has a three-tier structure. There are more than 2,500 Local Banks grouped into 48 Regional Banks, which in turn hold a majority of the capital of Credit Agricole S.A., the central bank of the Group. The Federation Nationale du Credit Agricole (FNCA) is the representative body of the Group. The Federation also offers support and services to the Regional Banks, such as occupational training and human resources management. Credit Agricole S.A. is the largest bank

of France having a unified, yet decentralised, organisation.

(ii) **Ownership Structure:** The Local Banks own most of the capital of Regional Banks, and form the base of the group. As a key player in France's local communities, the Local Bank directors play an important part in France's local economies, enabling Crédit Agricole to tailor its product and service offering to customer requirements. The Regional Banks are co-operative entities and undertake all banking activities. Some of the Regional Banks have obtained funds from capital markets by issuing non-voting shares (certificats cooperatifs d'investissement). Regional Banks, via SAS Rue La Boetie (SPV), hold a majority stake in Credit Agricole S.A. Credit Agricole S.A. in turn, holds 25 per cent of the share capital of each Regional Bank.

(iii) **Role of Credit Agricole S.A.:** As a result of Credit Agricole's desire to embrace the market while strengthening its mutual identity, Credit Agricole S.A. was floated on the stock market in December 2001. Credit Agricole S.A. is a universal bank, present across the entire spectrum of banking and insurance activities. Credit Agricole S.A. represents all Group business lines and entities, and has three main roles within the Group, i.e. lead institution, central banker and the entity responsible for ensuring consistent development. It manages the treasury operations of Credit Agricole and raises and lends funds on the international capital markets. It also provides many of the international services offered by the Group as well as a number of technical and financial services through its specialised subsidiaries. Credit Agricole S.A. designs the products

marketed by the Regional Banks and is responsible for its subsidiaries and for international growth.

(iv) Credit Agricole S.A. owns 25 per cent of the Regional Banks' capital and all Group interests in foreign banks and operating subsidiaries specialising in particular business lines. In view of Credit Agricole S.A.'s stake in the Regional Banks, 25 per cent of the Regional Banks' results are accounted for in the results of Credit Agricole S.A. using the equity method. Credit Agricole S.A. co-ordinates the implementation of commercial strategy, in particular by defining broad marketing and communications policy. As the Group's lead body, it also is in charge of managing centralised savings and advances for the Regional Banks apart from audit and risk management.

#### (D) OP Bank Group (Finland)

(i) **Structure:** OP Bank Group comprises 239 independent member co-operative banks (these are independent, local deposit banks that are engaged in retail banking) and the Group's statutory central institution, OP Bank Group Central Co-operative. The central co-operative is the OP Bank Group's development and service centre, and its strategic owner institution. The Central Co-operative is owned by the member co-operative banks. As a central institution, it is in charge of Group steering and control. OKO Bank is the largest subsidiary of the Central Co-operative. OKO Bank is a commercial bank, which also acts as the OP Bank Group's central bank. The OP Bank Group Central Co-operative own 29.93 per cent of shares and have 56.8 per cent of votes of OKO bank (April 30, 2007).

(ii) **OKO Bank** acts as an independent commercial bank and financial institution for the member co-operative banks. It has three subsidiaries. The OKO Bank is the central financing institution of the co-operative banks and as a commercial bank it engages in the business operations set forth in the Credit Institution Act. The special purpose of the Bank is to promote and support, as a central financing institution, the activities of the co-operative banks and other institutions belonging to the Co-operative Banks Group. The bank can offer investment services as well as custodial and asset management services. The bank is responsible for the debts and commitments of the central institution and its member banks and other Co-operative Credit Institutions. The central institution and its other member banks are in turn responsible in the same way for this bank's debts and commitments. The central institution has the right to issue instructions to OKO Bank on its operations in order to ensure the Bank's liquidity, capital adequacy and risk management as well as the right to supervise the bank's operations.

(iii) **Shareholding of OKO bank:** OKO Bank issues two categories of shares. Series-A and K. Series A are intended for the public and are listed on the Helsinki Exchanges. Each Series A share entitles its holder to one vote at the general meeting of shareholders. Series K

shares can only be owned by a Finnish co-operative bank and the central institution, OKO Bank Group Central Co-operative. Each Series K share gives its holder five votes. The Series K share can be converted into Series A share upon a demand of the shareholder or, in respect of nominee-registered shares, subject to certain conditions and the Articles of Association. The majority of Supervisory Board members are elected from among the members of the Supervisory Board of the OKO Bank Group Central Co-operative. One of their duties is to appoint the Chairman of the Executive Board and the President.

(iv) **Co-operative Control:** OKO Bank, through its issuance of two categories of shares, presents a hybrid model that blends the benefits of a listed entity and those of a co-operative. While the Series A shares enable raising capital on stock exchange, the Series K share ensures co-operative control over the institution.

E. **Corporate Credit Unions – U.S.**

U.S. has a good network of credit unions that service the customers, across the Country. There are "central" credit unions which support a group of credit unions in a State. The support is given in the areas of investment, liquidity and cash management, products & services, risk management funds transfers and settlement, analytical services *etc.* These central credit unions are again served by



the US Central, which is the whole sale financial centre for them. These assets of US Central are approximately US \$40 billions.

A similar system exists in Canada.

#### **F. The Co-operative Bank Group (UK)**

The co-operative group is a co-operative society and is not a company. The co-op bank and co-op insurance society (CIS) are both part of the Co-operative Group (CG). The CG is one of the biggest consumer co-operatives in the world and engaged in a family of businesses engaged in a wide range of activities, including food, finance, farms and funerals.

The bank also has approximately 1,700 preference shareholders. The preference shares are fixed interest shares and are non-cumulative and non-redeemable.

The bank and its subsidiaries (investment, leasing, financial advisors investment managers, *etc.*) provide an extensive range of banking and financial services in the United Kingdom. The bank also takes advantage of the synergies within the Co-op group, establishing automated teller machines in Co-op convenience stores and having a sister company, the Co-operative Insurance Society as stated above, which provides insurance products for the bank's mortgages.

The Co-operative Bank applies co-operative principles through a "Partnership Approach," whereby the bank seeks to deliver value to all Partners (customers, staff and their families, shareholders, suppliers, local communities, national and international society, and past and future generations) in a socially responsible and environmentally sustainable manner. Since 1998 the bank has been publishing a sustainability report, *The Partnership*

*Report*, to inform the public on its performance in meeting its three broad objectives of ecological sustainability, social responsibility and delivering value. This desire to serve not only members but also the broader community is at the heart of the institution's mission.

The model is a manifestation of the desire of the Group to leverage the benefits/synergy of co-operation & co-operative stores spread across UK and co-operative bank by the group is an extension of the co-operative spirit. The model is a fine example of co-operation among co-operatives.

#### **G. Banque Coop (Switzerland):**

Banque Coop did not have a traditional co-operative ownership structure. It is incorporated as a public company and listed on the stock market. Groupe Coop Suisse, a group of co-operatives operating mainly in food processing and retailing, owned 54 per cent of the shares while Swiss trade unions owned another 11 per cent. The remainder of shares was distributed among the general public, institutional investors and small and medium-sized enterprises.

The distribution of shares ensured that a majority of directors represented co-operative shareholders at all times and that the co-operative mission of the institution was respected. The co-operative principles were written into its mission statement. Structure provides an alternative perspective on the governance and ownership of co-operative institutions in that it did not abide by the one member, one vote rule.

The fact that co-operative interests held the majority of shares ensured that the co-operative principles and co-operative mandate of the institution were respected.

Annex

**Comments of Peer Reviewer Mr. Eric Rosengren, President and CEO, Federal Reserve Bank of Boston and Stance of the Advisory Panel**

Thank you for the opportunity to review your draft report on the assessment of Basel Core Principles. The analysis is very thorough and provides many useful insights into the Indian financial and banking systems. While I have spent a career thinking about the types of issues addressed in this report, I am not an expert on the institutional details of Indian banking organisations and financial markets. Nevertheless, I hope you find my comments useful in the process of finalising your report.

***Stance of the Panel: No comments***

Above all, I found it particularly commendable that the report recognised the critically important need to attract and retain top quality staff to serve in the supervisory and regulatory community. This is an area that is often overlooked, but has become increasingly important as financial institutions rely more and more on models to devise complex financial instruments. The second key contribution of the report is that it points out the urgent need to improve co-operation among the regulatory agencies and suggests streamlining the overall regulatory infrastructure in the long run. Efficient information sharing and co-ordination among regulators is crucial for preventing regulatory arbitrage, an issue that is also given due consideration in the report. Thirdly, I appreciate the report's recognition of the need to tailor your own regulatory program to fit the Indian financial system. While many Basel principles should be applicable to any financial

system, the exact implementation must consider the local context, which is shaped by the specific characteristics of local legal and judicial systems, tax policies, regulatory structure, accounting conventions, and local custom to name just a few of the institutional aspects that must be taken into account.

***Stance of the Panel: No comments***

I now provide some specific comments that you may find helpful to consider as you finalise the report. Should my remarks be unclear, I hope you will contact me for clarification.

1. Just as it is crucial to foster greater co-operation among domestic regulatory agencies, it also becomes increasingly important nowadays to promote greater and more effective cross-border collaboration among regulators, as the operations of financial institutions have grown more global. It might be advisable for the Reserve Bank to establish formal memoranda of understanding with regulatory agencies in other countries about issues such as the sharing of confidential supervisory information.

***Stance of the Panel: Accepted. This has been appropriately incorporated under the head 'Home host country co-operation' in the chapter on 'Overarching Issues' of the report.***

2. Recent financial turmoil around the world has underscored the need for more careful management of liquidity risk. The incidents of Northern Rock and Bear Stearns have highlighted the fact that even large established

financial institutions in well developed financial markets can precipitate significant financial instability if liquidity risk is not addressed appropriately. In markets where aggregate volatility may be greater, the importance of monitoring liquidity risk is likely to be greater as well. I would suggest expanding the discussion in the report on liquidity risk. Specifically, you might consider the following additions to your report.

- a. You might provide some background information on liquidity risk at the major types of institutions critical to financial markets.

***Stance of the Panel: Accepted. This has been appropriately incorporated in the Summary Assessment of the Basel Core Principles as regards commercial banks.***

- b. The role of lender of last resort might be discussed in more detail. The mechanisms for fulfilling the lender-of-last-resort responsibilities have important implications for regulatory structure. In particular, the lender of last resort must have the ability and necessary data to assess the solvency risk and liquidity risk of institutions that may use the facility. Apart from ensuring proper utilisation of the facility, this risk assessment capacity should also help to reduce the incidence of events that cause an aggregate shortage of liquidity and thus call for interventions from the lender of last resort.

***Stance of the Panel: Accepted. This has been appropriately incorporated under the head 'Liquidity Risk' in the recommendations arising from assessment of the Basel Core Principles as regards commercial banks.***

3. I would also suggest expanding the discussion on the synergies between regulation and supervision and the promotion of financial stability. I have attached a recent speech that

explains some of my views; I must note though that I am not unbiased in this area. In the speech, I argued strongly that the distinctions between regulator, monetary policy maker, and lender of last resort often become blurred during crises or periods of significant illiquidity such as we are seeing in some countries at this time.

***Stance of the Panel: Accepted. This has been appropriately incorporated under the head 'Synergies between regulation and supervision and promotion of financial stability' covered in the chapter on 'Overarching Issues' of the report.***

4. Financial institutions are increasingly using complicated financial instruments. Many of these instruments do not trade through exchanges but instead through broker/dealer networks. In many such dealer markets, the role of operational risk in impeding the smooth functioning of markets has become a prominent problem. The report might consider more detailed discussions of operational risk, such as the risks inherent in the back office operations that are critical to key markets.

***Stance of the Panel: Accepted. This has been appropriately incorporated in the summary Assessment of Basel Core Principles as regards commercial banks.***

5. I would like to point out that moving to principles-based regulation increases the need to attract and retain highly skilled people to public service. Principles-based regulation requires the staff of regulatory agencies to have both a holistic understanding of financial institutions and financial markets and a technical understanding of modern risk management models. Such individuals are in short supply, and there is intense competition from the private sector for them. The report might want to emphasise more explicitly the link between the human resources challenges and the effective implementation of principles-based regulation.

***Stance of the Panel: Accepted. This has been appropriately incorporated under the head 'Applicability of Principles Based Regulation in the Indian Context' in the chapter on 'Overarching Issues' of the report.***

6. The report might consider elaborating somewhat on the Central Government's role in the operation of public sector banks as well as local governments' role in the operation of co-operative societies, and how the involvement of government affects the ability of the Reserve Bank to carry out its regulatory and supervisory duties. Undue governmental influence can lead to poor governance and render regulation ineffectual. This clearly has direct bearing on the regulator's ability to enforce compliance with BCP. Moreover, it can be a hindrance to economic development.

***Stance of the Panel: This has been appropriately incorporated under the head 'Ownership issues' in the 'Broad Issues' chapter of the report.***

7. To make this assessment as good a guidance as possible for future banking reforms, the report may want to take greater account of the broad institutional infrastructure in India. Research has shown that weak institutions in developing countries often hamper regulators' efforts to carry out their supervisory responsibilities. For example, antiquated bankruptcy laws and an inefficient judicial system can make it more difficult and time-consuming to collect loan payments and foreclose on collateral. Weak accounting standards and unreliable auditing can result in regulators' lacking meaningful financial data to conduct off-site surveillance. So, it might be

useful to consider whether these types of issues are important in India.

***Stance of the Panel: Accepted. This has been appropriately incorporated under the head 'Institutional infrastructure' in the chapter on 'Overarching Issues' of the report.***

8. To arrive at an effective assessment of BCP compliance, it would be helpful to know not only that the requisite rules are in place but also how closely these rules have been followed in banks' routine operations. In cases where compliance with the rules is less than satisfactory, it would be useful to know what measures the regulators have taken and/or plan to take to remedy the situation. On a related note, it seems desirable for the report to provide more concrete recommendations in areas where challenges and problems have been identified, since one objective of reports on such assessment programs is to serve as a roadmap for future reforms in the Indian banking industry.

***Stance of the Panel: Accepted. The assessment of Basel Core Principles is based on the how the rules are complied by the banks in their routine operations. This has been stated in the chapter on 'Overarching Issues' of the report. Recommendations have been made in related assessments where challenges and problems have been identified.***

9. The issue of how best to regulate conglomerates, especially those that own both financial and non-financial subsidiaries, seems to deserve more attention. Large conglomerates engaging in a diverse array of businesses is not uncommon in developing economies. These conglomerates conduct many internal

transactions within – across the myriad of subsidiaries – and the intra-conglomerate cash flows are generally opaque to outside investors and even to regulators. Because of their size, the conglomerates are critical to the stability of the overall economy. Since the ultimate goal of implementing the BCP principles is to promote financial stability, it seems vital that the relevant

agency have the authority to both issue regulations and enforce supervisory actions as necessary.

***Stance of the Panel: Accepted. This has been appropriately incorporated under the head 'Inter-regulatory co-operation' in the chapter on 'Overarching Issues' of the report.***

## Chapter IV

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## List of Acronyms

ADs	Authorised Dealers	ETF	Exchange Traded Fund
AMBI	Association of Merchant Bankers of India	FCAC	Fuller Capital Account Convertibility
AMFI	Association of Mutual Funds of India	FCR	Forward Contract Regulation
AML	Anti Money Laundering	FDIC	Federal Deposit Insurance Corporation
ANMI	Association of National Exchange Members of India	FEDAI	Foreign Exchange Dealers Association of India
ASIC	Australian Securities and Investment Commission	FEMA	Foreign Exchange Management Act
ASX	Australian Stock Exchange	FFAJ	Financial Futures Association of Japan
BSE	Bombay Stock Exchange	FFMCs	Full Fledged Money Changers
CAG	Comptroller and Auditor General of India	FII	Foreign Institutional Investors
CBLO	Collateralised Borrowing and Lending Obligation	FIMMDA	The Fixed Income Money Market and Derivatives Association of India
CBOT	Chicago Board of Trade	FMC	Forward Markets Commission
CCIL	Clearing Corporation of India Ltd.	FPSBI	Financial Planning Standards Board of India
CCP	Central Counter Party	FSA	Financial Services Authority
CD	Certificate of Deposit	FSAP	Financial Sector Assessment Program
CDSL	Central Depository Services (India) Ltd.	GASAB	Government Accounting Standards Advisory Board
CEO	Chief Executive Officer	GDP	Gross Domestic Product
CIS	Collective Investment Scheme	GoI	Government of India
CMD	Capital Markets Department	G-secs	Government Securities
CME	Chicago Mercantile Exchange	HKEx	Hong Kong Exchange and Clearing
CMI	Capital Markets Intermediaries Department	HLCCFM	High Level Co-ordination Committee for Financial Markets
CP	Certificate of Deposit	HR	Human Resources
CSGL	Constituents Subsidiary General Ledger	ICAI	Institute of Chartered Accountants of India
DGBA	Department of Government and Bank Accounts		
DP	Depository Participant		
DVP	Delivery Versus Payment		

IDA	Investment Dealers Association of Canada	NYSE	New York Stock Exchange
IFIs	International Financial Institutions	LLC	Limited Liability Company
IMF	International Monetary Fund	LSE	London Stock Exchange
IMSS	Integrated Market Surveillance System	NDS	Negotiated Dealing System
IOSCO	International Organisation of Securities Commission	NDS-OM	Negotiated Dealing System – Open Market
IPOs	Initial Public Offers	OCC	Office of the Comptroller of the Currency
IRDA	Insurance Regulatory Development Authority	OECD	Organisation for Economic Co-operation and Development
JSDA	Japan Securities Dealers Association	OTC	Over the Counter
JSIAA	Japan Securities Investment Advisers Association	OTCEI	Over the Counter Exchange of India
LA	Listing Agreement	PDs	Primary Dealers
LAF	Liquidity Adjustment Facility	PDAI	Primary Dealers Association of India
MAS	Monetary Authority of Singapore	PFRDA	Pension Funds Regulatory Development Authority
MCX	Multi Commodities Exchange	RBI	Reserve Bank
MF	Mutual Fund	REITs	Real Estate Investment Trusts
MMMFs	Money Market Mutual Funds	RSE	Registered Stock Exchange
MoU	Memorandum of Understanding	RTGS	Real Time Gross Settlement System
MSRB	Municipal Securities Rulemaking Board	SC(R) Act	Securities Contract Regulation Act
NASDAQ	National Association of Securities Dealers Automated Quotations	SGF	Settlement Guarantee Fund
NASD	National Association of Securities Dealers	SEs	Stock Exchanges
NBFCs	Non Banking Financial Companies	SEBI	Securities and Exchange Board of India
NCDEX	National Commodities and Derivatives Exchange	SEC	Securities and Exchange Commission
NFA	National Futures Association	SEHK	Stock Exchange of Hong Kong
NSDL	National Securities Depository Ltd.	SGL	Subsidiary General Ledger
NSE	National Stock Exchange	SGX	Singapore Exchange
		SRO	Self Regulatory Organisation
		TSE	Tokyo Stock Exchange
		UMIR	Universal Market Integrity Rules



## Chapter IV

# Assessment of Adherence to IOSCO Principles

### Section 1

#### Background

##### 1.1 IOSCO Principles as Benchmark

International Organisation of Securities Commissions (IOSCO) was established in 1983 as an international co-operative body of securities market regulators, initially by eleven securities regulatory agencies from North and South America. Currently, there are more than 100 securities regulatory agencies who are members of IOSCO, covering more than 90 per cent of the world's securities markets. In India, the Securities Exchange Board of India (SEBI) is a member of IOSCO.

The objectives of securities market regulation are

- (i) protection of investors –recognising the growing incidence of retail participation in the capital, particularly equity markets;
- (ii) ensuring that markets are fair, efficient and transparent; and
- (iii) reduction of systemic risk.

In 1998, IOSCO adopted a comprehensive set of Objectives and Principles of Securities Regulation (IOSCO Principles), which are recognised as the international regulatory benchmarks for all securities markets. Although

there are local differences in market structures, these objectives form a basis for an effective system of securities regulation. The IOSCO principles, given the stage of market development in many emerging markets are aspirational in nature, but have been used by the World Bank and the IMF in the Financial Sector Assessment Program, for assessing securities market regulation.

IOSCO resolutions, which provide content to the more broadly-stated IOSCO Principles and cited IOSCO reports, are also consulted in regard to the Principles and the tools and techniques in assessing their compliance. The Principles were updated as of May 2003 to cross-reference additional IOSCO reports and resolutions to each principle. The report presents assessment and recommendations which are based on the assessment of the relevant financial markets in India. It applies the IOSCO principles to securities market regulation.

##### 1.2 Earlier Assessments

The FSAP conducted in 2001 in respect of the securities market had revealed that India was fully compliant in respect of 3 IOSCO principles, largely compliant in respect of 17 principles and materially non-compliant in respect of 10 principles. The principle-wise assessment is furnished in **Appendix 1**.

Concurrently, in order to guide the process of implementation of international standards and codes in India as also to position India's stance on such standards, the Reserve Bank of India in consultation with the Government of India constituted a Standing Committee on International Financial Standards and Codes. One of the advisory groups constituted by the Committee assessed the status of securities market regulation evaluating the adherence to IOSCO Principles in respect of regulation and supervision of the equity and debt markets. The recommendations given by the Advisory Group are furnished in **Appendix 2**.

A Review Committee in 2004 monitored the progress made in respect of the recommendations emanating from the above exercise. The progress made in this regard as reported by the Review Committee are summarised in **Appendix 3**.

#### 1.3 Key Developments since 2001

SEBI has been continually reviewing and strengthening the prudential, regulatory and supervisory framework as part of the ongoing reform process. Some of the key developments in this regard in respect of equities/corporate bond market are enumerated below:

- The SEBI Act has been amended in October 2002 so that SEBI is vested with investigation power, cease and desist proceedings and search and seizure powers in cases relating to insider trading and market manipulations. The amount of penalty has been raised substantially in respect of various offences under the SEBI Act.
- The Securities Contract Regulation Act (SC(R) Act) was also amended in October 2002 for enabling the corporatisation and demutualisation of the stock exchanges and approval of clearing corporation by SEBI. Further, SEBI was vested with powers to issue direction and impose monetary penalty for violations of provision of SC(R) Act.
- SEBI issued the Delisting of Securities Guidelines in 2003 which provides the framework for giving an exit option to investors in case of delisting of securities from Recognised Stock Exchanges (RSEs).
- SEBI has framed the Securities and Exchange Board of India (Self Regulatory Organisations) Regulations, 2004 (SRO Regulations) to enable appropriate organisations of intermediaries to be recognised as SRO.
- The Companies (Issue of Indian Depository Receipts) Rules, 2004 were issued to lay the framework for the issue of Indian Depository Receipts (IDRs) by foreign companies in India and listing of the IDRs in RSEs.
- Section 11 (2) (1a) of the SEBI Act enables the sharing of information with foreign countries. Till date it has entered into Memorandum of Understanding (MoU) with 13 countries. SEBI has shared information on numerous occasions with foreign counterparts when requested, after ensuring that appropriate safeguards are in place for sharing information.
- Companies are required to prepare financial statements in accordance with

accounting standards as provided in Company (Accounting Standard) Rules, 2006 issued by Ministry of Corporate Affairs (MoCA). Clause 50 of the Listing Agreement makes it mandatory for listed companies to follow accounting standards issued by the Institute of Chartered Accountants of India (ICAI).

- Capital adequacy requirements such as Base Minimum Capital, Trade Guarantee Fund and Deposit *etc.* for brokers are structured to address market and liquidity risks. Besides maintaining capital adequacy, brokers are also required to contribute to Trade Guarantee Fund of the Exchange.
- SEBI has taken steps to streamline procedures relating to the detection of frauds. The Integrated Market Surveillance System (IMSS) has been put in place by it for the surveillance of trading and securities transactions in exchanges and depositories.
- As regards the demutualisation and corporatisation of stock exchanges, the Securities Contracts (Regulation) (Manner of Increasing and Maintaining Public Shareholding in Recognised Stock Exchanges) Regulation, 2006, has been notified. Accordingly, SEBI has approved and notified the corporatisation and demutualisation of 16 stock exchanges under Section 4B(8) of SC (R) ACT, 1956 in addition to already corporatised/demutualised RSEs such as NSE and OTCEI.
- The mutual fund regulations were amended in January, 2006 laying regulatory framework for launching of Gold Exchange Traded Fund (Gold ETF) by the mutual funds.
- SEBI DIP guidelines were amended in May, 2006 to introduce an additional mode for listed companies to raise funds from domestic markets in the form of qualified institutional placement.
- In July, 2007 SEBI created an Investor Protection Education Fund for the purpose of investor education and related activities.
- SEBI laid down the framework for the certification of intermediaries and associated persons who are operating or working in the securities market or industry vide SEBI (Certification of associated persons in the Securities Markets) Regulations, 2007.
- To enable well established and compliant listed companies to access Indian primary market in a timely and effective manner through follow-on public offering and rights issue, SEBI introduced fast track issue mechanism in November, 2007. Such companies were exempted from filing draft offer documents with SEBI and Stock Exchanges.
- In April, 2008 mutual fund regulations were amended to permit mutual funds to launch Real Estate Mutual Fund to invest directly or indirectly in the real estate.
- SEBI specified in April, 2008 the broad regulatory Board for short selling by institutions, investors and full fledged securities lending and borrowing schemes enabling FIIs and mutual funds to participate in the framework for short selling and securities lending and borrowing.
- SEBI introduced in April 2008 four new derivatives products *viz.* (i) mini contracts in equity indices (ii) options contracts with longer life tenure, (iii) volatility index and F&O contracts on the same and (iv) bond index and F&O contracts on the same.



- The SC(R) Act was amended in May 2007 empowering SEBI to regulate public issue and the listing of securitised debt instruments by the Special Purpose Distinct Entity<sup>19</sup>. SEBI has notified SEBI (Public Issue and Listing of Securitised Debt Instruments) Regulations, 2008 in May 2008.
- In order to facilitate development of vibrant primary market for corporate bonds in India, SEBI has notified in June 2008 regulations for issue and listing of debt instruments to provide for simplified regulatory framework for issuing and listing of non-convertible debt securities to be issued by any company, PSUs or statutory corporations.
- In August, 2008 SEBI laid down guidelines on trading of currency futures in RSE or new exchanges.

#### 1.4 An Outline of Regulatory Structure of Financial Markets

Over the last 15 years, India has taken several steps to develop financial markets. An important aspect of this has been the streamlining and strengthening of market regulations. SEBI is the apex securities market regulator and a member of International Organisation of Securities Commissions (IOSCO). Where the government securities market is concerned, regulatory powers are shared with the Reserve Bank. Some regulatory

powers are exercised by the Government of India also through the Ministry of Finance and the Ministry of Corporate Affairs.

SEBI was initially set up as an administrative body in 1988. In 1992 it was established as the securities market regulator. Its powers and functions have been laid down in the SEBI Act of 1992. It also exercises powers under the Securities Contract Regulation Act, 1956, the Depositories Act, 1996 and certain provisions of the Companies Act, 1956. It regulates the securities markets and securities market institutions such as the stock exchanges, depositories, mutual funds and asset management companies, securities dealers and brokers, merchant bankers, credit rating agencies and venture capital funds.

The Reserve Bank also regulates some segments of financial markets. It has regulatory jurisdiction over the government securities markets and the related derivatives segments besides the money and foreign exchange markets. The Reserve Bank derives its regulatory power from various legislations, *viz.*, the RBI Act of 1934, the Securities Contract (Regulation) Act 1956, the Foreign Exchange Management Act 1999 and the Government Securities Act 2006.

An outline of the existing structure of financial markets regulation and governing legislations in India is furnished in Table 1:

In the above backdrop, Section 2 brings out the coverage, scope and methodology of

<sup>19</sup> Special purpose distinct entity means a body corporate or trust which acquires debt or receivables out of funds mobilised by it by issuance of securitised debt instruments through one or more schemes or a body corporate which acts as a trustee in respect of such schemes and includes the National Housing Bank constituted under the National Housing Bank Act, 1987 (53 of 1987) or any trust or other body set up by it in terms of that Act.

**Table 1: Existing structure of Financial Markets Regulation in India**

<b>Instruments</b>	<b>Regulator</b>	<b>SROs</b>	<b>Acts/ Guidelines</b>	<b>Trading platform/ Regulation of trading/ Market intermediaries</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<p><b>Equities/corporate bond market</b></p> <p>i) Equities ii) Corporate bonds other than money market instruments iii) Collective Investment Schemes\$ iv) Venture Capital v) Derivatives related to equities vi) Mutual Funds \$\$ vii) Public issue, listing and trading of securitised debt instruments</p>	SEBI\$\$\$\$	Stock Exchanges are recognised as SRO under SC(R) Act. Presently there is no recognised SRO under SEBI SRO Regulation \$\$\$\$	SEBI Act, 1992  SC(R) Act, 1956  Depositories Act, 1996  Companies Act, 1956\$\$\$\$	Stock exchanges\$\$\$\$\$\$.
<p><b>Government Securities Market</b></p> <p>i) Dated government securities&amp; ii) Derivatives on government securities market</p>	RBI SEBI	#	Government Securities Act, 2006  SC (R) ACT, 1956 vide Govt. notification dated March 1, 2000	Trading in G-secs can take place in only dematerialised form and all the trades are settled in a guaranteed mode through CCIL in a DVP mode.  As these instruments are listed on stock exchange provisions relating to SC(R) Act, 1956 shall be applicable and SEBI can take actions in respect of issues relating to listing and trading in RSE. Further, these securities can be traded through brokers and as brokers are regulated by stock exchanges who are in turn regulated by SEBI, any issues relating to brokers would fall under the purview of SEBI. Likewise, any transactions in RSE if they have been dealt with in a manner detrimental to investors, action can be taken by SEBI.  The Reserve Bank has issued detailed guidelines to Primary Dealers## regarding management oversight, policy/operational guidelines, concurrent audit, provisioning, audit of brokers business, internal control systems, engagement of brokers for securities transactions, accounting standards to be followed for securities transactions (cf. IDMC. No.PDRS./2049A/03.64.00/99-2000 dated 31-12-1999).
<p><b>Money market</b></p> <p>i) Treasury bills ii) Call money/notice money iii) Term money</p>	RBI	#	RBI Act, 1934  SC(R) Act, 1956 vide Govt.	The trading in money market instruments can take place on trading platform or in the OTC market. Electronic platforms are available for deals in Call,

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### Assessment of Adherence to IOSCO Principles

Instruments	Regulator	SROs	Acts/ Guidelines	Trading platform/ Regulation of trading/ Market intermediaries
1	2	3	4	5
i) CPs* ii) CDs**	RBI SEBI	#	notification dated March 1, 2000  RBI Act, 1934 SC(R) Act, 1956 vide Govt. notification dated March 1, 2000	Notice and Term money transactions, market repo and CBLO. OTC deals are done for CP, CD as well as for Call/Notice/Term money market.  OTC deals are done for CP, CD. As these instruments are listed on stock exchanges provisions relating to SC(R) Act shall be applicable and SEBI can take actions in respect of issues relating to listing. CPs can be traded through brokers and as brokers are regulated by stock exchanges who are in turn regulated by SEBI, any issues relating to brokers would be fall under the purview of SEBI. Likewise, any transactions in RSEs if they have been dealt with in a manner detrimental to investors, action can be taken by SEBI.
Derivative products	RBI SEBI	#	Companies Act, 1956 RBI Act, 1934  SC(R) Act 1956 vide Govt. notification dated March 1, 2000	Standing Committee on Finance in its 25 <sup>th</sup> Report published in 2005-06 stated that "there would be two statutes governing derivative transactions viz., the SCR Act for exchange traded derivative transactions and RBI Act for OTC derivatives, which involve a Reserve Bank regulated entity as a party." The derivative products arising from money market instruments are regulated by the Reserve Bank. Section 16 of SC(R) Act states that Central Government in order to prevent undesirable speculation in specified securities can by notification specify securities dealing in which is prohibited. Powers under Section 16 are exercisable by SEBI/ the Reserve Bank. Section 13 of SC(R) Act empowers Central Government to notify states or areas where securities transactions entered into by individuals otherwise than between members of RSE would be treated as illegal. Powers under Section 13 are exercisable by SEBI also. Central Government or SEBI can regulate and control the business of dealing in
Interest rate futures	SEBI	#	SC(R) Act, 1956 Section 45U(a) of RBI Act	

Instruments	Regulator	SROs	Acts/ Guidelines	Trading platform/ Regulation of trading/ Market intermediaries
1	2	3	4	5
Money market mutual funds&&	SEBI	Stock Exchanges	SC(R) Act 1956 SEBI Act, 1992	spot delivery contracts in securities under Section 18(2) of SCR Act by issue of notification. The powers in respect of money market mutual funds vest with SEBI but money market instruments are defined by the Reserve Bank under Section 45U(b) of RBI Act.
<b>Foreign exchange Market</b> i) Foreign exchange products ii) Derivatives on foreign exchange market	RBI	%	FEMA, 1999  SC(R) Act,1956 vide Govt. notification dated March 1, 2000  RBI Act, 1934 as amended in December 2005	OTC products would not be listed on exchange. In terms of notification issued by Government of India, in March 2000, as foreign exchange products and its related derivatives would be regulated by the Reserve Bank. A number of trading platforms are presently available for market participants such as FX clear (promoted by CCIL), Fx Direct (promoted by IBS foreign exchange Ltd.), Reuters D2 and Reuters Market Data Systems (both promoted by Reuters). FX Clear and Fx Direct both offer real time order matching and negotiation modes for dealing.
<b>Gold related securities</b>	RBI SEBI	-	SC(R) Act, 1956 SEBI, 1992 RBI, 1934  Banking Regulation Act, 1949  FEMA, 1999	Listed on exchange. In terms of notification issued by Government of India, in March 2000, gold and its related securities would be under purview of the Reserve Bank. However, if the security is traded on exchange then SEBI also has powers inasmuch as it can take action in respect of issues relating to listing and trading of securities in RSE. Gold related securities can be traded through brokers and as brokers are regulated by stock exchanges who are in turned by SEBI, any issues relating to brokers would be fall under purview of SEBI. Likewise, any transactions in RSEs if they have been dealt with in a manner detrimental to investors, action can be taken by SEBI.
<b>Gold exchange traded funds</b>	SEBI	-	SEBI Custodian Regulations  SEBI Mutual Funds Regulation	The Gold ETFs are launched as mutual fund scheme by AMCs approved by SEBI. Units of Gold ETFs are listed and traded on exchange they would fall under the purview of SEBI. Terms of GETFs governed by Gazette notification dated January 12, 2006 and SEBI (MF) Regulations 1996.
<b>Gold futures</b>	FMC	-	Broad frame work for	Listed on MCX, NCDEX. Forward Contracts (Regulation) Act, 1952

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### Assessment of Adherence to IOSCO Principles

Instruments	Regulator	SROs	Acts/ Guidelines	Trading platform/ Regulation of trading/ Market intermediaries
1	2	3	4	5
<b>Credit derivatives</b>	The Reserve Bank as regards RBI regulated entities SEBI in case such derivatives are traded on RSE	-	Forward Markets Commission  Guidelines have to be framed by respective exchanges.  Banking Regulation Act, 1949  Chapter IIID of RBI Act  SCR Act – Section 18A.	provides for the powers and functions of FMC. The associations which provide platforms for trading in derivative contracts in commodities come under the regulatory purview of FMC.  Comprehensive powers have been given to FMC under ordinance issued in 2008 amending FCR Act  As of now not listed.  SEBI in case such derivatives are traded on RSE.

§ SEBI (Collective Investment Scheme) Regulations 1999 (CIS Regulations) states / provides that no person other than a Collective Investment Management Company which has obtained a certificate under the regulations can carry on a collective investment scheme. The CIS Regulation lays down legal and regulatory framework for launching and operating CIS schemes which comes under definition of CIS u/s 11AA of SEBI Act which includes agro bonds, teak bonds, plantation bonds etc. No entity has been registered with SEBI as CIS. As per regulation 9 (a) of CIS Regulations, 1999 the regulatory framework mandates that the form and structure of a CIS must be a company registered under Companies Act, 1956.

§§ SEBI (Mutual Fund) Regulations, 1996 (referred to as MF Regulations) set standards for the eligibility and regulation for those who wish to market a Mutual Fund Scheme. The Mutual Fund Regulation lays down legal and regulatory framework for schemes by which funds of investors are pooled to invest in securities, money market instruments, gold or gold related instruments, etc. Regulation 7 lays down eligibility criteria for registration of a Mutual Fund. Regulation 10 lays down terms and conditions of registration. Regulation 21 lays down eligibility criteria for appointment of Asset Management Company (AMC). Regulation 18(4) provides for requirement to be complied with before launch of any scheme. Regulation 28 lays down procedure for launching of Schemes of Mutual Fund.

§§§ SEBI has comprehensive inspection, investigation and surveillance powers. SEBI can call for information from, undertake inspection, conduct inquiries and audits of stock exchanges u/s 11(2)(i), MFs, other persons associated with securities market, intermediaries and SROs. SEBI can investigate without prior notice u/s 11C.

§§§§ Section 11(2)(d) of SEBI Act empowers SEBI to promote and regulate SRO. It has framed the SEBI (SRO) Regulations, 2004 (SRO Regulations) to enable organisation of intermediary to be recognised as SRO. As per Reg. 3 & 4 of SRO Regulations any applicant which seeks to be recognised as SRO should have the capacity to carry out the purposes for which it is seeking recognition. There are also other organisation such as Association of National Exchanges Members of India (ANMI), Association of Mutual Funds of India (AMFI), Association of Merchant Bankers of India (AMBI) and Financial Planning Standards Board of India (FPSBI). The organisations like ANMI, AMFI, AMBI, FPSBI etc. at present function primarily as trade association.

\$\$\$\$ SEBI has power of inspection over listed companies u/s 209A of Companies Act.

\$\$\$\$ The SC(R) Act has laid down legal and regulatory framework for recognition / authorisation and operation of the RSE and regulations of contract in securities. Section 19 of SC(R) Act prohibits stock exchanges (SEs) other than RSEs. Any SE desirous of being recognised as RSE, has to make an application for recognition to SEBI, as per Section 3 of SC(R) Act. The RSE may establish trading floor with prior approval of SEBI, on terms and conditions stipulated by SEBI as per Section 13A of SC(R) Act. Derivative Exchanges or separate derivative segment of an existing exchange also require approval from SEBI. Section 17(A) of SCR Act inserted by SC(R) Amendment Act, 2007 w.e.f 28.5.07 empowers SEBI to regulate public issue, listing and trading of securitised debt instruments.

# Though, FIMMDA and PDAI do SRO like function for government securities market, they are not SROs. Likewise, though, FIMMDA does some SRO like function for money market, they are not SROs. FIMMDA stands for The Fixed Income Money Market and Derivatives Association of India (FIMMDA). It is an Association of Commercial Banks, Financial Institutions and Primary Dealers. FIMMDA is a voluntary market body for the bond, Money and Derivatives Markets. FIMMDA has members representing all major institutional segments of the market. The membership includes Nationalised Banks such as State Bank of India, its associate banks, Bank of India, Bank of Baroda; Private sector Banks such as ICICI Bank, HDFC Bank, IDBI Bank; Foreign Banks such as Bank of America, ABN Amro, Citibank, Financial institutions such as ICICI, IDBI, UTI, EXIM Bank; and Primary Dealers. The objectives of FIMMDA are

- To function as the principal interface with the regulators on various issues those impact the functioning of these markets.
- To undertake developmental activities, such as, introduction of benchmark rates and new derivatives instruments, etc.
- To provide training and development support to dealers and support personnel at member institutions.
- To adopt/develop international standard practices and a code of conduct in the above fields of activity.
- To devise standardised best market practices.
- To function as an arbitrator for disputes, if any, between member institutions.
- To develop standardised sets of documentation.
- To assume any other relevant role facilitating smooth and orderly functioning of the said markets.

(Source: FIMMDA website)

### ##PDs' role and obligations

PDs are required to have a standing arrangement with the Reserve Bank based on the execution of an undertaking each year. The major roles and obligations of PDs are as below:

- i) Support to Primary Market: PDs are required to support auctions for issue of government dated securities and Treasury Bills as per the minimum norms for bidding commitment and success ratio prescribed by the Reserve Bank from time to time.
- ii) Market making in Government securities: PDs should offer firm two-way quotes in Government securities, through the Negotiated Dealing System, over the counter telephone market and through recognised Stock Exchanges in India and take principal positions in the secondary market for Government securities.
- iii) PDs should maintain minimum capital standards at all points of time as prescribed by the Reserve Bank.
- iv) PDs should achieve minimum turnover ratio of 5 times for Government dated securities and 10 times for Treasury Bills of the average month-end stocks (turnover ratio computed as the ratio of total purchase and sales during the year in the secondary market to average month-end stocks) in the secondary market for Government dated securities and Treasury Bills.
- v) PDs' operations are subject to all prudential and regulatory guidelines issued by the Reserve Bank.

(cf. IDMD.PDRS.05/03.64.00/2004-2005 dated October 1, 2004)

\* Guidelines on CPs issued by the Reserve Bank vide FMD.No.6/02.06.001/2006-07 dated July 13, 2006

\*\* Guidelines on CDs issued by the Reserve Bank vide FMD.No.7/02.06.001/2006-07 dated July 13, 2006

& **Trading in government securities over exchanges** (cf. IDMC.PDRS.No.2896/03.05.00/2002-03 dated January 14, 2003)



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### Assessment of Adherence to IOSCO Principles

With effect from January 16, 2003, trading of dated Government of India (GOI) securities in dematerialised form is being allowed on automated order driven system of the National Stock Exchange (NSE), The Stock Exchange, Mumbai (BSE) and the Over the Counter Exchange of India (OTCEI). This is in addition to the present system of trading in government securities. Being a parallel system, the trades concluded on the exchanges will be cleared by their respective clearing corporations/clearing houses. The trades of Primary Dealers have to be settled either directly with clearing corporation/clearing house (in case they are clearing members) or else through clearing member custodian.

Primary Dealers (PDs) are expected to play an active role in providing liquidity to the government securities market and promote retailing. With a view to facilitating participation on the Stock Exchanges within the regulations prescribed by the Reserve Bank, SEBI and the exchanges, the PDs are being extended following facilities:

- a. PDs may open demat accounts with a Depository Participant (DP) of NSDL/CDSL in addition to their accounts with the Reserve Bank.
- b. Value free transfer of securities between SGL/CSGL and demat accounts would be enabled by PDO-Mumbai subject to operational guidelines being issued by our Department of Government and Bank Accounts (DGBA) separately.

PDs should take specific approval from their Board of Directors to enable them to trade in the Stock Exchanges. PDs should put up an effective internal control system and enabling IT infrastructure to track the orders executed for settlement / reconcile balances with the custodians, etc. As in the case of equities, PDs as institutional investors, would be exempted from margin requirements. As a consequence, they can undertake transactions only on the basis of giving and taking delivery of securities. Brokers/trading members shall not be involved in the settlement process; all trades have to be settled either directly with clearing corporation/clearing house (in case they are clearing members) or else through clearing member custodians. The trades done through any single broker will also be subjected to the current regulations on transactions done through brokers. At the time of trade, securities must be available with the PDs either in their SGL or in the demat account. Any settlement failure on account of non-delivery of securities/ non-availability of clear funds will be treated as SGL bouncing and the current penalties in respect of SGL transactions will be applicable. Stock Exchanges will report such failures to the respective Public Debt Offices. PDs who are trading members of the Stock Exchanges may have to put up margins on behalf of their non-institutional client trades. Such margins are required to be collected from the respective clients. PDs are not permitted to pay up margins on behalf of their client trades and incur overnight credit exposure to their clients. In so far as the intra day exposures on clients for margins are concerned, the PDs should be conscious of the underlying risks in such exposures. PDs who intend to offer clearing /custodial services should take specific approval from SEBI in this regard. Similarly, PDs who intend to take trading membership of the Stock Exchanges should satisfy the criteria laid down by SEBI and the Stock Exchanges.

&& MFD/CIR/1/189/2000 dated April 10, 2000

The Reserve Bank has withdrawn its guidelines issued in 1992 on money market mutual funds (MMMFs) w.e.f. March 7, 2000. Accordingly, such money market mutual fund schemes, like any other mutual fund schemes, would exclusively be governed by the SEBI (Mutual Funds) Regulations, 1996

● In case of foreign exchange market, Foreign Exchange Dealers Association of India (FEDAI) though recognised as an SRO by the Reserve Bank since August 1958 acts more in the nature of an industry level body representing the authorised dealers (banks and other players who are authorised to deal in foreign exchange). The major activities of FEDAI include framing of rules governing the conduct of inter-bank foreign exchange business among banks vis-à-vis public and liaison with the Reserve Bank for reforms and development of foreign exchange market. However, as required in terms of IOSCO Principles it does not establish any eligibility criteria that must be satisfied in order for individuals or firms to participate in activities in foreign exchange markets thereby not fulfilling the basic tenet of an SRO. Further, FEDAI is also not within the regulatory jurisdiction of the Reserve Bank. Some more empowerment of FEDAI is necessary for its transition to a full fledged SRO.

assessment. After addressing certain broader issues arising out of the assessment, summary of assessments and recommendations are presented respectively on corporate debt and equities markets and exchange traded derivatives market in Section 4 and on government securities, money and foreign exchange markets in Section 5. Section 6 provides a summary of the recommendations by the Panel.

## Section 2

### Coverage, Scope and Methodology

#### 2.1 Coverage and Scope

The earlier assessments of India's adherence to IOSCO Principles were conducted only in respect of the equities and the corporate bonds market, *i.e.*, markets that were primarily within the regulatory domain of SEBI. Derivative trading on equity related instruments / indexes started operations from June 12, 2000, and the earlier assessment did not cover it. The government securities market because it is mainly regulated by the Reserve Bank has also not been fully assessed thus far. Given the systemic importance and exposure of banks and financial institutions to this market, the Panel feels that it was necessary that an assessment of the adherence to IOSCO principles did not leave out the government securities market. This is consistent with the approach set out in IOSCO methodology.

Though IOSCO observed that the principles related to securities market regulations are not applicable to other segments of financial markets such as the currency markets, the Panel considered the relevance and applicability of certain principles to the money market and the foreign exchange market.

The approach taken by the Panel in assessing the observance of IOSCO Principles in respect of the money and foreign exchange markets is similar to the approach taken in assessing the adherence to Basel Core Principles in respect of financial institutions other than commercial banks. The Panel adopted the following steps in assessing the regulation and supervision in respect of these markets:

- i Identify the principles applicable and relevant to each of these markets;
- ii Assess the adherence to the relevant principles;
- iii Identify gaps in observance; and
- iv Delineate an action plan.

The Panel feels that the results of such assessments would also provide important directions for improving the regulatory and supervisory framework. But it would not be appropriate to treat the assessments in respect of the money and the foreign exchange markets on par with those of the equities and corporate bond or equity derivatives or government securities markets, where a rigorous application of all IOSCO principles is directly relevant.

#### 2.2 Methodology

IOSCO endorsed in 2003 a comprehensive methodology (IOSCO Principles Assessment Methodology<sup>20</sup>) that enables an objective assessment of the implementation of the IOSCO principles in the jurisdictions of its members and the development of action plan to correct identified gaps in implementation.

The assessment builds on answers to a set of key questions based on which the adherence or compliance status is scaled

<sup>20</sup> **Reference:** Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation - October 2003.

## Box 4.1: IOSCO Principles

The IOSCO Principles comprise 30 principles that need to be in place for a regulatory and supervisory system to be effective. The principles relate to the following:-

**Principle 1 to 5: Principles relating to regulator**

- Principle 1: Responsibilities of regulator
- Principle 2: Operational independence and accountability
- Principle 3: Power, resources and capacity to perform functions
- Principle 4: Regulatory processes of regulator
- Principle 5: Professional standards of staff of regulator

**Principles 6 to 7: Principles relating to self regulation**

- Principle 6: Regulatory regime
- Principle 7: Regulator's oversight over SROs and standards adopted by SROs

**Principles 8 to 10: Principles relating to enforcement**

- Principle 8: Inspection, investigation and surveillance powers
- Principle 9: Enforcement powers
- Principle 10: Use of inspection, investigation, surveillance and enforcement powers

**Principles 11 to 13: Principles relating to co-operation**

- Principle 11: Authority to share information with domestic and foreign counterparts
- Principle 12: Information sharing mechanisms
- Principle 13: Assistance provided to foreign regulators

**Principles 14 to 16: Principles relating to issuers**

- Principle 14: Disclosure of financial results

- Principle 15: Treatment of holders of securities
- Principle 16: Accounting and auditing standards

**Principle 17 to 20: Principles relating to collective investment schemes**

- Principle 17: Standards for eligibility and regulation
- Principle 18: Rules governing legal form and structure
- Principle 19: Disclosure requirements
- Principle 20: Asset valuation and pricing and redemption of units

**Principles 21 to 24: Principles relating to market intermediaries**

- Principle 21: Minimum entry standards
- Principle 22: Capital and prudential requirements
- Principle 23: Internal organisation and operational conduct
- Principle 24: Procedure for dealing with failure of market intermediary

**Principles 25 to 29: Principles relating to secondary markets**

- Principle 25: Trading systems
- Principle 26: Regulatory supervision
- Principle 27: Transparency of trading
- Principle 28: Detection of manipulation and unfair trading practices
- Principle 29: Management of large exposures, default risk and market disruption

**Principle 30: Principle relating to clearing and settlement of securities**

principle-wise as fully implemented, broadly implemented, partly implemented, not implemented or not applicable<sup>21</sup>. The Panel has adopted this methodology for assessing the

observance of regulation of the securities market. Based on the assessment of various market segments, the Panel has recommended an action plan for a convergence to principles,

<sup>21</sup> **Fully implemented:** A principle will be considered to be *fully implemented*, whenever all assessment criteria is generally met, without any significant deficiencies.

**Broadly implemented:** A principle will be considered to be *broadly implemented* whenever a jurisdiction's inability to provide affirmative response to applicable key questions for a particular principle are limited to the question excepted under the principle's broadly implemented benchmark and in the judgement of assessors such exceptions do not substantially affect the overall adequacy of the regulation that the principle is intended to address.

**Partly implemented:** A principle will be considered to be *partly implemented*, wherever the assessment criteria is generally met without any significant deficiencies.

**Not implemented:** A principle will be considered to be *not implemented* whenever major shortcomings are found in adhering to the assessment criteria as specified in the not implemented benchmark.

**Not applicable:** A principle will be considered to be *not applicable* whenever it does not apply given the nature of the securities market in the given jurisdiction and relevant structural, legal and institutional considerations.

as also for a further strengthening of regulation from a medium-term perspective.

## 2.3 Brief Profile of Markets covered in the Assessment

### 2.3.1 Equities/Corporate Bond Market/ Derivative Market

The securities market has three major groups of participants, viz. the issuers, the investors and the intermediaries. It has two inter dependent segments, viz. the primary market and the secondary market.

#### (i) Primary Market

Securities such as equities, debentures, bonds, etc. are issued by public limited companies or other issuers such as financial institutions and municipal corporations. SEBI has laid down a detailed regulatory framework for the issue of securities. The regulatory framework has specific disclosure requirements that apply to the public and rights offerings of securities such as of equity shares and debt instruments, including the conditions applicable to an offering of securities for public sale (offer for sale), the content and distribution of prospectus and other offer documents and other supplementary documents prepared in the offering. Resources mobilised in the primary market during last three years is shown in Table 2.

**Table 2: Resource Mobilisation from the Primary Market through Public and Rights issue**

(Amount in Rs. crore)

Year	Total	
	No.	Amount
1	2	3
2004-05	60	28,256
2005-06	139	27,382
2006-07*	124	33,508
2007-08 (Apr-Jan)*	124	87,029

\* The resource mobilisation is inclusive of amount raised through Qualified Institutional Placement (QIP)

Source: SEBI

#### (ii) Secondary Market

The secondary market covers trades in the 19 Recognised Stock Exchanges (RSEs) including the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). RSEs also perform member and market regulation functions.

#### (iii) Equity Market

There has been a considerable increase in the market capitalisation of the BSE and NSE. At BSE the market cap/GDP ratio increased from 46.76 per cent to 123.49 per cent, but the turnover ratio decreased from 0.75 per cent to 0.29 per cent during 1999-00 to 2007-08 (April-January). During the same period, the market cap/GDP ratio and the turnover ratio moved from 52.27 to 112.82 and 0.82 to 0.64 respectively at NSE (Table 3).

**Table 3: Statistics of listed companies in equity market**

(Amount in Rs. crore)

Year	No. of Companies Listed		Turnover (in Rs. crore)		MKT Cap -GDP Ratio (Per Cent)		Turnover Ratio	
	BSE	NSE	BSE	NSE	BSE	NSE	BSE	NSE
1	2	3	4	5	6	7	8	9
1999-00	5,815	720	6,86,428	8,39,052	46.76	52.27	0.75	0.82
2004-05	4,731	970	5,18,715	11,40,072	54.32	50.71	0.31	0.72
2005-06	4,781	1,069	8,16,074	15,69,558	84.72	78.86	0.27	0.56
2006-07	4,821	1,228	9,56,185	19,45,287	85.51	81.22	0.23	0.47
2007-08 (Apr-Jan)	4,895	1,362	13,45,900	30,17,800	123.49	112.82	0.29	0.64

Source: SEBI

Table 4: Futures and Options Volume

(Amount in Rs. crore)				
Year	Futures Turnover		Options Turnover	
	BSE	NSE	BSE	NSE
1	2	3	4	5
2004-05	13,813	22,56,241	2,300	2,90,812
2005-06	6	43,05,512	3	5,18,739
2006-07	59,006	63,70,547	0.3	9,85,723
2007-08 (Apr-Jan)	2,01,100	99,04,800	29	14,65,200

Source: NSE, BSE

**(iv) Derivatives Market**

SEBI has permitted derivatives contracts to be traded in a separate segment of an existing exchange. There are five types of derivative products available in Indian market: index futures, stock futures, interest rate futures, index options and stock options. In January 2008, SEBI permitted the exchanges to introduce new derivative products such as the index option with a longer tenure, the volatility index and futures and options on this index. In April 2008 the Bond Index (both corporate and GOI) and futures and options on this index were also allowed. The volumes in the derivatives segment have been growing fast (Tables 4 and 5).

Table 5: Futures on Individual Equities (Stock Futures)

(Amount in Rs. crore)		
Year	BSE	NSE
	Stock Futures Turnover	Stock Futures Turnover
1	2	3
2004-05	213	14,84,067
2005-06	1	27,91,721
2006-07	3,515	38,30,972
2007-08(Apr-Jan)	7500	67,96,300

Source: NSE, BSE

Table 6: Turnover of corporate bond market

(Amount in Rs. crores)	
Year	Turnover
1	2
2004-05	37300
2005-06	24600
2006-07 (Apr -Feb)	12100
2007-08*	75700

Source: RBI

\*SEBI

**(v) Corporate Bonds**

The rules and operating procedures for the clearing and settlement of corporate bonds were specified by SEBI (in April 2007). It has recently issued the SEBI (Issue and Listing of Debt Securities) Regulation, 2008. This market is still not substantially developed (Table 6).

**(vi) Mutual Funds**

The SEBI (Mutual Fund) Regulations, 1996 lays down the legal and regulatory framework for schemes by which the funds of investors are pooled to invest in securities, money market instruments, gold or gold related instruments, and real estate mutual funds *etc.* There are about 39 MFs registered with SEBI with 772 schemes. Assets under management were in excess of Rs. 5 lakh crore as on January 31, 2008. Table 7 provides data on resource mobilisation by mutual funds.

Table 7: Resource Mobilisation by Mutual Funds

(Amount in Rs. crore)		
Year	Gross mobilisation	Assets at the end of Period
1	2	3
2004-05	8,39,708	1,49,600
2005-06	10,98,149	2,31,862
2006-07	19,38,493	3,26,292
2007-08 (Apr-Jan)	35,40,500	5,48,100

Source: SEBI

**Table 8: Private Placement of Corporate Bonds by listed companies during the period  
January - December 2007\***

(Amount in Rs. crore)

<b>Month/Year</b>	<b>BSE</b>	<b>NSE</b>	<b>Total</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
2005-06	21,142	64,087	83,827
2006-07	35,859	74,659	1,04,974
January	1,405	2,386	3,791
February	1,277	5,128	6,405
March	4,477	8,628	13,105
April	2,141	10,251	12,392
May	3,957	5,217	9,174
June	1,209	11,053	12,262
July	1,209	6,310	7,519
August	1,058	6,121	7,179
September	7,959	11,972	19,931
October	1,226	5,455	6,681
November	4,637	8,760	13,397
December	2,085	3,769	5,854
January	2,587	13,951	16,538
<b>2007-08 (Apr-Jan)</b>	<b>28,068</b>	<b>82,859</b>	<b>1,10,927</b>

\*includes issuances pursuant to offers made to 50 persons or more under exemption provided under S.67(3) of the Companies Act."

Source: SEBI

### (vii) Private Placement

The Table 8 gives data on private placement of corporate bonds of listed companies during January to December 2007.

### (viii) Securitised Debt Instruments

Section 17A of the SCR Act, 1956, inserted by SC(R) Amendment Act, 2007 w.e.f May 28, 2007 empowers SEBI to regulate public offerings, listing and trading of securitised debt instruments. SEBI has made regulations for offering listing and trading of securitised debt instruments. This has been notified on May 26, 2008.

### 2.3.2 Government Securities Market

The government securities market deals with tradable debt instruments issued by the Central and State Governments. The

government securities market has witnessed a significant transformation over the years in terms of the system of issuance, instruments, investors, and trading and settlement infrastructure. The market structure is broad-based because of the participation by securities trading firms, commercial banks, co-operative banks, rural banks, insurance companies, provident funds, corporates, FIIs, NRIs and individuals. A brief profile of G-sec market is provided in Table 9.

### 2.3.3 Money Market

The money market is a market for short-term funds with maturity ranging from overnight to one year and includes financial instruments deemed to be close substitutes of money. The most important components of money market in India are the inter-bank call



Table 9: Brief profile of g-sec market

(Amount in Rs. crore)			
	2005	2006	2007
1	2	3	4
Outstanding stock (Rs. crore)	8,24,612	9,29,612	10,32,296
Outstanding stock as ratio of GDP (per cent)	28.6	27.4	26.3
Turnover (Rs. crore)	27,79,400	27,89,800	38,06,600
Turnover / GDP (per cent)	87.78	78.21	92.24

Source: Reserve Bank

(overnight) money, market repo, Collateralised Borrowing and Lending Obligation (CBLO) and the term money markets. Treasury Bills constitute the main instrument of short-term borrowing by the Government and serve as a convenient gilt-edged security for the money market. Commercial papers and certificate of deposits are also important segments. Historically, the call money market has constituted the core of the money market in India. However, the collateralised segments, *viz.* market repo and CBLO have come in to prominence recently.

The market structure is broad-based with the participation of banks, primary dealers,

insurance companies, mutual funds, provident funds, corporates, *etc.* A brief profile of the money market is provided in the Table 10.

#### 2.3.4 Foreign Exchange Market

Trading in foreign exchange effectively began from 1978 when banks in India were allowed to undertake intra-day trading. After 1992, wide-ranging reforms were ushered in. The foreign exchange market was progressively de-regulated and new instruments such as rupee foreign currency swaps, foreign currency rupee options, cross currency options, cross currency swaps, interest rate swaps, caps and collars *etc.* have been introduced. Participants in the foreign exchange markets are permitted

Table 10: Brief profile of money market

(Amount in Rs. crore)							
Year	Average Daily turnover				Outstanding Amount		
	Call Money Market	Market Repo (Outside LAF)	CBLO	Term Money Market	CP	CD	Treasury Bills
2004-05	14,170	17,135	6,697	526	11,723	6,052	34,486
2005-06	17,979	21,183	20,039	833	17,285	27,298	52,149
2006-07	21,725	33,676	32,390	1,012	21,314	64,814	73,427

# : Turnover is twice the single leg volumes in case of call money and CBLO to capture borrowing and lending both, and four times in case of market repo (outside LAF) to capture the borrowing and lending in the two legs of a repo.

Source: RBI

to avail of forward-cover and enter into derivative transactions provided they are backed by genuine underlying exposures.

The players in the foreign exchange markets include Authorised Dealers (ADs) which include 77 commercial banks and 8 co-operative banks, foreign exchange brokers, individuals and corporates. The foreign exchange market in India comprises two segments *viz.* the spot market and derivatives market. Foreign exchange derivatives instruments in India are foreign exchange forwards, foreign currency rupee and cross currency swaps and options. The average yearly turnover in the Indian foreign exchange market for the last three years is shown in Table 11.

### Section 3

#### Broad Issues

While carrying out the assessments the Panel considered some broad regulatory issues which have implications for market development. These issues are addressed in this Section.

#### 3.1 Development of Exchange Traded Foreign Exchange Operations

**3.1.1** At present, the foreign exchange risk can only be hedged in the OTC market using forwards, currency swaps and options. There are also products like currency and interest rate swaps which are permissible for hedging long-term exposures. The use of these products is subject to certain requirements as laid down in terms of the Foreign Exchange Management

Act (FEMA). The Committee on Fuller Capital Account Convertibility has observed that internationally many investors use futures rather than the cash market to manage their portfolio or asset allocation because of the low upfront payments and quick transactions. Accordingly, the Committee recommended that currency futures be introduced subject to risks being contained through a proper trading mechanism, the structure of contracts and the regulatory environment. In recognition of the perceived need for currency futures to enhance the menu of tools available for hedging currency exposure and considering the recommendations of the Committee on FCAC, the Reserve Bank had set up a Working Group on Currency Futures to study the international experience and suggest a suitable framework to operationalise the proposal that was consistent with the current legal and regulatory framework in India. The Group in its report recommended the introduction of currency futures to provide the market participants with an additional hedging tool.

**3.1.2** The Panel observed that due to the preponderance of OTC transactions, the level of transparency is not adequate in foreign exchange markets. Despite recognising that OTC is the more popular mode of foreign exchange transactions the world over, the Panel feels the need to encourage the development of exchange traded foreign exchange operations, both in the cash and the derivatives segments as it would improve the process of price discovery. The Panel feels that the process of introduction of currency futures in India needs to be expedited in the interest of better risk management and transparency. (The RBI – SEBI Standing Technical Committee on Exchange Traded Currency Futures on May 29, 2008 recommended introduction of currency futures contract on US Dollar – Indian Rupee (US \$ - INR). On June 6, 2008 SEBI laid down guidelines on trading in currency futures in

**Table 11: Brief Profile of foreign exchange market**

Year	Yearly turnover (\$ billion)	Rate of Growth (%)
1	2	3
2004-05	2,892	36.5
2005-06	4,404	52.3
2006-07	6,571	49.2

Source: RBI

RSE or new exchanges. Currency futures/ derivatives has been introduced in NSE from August 29, 2008, in BSE from October 1, 2008 and MCX Stock Exchange on October 6, 08)

#### **3.2 Introduction of Foreign Currency Hedging without Underlying**

The Panel deliberated at depth on the issue of allowing foreign currency hedging without underlying exposure. There has been a very significant increase in the size of the foreign exchange market in terms of volume. The market has also matured in terms of the types and complexities of the instruments being used. Consequently, the foreign exchange exposure of the Indian corporate sector has increased manifold. Unhedged corporate exposure in foreign exchange entails a systemic risk and it is in the interest of the entire financial sector to add further options for hedging in respect of the foreign currency exposures of corporates. The Panel feels that in the interest of systemic stability all restrictions regarding underlying needs to be abolished in a phased manner.

#### **3.3 Development of Trade / Industry Association as Self Regulatory Organisation (SRO)**

**3.3.1** Self Regulatory Organisations (SROs) aid the regulatory process and are important for market development. They are different from an industry association inasmuch as they are vested with powers to frame regulations in certain demarcated areas of operations. They are platforms which function closer to the market and help market players deal with implementation issues. They can perform a

beneficial role in the development and regulation of the market. But in the interest of orderly development of markets, the Panel views that SROs should not be allowed to operate in a market vacuum and should be under the jurisdiction of the market regulator.

**3.3.2** Section 11(2)(d) of SEBI Act empowers SEBI to promote and regulate SRO. SEBI has framed the SEBI (SRO) Regulations, 2004 (SRO Regulations) to enable organisation of intermediaries to be recognised as SROs. At present, there is no recognised SRO under SRO Regulations. There are organisations such as Association of National Exchanges Members of India (ANMI), Association of Mutual Funds of India (AMFI), Association of Merchant Bankers of India (AMBI) and Financial Planning Standards Board of India (FPSBI). The organisations like ANMI, AMFI, AMBI, and FPSBI at present function primarily as trade and industry associations. The Panel proposes that various trade or industry associations may be encouraged to become SROs and should be accorded SRO status gradually by defining their jurisdiction and the delegation of appropriate powers. They should also be brought under the regulatory ambit of the SEBI. Effective steps are also required to be taken to address the conflict of interest and moral hazard issues that may arise in this regard.

**3.3.3** It has been observed that the Foreign Exchange Dealers Association of India (FEDAI) is an SRO as regards the foreign exchange market. It is an independent decision making body as also an industry association. But it is technically not a full-fledged SRO, as it is not under the oversight of the Reserve Bank. The

## Box 4.2: Securities Market Regulatory Structure in Select Countries

### United States

1. The Securities and Exchange Commission (SEC) regulates the securities market. This includes: (1) regulating the major securities market participants, including broker-dealers and SROs; (2) regulating the investment management industry, including investment companies and investment advisers; and (3) overseeing the disclosure of financial information by publicly-held companies. In addition to the exchanges, NASD and the MSRB, registered clearing agencies and the Public Company Accounting Oversight Board are also SROs that are regulated by the SEC
2. State securities administrators license securities firms and investment professionals active in their states, register certain securities offerings, review financial offerings of small companies, audit branch office sales practices and record-keeping, and enforce state securities laws.
3. Exchanges regulate their own markets, either directly or through a contractual agreement with another SRO. Exchanges also regulate, either directly or through a contractual agreement with another SRO, the companies that list on their markets and broker-dealers that are active on their markets.
4. The Municipal Securities Rulemaking Board (MSRB) is the rulemaking SRO that establishes regulations for broker dealers and banks dealing in municipal bonds, notes and other municipal securities. The SEC, NASD, Federal Reserve, FDIC and OCC enforce the MSRB's rules.
5. NASD is the industry-wide SRO for the securities market and regulates broker-dealers and associated persons (registered and non-registered) of broker dealers with respect to equity and fixed income markets, interactions with investors, corporate financing and advertising.
6. NASD and NFA provide market and member regulation services for exchanges on a contractual basis.

### United Kingdom

1. The Financial Services Authority is the unified regulator in UK.
2. It regulates banks, money market institutions, securities firms, fund managers, financial advisers, lawyers, accountants, recognised investment

exchanges (including clearing housing exchanges), building societies and insurance companies.

3. The FSA's regulatory scope includes regulation and registration function of Securities and Futures Authority which looks into securities and derivatives business.
4. The legislation through which it regulates the aforesaid entities is the UK Financial Services and Markets Act.
5. The responsibility on FSA is prudential supervision, conduct of business for investment activities (including information on mortgages and market conduct).

### Singapore

1. MAS is the central bank of Singapore which is also a unified regulator. It formulates and executes Singapore's monetary policy, and issues Singapore currency. As banker and financial agent to the government, MAS manages the country's official foreign reserves and issues government securities. As supervisor and regulator of Singapore's financial services sector, MAS has prudential oversight over the banking, securities, futures and insurance industries. It is also responsible for the development and promotion of Singapore as an International Financial Centre.
2. The Capital Markets Department (CMD) has supervisory responsibility for capital markets through the administration of the Securities and Futures Act, the Business Trusts Act and the Singapore Code on Take-overs and Mergers. It regulates (i) the offering of securities, business trusts, REITs and collective investment schemes; (ii) trading of securities and derivatives products; (iii) securities and futures market operators and clearing houses; (iv) the conduct of takeover transactions; and (v) SGX as a listed entity. It also enforces the civil penalty regime for market misconduct.
3. The Capital Markets Intermediaries Department (CMI) has the responsibility for the admission and supervision of capital markets intermediaries, including broker-dealers, fund managers, corporate finance advisers, financial advisers and trust companies. It administers the licensing and business conduct rules for intermediaries under the Securities and Futures Act, Financial Advisers Act and Trust Companies Act.

**Canada**

1. Canada does not have a national regulator for the securities market. Instead, securities regulators from each province and territory in Canada regulate the securities markets in their respective jurisdictions.
2. The Investment Dealers Association of Canada (IDA) is the main self-regulatory organisation for Canada's securities markets. It regulates all investment dealers and monitors trading activity in the bond and money markets.
3. The Mutual Fund Dealers Association (MFDA) is the self-regulatory organisation responsible for regulating mutual fund dealers.
4. Market Regulation Services (MRS) is an independent regulation services provider for Canada's equity markets. It is responsible for developing and implementing the Universal Market Integrity Rules (UMIR), a common set of rules for equities trading across Canada, and monitors and enforces compliance with the UMIR.
5. The Montreal Exchange specialises in financial derivatives.

**Japan**

1. The Financial Services Agency (FSA) is responsible for regulating all financial market participants in Japan. In the securities market, the FSA regulates the SROs and other market

participants such as broker-dealers, investment banks and investment trust companies. The FSA also oversees the disclosure of financial information by listed companies.

2. Exchanges have the authority to regulate their own markets, as well as companies listed on those markets and broker-dealers active on those markets.
3. Investment Trusts Association regulates investment trust companies and broker dealers in the investment trust industry.
4. Japan Securities Dealers Association (JSDA) regulates all securities companies operating in Japan as well as registered financial institutions, which are banks and other financial companies authorised by the government to engage in certain securities transactions. JSDA also regulates the over-the-counter equity and fixed income markets.
5. Financial Futures Association of Japan (FFAJ) regulates broker dealers in the financial futures industry.
6. Japan Securities Investment Advisers Association (JSIAA) regulates investment advisers.

**References:** (i) *ICSA International Council of Securities Associations - Self-Regulation in Financial Markets: An Exploratory Survey* (ii) *Monetary Authority of Singapore* (iii) *Financial Services Authority*.

Panel recommends that FEDAI should be made a full-fledged SRO by giving it more powers and brought under the regulatory purview of the Reserve Bank.

**3.3.4** The government securities and the money markets do not have any SROs. The Panel proposes that Fixed Income Money Market Dealers Association (FIMMDA) should be accorded an SRO status by defining its

jurisdiction and delegation of appropriate powers. It should also be brought under the regulatory ambit of the Reserve Bank.

**3.4 Enhancement of Regulatory Coverage**

The Panel observed that with the development of the retail segment, particularly in the equities market, there has been a proliferation of investment advisors. Some investment advisers also manage portfolios of



### Box 4.3: Self Regulation in Securities Markets

Self regulatory organisations (SROs) are non-governmental bodies having responsibility to regulate their own members through a set of rules of conduct for fair, ethical and efficient practices. SROs often act in conjunction with the regulatory authorities and augment regulatory resources by requiring observance of principles which go beyond government regulation and permit faster and more flexible responses to market conditions.

According to the International Council of Securities Association, SROs are non-governmental organisations that exhibit the following characteristics:

- Share a common set of public interest objectives including the enhancement of market integrity, market efficiency and investor protection;
- Are actively supervised by the government regulator(s);
- Have statutory regulatory authority;
- Establish rules and regulations for firms and individuals that are subject to their regulatory authority;
- Monitor members' compliance with applicable rules and regulations and, in the case of SROs that regulate trading markets, conduct surveillance of those markets;
- Have the authority to discipline members that violate applicable rules and regulations;
- Include industry representatives on their Boards or otherwise ensure that industry members have a meaningful role in governance; and
- Maintain structures, policies and procedures to ensure that conflicts of interest between their commercial and regulatory activities are appropriately managed.
- Further they carry out some more activities that are consistent with their mandate to enhance market integrity, market efficiency and investor protection which include the provision of: (1) consumer redressal services; (2) dispute resolution services for members; (3) investor education for consumers and educational services for market professionals; and (4) market data for member firms and other market participants.

The first form of self-regulation appeared in the early 19<sup>th</sup> century when London stock Exchange framed specific rules for its members. It was followed by New York Stock and Exchange Board which set rules for trading, criteria for admission of new members and dispute resolution mechanisms. Presently, most stock exchanges across the globe are vested with some regulatory powers though the extent and form of self-regulation varies widely from country to country.

In addition to exchanges there are national self-regulatory bodies that regulate a broad number of

market participants. These regulate markets as well as market participants, but do not own or operate an exchange or market and in many cases are trade associations which represent the industry. There are a third category of SROs which regulate markets and a broad number of market participants as also own or operate an individual exchange or market.

The self-regulatory regimes existing in many countries have come under intense scrutiny as concerns have been raised about the potential conflicts of interest between the exchanges' self-regulatory operations and their commercial activities. Various countries have adopted different models to address this potential conflict. Some of them are summarised below.

- Exchange functions as an SRO with regulatory powers – Chicago Mercantile Exchange, Chicago Board of Trade, Tokyo Stock Exchange
- Exchange creates separate entity to carry out regulation – New York Stock Exchange, Australian Stock Exchange
- Exchange's regulatory activities take place in a quasi-public entity that is completely separate from the commercial operations of the exchange – Frankfurt Stock Exchange
- Exchange contracts with third party supplier of regulatory services – NASDAQ, Toronto Stock Exchange
- Government regulator has responsibility for most regulatory activities and exchange has limited regulatory authority – London Stock Exchange, Euronext

The role of the nationwide self-regulatory bodies has also been under scrutiny because of concerns over possible conflicts of interests as most of them also function as associations of trade/industry representatives. In this case also, various self-regulatory bodies have responded in different ways to address these concerns. The more popular being:

- Functioning solely as SROs by suspension of their functions as trade/industry associations - Investment Dealers Association (IDA), Canada
- Changing the governance structure ensuring separation of operations as trade organisations and SROs - Japan Securities Dealers Association (JSDA), Japan

Similar changes have been taking place across the globe to eliminate concerns about potential conflicts of interest and to strengthen the regulatory operations of SROs.

**Reference:** *ICSA International Council of Securities Associations - Self-Regulation in Financial Markets: An Exploratory Survey*



**Box 4.4: Regulatory Practices with particular reference to Self Regulatory Organisations (SROs) in select Securities Markets**

<b>Government Regulatory Authority</b>	<b>Stock Exchange</b>	<b>Regulatory Practices</b>
<b>1</b>	<b>2</b>	<b>3</b>
Australian Securities and Investment Commission (ASIC)	Australian Stock Exchange (ASX)	There is no legal definition of a SRO under Australian law. However, as a market licensee under Corporations Act, ASX has power to establish rules and standards for listed entities and market participants, monitor compliance with those rules and standards and impose disciplinary actions. In July 2006, ASX established a separate subsidiary for its market supervisory operations called ASX Markets Supervision. The subsidiary will carry out all of the ASX's supervisory operations, has its own Board and is headed by Chief Supervision Officer who reports to the Board of subsidiary and Board of ASX. ASIC and ASX supervisory review provide oversight to ASX Markets Supervision.
Securities and Exchange Commission (SEC) -do-	Chicago Board of Trade (CBOT)  Chicago Mercantile Exchange (CME)	CBOT's office of Investigations and Audit (OIA) performs the self-regulatory functions of the exchange. Among other activities, OIA audits firms and requires them to meet minimum capital requirements, monitors actual trading activity and oversees contracts as they move close to expiration.  In early 2004, CME created the Market Regulation Oversight Committee, a separate and independent Board level Committee, composed solely of independent directors that has direct oversight responsibility for all of the regulatory functions at the exchange, including market regulation, market surveillance, audit and financial supervision.
Securities and Futures Commission (SFC)	Stock Exchange of Hong Kong (SEHK)	Hong Kong Exchange and Clearing (HKEx) is the holding company that owns and operates stock and futures exchanges in Hong Kong and their related clearing houses. Since SEHK demutualised in 2000, the SFC has assumed many of the responsibilities for the stock exchange. Specifically, the SFC is the front-line regulator for listed companies and in that capacity carries out market surveillance, investigates and punishes all breaches of law and is statutory regulator for listed companies disclosure.

Government Regulatory Authority	Stock Exchange	Regulatory Practices
1	2	3
Financial Services Authority (FSA)	London Stock Exchange (LSE)	<p>The SFC is also responsible for member regulation and carries out routine inspections, monitors compliance with business conduct and financial resource rules and investigates and punishes all breaches of applicable rules and regulations. The exchange remains responsible for front line monitoring of compliance with its trading and clearing rules and maintenance of market transparency on a contractual basis.</p> <p>The LSE's listing activities were transferred to FSA in 2001 in part because the government was concerned that competition between exchanges continue to increase and that it would not be appropriate for the LSE which has been designated as the UK Listing Authority, to act as a gatekeeper for all the exchanges. As a result of this and subsequent changes the FSA now regulates all securities trading in UK and is also listing authority for the UK. The LSE continues to maintain a rulebook for trading firms and as the frontline monitor of market behaviour, conducts surveillance of trading activities.</p>
Securities and Exchange Commission (SEC)	NASDAQ	<p>NASDAQ is responsible for regulating its market but has contracted for the day-to-day administration of market regulation, including the investigation and prosecution of disciplinary actions to National Association of Securities Dealers (NASD).</p>
Securities Exchange and Commission (SEC)	New York Stock Exchange	<p>After its demutualisation in March 2006, the NYSE's business and assets were separated into three entities <i>viz.</i> NYSE Limited Liability Company (LLC), NYSE Market and NYSE Regulation. NYSE LLC is a wholly owned subsidiary of NYSE Group and has assumed NYSE's registration as a national securities exchange. NYSE LLC has delegated performance of its market and self-regulatory functions to two wholly owned subsidiaries, NYSE Market and NYSE Regulation. NYSE Market operates the exchange trading market and issues trading licences to market participants. NYSE Regulation a not for profit corporation performs the regulatory functions of NYSE LLC. The NYSE Regulation CEO reports directly to the NYSE Regulation Board, a majority of which are independent directors that are not NYSE group Directors. The remaining members of NYSE Regulation Board are also NYSE group independent directors.</p>
-	Tokyo Stock Exchange (TSE)	<p>The Tokyo Stock Exchange has statutory authority as a SRO and in that capacity is responsible for maintaining a transparent, equitable and reliable market. To fulfil that objective, TSE establishes rules and regulations for member firms and listed companies, continuously monitors member firms and listed companies in order to ensure that they comply with TSE's rules and regulations and carries out enforcement actions when violations are found to have occurred. TSE also establishes rules for the listing of securities and conducts surveillance activities.</p>

**Source :** ICSA International Council of Securities Associations - Self-Regulation in Financial Markets: An Exploratory Survey

securities. There are also research analysts who are employed by investment, broking, underwriter or mutual funds. They study companies and industries and analyse the disparate raw data and often make forecasts and recommendations about whether to buy, sell or hold securities. Such analysts often face conflicts of interest that can interfere with the objectivity of their analysis. These conflicts can erode investor confidence in research and, potentially, the markets as a whole if not adequately addressed. In India, these advisors and analysts appear to operate in a regulatory vacuum. In the interest of investor protection, the Panel strongly recommends that investment advisers and research analysts be brought within the regulatory ambit through SRO or directly by prescribing licensing and registration requirements, apposite credentials, appropriate returns, *etc.*

#### 3.5 Responsibility of Auditors

Most market participants, especially those operating in the wholesale markets, are subject to audit/certification by external auditors/functionaries. Unlike bank auditors who are responsible to the Reserve Bank in the sense that appointment and removal of auditors by a banking company requires the Reserve Bank approval, auditors of mutual funds, broking houses or listed companies, primary dealers *etc.*, are not accountable to the Reserve Bank / SEBI in any manner. To enhance the efficacy of regulation and augment accountability, the Panel recommends that the certification authorities/auditors should be made responsible to the respective regulatory

authorities, to the extent that they are involved in certifying/auditing these entities that fall within the regulatory domain of the Reserve Bank /SEBI or any other regulator as applicable. The Panel suggests that the matter should be discussed with ICAI/ICWAI/ICSI or any other similar body for the issuance of appropriate directions in this regard.

## Section 4

### Equities and Corporate Bond Market

#### 4.1 Regulatory and Supervisory Mechanism

SEBI has been set up under the Securities and Exchange Board of India Act, 1992 (SEBI Act) with responsibilities to protect the interest of investors, to regulate and to promote the development of the securities market. SEBI administers the following Acts/Regulations:

1. The SEBI Act and regulations made thereunder.
2. The Securities Contracts (Regulation) Act, 1956 (SC(R) Act); and the rules and regulations made thereunder.
3. The Depositories Act, 1996 and regulations made thereunder.
4. The Companies Act, 1956 in respect of listed companies and companies proposed to be listed in Recognised Stock Exchange (RSE).

SEBI has extensive regulatory powers over market intermediaries, product and securities markets. It also exercises direct power of regulation and supervision of stock markets.

In terms of the notification of March 1, 2000 issued by Central Government under

Section 16 of the SC(R) Act, contracts for sale and purchase of government securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities are regulated by the Reserve Bank. Contracts executed on the stock exchanges are regulated by SEBI, besides contracts in derivatives. The Parliamentary Standing Committee on Finance in its 25<sup>th</sup> Report published in 2005-06 stated that there would be two statutes governing derivative transactions *viz.* the SC(R) Act for exchange-traded derivative transactions and the RBI Act for OTC derivatives, which involve a Reserve Bank regulated entity as a party.

As per Section 55A of Companies Act, SEBI administers listed companies and companies proposed to be listed, in respect of issue, transfer of securities and non-payment of dividend.

#### 4.2 Summary Assessment

The 30 IOSCO Principles for securities regulation fall under the following broad heads:

- (i) Principles relating to regulator
- (ii) Principles relating to self-regulation
- (iii) Principles relating to enforcement
- (iv) Principles relating to co-operation
- (v) Principles relating to issuers
- (vi) Principles relating to collective investment schemes
- (vii) Principles relating to market intermediaries
- (viii) Principles relating to secondary markets
- (ix) Principles relating to clearing and settlement of securities.

The equities/corporate bond/ exchange traded derivative markets are under the regulatory jurisdiction of SEBI. A summary

assessment of the observance of the IOSCO principles in respect of these markets under the broad heads is provided in this Section. The detailed principle-wise assessment of observance of IOSCO principles is furnished in **Appendix 4**.

##### 4.2.1 Principles 1-5 (The Regulator)

Out of the five principles relating to the regulator, three are fully implemented and two are broadly implemented.

SEBI regulates the equities/corporate bond/exchange-traded derivatives markets. The responsibilities of the SEBI are clearly and objectively defined. However, the Central Government continues to have power under SC (R) Act and also have power to make rules in respect of all the matters under the SC (R) Act. The Ministry of Corporate Affairs has concurrent powers under the Companies Act in respect of matters relating to capital market such as prospectus, issue of shares to public *etc.* Only Central Government has the power to make rule and prescribe schedules including in respect of prospectus and financial statements.

As regards operational independence, SEBI is empowered to frame regulations or file prosecution *etc.* without approval of Central Government. SEBI is able to operate and exercise its powers without external political and commercial interference. It has adequate powers, resources and capacity to perform its functions. However, there are certain provisions in the SEBI Act which may impinge upon its independence. Section 16 of SEBI Act empowers the Central Government to issue directions on question of policy and the decision of the Central Government shall be final whether a question is one of policy or not. Further, under Section 17 the Central Government has been given power to supersede the Board, *inter alia*, on the ground of persistent default in complying with any

directions issued by the Central Government. Section 5(2) gives right to the Central Government to terminate the services of the Chairman or member at any time by giving a notice of three months.

SEBI adopts a clear and consistent regulatory process. The staff observes highest professional standards including appropriate standards of accountability.

SEBI is accountable through the Ministry of Finance to Parliament in the use of its powers and resources. Its orders are subject to appeal before an independent tribunal which is a three member Securities Appellate Tribunal (SAT). Thus, it is operationally independent and accountable in exercise of its functions and powers.

Sections 3 to 5 of the SEBI Act, 1992 provide for the constitution of the SEBI Board and terms and conditions of service of the members. The members and the staff have been given statutory protection under Section 23 of the Act, for action taken in good faith. The income of SEBI from fees, and charges for performing its functions from the above sources are currently sufficient to meet its regulatory and operational needs. Thus, it has adequate resources and capacity to perform its functions and exercise its powers.

SEBI has power over intermediaries, products and securities market. It has direct power of regulation and supervision over RSE under the SC (R) Act. It also has power to control and prohibit manipulative and deceptive devices, insider trading and substantial acquisition of securities or takeover

under Section 12A of SEBI Act. The power of SEBI to suspend / cancel licence or impose monetary penalty are subject to procedural rules such as SEBI Enquiry Proceedings Regulation, 2002 or Adjudication Rules, 1995. It has instituted a consultative approach for framing regulations, such as putting the draft regulation on the SEBI website for seeking comments, holding consultations with industry, investors and the public before framing regulations. Thus, SEBI adopts clear and consistent regulatory processes.

SEBI practises sound Human Resource (HR) policies and practices. Its staff has to maintain secrecy and cannot make use of any information which has come to their knowledge in the discharge of their duties, nor can the staff communicate such information to any other persons except in the course of their official duties.

#### 4.2.2 Principles 6-7 (Self Regulation)

The two principles relating to self-regulation are fully implemented. There are regulations in place which make appropriate use of the SROs that exercise a direct oversight responsibility for their respective areas of competence. The SROs are subject to regulatory oversight and observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

There are some entities such as distributors, operating in the securities market, who are certified by AMFI, a trade association of mutual funds. There are other trade or industry associations such as ANMI/ AMBI/ FPSBI.



There are a total of 19 Recognised Stock Exchanges (RSEs) which have been recognised as a RSE under SC(R) Act. There are about 9443 brokers and 4076 corporate brokers. The RSEs perform the role of both market and member regulation. Membership of a RSE is mandatory to act as stockbroker as per Regulation 6A (1) (a) of Stock Broker Regulations. There are two depositories registered under the Depositories Act and the Depositories & Participants Regulations. The depositories regulate depository participants as per the bye-laws made by it under the Depositories Act. There are about 656 Depository Participants. Thus SEBI makes appropriate use of SROs that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.

The SC (R) Act lays down the framework of oversight of RSE by SEBI, criteria for recognition of a stock exchange (which includes standards for its members). SRO Regulations, 2004, lay down the framework for oversight of the SROs (other than the RSEs), standards of fairness, confidentiality, exercise of delegated responsibilities by recognised SROs. The SROs are subject to oversight of SEBI and observe standards of fairness and confidentiality when exercising their powers and delegated responsibilities.

#### **4.2.3 Principles 8-10 (Enforcement)**

Of the three principles relating to enforcement two are fully implemented and one is broadly implemented. SEBI has comprehensive inspection, investigation and surveillance powers. The regulatory system ensures an effective and credible use of inspection, investigation, surveillance and enforcement powers for an effective implementation of compliance. SEBI can call for information from, undertake inspection, conduct inquiries and audit of stock

exchanges, Mutual Funds, other persons associated with securities market, intermediaries and SROs. It has power of inspection over listed companies u/s 209A of Companies Act.

It also has comprehensive enforcement powers. It has the power to call for information, summon and enforce the attendance of persons, to examine them on oath and to issue commissions for the examination of witnesses and documents. It has powers of investigation under SEBI Act. It has enforcement powers such as cease and desist orders, suspension / cancellation of license, imposing monetary penalty, and prosecution. Similar powers have been given to SEBI under SC(R) Act and the Depositories Act. It has powers of inspection and prosecution over listed companies under the Companies Act in respect of matters within its regulatory jurisdiction as specified under section 55A of the Companies Act.

It regulates market players through a combination of on-site inspection, off-site reporting, investigation and surveillance of the market and regulated entities. It has separate surveillance, inspection, investigation and enforcement departments. They carry out these functions. There is on-line surveillance of market on a real-time basis by RSE. The second level of surveillance is done by SEBI. SEBI has put in place an Integrated Market Surveillance System (IMSS) to monitor surveillance activities in multiple exchanges and depositories. It conducts routine inspection of intermediaries and exchanges. In some cases it appoints outside auditors for inspection. The RSE and depositories are mandated to carry out routine inspections of their members/depository participants. It also conducts risk-based inspection and surprise inspections of intermediaries. SEBI takes enforcement actions such as the suspension/



cancellation of licenses, imposition of fines, prosecution *etc.*, based on the findings of the inspection or investigation.

SEBI's Annual Report says that it has taken a large number of enforcement actions (such as suspension or cancellation of license, imposition of monetary penalty and prosecution). However, very few cases have been decided by the Courts<sup>22</sup>. While outside the direct control of the regulators, this raises questions about the overall effectiveness of enforcement efforts in acting as an effective deterrent.

The existing regulations do not explicitly provide for private persons' redressal for misconduct relating to securities laws.

#### **4.2.4 Principles 11-13 (Regulatory Co-operation)**

Of the three principles relating to co-operation, two are fully implemented and one is partly implemented. SEBI has the authority to share public and non-public information with domestic and foreign counterparts and has established an information sharing mechanism in this regard. As regards the domestic regulator's ability in assisting foreign counterparts in obtaining court orders, SEBI is neither entitled to nor has any locus to approach the Courts on behalf of foreign regulator.

SEBI can share information on receipt of a written request from domestic authorities. As regards sharing of information with domestic counterparts, in the absence of similar enabling clauses in the Acts governing

the function of other principal regulators, (The Reserve Bank and IRDA); there is no formal MoU with them. Regulatory co-ordination is achieved through the HLCCFM. An integrated alert system has also been developed to enhance surveillance across sectors. As regards foreign counterparts, SEBI has signed MoUs with the foreign regulators of many countries and also entered into multilateral MoU with IOSCO. SEBI can extend informal assistance to foreign regulators in conducting enquiries or investigations of domestic regulated entities.

The partly implemented principle relates to assisting foreign counterparts in obtaining injunctions *etc.* SEBI is neither able to offer effective and timely assistance to foreign regulators in obtaining court orders. Only the aggrieved party can approach the court of competent jurisdiction for obtaining orders / injunctions. SEBI is not entitled, nor has any locus standi to approach the courts on behalf of a foreign regulator.

#### **4.2.5 Principles 14-16 (Issuers)**

Of the three principles relating to issuers, two are fully implemented and one is broadly implemented. There is full, timely and accurate disclosure of financial results and information, that is material to investors' decisions. The holders of securities are treated in a fair and equitable manner. Though accounting and auditing standards used are of highest quality, the certifying/auditing functionaries such as Chartered Accountants, Company Secretaries, *etc.* are not responsible and accountable to regulators.

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<sup>22</sup> Ref : SEBI Annual Report 2007-08

The regulatory framework has prescribed issuer specific disclosure requirements for issuers, material to investors' decisions that apply to public offering of securities such as equity shares and debt instrument, including the conditions applicable to offer for sale, the content and distribution of prospectus or offer documents and supplementary documents prepared in the offering. A continuous disclosure requirement in respect of listed securities is required to be complied with as per the Listing Agreement (LA).

The legal framework under the Companies Act and securities regulation ensures that holders of securities in a company are treated in a fair and equitable manner. Share holder(s)/ member(s) are entitled to vote in the election of directors, *etc.* The Companies Act provides for proxy voting. Members are entitled to cast as many votes as correspond to the number of their shares. There are no guidelines regarding the voting pattern of institutional shareholders in corporates. Fundamental corporate changes such as a merger or amalgamation, have to be approved by a majority in number and three fourth in value of the shareholders. SEBI (Substantial Acquisition of Shares and Take Over) Regulations, 1997 requires the disclosure and exit option to be given to shareholders at the same price if there is substantial acquisition or any change in the control of the company or management.

The broadly implemented principle relates to the requirement on accounting and auditing standards. As per the Companies Act, the company is required to prepare the financial statements in accordance with the accounting standards as provided in the Company (Accounting Standard) Rules, 2006 issued by Ministry of Corporate Affairs. The Listing Agreement makes it mandatory for listed companies to follow accounting standards issued by the Institute of Chartered Accountants of India (ICAI). ICAI has proposed

to move to International Accounting Standards i.e. IFRS from 01.04.2011 for listed companies. The financial statements have to be audited in accordance with Auditing and Assurance Standards of ICAI. It is observed that all the certifying/auditing functionaries such as chartered accountants, company secretaries are not responsible and accountable to regulators to the extent they are involved in certifying/auditing of regulated entities.

#### **4.2.6 Principles 17-20 (Collective Investment Schemes)**

Out of the four principles, three principles relating to collective investment schemes are fully implemented and one is broadly implemented. The regulatory systems has standards for the eligibility and regulation of those who wish to market or operate collective investment schemes. There are elaborate disclosure norms through offer documents. SEBI has made it mandatory for any entity/person engaged in the marketing and selling of mutual fund products to pass the AMFI certification test (Advisors Module) and obtain registration number from AMFI. Firms and corporates have to obtain certification of registration from AMFI and all employees of corporate distributors engaged in selling and marketing of mutual fund products have to pass the AMFI certification test and get registered with AMFI before canvassing business for mutual funds.

There are also rules governing the legal form and structure of collective investment schemes. These require disclosures which are necessary for evaluating the suitability of a collective investment scheme for a particular investor. The regulation ensures that there is a proper and disclosed basis for asset valuation, pricing and redemption of units in a collective investment scheme.

SEBI (Mutual Fund) Regulations, 1996 (MF Regulations), lay down the eligibility and

regulation standards for those who wish to market/launch/operate a mutual fund scheme. Mutual Fund Regulations lay down legal and regulatory framework for MFs and framework for floating of schemes by which funds of investors are pooled to invest in securities, exchange traded funds (ETF), money market instruments, gold or gold related instruments, real estate mutual funds (REMF) *etc.*

The MF Regulations provide for disclosures in the offer document in order to enable the investor to make informed investment decisions. They also provide for a proper and disclosed basis for asset valuation and the pricing and redemption of units. As per regulation 46 of MF Regulations, every MF has to compute and carry out the valuation of investments in its portfolio in accordance with the valuation norms specified in the Eighth Schedule and the guidelines issued by SEBI. As per regulation 49(1), the price at which units can be subscribed or sold and the price at which units can be repurchased has to be made available to investors. SEBI guidelines require that the NAV shall be displayed on the Association of Mutual Fund of India (AMFI) website by 9 pm of the same day and for fund of funds scheme by 10:00 a.m. of the following day. The regulatory framework for disclosure on the voting pattern by MF to its unit holders/market is not specified.

#### **4.2.7 Principles 21-24 (Market Intermediation)**

Of the four principles relating to market intermediaries, three principles are broadly implemented and one is partly implemented. SEBI has prescribed minimum standards for

market intermediaries. However, information on market intermediaries like identity of senior management and employees who are authorised to deal as market intermediaries is not made public. It has prescribed capital requirements for them, but they are not risk-related capital requirements. It has not prescribed any specific requirements on internal controls for market intermediaries. It has no specific policy in place for dealing with the failure of any market intermediary or financial conglomerate

SEBI has made regulations for various intermediaries such as stock broker, share transfer agents, merchant bankers, underwriters, portfolio managers, credit rating agencies. These lay down registration requirements, minimum entry standards and conditions for operating. As per the SEBI Act, no market intermediary who is associated with the securities market can buy, sell or deal in securities except in accordance with the conditions of certificate of registration obtained from SEBI. Also, associate persons are required to obtain/maintain the requisite certificate recognised by SEBI for working/operating in the securities market. This principle is broadly implemented as information on market intermediaries, identity of senior management and employees who are authorised to deal as market intermediary are not made public and investment advisors are not regulated at present by SEBI.

All regulations pertaining to market intermediaries specify capital adequacy requirements which are conditional for

granting registration. The intermediary has to continuously maintain the capital adequacy requirement at all times during the period of certificate of registration or its renewal. The prudential requirement in respect of brokers includes the initial margin, the exposure margin, the mark to margin, *etc.* In case of other intermediaries who undertake fund based activities such as the underwriter, exposure limit such as its underwriting obligation shall not exceed 20 times the net worth. The principle is broadly implemented as risk related capital requirement for intermediaries have not been stipulated.

SEBI has laid down norms in place to be taken into account while granting the certificate of registration to a market intermediary. Market intermediaries are required to maintain a system and procedure for the redressal of grievances of investors / clients for segregating each client's funds and securities separately from his own. They have an internal control system and procedure for the prevention of insider trading and for anti money laundering measures. Every intermediary is required to appoint a compliance officer for monitoring compliance. This principle is partly implemented as there are no specific requirements on internal controls prescribed for market intermediaries.

The reporting system for intermediaries serves as an early warning system for potential defaults. In addition, capital adequacy has been prescribed. Besides, Delivery Versus Payment on settlement cycle of the T+2 rolling basis and guaranteed settlement by the Clearing Corporations mitigate the impact of failure. The clearing and settlement agencies of the RSEs maintain a guarantee fund such as the Settlement Guarantee Fund (SGF) to mitigate counterparty and systemic risks. The bye-laws of the stock exchanges contain elaborate provisions for dealing with the eventuality of a firms' failure or when it is

declared as a defaulter. This principle is only broadly implemented as there is no specific policy for dealing with the failure of a market intermediary or financial conglomerate.

#### **4.2.8 Principles 25-29**

##### **(The Secondary Market)**

All the five principles relating to the secondary market are fully implemented. The establishment of trading systems, including securities exchanges is subject to regulatory authorisation and oversight. There is ongoing regulatory supervision of exchanges and trading systems to ensure the integrity of trading. There are regulations which promote transparency in trading and detect and deter manipulation and other unfair trading practices. There are also regulations to ensure the proper management of large exposures, default risk, and market disruption.

The establishment of a trading system, including securities/ derivatives exchanges, is subject to regulatory authorisation and oversight. The SC (R) Act has laid down the legal and regulatory framework for the recognition / authorisation and operation of the RSE and regulations of contracts in securities and exchange-traded derivative transactions. Any stock exchange desirous of being recognised as an RSE has to make an application for recognition to SEBI, as per Section 3 of SC (R) Act. Exchanges in India have been corporatised and demutualised.

The RSE monitors day-to-day operations and trading in the exchanges under the overall supervision of SEBI. SEBI supervises the RSEs and conducts the oversight of RSEs . The monitoring also includes, periodic and event driven reporting by the RSE and an inspection. SEBI also conducts weekly surveillance meetings with the RSEs and depositories to review market movements. It has established the IMSS to monitor surveillance activities in multiple exchanges and depositories.

## Chapter IV

### Assessment of Adherence to IOSCO Principles

Table 12: Summary assessments of equities/corporate bond market					
Principle	FI	BI	PI	NI	NA
<b>Principles of regulator</b>					
1. Responsibilities of regulator		√			
2. Operational independence and accountability		√			
3. Power, resources and capacity to perform functions	√				
4. Regulatory processes of regulator	√				
5. Professional standards of staff of regulator	√				
<b>Principles relating to self regulation</b>					
6. Regulatory regime	√				
7. Regulators' oversight over SROs and standards adopted by SROs	√				
<b>Principles relating to enforcement</b>					
8. Inspection, investigation and surveillance powers	√				
9. Enforcement powers	√				
10. Use of inspection, investigation, surveillance and enforcement powers		√			
<b>Principles relating to co-operation</b>					
11. Authority to share information with domestic and foreign counterparts	√				
12. Information sharing mechanisms	√				
13. Assistance provided to foreign regulators			√		
<b>Principles relating to issuers</b>					
14. Disclosure of financial results	√				
15. Treatment of holders of securities	√				
16. Accounting and auditing standards		√			
<b>Principles relating to collective investment scheme</b>					
17. Standards for eligibility and regulation		√			
18. Rules governing legal form and structure	√				
19. Disclosure requirements	√				
20. Asset valuation and pricing and redemption of units	√				
<b>Principles relating to market intermediaries</b>					
21. Minimum entry standards		√			
22. Capital and prudential requirements		√			
23. Internal organisation and operational conduct			√		
24. Procedure for dealing with failure of market intermediary		√			
<b>Principles relating to secondary markets and clearing and settlement</b>					
25. Trading systems	√				
26. Regulatory supervision	√				
27. Transparency of trading	√				
28. Detection of manipulation and unfair trading practices	√				
29. Management of large exposures, default risk and market disruption	√				
30. Systems for clearing and settlement of securities	√				
<b>Total</b>	<b>20</b>	<b>8</b>	<b>2</b>	<b>-</b>	<b>-</b>
<i>FI- Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable</i>					



There are regulations to promote transparency in trading. An RSE can make by-laws and rules only with the approval of SEBI, which ensures that these are fair and equitable. SEBI has permitted short selling by all classes of investors and has put in place a full-fledged securities lending and borrowing scheme for all market participants. RSEs are required to arrange for the dissemination of information about trades, quantities and quotes (first five bids) on a real-time basis through at least two information vending networks that are easily accessible to investors.

There are also regulations to detect and deter manipulation and other unfair trading practices. The regulatory approach to detect and deter manipulation and other unfair practices includes on-line surveillance, inspection, reporting and investigation of abnormal and suspected transactions.

SEBI has regulations for ensuring the proper management of large exposures, default risks and market disruption for which the RSEs have set up a surveillance system. There is also a risk-management system which *inter alia*, includes the collection of margins from members such as marked-to-market. The RSEs are authorised to ask for special or additional margin or a reduction of exposure or concentration. There is a mechanism by which RSE authorities and SEBI can consult each other to avoid market disruption.

#### **4.2.9 Principle 30**

##### **(Clearing and Settlement)**

The systems for the clearing and settlement of securities transactions are subject to regulatory oversight.

The clearing and settlement of securities transactions in an RSE is monitored by the RSEs themselves under the overall supervision of SEBI. The rules and regulations for clearing and settlement have been designed to ensure that they are fair, effective and reduce systemic

risk. Robust, guaranteed, and DVP-based clearing and settlement system using multilateral netting is undertaken through Clearing Corporations in respect of all deals in securities. The RSEs have a screen-based on-line trading system through which trades between direct market participants are confirmed online at the time of trade. The Exchanges/Clearing Corporations have back-up systems. A comprehensive risk management framework as prescribed by SEBI from time to time is followed by the Clearing Corporation / Clearing House. RSEs such as NSE and BSE have put in place an on-line monitoring and surveillance system, whereby exposure of the members is monitored on a real-time basis.

#### **4.3 Recommendations**

In light of the gaps observed in its assessment of adherence to IOSCO Principles in respect of regulation of securities market the Panel has made certain recommendations to strengthen the regulation and supervision of Indian equity and debt and exchange traded derivative markets. They are as under:

##### **4.3.1 Overlap of Jurisdiction**

The areas of responsibility among SEBI, the Reserve Bank, the Central Government and Ministry of Corporate Affairs have been specified in the Acts, and/or notifications. Section 55A of the Companies Act, 1956 divides the responsibility between Ministry of Corporate Affairs and SEBI and the notification dated March 1, 2000 issued by the Central Government, under Section (u/s)16 of the SC (R) Act divides responsibility between the Reserve Bank and SEBI. However, there are areas of jurisdictional overlap.

The Central Government continues to have power under SC (R) Act as also the power to make rules in respect of all the matters under the SC(R) Act. It is recommended that SC (R) Act be suitably amended deleting the concurrent power of the Central Government.



The power of Central Government to make rules in respect of capital market related issues under SC (R) Act could also be deleted. SEBI should be empowered to make regulation in respect of capital market related matters specified under Section 30 of SC (R) Act.

Ministry of Corporate Affairs has concurrent powers under the Companies Act in respect of matters relating to capital market such as the prospectus, issue of shares to the public *etc.* Even though Section 55A empowers SEBI to administer provisions of the Companies Act in respect of issues, the transfer of securities and the non-payment of dividends in respect of listed or proposed to be listed companies, SEBI does not have the power to make regulations. Only Central Government has the power to make rules and prescribe schedules, including prospectus and financial statements. It is recommended that all capital market related matters in respect of listed companies be exclusively in SEBI's domain including the power to make regulations in respect of matters specified under Section 55A.

#### **4.3.2 Specific Conflict Rule for Staff**

SEBI staff has to maintain secrecy and should not make use of any information which has come to their knowledge in discharge of their officials duties and nor can they communicate any such information to any other person except in the course of their official duty. The Panel recommends that there should be a specific conflict rule for the staff relating to investigation or consideration of licensing application of related entities of staff.

#### **4.3.3 Comprehensive Inspection Programme for Intermediaries**

In case of outsourced inspection, SEBI appoints auditors who are in the Reserve Bank panel as Central Statutory Auditors. The auditors are given detailed guidance note for inspection and are also given a format for preparation of inspection reports. There should be a mechanism for supervision / monitoring of out sourced inspection and also for supervision and monitoring of out sourced activities of the intermediaries. The Panel recommends that a comprehensive inspection policy /programme for all intermediaries may be adopted to increase overall effectiveness of enforcement.

#### **4.3.4 Private Right of Action**

There is no specific provision empowering a private person to seek his or her own remedies for misconduct relating to the securities law. Only SEBI is empowered to take action for a violation of the SEBI Act and Regulations.

A private person can mainly seek remedies such as compensation for deficiency in services provided by an intermediary before a consumer forum as per the Consumer Protection Act, 1986 or for any claim against broker before Arbitrator under bye-laws of a RSE.

However, Section 15Y and 20A of SEBI Act bar the jurisdiction of civil courts in matters which are within the purview of the adjudicating officer, SAT or SEBI. Only SEBI can file a criminal complaint under section 26 for violation of the SEBI Act and regulations.

It is therefore, recommended that private right of action and / or class action suit by investors may be allowed by law.

#### **4.3.5 Disclosure and Investment Protection**

Along with Schedule II of Companies Act and Form 2A of Companies Rules, the disclosure requirements are based on Disclosure and Investor Protection (DIP) Guidelines issued by SEBI. To impart enforceability, the Panel recommends that the guidelines may be converted into regulations.

#### **4.3.6 Related Party Transactions**

All related party transactions have to be informed in the Annual Report and Audit Committee as per Listing Agreement. The Panel recommends that interested party transactions may be subject to shareholders approval.

#### **4.3.7 Disclosure of Voting Patterns**

At present there is no disclosure requirement of the voting pattern of significant shareholders. The OECD principles of corporate governance define the basic rights of shareholders. These include, *inter alia*, the right to information. As a part of transparency and good corporate governance, the Panel recommends that it would be desirable that the voting pattern on important decisions of significant shareholders are made public in relation to capital market.

#### **4.3.8 Regulation of Distributors**

The key channel in bringing the mutual funds to a large number of investors all over the country is the network of distributors. The distributors also have to take on the role of financial advisors to investors. AMFI Mutual Fund Certification and Registration Programme has been put together to give the fund distributors the knowledge and insight required for them to become both better intermediaries and more informed mutual fund advisors.

SEBI has made it mandatory for any entity / person engaged in the marketing and selling of mutual fund products to pass the Association of Mutual Fund Industries (AMFI)

certification test (Advisors Module) and to obtain a registration number from AMFI. Firms and corporates have to obtain certification of registration from AMFI and all employees of corporate distributors engaged in selling and marketing of mutual fund products have to pass the AMFI certification test (Advisors Module) and obtain registration with AMFI before canvassing business of mutual funds.

As per the IOSCO principles the operators and distributors of mutual funds are required to be regulated / licensed. Distributors of units of mutual funds as well as distributor of securities in primary market should be brought within the regulatory fold through SROs or direct regulations.

#### **4.3.9 Transparency**

The Panel is of the view that information on market intermediaries, the identity of senior management and employees authorised to deal on behalf of an intermediary needs to be made public. This would also enhance investor protection.

#### **4.3.10 Addressing Risk arising from Unlicensed Affiliates of Regulated Entities**

While SEBI has a process for registering and inspecting brokers, there is no such mechanism currently available for unlicensed affiliates of these entities. Hence, the Panel recommends that risk arising from unlicensed affiliates of the regulated entity needs to be addressed.

#### **4.3.11 Market Intermediaries**

A. Capital Requirements: While SEBI has prescribed minimum capital adequacy requirements for market intermediaries operating within its regulatory domain, this is not based on the riskiness of assets. The Panel recommends that there is a need to move to a risk-based prudential capital requirement for these intermediaries on the lines of the capital adequacy

requirement prescribed for primary dealers in government securities market.

- B. Internal Control: The Panel found that there was no separate or specific requirement of adequate internal controls for market intermediaries. The Panel recommends that detailed guidelines be issued by SEBI regarding internal controls as a part of good practice.
- C. Failure Resolution: The Panel recommends that policies and procedures should be laid down for dealing with the failure of a market intermediary or financial conglomerate to reduce risks to systemic stability. The enhancement of efficacy in regulatory and supervisory co-operation, with particular reference to financial conglomerates, is a prerequisite in this regard.

#### **4.3.12 Management of Conflict arising from Research, Investment Banking, Mutual Fund and Broking being under one entity**

The Panel feels that the issue of management of conflict is relevant in a situation where research, investment banking, mutual fund and broking are housed under one roof needs to be addressed.

#### **4.3.13 Secondary Markets**

Stock exchanges have been corporatised and demutualised. This has brought to focus new conflicts. Demutualised exchanges have to cater to the needs of shareholders besides discharging functions under the SC (R) Act, such as market and member regulation. To give an exit option to shareholders some demutualised exchanges can also seek listing in the exchanges. The Panel feels there should be strong oversight of demutualised exchanges to address the problem of potential conflicts that may arise because of commercial objectives coming in conflict with the regulatory role.

### **Section 5**

## **Government Securities, Money and Foreign Exchange Markets**

### **5.1 Regulatory and Supervisory Mechanism- Government Securities Market**

The Reserve Bank manages public debt and the issue of new loans of the Central and State Governments. The Reserve Bank's operations in the government securities<sup>23</sup> market are governed by Section 20, 21 and 21A of the RBI Act, 1934. The Reserve Bank derives

<sup>23</sup> "Government security" means a security created and issued by the Government (Central or State Government) for the purpose of raising a public loan or for any other purpose as may be notified by the Government in the Official Gazette and having one of the forms mentioned below:

- (i) a Government promissory note payable to or to the order of a certain persons; or
- (ii) a bearer bond payable to bearer; or
- (iii) a stock; or
- (iv) a bond held in a bond ledger account.

*Explanation.— "stock" means a Government security,—*

- (i) registered in the books of the Bank for which a stock certificate is issued; or*
- (ii) held at the credit of the holder in the Subsidiary General Ledger (SGL) account including the Constituents Subsidiary General Ledger (CSGL) account maintained in the books of the RBI, and transferable by registration in the books of the RBI.*

its regulatory power from Section 16 of SC(R) Act. As a part of the Reserve Bank of India (Amendment) Act, 2006, a new Chapter III D has been inserted in the the Reserve Bank Act which, *inter alia*, has clarified the role of the Reserve Bank to determine policies relating to interest rate products and regulate the agencies dealing in such securities. The Government Securities Act, enacted in 2006, has replaced the erstwhile Public Debt Act and has provisions relating to the issue of new loans, payment of interest *etc.* This Act allows the holding of government securities in depositories while specifically excluding them from the purview of the Depositories Act, 1996. To the extent that government securities are listed and securities and related derivatives are traded in stock exchanges some aspects of government securities market regulation are shared by the Reserve Bank with SEBI.

The two market associations, *viz.*, the Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) play a supporting role in market regulation. But they are not recognised as Self Regulatory Organisations (SROs). Trading in government securities can take place on exchanges, on order matching and an anonymous trading platform (NDS-OM) and in the OTC market either directly or through brokers. All institutional investors maintain Subsidiary General Ledger (SGL) accounts with the Reserve Bank. Trading in government securities takes place predominantly in a dematerialised form, which is settled in a DVP mode guaranteed through Clearing Corporation of India Ltd. (CCIL), which is a central counter party.

Under Section 29A of SC(R) Act, the Central Government has delegated to the Reserve Bank, the powers exercisable by it under Section 16 of the Act. The Reserve Bank is, thus authorised to regulate dealings in government securities, money market

securities, gold related securities and securities derived from these securities, as also ready-forward contracts in debt securities. The Government Securities Act, 2006 contains provisions relating to the transfer of government securities, the nomination of holders of government securities, the issue of duplicate securities, and of new securities. The Act empowers the Reserve Bank to frame regulations as to the terms and conditions for the issue of government securities, form in which they can be issued and fee to be charged for the maintenance of the Subsidiary General Ledger (SGL) and Constituents Subsidiary General Ledger (CSGL) accounts and bond ledger accounts, form and manner in which government securities can be transferred, the manner in which the Reserve Bank can determine the title to government securities, *etc.* The Reserve Bank is also empowered under the Act to impose penalties if any person contravenes any of the provisions of the Act. Nothing contained in Depositories Act, 1996 or regulations made thereunder are applicable to government securities covered by the Government Securities Act, 2006.

## **5.2 Regulatory and Supervisory Mechanism - Money Market**

The money market is a market for short-term funds with maturities ranging from overnight to one year. The major components of the money market are inter-bank call (overnight) and notice money (upto 14 days), market repo, collateralised borrowing and lending obligation (CBLO), inter-corporate deposits and term money markets. Treasury bills, Commercial Paper and Certificates of Deposits are other instruments in the money market. The market structure is broad-based because of the participation of banks, primary dealers, insurance companies, mutual funds, provident funds, corporates, *etc.* The Reserve Bank's regulatory powers over money market securities have gained clarity through a Government notification under Section 16 of

the SC(R) Act. This was further strengthened by clause 45 (W) of the RBI Amendment Act, 2006, wherein the Reserve Bank has been given specific powers to 'regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products, and give directions in that behalf to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time'.

Trading in money market instruments can take place on a trading platform or in the OTC market. Electronic platforms are available for deals in the call, notice and term market transactions, market repo and CBLO. OTC deals are done for Commercial Paper (CP), Certificate of Deposit (CD) as well as for call/notice/term money markets. Settlement is done over Real Time Gross Settlement (RTGS) system – either as a gross settlement or as a multilateral netted batch. CP and CD deals, which are mostly in the form of private placements are done OTC.

### 5.3 Regulatory and Supervisory Mechanism -Foreign Exchange Market

Foreign exchange<sup>24</sup> markets in India are primarily regulated under the powers conferred

to the Reserve Bank under the RBI Act, 1934 read with the Banking Regulation Act 1949 and the Foreign Exchange Management Act, 1999 (FEMA). The Reserve Bank monitors the foreign exchange markets under the various provisions of FEMA which replaced the old Foreign Exchange Regulation Act, 1973. The Reserve Bank licenses Authorised Dealers including Full Fledged Money Changers (FFMCs). It intervenes in the foreign exchange market to ensure orderly market conditions. Foreign Exchange Dealers Association of India (FEDAI) plays an important role in the market for ensuring the smooth and speedy growth of the market. It has been designated as a Self Regulatory Organisation (SRO) for the foreign exchange markets by the Reserve Bank. Some functions previously handled by the Reserve Bank have been delegated to FEDAI. Some regulatory/supervisory oversight of the foreign exchange markets are being undertaken by FEDAI, including the approval of electronic trading systems and the accreditation of brokers in the foreign exchange market. However, FEDAI cannot be recognised as a full-fledged SRO. This is because as required by IOSCO principles, it does not establish any eligibility criteria that must be satisfied in order for individuals or firms to participate in the foreign exchange market thereby not fulfilling a basic tenet.

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<sup>24</sup> As per the Act foreign exchange means 'foreign currency' and includes:-

- (i) deposits, credits and balances payable in any foreign currency;
- (ii) drafts, travellers' cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency; and
- (iii) drafts, travellers' cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency.



Foreign exchange markets are primarily OTC markets. A number of trading platforms are available for market participants such as FX clear (promoted by the Clearing Corporation of India Limited), Fx Direct (promoted by IBS Foreign exchange Ltd.), Reuters D2 and Reuters Market Data Systems (both promoted by Reuters). Fx Clear and Fx Direct both offer real time order matching and negotiation modes for dealing. CCIL undertakes the settlement of foreign exchange transactions on a multilateral net basis through a process of novation. The guaranteed settlement of transactions, however, is not extended to all forward trades.

In India, all transactions that include foreign exchange are governed by FEMA. Broadly, its objectives are: to facilitate external trade and payments and to promote the orderly development and maintenance of foreign exchange market. The rules, regulations and norms pertaining to Act are laid down by the Reserve Bank in consultation with the Central Government. The Government is the adjudicating and appellate authority.

The foreign exchange market comprises of the spot and the derivatives segments. The foreign exchange derivatives market includes foreign exchange forwards, foreign currency rupee and cross-currency swaps and options. Very recently, trading in currency futures in RSEs have been allowed by SEBI. FEMA permits only authorised persons to deal in foreign exchange or foreign securities. Such authorised persons cover Authorised Dealers (ADs), money changers, off-shore banking units or any other person for the time being authorised by the Reserve Bank. Therefore, while analysing compliance or otherwise of the IOSCO principles regarding market intermediaries, the matter has primarily been viewed from the applicability and compliance to these principles with regard to authorised persons only.

## 5.4 Summary Assessment

A summary of assessment of adherence to IOSCO principles in respect of regulation and supervision of government securities, money and foreign exchange markets as applicable to the Reserve Bank regulation is furnished below. The detailed principle-wise assessment is furnished in **Appendices 5, 6 and 7** respectively.

### 5.4.1 Government Securities Market

Some of the principles are not applicable to the government securities market in as much as the key questions cannot be answered given the specific conditions of the market in India. The following principles are not applicable in case of government securities market.

- i) **Principle 6 and 7 (Self Regulatory Organisations):** The principles relating to SROs are technically treated as not applicable. But the Panel has made certain specific recommendations in the section on Broader Issues (Section 3). FIMMDA and PDAI play some SRO-like roles. However, while they assist the Reserve Bank in regulation, they are yet to be recognised as SROs and they are not subject to regulatory oversight. Further, as required in terms of IOSCO principles they do not establish eligibility criteria that must be satisfied in order for individuals or firms to participate in activities in the government securities market, thus not fulfilling the basic requirement of an SRO. In view of the above, at present there are effectively no SROs in government securities markets. Therefore, the Panel decided to assess these principles relating to SROs as not applicable.
- ii) **Principle 15 (Fair and Equitable Treatment of Shareholders):** This principle is not applicable to the government securities market because holders of government



securities are treated in fair and equitable manner. The key questions of IOSCO principles as regards fair and equitable treatment of shareholders are therefore treated as not applicable.

**iii) Principle 16 (Accounting and auditing standards):** The principle is not applicable, as it is primarily intended to assess the accounting and auditing standards for the corporate sector. However, the spirit of the principle is relevant and hence an attempt has been made here to explain the position of the issuer, i.e., Government of India on the relevant points (see detailed assessment in-**Appendix 5**).

- a. The accounting systems followed by the Central and State Governments are currently based on an elaborate department-specific account codes and rules. For historic reasons and considerations of budgetary control and perceived simplicity and certainty of the cash-based system, Governments use the cash based system of accounting and financial reporting. However, a roadmap has been suggested for switching on to accrual accounting;
- b. In order to standardise the codal provisions and move from a rules-based system to standards common to all departments within the Government, the Government Accounting Standards Advisory Board (GASAB) has been set up. The GASAB's objective is to identify the principles underlying the various accounting rules, address lacunae and improve their quality.

The GASAB is seeking to promote understandability, reliability, relevance, timeliness, consistency and comparability of Government accounts across departments, authorities and organisations in the Central and State Governments. A technical committee has been constituted to examine the various related aspects of public finance and development administration while evolving the Government accounting standards;

- c. To provide a mechanism for ensuring value for money in public expenditure, an Outcomes Budget is being presented since 2005. It provides an operational framework through a set of monitorable indicators. Together with the Right to Information Act, it is expected to empower civil society to evaluate the performance through benchmarks of achievement that would emerge from various governance structures across the country.
- d. The Comptroller and Auditor General of India (CAG), who is the head of the highest audit institution in public finance, derives his duties and powers from the Constitution of India. The CAG is the sole auditor of the accounts of the Central Government and the State Governments. The CAG is also responsible for ensuring a uniform policy of accounting and audit in the Government sector as a whole. The CAG lays down for the guidance of the Government departments, the general principles of Government accounting and the broad principles in regard to audit of

receipts and expenditure. The reports of the CAG relating to the accounts of the Union and the States are submitted to the President/Governor of the State for being laid before the Parliament/State Legislature.

The summary assessment of government securities market in respect of other principles as relevant and applicable is as under:

**(i) Principles 1-5 (The Regulator)**

Of the five principles relating to the regulator, four are fully implemented. The objectives of the regulator are clearly and objectively stated. It has adequate powers, resources and capacity to perform its functions. It adopts a clear and consistent regulatory process. It has staff which observes highest professional standards including appropriate standards of accountability. One principle relating to the operational independence of the regulator is partly implemented. Conventionally the Reserve Bank is de facto operationally independent and accountable.

The responsibilities of the Reserve Bank are clearly and objectively defined. It draws its authority to regulate the government securities market from various legal enactments, viz., the RBI Act, 1934, the Public Debt Act, 1944, the Securities Contract (Regulation) Act, 1956 and the Government Securities Act, 2006. The Reserve Bank formulates policy in respect of the government securities market in consultation with the Government but enjoys considerable operational independence.

The RBI Act provides the basis for its independence, accountability and governance structure. Though conventionally, the Reserve Bank is perceived as an independent authority, as regards the operational independence and accountability in exercise of powers and functions, the reasons for removal of head of the supervisory authority are not legally prescribed inasmuch as the Central

Government can remove the Governor of the Reserve Bank (as per Section 11 of RBI Act, 1934) without specifying any reasons in this regard. Further, as per Section 30 of RBI Act, the Central Government can supersede its Central Board. The Reserve Bank is not directly accountable to Parliament and works through the Ministry of Finance.

The Reserve Bank has adequate powers, proper resources and capacity for licensing, regulation and supervision of market intermediaries. It adopts clear and consistent regulatory processes. The staff of the Reserve Bank observes the highest professional standards including appropriate standards of confidentiality.

**(ii) Principles 8-10 (Enforcement)**

The Reserve Bank has comprehensive inspection, investigation and surveillance powers. It can inspect a regulated entity's business operations including its books and records. It has access to the identity of all customers of the regulated entities. A system of on-site supervision and off-site surveillance of the market participants is in place to ensure the maintenance of high standards along with investor protection. Inspections are carried out by the Reserve Bank, supplemented by internal audit/inspection and concurrent audit of market intermediaries.

The Reserve Bank has comprehensive enforcement powers. It has powers to impose administrative sanctions. The regulatory system ensures an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of effective compliance program. It is vested with powers to obtain data, information, documents, statements and records from market intermediaries, to take suitable regulatory action to ensure compliance with regulatory guidelines, to impose monetary/non-monetary and/or administrative

sanctions, and to order the suspension of trading in securities by any market player(s) or to take other appropriate action *etc.*

**(iii) Principles 11-13  
(Regulatory Co-operation)**

All the three principles relating to co-operation are partly implemented. Though there is an information-sharing mechanism in place, there is no formal Memorandum of Understanding (MoU) in place for sharing information with domestic regulators. Likewise, assistance to foreign regulators is given whenever it is sought, but there are no formal MoUs in place. As regards, the domestic regulator's ability in assisting foreign counterparts in obtaining court orders, the Reserve Bank is neither entitled nor has any authority to approach the court of law on behalf of a foreign regulator.

The Reserve Bank shares information with other domestic regulators. The sharing of information encompasses regulatory/supervisory concerns, market conduct, financial performance, *etc.* The High Level Co-ordination Committee for Financial Markets (HLCCFM) is a forum for regulatory heads to discuss issues that concern banking, money / securities market and insurance.

There is no formal information-sharing mechanism with foreign regulators. The regulatory system also does not allow assistance to be provided to foreign regulators who need to make inquiries in discharge of their functions and exercise of their powers. There are no provisions under the RBI Act, 1934 and Banking Regulation Act, 1949 that allow

the Reserve Bank to provide assistance to foreign regulators. Assistance to foreign regulators has been provided in the past as and when sought for and wherever possible. The Reserve Bank also extends informal assistance to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers. Thus, assistance to foreign regulators is need-based. A formal co-operation mechanism needs to be put in place at the international level to facilitate the detection and deterrence of cross-border misconduct and to assist in the discharge of supervisory responsibilities.

**(iv) Principle 14(Issuers)**

The primary auctions of government securities are governed by general and specific notifications which contain, in detail, the terms of the issue. The disclosures are contained in the annual budget statements. Periodic information on the fiscal position is published by the Central and State Governments.

**(v) Principles 17 to 20  
(Collective Investment Schemes)**

There are collective investment schemes like gilt funds which are subject to guidelines issued by SEBI. All issues relating to these funds such as the rules governing the legal form and structure, disclosure norms, and pricing, come under the purview of SEBI.

Mutual funds can offer schemes which invest in government securities, subject to the SEBI guidelines. Debt funds also hold government securities as part of their portfolio. There are dedicated gilts funds also to meet the needs of investors.

The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets. These are governed by mutual fund regulations of SEBI. They are legal entities registered as companies/trusts.

Stringent disclosure norms are prescribed and the funds are required to publish the Net Asset Value daily. Pricing and redemption of units in a collective investment scheme is done at market value.

**(vi) Principles 21-24  
(Market Intermediation)**

There are intermediaries in the government securities market (primary dealers and brokers). The former are required to be authorised to conduct their business. Stringent entry norms have been prescribed for them. As regards brokers in the government securities market the principle has been assessed as part of assessment of securities market as the guidelines for these intermediaries are framed by SEBI and they come under the purview of SEBI. Of the four principles relating to market intermediaries, three are fully implemented and one is broadly implemented.

The Reserve Bank has prescribed minimum standards for primary dealers. It has prescribed risk-based capital requirements for them and specific requirements on internal controls. There are no provisions requiring the disclosure of a firm's trading / financial position to the market.

There are also risk-based capital requirements. Initial capital and prudential requirements are specified separately for banks and stand-alone primary dealers. These regulatory guidelines are checked for compliance by internal auditors as also during inspections by the Reserve Bank. The regulatory capital requirements have been

prescribed, based on on-and off-balance sheet risks.

The Reserve Bank has prescribed requirements for internal control for market intermediaries. All of them are regulated entities and are subject to periodic inspections by the Reserve Bank, regular surveillance, audits and oversight by their own Boards.

The Reserve Bank has in place a procedure for dealing with the failure of a market intermediary. The purpose is to minimise the damage and loss to investors and to contain systemic risk. Periodic inspections by the Reserve Bank, coupled with regular surveillance as also DVP and guaranteed settlement by the CCIL, mitigate the impact of such failures. However, there are no provisions requiring the disclosure of a firm's trading / financial position to the market.

**(vii) Principles 25-29  
(The Secondary Market)**

All five principles relating to secondary market are fully implemented. Though the establishment of the trading platforms requires the exclusive approval of the Reserve Bank, the single trading system in India dedicated exclusively to government securities market is owned by the Reserve Bank. There are no other independent trading platforms. There is ongoing regulatory supervision of exchanges and trading systems to ensure the integrity of trading. There are also regulations in place to promote transparency in trading and to detect and deter manipulation and other unfair trading practices. The regulations also ensure the proper management of large exposures, default risk and market disruption.

The establishment of trading systems for government securities requires exclusive approval of the Reserve Bank. However, so far, the single trading system in India dedicated exclusively to Government securities market is owned by the Reserve Bank itself and

## Chapter IV

### Assessment of Adherence to IOSCO Principles

Table 13: Summary assessment of government securities market					
Principle	FI	BI	PI	NI	NA
<b>Principles of regulator</b>					
1. Responsibilities of regulator	√				
2. Operational independence and accountability			√		
3. Power, resources and capacity to perform functions	√				
4. Regulatory processes of regulator	√				
5. Professional standards of staff of regulator	√				
<b>Principles relating to self regulation</b>					
6. Regulatory regime					√
7. Regulators' oversight over SROs and standards adopted by SROs					√
<b>Principles relating to enforcement</b>					
8. Inspection, investigation and surveillance powers	√				
9. Enforcement powers	√				
10. Use of inspection, investigation, surveillance and enforcement powers	√				
<b>Principles relating to co-operation</b>					
11. Authority to share information with domestic and foreign counterparts			√		
12. Information sharing mechanisms			√		
13. Assistance provided to foreign regulators			√		
<b>Principles relating to issuers</b>					
14. Disclosure of financial results			√		
15. Treatment of holders of securities					√
16. Accounting and auditing standards					√
<b>Principles relating to collective investment scheme</b>					
17. Standards for eligibility and regulation		√			
18. Rules governing legal form and structure	√				
19. Disclosure requirements	√				
20. Asset valuation and pricing and redemption of units	√				
<b>Principles relating to market intermediaries</b>					
21. Minimum entry standards	√				
22. Capital and prudential requirements	√				
23. Internal organisation and operational conduct	√				
24. Procedure for dealing with failure of market intermediary		√			
<b>Principles relating to secondary markets and clearing and settlement</b>					
25. Trading systems	√				
26. Regulatory supervision	√				
27. Transparency of trading	√				
28. Detection of manipulation and unfair trading practices	√				
29. Management of large exposures, default risk and market disruption	√				
30. Systems for clearing and settlement of securities	√				
<b>Total</b>	<b>19</b>	<b>2</b>	<b>5</b>	<b>-</b>	<b>4</b>
<i>FI- Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable</i>					



managed by Clearing Corporation of India Ltd. (CCIL). The launch of Negotiated Dealing System (NDS) has been a major development. NDS is an electronic platform for facilitating dealing in government securities. It facilitates the issuance of government securities by the Reserve Bank through auctions and floatation. It also provides an interface to the Securities Settlement System of Public Debt Office hosted in the Reserve Bank, thereby facilitating the settlement of transactions in government securities both outright as well as repos. All decisions related to the system are taken by the Reserve Bank itself. The Reserve Bank decides on the type of securities that can be traded on these trading platforms. The trading information is disseminated on real-time basis through its website. As per regulations, government securities are deemed to be listed on the stock exchanges and are eligible for being traded on those platforms. Stock exchanges are within the regulatory jurisdiction of SEBI. The quantum of transactions in government securities in the RSEs however, is not very significant.

There is an ongoing supervision of trading systems to ensure that the integrity of trading is maintained through fair and equitable rules. The Negotiated Dealing System (NDS) trading platforms are supervised by the Reserve Bank regularly. The trading platforms in stock exchanges are supervised by the SEBI.

The existing regulations promote transparency. All trades on the OTC platform are required to be reported on NDS within 15 minutes. The trade data is also disseminated on the Reserve Bank's website.

There are regulations in place to detect and deter manipulation and other unfair trading practices. There is a market surveillance division within the Reserve Bank to scrutinise market transactions on an ongoing basis.

There are regulations in place to ensure the proper management of large exposures,

default risk and market disruption. To manage exposures, default risk and market disruption, market participants are required to put in place credit exposure norms, contingency plans to meet operational breakdowns and market disruptions. Credit risk is nearly zero as the settlement is based on DVP mechanism in a guaranteed mode.

#### **(viii) Principle 30 (Clearing and Settlement)**

The systems for the clearing and settlement of securities transactions are subject to regulatory oversight and ensure that they are fair, effective and efficient and that they reduce systemic risk. A robust, guaranteed, and DVP based clearing and settlement system using multilateral netting is undertaken through CCIL for all deals in government securities. This eliminates settlement risk.

#### **5.4.2 Recommendations-Government Securities Market**

##### **(i) Market Intermediaries**

The regulator should have the power to disclose a firm's trading/financial position to the market. At present, the risks underlying the trading/financial position of the PDs are not disclosed by the regulator. The Panel recommends that given the sensitive nature of the information, the Reserve Bank could consider disclosing the PD's trading/financial position with a sufficient time lag and that greater disclosure should be encouraged subject to its impact on systemic stability.

##### **(ii) Trading Platforms**

The establishment of trading systems for government securities requires approval of the Reserve Bank. However, so far, the only trading system in India dedicated to the government securities market is owned by the Reserve Bank itself and managed by Clearing Corporation of India Ltd. (CCIL) on the Reserve Bank's behalf. There are no other trading platforms.



The Panel feels that given that the Reserve Bank manages public debt as also regulates the government securities market, owning of the trading platforms increases the possibility of conflict of interest. It therefore recommends that the ownership of trading platforms should be divested from the Reserve Bank in a phased manner to a separate agency.

#### **(iii) Increased Transparency in Disclosures by Governments**

Disclosure standards for a company's financial results and for the Government cannot be treated on the same footing. By virtue of being issued by the sovereign authority, government securities bear no credit risk for subscribers. Consequently, disclosure of the financial results in a manner similar to that of a company may not be feasible. As a part of disclosure the Governments publish their annual budgets, a key component of which is the annual financial statement. The Economic Survey of Governments, giving a qualitative overview of the state of the economy, is also published simultaneously. The monitoring of targets under provisions of the Fiscal Responsibility and Budget Management (FRBM) Act has also enhanced transparency. Though the annual budgets of the Central and State Governments are primarily statements of authorisation by legislatures, they also contain information regarding the audited financial results. However, there is an issue of timeliness in this regard. The audited financial results of the Central Governments are made public after a lag of six to nine months. As regards the State Governments, the delay is even more.

The Panel feels that there is a need for speedier disclosures. In the present scheme of things, it is informed and mostly regulated market participants who invest in government securities. However, if the market opens up for smaller players, there would be demand for increased transparency. Further, given the country's growing requirements of funds the Central and State Governments may need to access foreign funds which, in turn, would require Government debt to be rated. This calls for an increase in transparency in a timely manner. The Panel feels that the Governments should reduce the time lag in the publication of audited financial results. There could also be an increase in the frequency of disclosures.

#### **5.4.3 Money Market**

The principle relating to Self Regulatory Organisations (SROs) are technically treated as being not applicable in the case of the money markets. But the Panel has made certain specific recommendations in the section on "Broad Issues". FIMMDA plays some SRO roles in the money market. But while it assists the Reserve Bank in regulation, it is yet to be recognised as a SRO. Further, as required in terms of IOSCO principles, it does not establish any eligibility criteria that have to be satisfied in order for individuals or firms to participate in the money market thereby not fulfilling one of the basic tenets of the SRO. The Panel is of the view at present there are effectively no SROs in the money market. Technically, therefore, the Panel decided to assess principles relating SROs as not applicable.

The summary assessment of the money market in respect of the other principles is given:

**(i) Principles 1-5 (The Regulator)**

Of the five principles relating to the regulator, four principles are fully implemented. The objectives of the regulator are stated clearly and objectively. It has adequate powers, resources and the capacity to discharge its duties. It adopts a clear and consistent regulatory process. It has staff which observes the highest professional standards, including appropriate standards of accountability. One principle relating to the operational independence of the regulator is partly implemented. Conventionally the Reserve Bank is operationally independent and accountable.

The responsibilities of the Reserve Bank are defined clearly and objectively. It draws its authority to regulate the money market from various legal enactments, viz., the RBI Act, 1934 and the Securities Contract Regulation Act, 1956. The Reserve Bank formulates policy in respect of money market and enjoys considerable operational independence. There is a High Level Coordination Committee for Financial Markets (HLCCFM), consisting of the heads of the Reserve Bank, SEBI and the Insurance Regulatory and Development Authority (IRDA) to address issues requiring inter-regulatory co-ordination.

The Panel's assessment of the principles relating to operational independence and accountability; powers, resources and capacity for licensing, regulation and supervision and professional standards, is the same as given in respect of the government securities market.

**(ii) Principles 8-10 (Enforcement)**

All three principles relating to enforcement are fully implemented. The regulator has comprehensive inspection, investigation and surveillance powers. The regulatory system ensures an effective and credible use of inspection, investigation,

surveillance and enforcement powers for effective implementation of compliance.

The Panel's assessment as regards enforcement is same as for government securities market.

**(iii) Principles 11-13  
(Regulatory Co-operation)**

All three principles relating to co-operation are partly implemented. Though, there is an information sharing mechanism in place, there are no formal Memorandum of Understandings (MoU) for sharing of information with domestic regulators. Likewise, assistance to foreign regulators is given whenever it is sought for, but there are no formal MoUs. As regards the domestic regulator's ability in assisting foreign counterparts in obtaining court orders, the Reserve Bank is neither entitled nor has it the authority to approach the courts on behalf of a foreign regulator.

The Panel's assessment as regards authority to share information, formal information sharing mechanisms and assistance to be provided to foreign regulators is the same as for the government securities market.

**(iv) Principles 14 to 16 (Issuers)**

The principle relating to full, accurate and timely disclosure of results is fully implemented for the money market. Holders of money market instruments are treated in a fair and equitable manner. The accounting and auditing standards followed are of a high and internationally acceptable quality.

The principle on disclosure is mainly concerned with public offerings and trading of securities. As the participants in the uncollateralised call, notice and term money market are banks and primary dealers who are regulated entities, they are subject to

appropriate disclosure norms. As regards the collateralised segments (the CBLO and the market repo segment), since the transactions are fully collateralised, disclosure norms are not necessary. In the case of commercial papers, there is a requirement of disclosure of the rating of the issue while in the case of CDs issued by banks, the issuers are regulated; and subject to disclosure norms.

The issuers of securities in the money market include the Government (Treasury Bills), banks (CDs and other money market borrowings), Mutual Funds, Insurance Companies, NBFCs and corporates (CPs). The investors in these instruments are treated in a fair and equitable manner.

Among the issuers of securities in the money market, the Government follows a cash based accounting practice which is an internationally accepted accounting practice for Governments world-wide. Other entities follow comprehensive accounting norms framed by ICAI.

**(v) Principles 17 to 20  
(Collective Investment Schemes)**

There are collective investment schemes like money market mutual funds which are subject to guidelines issued by SEBI. All issues relating to these funds such as the rules governing the legal form and structure, disclosure norms and pricing come under the purview of SEBI.

Mutual funds can offer schemes which invest in the money market, subject to SEBI guidelines. There are dedicated money market

mutual funds also to meet the needs of investors.

The regulatory system provides for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets. These are governed by mutual fund regulations of SEBI. They are legal entities registered as companies/trusts.

Stringent disclosure norms are prescribed and the funds are required to publish Net Asset Value daily. The pricing and redemption of units in a Collective Investment Scheme is done at market value.

**(vi) Principles 21-24  
(Market Intermediation)**

The principles relating to market intermediaries as regards the money market have been assessed as part of the assessment of the equities and corporate bond markets as there are market intermediaries in the form of brokers who deal in money market instruments. The guidelines for these intermediaries are framed by SEBI and they come under the purview of SEBI. Of the four principles relating to market intermediaries, three principles are broadly implemented and one is partly implemented (For greater details please see Section 4.2.7).

**(vii) Principles 25-29  
(The Secondary Market)**

All the five principles relating to the secondary market are fully implemented. There are regulations which require the permission of the Reserve Bank for establishing a trading

platform. There are also regulations which promote transparency. There are also regulations in place to detect and deter manipulation and other unfair trading practices. There are regulations to ensure the proper management of large exposures, default risk and market disruption. The systems for clearing and settlement of transactions are also subject to regulatory oversight.

Though, there is no Reserve Bank regulation for the authorisation and regulation of independent trading platforms, entities interested in the establishment of trading system have to seek permission from the Reserve Bank. For example, CCIL had sought permission for establishing the CBLO trading platform, owned and operated by it. Trading in the call, notice and term money market are either OTC or take place on the NDS-CALL platform, which is operated by the Reserve Bank. CBLO is a money market instrument with no restrictions on the minimum denomination as well as a lock-in period for secondary market transactions. It is issued in an electronic book-entry form only. CCIL provides the trading platform for trading of the CBLO.

There is oversight and supervision of trading systems to ensure that the integrity of trading is maintained through fair and equitable rules. Trades on the NDS-CALL trading platform are monitored by the market surveillance team of the Reserve Bank. The trading on exchanges is under the purview of the stock exchanges and regulation by SEBI.

The regulations promote transparency. The trades are largely order-matching and anonymous. All trades on the OTC platform have to be reported on NDS within 15 minutes. The data is disseminated.

There are regulations to detect and deter manipulation and other unfair trading

practices for which there is a market surveillance function within the Reserve Bank.

There are regulations in place to ensure the proper management of large exposures, default risk and market disruption. Market participants are required to put in place credit exposure norms, contingency plans to meet operational breakdowns and market disruptions. Credit risk is greatly reduced as the settlement is based on the DVP mechanism in a guaranteed mode.

**(viii) Principle 30  
(Clearing and Settlement)**

There are systems for clearing and settlement of securities transactions. These are subject to regulatory oversight and it is ensured that they are fair, effective and efficient and that they reduce systemic risk. A robust, guaranteed and DVP based clearing and settlement system using multilateral netting is undertaken for some segments of money market.

**5.4.4 Foreign Exchange Market**

The following principles are not applicable in case of this market.

- (i) **Principle 6 and 7 (Self Regulatory Organisations):** The principles relating to Self Regulatory Organisations (SROs) are technically not applicable. But the Panel has made certain recommendations in the section on "Broad issues". In the case of the foreign exchange market, FEDAI though recognised as an SRO by the Reserve Bank since August 1958, acts more as an industry level body representing authorised dealers (banks and other players authorised to deal in foreign exchange). The major activities of FEDAI include framing of rules governing the conduct of inter-bank foreign exchange business among banks vis-à-vis the public and liaison with the Reserve

Table 14: Summary assessment of money market					
Principle	FI	BI	PI	NI	NA
<b>Principles of regulator</b>					
1. Responsibilities of regulator	√				
2. Operational independence and accountability			√		
3. Power, resources and capacity to perform functions	√				
4. Regulatory processes of regulator	√				
5. Professional standards of staff of regulator	√				
<b>Principles relating to self regulation</b>					
6. Regulatory regime					√
7. Regulators' oversight over SROs and standards adopted by SROs					√
<b>Principles relating to enforcement</b>					
8. Inspection, investigation and surveillance powers	√				
9. Enforcement powers	√				
10. Use of inspection, investigation, surveillance and enforcement powers	√				
<b>Principles relating to co-operation</b>					
11. Authority to share information with domestic and foreign counterparts			√		
12. Information sharing mechanisms			√		
13. Assistance provided to foreign regulators			√		
<b>Principles relating to issuers</b>					
14. Disclosure of financial results	√				
15. Treatment of holders of securities	√				
16. Accounting and auditing standards	√				
<b>Principles relating to collective investment scheme</b>					
17. Standards for eligibility and regulation		√			
18. Rules governing legal form and structure	√				
19. Disclosure requirements	√				
20. Asset valuation and pricing and redemption of units	√				
<b>Principles relating to market intermediaries</b>					
21. Minimum entry standards		√			
22. Capital and prudential requirements		√			
23. Internal organisation and operational conduct			√		
24. Procedure for dealing with failure of market intermediary		√			
<b>Principles relating to secondary markets and clearing and settlement</b>					
25. Trading systems	√				
26. Regulatory supervision	√				
27. Transparency of trading	√				
28. Detection of manipulation and unfair trading practices	√				
29. Management of large exposures, default risk and market disruption	√				
30. Systems for clearing and settlement of securities	√				
<b>Total</b>	<b>19</b>	<b>4</b>	<b>5</b>	<b>-</b>	<b>2</b>
<i>FI- Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable</i>					



Bank for the reform and development of foreign exchange market. But as required by IOSCO principles, it does not establish any eligibility criteria that must be satisfied in order for individuals or firms to participate in the foreign exchange market thereby not fulfilling a basic tenet (Other than for foreign exchange business). Further, FEDAI is also not within the regulatory jurisdiction of the Reserve Bank. So the Panel feels that at present, there are effectively no SROs in the foreign exchange market. The Panel decided to assess these principles relating to SROs as technically not applicable. Further, empowerment of FEDAI is necessary for its transition to a full-fledged SRO.

- (ii) **Principle 14 (Accurate Disclosure of Financial Results):** The principle is not applicable to the foreign exchange market
- (iii) **Principle 15 (Fair and Equitable Treatment of Shareholders):** The principle relating to issuers dealing with the fair and equitable treatment of shareholders is not applicable to the foreign exchange market. Though holders of foreign exchange derivatives are treated in a fair and equitable manner, IOSCO principles as regards fair and equitable treatment of shareholders are not applicable.
- (iv) **Principle 16 (Accounting and Auditing Standards):** As regards accounting and auditing standards and accurate disclosure of financial results, IOSCO principles are not applicable.
- (v) **Principles 17 to 20 (Principles Relating to Collective Investment schemes):** These are not applicable to the foreign exchange market.

The summary assessment of foreign exchange market in respect of the other

principles as relevant and applicable is given below:

**(i) Principles 1-5 (The Regulator)**

Of the five principles relating to the regulator, four are fully implemented. The Reserve Bank's objectives are clearly and objectively stated. It has adequate powers, resources and capacity to perform its functions. It adopts a clear and consistent regulatory process. It has staff which observes high professional standards including the appropriate standards of accountability. One principle relating to operational independence of the regulator is partly implemented. *De facto*, it is operationally independent and accountable but there are some legislative gaps in this regard.

The responsibilities of the Reserve Bank are clearly and objectively defined. It is entrusted with the regulation of the foreign exchange market. It derives this power from the RBI Act, 1934 and the Foreign Exchange Management Act, 1999. There is a High Level Coordination Committee for Financial Markets (HLCCFM), consisting of the heads of the Reserve Bank, SEBI and the Insurance Regulatory and Development Authority (IRDA), to address issues requiring inter-regulatory agency coordination.

The Panel's assessment of the principles relating to operational independence and accountability, powers, resources and capacity, regulatory processes and professional standards is the same as for the government securities market.

**(ii) Principles 8-10 (Enforcement)**

All the three principles relating to enforcement are fully implemented. The Reserve Bank has comprehensive inspection, investigation, surveillance and enforcement powers. The regulatory system ensures an



effective and credible use of inspection, investigation, surveillance and enforcement powers for ensuring compliance.

The Panel's assessment as regards enforcement is the same as for the government securities market.

**(iii) Principles 11-13  
(Regulatory Co-operation)**

Three principles relating to co-operation are partly implemented. Though there is an information-sharing mechanism in place, there is no formal Memorandum of Understanding (MoU) for sharing information with domestic regulators. Likewise, assistance to foreign regulators is given whenever it is sought, but there are no formal MoUs. As regards the domestic regulator's ability in assisting foreign counterparts in obtaining court orders, the Reserve Bank is not entitled and has no locus standi to approach the courts on behalf of foreign regulators.

The Panel's assessment as regards the authority to share information, formal information sharing mechanisms and assistance to be provided to foreign regulators is the same as for the government securities market.

**(iv) Principles 21-24  
(Market Intermediation)**

All four principles relating to market intermediaries are fully implemented. Reserve Bank licences authorised persons who are authorised dealers (banks, FIs and full fledged money changers).

The Reserve Bank has prescribed capital requirements for market intermediaries. Initial capital and risk-based capital requirements are specified separately for banks. There are capital requirements in terms of net-owned funds for the Authorised Persons. The authorised dealers also have regulatory capital requirements which take into account their on-and off-balance sheet risks. There are no risk-based capital requirements for FFMCS. These regulatory guidelines are checked for compliance by internal auditors as also during inspections by the Reserve Bank.

The Reserve Bank has prescribed requirements for internal controls for Authorised Persons. They are required to have adequate internal controls and an appropriate management structure. Guidelines have also been issued to banks to ensure customer protection. Specific guidelines regarding KYC norms also exist.

Although there is no documented procedure for dealing with the failure of a market intermediary, there are various risk mitigating elements in place. The banks are subject to prompt corrective action that are based on triggers in relation to their key financial indicators. This is to minimise the damage to investors and to contain systemic risk. As regards FFMCS, the only risk they pose is in respect of overnight foreign exchange holdings. But they do not pose systemic risk as they only buy and sell foreign exchange routing their transactions through banks.

**Table 15: Summary assessment of foreign exchange market**

<b>Principle</b>	<b>FI</b>	<b>BI</b>	<b>PI</b>	<b>NI</b>	<b>NA</b>
<b>Principles of regulator</b>					
1. Responsibilities of regulator	√				
2. Operational independence and accountability			√		
3. Power, resources and capacity to perform functions	√				
4. Regulatory processes of regulator	√				
5. Professional standards of staff of regulator	√				
<b>Principles relating to self regulation</b>					
6. Regulatory regime					√
7. Regulators' oversight over SROs and standards adopted by SROs					√
<b>Principles relating to enforcement</b>					
8. Inspection, investigation and surveillance powers	√				
9. Enforcement powers	√				
10. Use of inspection, investigation, surveillance and enforcement powers	√				
<b>Principles relating to co-operation</b>					
11. Authority to share information with domestic and foreign counterparts			√		
12. Information sharing mechanisms			√		
13. Assistance provided to foreign regulators			√		
<b>Principles relating to issuers</b>					
14. Disclosure of financial results					√
15. Treatment of holders of securities					√
16. Accounting and auditing standards					√
<b>Principles relating to collective investment scheme</b>					
17. Standards for eligibility and regulation					√
18. Rules governing legal form and structure					√
19. Disclosure requirements					√
20. Asset valuation and pricing and redemption of units					√
<b>Principles relating to market intermediaries</b>					
21. Minimum entry standards	√				
22. Capital and prudential requirements	√				
23. Internal organisation and operational conduct	√				
24. Procedure for dealing with failure of market intermediary	√				
<b>Principles relating to secondary markets and clearing and settlement</b>					
25. Trading systems	√				
26. Regulatory supervision	√				
27. Transparency of trading	√				
28. Detection of manipulation and unfair trading practices			√		
29. Management of large exposures, default risk and market disruption	√				
30. Systems for clearing and settlement of securities	√				
<b>Total</b>	<b>16</b>	<b>-</b>	<b>5</b>	<b>-</b>	<b>9</b>
<i>FI- Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable</i>					

**(v) Principles 25-29  
(The Secondary Market)**

Of the five principles relating to the secondary market, four are fully implemented and one is partly implemented.

Technically, the establishment of trading systems including securities exchanges is subject to regulatory authorisation and oversight. However, there are no exchanges trading in foreign currency at present. The trading systems used are proprietary and only serve for electronic communication and order-matching platforms. CCIL, the central counterparty for spot trades among banks, is regulated and supervised by the Reserve Bank.

The existing regulation promote transparency of trading as the foreign exchange market is transparent and spreads are small. With the advent of electronic trading systems there is now greater transparency.

As regards regulations the aim to ensure proper management of large exposures, default risk and market disruption. Banking regulations have laid down appropriate safeguards in the form of exposure norms, prudential guidelines, capital adequacy *etc.*

**(vi) Principle 30  
(Clearing and Settlement)**

The Reserve Bank has gained full powers to regulate payment and settlement systems, with the enactment of Payment and Settlement Systems Bill.

**5.4.5 Recommendations - Foreign Exchange Market**

**(i) Authorisation of Trading Platforms**

Foreign exchange markets are at present primarily OTC markets. There are some trading platforms with specific foreign exchange products. Any trading system linked to the Payments and Settlement system needs the approval of the Reserve Bank under the Payment and Settlement Systems Act, 2007. No exchange can trade foreign currency onshore without the specific approval of the Reserve Bank. Electronic trading platforms currently operational in the market are authorised by FEDAI since these provide broking services and order-matching facilities.

The Panel recommends that since the Reserve Bank regulates the foreign exchange market, it should be incumbent on the entity setting up a trading platform to seek prior permission from the Reserve Bank. Specific provisions in the FEMA Act should be incorporated in this regard. The Reserve Bank needs to have guidelines in place whereby if any entity intends to set up a trading platform, it should seek prior permission from the Reserve Bank.

**(ii) Capital Adequacy Norms**

As regards capital adequacy norms for market intermediaries, there are three types of intermediaries in foreign exchange market: Authorised Dealers (Category I) which are commercial banks; Authorised Dealers (Category II) which are co-operative banks, regional rural banks and full fledged money changers and Authorised Dealers (Category III)

which are development financial institutions and non banking finance companies. The Category I and III have capital adequacy requirements. In Category II urban co-operative banks have capital adequacy requirements but rural co-operative banks, RRBs and FFCs do not. As regards requirements for operating in foreign exchange market, the Reserve Bank has prescribed net-owned-funds requirement for these intermediaries.

The Panel recommends that risk-based capital requirement should be in place as a prudential requirement for FFCs though they do not pose a systemic risk. The Reserve Bank should review this aspect. As regards RRBs and rural co-operative banks, the concept of capital adequacy would be applicable only after the Vaidyanathan Committee recommendations in case of rural co-operatives and amalgamation of RRBs are fully implemented.

## Appendix 1

## Assessment of IOSCO Principles Assessment in respect of Securities Market - FSAP-2001

The Financial Sector Assessment Program- 2001 (FSAP-2001) conducted by IMF/World Bank had done an assessment of adherence to IOSCO Principles in respect of regulation and supervision securities markets. This was based on the then extant Principles which were issued in September 1998.

IOSCO Principle	Description	FSAP-2001 assessment
1	2	3
1.	Clear responsibilities	LC
2.	Independence and accountability	LC
3.	Adequate power, resources and capacity	LC
4.	Clear and consistent regulatory process	C
5.	Professional Standards	LC
6.	Use of Self Regulatory Organisation	MNC
7.	Supervision of Self Regulatory Organisations	MNC
8.	Adequate inspection, investigation and surveillance powers	LC
9.	Adequate enforcement powers	LC
10.	Effective use of the powers	LC
11.	Authority to share information	LC
12.	Information sharing mechanisms	LC
13.	Assistance to foreign regulators	MNC
14.	Full, timely and accurate disclosure	MNC
15.	Fair and equitable treatment of securities holders	MNC
16.	Accounting standards	MNC
17.	Eligibility standards	C
18.	Legal form and structure	LC
19.	Disclosure for suitability and valuation	LC
20.	Basis for valuation and pricing for redemption	MNC
21.	Entry standards	LC
22.	Initial and ongoing prudential requirements	LC
23.	Internal organisation and operational conduct and risk management	MNC
24.	Procedures for failure	MNC
25.	Authorisation and oversight of exchanges	LC
26.	Ongoing supervision of exchanges and trading systems	LC
27.	Trading transparency	C
28.	Detection and deterrence of unfair trading practices	MNC
29.	Management of exposures, default risk and market disruption	LC
30.	Oversight of clearance and settlement systems and management of systemic risks	LC

*C- Compliant, LC- Largely Compliant, MNC- Materially Non Compliant, NC-Non-Compliant*

### Report of the Standing Committee on International Financial Standards and Codes – Summary of observations

#### 1. Regulatory Issues

##### The Regulator

To ensure operational independence and accountability in the exercise of functions and powers by the regulators, SEBI and the Reserve Bank have been constituted as autonomous bodies and are established under separate acts of the Parliament. Although the SEBI and the Reserve Bank are operationally independent, the government can issue directions to both in policy matters.

##### Enforcement of Securities Regulation

- The enforcement powers of SEBI include issuance of directions, imposition of monetary penalties, cancellation of registration and even prosecution of market intermediaries. The present penalty levels in many cases are not high enough to effectively deter market players from regulatory violations. There is a need to allow SEBI enhanced authority and powers to impose penalty commensurate with the gravity of the violation (*i.e.* disgorgement powers).
- A number of companies, which had collected funds in the past through public issues, could not even be traced. Though a number of initiatives have been taken, only limited success has been achieved. There is a need to streamline the procedures to quickly detect frauds and take appropriate remedial measures.
- In addition to the problem stated above, the slow response in case of frauds results from long delays arising from the obligation to follow due process. There is a need to streamline the procedures relating to due process. Also, dealing with cases of suspected fraud often requires

freezing the situation, while the legal process is being pursued.

##### Co-operation in Regulation

- Currently, coordination among domestic regulators is occurring through the High Level Group on Capital Markets (HLGCM) comprising the Reserve Bank, SEBI, the IRDA and Finance Ministry. The Committee meets periodically to exchange information and views. There is scope to further strengthen the co-ordination efforts. There may be merit in formalising the HLGCM by giving it a legal status. Besides, the HLGCM needs to meet more frequently and its functioning needs to be made more transparent. Also, a system needs to be devised to allow designated functionaries (not necessarily only at the top level) to share specified market information on a routine and automatic basis.
- As regards co-ordination with regulators in other countries, the powers of SEBI to assist foreign regulators or to enter into MoUs or other co-operation arrangements are not explicitly provided by legislation, although SEBI has signed a MoU with the Securities Exchange Commission of the USA. Hence, necessary legislative changes need to be made to enhance SEBI's scope in this regard.

##### Self-Regulation

- The SEBI Act provides for promotion and regulation of SROs. The stock exchanges are empowered to make rules and regulations for their members and for regulating the conduct of respective members. However, self-regulation is not always effective, because the current ownership and governance structures of



many stock exchanges allow scope for conflict of interest. This raises fairness issues, because the members of stock exchange governing Boards have access to valuable information about market participants. Elimination of such conflict of interest through demutualisation, which implies separation of ownership of exchange from the right to trade on it, can promote fairness and reinforce investor protection.

- Further, the slow evolution of the Association of Mutual Funds of India (AMFI) as a SRO has meant continuation of substantial regulatory burden on SEBI. In this regard, the Group suggests that SEBI assist the AMFI to develop into a full-fledged SRO.
- Similarly, in money and government securities markets, Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) are operating as industry level associations, who are gradually taking on the role of SROs. There is as yet no regulatory oversight of the Reserve Bank over these emerging SROs. On their part, to promote integrity of the markets, FIMMDA and PDAI need to establish a comprehensive code of conduct and best practices in securities transactions and also have a mechanism to enforce such codes. The Reserve Bank can play a supportive role here.

## 2. Prudential Issues

With a view to contain risk, secure market integrity and protect the interest of investors,

the regulators have prescribed elaborate margining and capital adequacy standards. In addition, intra-day trading limit and exposure limits have been prescribed. However, one lacuna that continues relates to the absence of margin requirement for institutional trades which needs to be addressed.

## 3. Legal Issues

### Institution-Specific Regulations

The legal framework constrains the Reserve Bank from exercising uniform powers *vis-à-vis* different groups of players, even though the activity regulated is the same because of a peculiar legal arrangement. The Reserve Bank's regulatory powers over FIs are not as comprehensive as over banks. With regard to Primary Dealers, the Reserve Bank exercises regulatory powers on the basis of guidelines issued by the Reserve Bank and MoU signed between PDs and the Reserve Bank on a contractual basis. This underlines the need for (a) the same legislation to include both regulatory responsibilities and the authority to carry them out and (b) the focus to shift from institution-specific regulation to market-specific regulation.

### Multiplicity of Acts

The problem of multiplicity of regulators emerges from the existence of multiplicity of Acts governing securities market regulation. Although the scope of the Acts is well defined, problems of interpretation have led to confusion. There is therefore a need to simplify and streamline the legal framework. Consolidating the SC(R) Act and the SEBI Act

in line with the recommendations of the Dhanuka Committee will be very helpful.

#### **4. Market Issues**

It is important to recognise the trade-off between over-regulation and high cost of compliance. To dilute this trade-off, it is important to modernise the microstructure. As regulations become more and more complex, certain regulatory objectives can be more easily attained through changes in microstructure rather than further addition to regulatory law.

##### **i) Market Infrastructure**

###### **Rolling Settlement**

The current international practice is predominantly rolling settlement on a T+3 basis. The slow progress toward the introduction of rolling settlement is on account of (a) lack of availability of electronic funds transfer across the country and (b) a general apprehension that such a move will reduce liquidity in the market. Even though a more effective payment and clearing system through a wider availability of EFT is important for switch-over to rolling settlement, the Group is of the view that even the current payment infrastructure can support a faster phasing-in. The Group also suggests that the Reserve Bank and SEBI expedite their scrutiny of the recent recommendations made by the joint task force of IOSCO and BIS on securities settlement systems, for early implementation.

###### **Clearing Corporations**

In contrast to the current Indian system of each stock exchange having its own clearing corporation or clearing bank, it may be appropriate to have perhaps only two clearing corporations in line with international practice, which would support many stock exchanges. Such an arrangement would allow the clearing agency to have an overall view of gross exposures of traders across the stock exchanges and would be much better geared to manage risks.

##### **Delivery vs. Payment**

The Group notes that SEBI and the Reserve Bank are jointly trying to evolve a mechanism, which would seamlessly link the depositories with the payment system through the clearing corporation/ clearing agency to ensure DVP. The Group recommends that establishment of such a mechanism is expedited.

##### **Straight-through Processing:**

At present, all the pre-requisites for Straight Through Processing (STP) are not yet available in India. While automated trading and dematerialisation have been largely achieved, the limited availability of EFT and absence of RTGS have constrained the introduction of STP. These constraints are likely to be eliminated in the near future.

##### **ii) Primary Issues and Transparency**

###### **Private Placement Market**

The dominance of private placement in primary issues market possibly reflects an absence of regulatory level playing field in the sense that public issues may be over-regulated while private placements could be under-regulated. Some recent initiatives such as the amendment to the Companies Act, making it mandatory for companies issuing debentures through private placement route to set up debenture redemption reserves as in the case of public issues, can partially restore the balance. These initiatives need to be complemented by simultaneous efforts to ease some of the regulations governing public issues.

#### **5. Mutual Funds**

The mutual fund industry has played a significant role in mobilisation of domestic savings. Substantial progress has been made in strengthening regulation and improving transparency in the mutual fund industry, however, a number of challenges still remain. The UTI is the largest mutual fund in India,

which was set up by an Act of the Parliament (the UTI Act, 1963). As such it is bound by the UTI Act and not by mutual funds regulations, although under a voluntary arrangement, SEBI oversees all the investment schemes launched by UTI since 1994. The US-64, the flagship scheme of the UTI and the largest scheme in India, does not have a disclosed basis for asset valuation or pricing of units although it has plans to move towards this. Bringing the UTI under SEBI's purview as well as the introduction and implementation of international accounting principles across the mutual fund industry will help promote fairness and stability of the sector. Currently, regulations appropriately require that the sale and redemption of funds should be based on their

NAVs, which have to be computed according to specified rules. However, there is scope for further improvement in one significant area: AMCs still have considerable room for discretion in adopting valuation of thinly traded or non-traded securities, as regulations specify only broad guidelines. There is a need to reduce the AMCs' discretion in this regard. Finally, a couple of issues relating to prudential norms and corporate governance need to be examined. Regulations provide that a fund's ownership in any single company should not exceed 10 per cent of a company's voting shares, although there is no upper limit on the total holdings of voting and non-voting shares of any single company. Further, there appears to be no restriction on corporate investment in a mutual fund's units.

## Appendix 3

### Review of Recommendation of the Committee on International Financial Standards and Codes – Report on the Progress

(Dr. Rakesh Mohan Committee 2004)

Sr. No.	Recommendation	Present Status
1	2	3
1.	Allow SEBI enhanced authority and powers to impose penalty commensurate with the gravity of the violation ( <i>i.e.</i> disgorgement powers).	Appropriate action has been taken. The SEBI Act, 1992 was amended in October 2002, and SEBI was vested with search and seizure powers in cases relating to insider trading and market manipulations. The amount of penalty has been raised substantially in respect of various offences under the SEBI Act.
2.	Streamline the procedures to detect frauds. Further, procedures relating to due process have also to be streamlined.	Significant steps have been taken in this direction. The Insider Trading (Amendment) Regulations were notified in February 2002 to enhance market transparency and strengthen insider-trading regulations. These regulations were amended to stipulate a code of conduct for intermediaries and listed companies. The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003 are now being enforced. These new regulations strengthened the provisions relating to action against market misconduct. The Weekly Joint Market Review Mechanism comprising Surveillance Chief, SEBI and the Chiefs of BSE and NSE are meeting regularly to review the markets in order to ascertain the safety and integrity of the markets and maintain constant vigil. SEBI is in the process of setting up a state-of-the-art online surveillance mechanism. SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 have been notified for expeditious completion of enquiry proceedings and to bring uniformity in conducting enquiries in respect of all intermediaries. As the process of streamlining procedures to detect fraud is an ongoing one, GOI, Reserve Bank and SEBI can co-ordinate on further implementation.

## Chapter IV

### Assessment of Adherence to IOSCO Principles

Sr. No.	Recommendation	Present Status
1	2	3
3.	<p>(i) The existing HLCCFM should be given legal status and its functioning should be made more transparent, (ii) also, a system needs to be devised to allow designated functionaries (not necessarily only at the top level) to share specified market information on a routine and automatic basis.</p>	<p>HLCCFM is functioning as an effective forum for consultations and co-ordination amongst various regulators. As such its present form is considered suitable. As regards recommendation (ii), three sub-committees have been formed, viz. Technical Committee on SEBI Regulated Entities, Technical Committee on Reserve Bank Regulated Entities and Technical Committee on IRDA Regulated Entities, consisting of representatives at senior level from each of the regulators. These committees meet regularly to discuss and share information on the issues concerning the entities coming under regulatory jurisdiction of each regulator. Further, to effect a monitoring system on financial conglomerates, a Working Group on Financial Conglomerates was constituted as an inter-agency group with a member each from Reserve Bank, SEBI and IRDA. The group, in its report submitted in May 2004, suggested criteria for identifying financial conglomerates, a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-regulatory exchange of information in respect of conglomerates. Regulators may consider further necessary action so that the envisaged system is put in place and new arrangements work smoothly.</p>
4.	<p>SEBI's power to enter into agreements with foreign regulatory authorities does not have statutory backing. Necessary legislative changes need to be made to enhance SEBI's scope in this regard.</p>	<p>SEBI has entered into several MOUs with foreign regulatory authorities. The existing provisions of SEBI Act enable SEBI to enter into such agreements.</p>

Sr. No.	Recommendation	Present Status
1	2	3
5.	Demutualise the stock exchanges to prevent conflict of interest.	The suggestion is being implemented. An Ordinance called the Securities Laws (Amendment) Ordinance, 2004 has been promulgated recently. The terms 'corporatisation' and 'demutualisation' of stock exchanges have been defined. The ordinance also empowers SEBI to restrict the voting rights of the shareholders who are also stockbrokers of recognised stock exchanges. Earlier, SEBI had approved the recommendations of the 'Group on Corporatisation and Demutualisation of Stock Exchanges' (Chairman: Shri. M.H. Kania) in January 2003, which recommended, <i>inter alia</i> , a uniform model of corporatisation and demutualisation to be adopted for all stock exchanges. SEBI in its circular of January 2003 had advised the stock exchanges to furnish their schemes on demutualisation based on the recommendations of the above Group. The schemes submitted by the exchanges are being examined by SEBI. Also, the Union Budget for 2003-04 granted one-time tax exemption for capital gains to stock exchanges which would be demutualised.
6.	The lacunae relating to the absence of margin requirement for institutional trades needs to be addressed.	This issue is being examined by SEBI as part of its regulatory guidelines on risk management.
7.	Same legislation to include both regulatory responsibilities and the authority to carry them. Further, the regulation should be made institution-specific rather than market-specific.	The SEBI Act contains both regulatory responsibility and the authority to carry it. Also, there is now substantial clarity on market-specific regulation. GOI has, by issue of a notification under SC(R) Act, delegated authority to the Reserve Bank to regulate contracts in Government securities, money market securities, gold-related securities, securities derived from these securities and repos. Thus, the Reserve Bank effectively regulates money market, government securities market, repo market as also OTC derivatives market. The Reserve Bank also regulates foreign exchange market under FEMA. Equity market and all exchange-traded



## Chapter IV

### Assessment of Adherence to IOSCO Principles

Sr. No.	Recommendation	Present Status
1	2	3
		contracts are regulated by SEBI. Commodity futures market is regulated by the Forward Markets Commission (FMC). However, as regards enforcement/supervision, since regulations operate on institution-specific basis, there are some gaps/overlaps. The regulators could mutually consult and decide on how best regulatory overlap could be reduced and regulatory gaps bridged.
8.	Consolidate the SC(R) Act and the SEBI Act in line with the Dhanuka Committee Recommendations.	Amendments have been made in the SEBI Act. The provisions of SC(R) Act are also being amended.
9.	Phase-in rolling settlement more rapidly.	Appropriate action has been taken. The rolling settlement on T+5 basis was implemented for all scrips and all categories of investors with effect from December 31, 2001. The settlement cycle has since been shortened to T+3 from April 1, 2002 and T+2 from April 1, 2003.
10.	Reserve Bank and SEBI may expedite their scrutiny of the recent recommendations made by the joint task force of IOSCO and BIS on securities settlement systems for early implementation.  (i) Adoption of rolling settlement in all securities markets. Final settlement should occur no later than T+3.	Most of the recommendations of the IOSCO-BIS joint task force on Securities Settlement Systems (SSS) have already been implemented by the Reserve Bank. The recommendations which have not been implemented fully include:  (i) The benefits and costs of a settlement cycle shorter than T+3 should be evaluated. In India, rolling settlement has been adopted in equity market (T+2) and in government securities traded on exchanges (T+3). In the case of government securities transactions on OTC basis, while rolling settlement exists, there are two settlement modes - T+0 and T+1. It has been decided in principle for standardising a T+1 rolling settlement in outright transactions in government securities.

Sr. No.	Recommendation	Present Status
1	2	3
	<p>ii) Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method of expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.</p> <p>iii) Central Securities Depositories (CSD) that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.</p>	<p>(ii) There is securities lending and borrowing of in equity market. Securities lending in government securities is not allowed on account of the existing prohibition on short sale. However, a limited purpose securities lending scheme for lending by approved institutions to Clearing Corporation of India Ltd. (CCIL) is being implemented for facilitating the meeting of securities shortfall in settlement. Re-purchase agreements (repos) in government securities are permitted and encouraged. Rollover of repo transactions in government securities was facilitated with the enabling of DvP III mode of settlement in government securities in April 2004 which involves settlement of securities and funds on a net basis.</p> <p>(iii) For government securities, the Public Debt Office of Reserve Bank is the CSD. The government securities market is only domestic. Public debt office does not have links to settle cross-border trades. In view of this, the recommendation is not applicable.</p> <p>SEBI is also by and large a compliant with the recommendations of the IOSCO CPSS Task Force on Clearing and Settlement. The Task Force is working towards finalisation of its recommendations on the settlement system and central counterparties.</p>
11.	<p>The current Indian system of each stock exchange having its own clearing corporation or clearing bank should be replaced by only two clearing corporations for the entire country, which would support many stock exchanges.</p>	<p>The law at present does not require settlement of trades by clearing corporation. Hence, some trades are settled by clearing houses and some others by clearing corporations. The recently promulgated Securities Laws (Amendment) Ordinance, 2004 has, however, provided for the transfer of the duties and functions of a clearing house by a recognised stock exchange (with the prior approval of SEBI) to a clearing corporation for the purpose of periodical settlement of contracts and differences under it and the delivery of, and payment for, securities. While the pros and cons of restricting the number of clearing corporations to two may be discussed, SEBI could consider how best an efficient system could be brought out in this respect.</p>

## Chapter IV

### Assessment of Adherence to IOSCO Principles

Sr. No.	Recommendation	Present Status
1	2	3
12.	Establish a mechanism to seamlessly link the depositories with the payment system through the clearing corporation/clearing agency to ensure DvP.	Currently, the two depositories, viz. NSDL and CDSL are connected to each other through a leased line connection. Linking of the depositories with the payment system would be facilitated by the phased operationalisation of the RTGS, which commenced live operations earlier this year. The number of direct participants in the RTGS system is expected to go up to about 125 from 92 participants at present. Banks, PDs and clearing houses would be the targeted members. The linking of depositories with the payment system would depend on the interface of the Clearing Corporations/Clearing Houses in the RTGS network. Upon the Clearing Corporation/Clearing Houses becoming a part of the RTGS network, the implementation of a secured scheme of networking the Clearing Corporation/Clearing House with the depositories to facilitate a payment gateway in the overall scheme of implementing DvP could be taken up. The Reserve Bank has agreed to take Clearing Corporations of the Exchanges as member in RTGS. Depositories are already connected to clearing corporations and are executing securities settlement as per their instructions. Since Clearing Corporation provides 'novation', it is also responsible for settlement of funds. It is, therefore, necessary to have a seamless link between Clearing Corporation and RTGS rather than with depositories. In addition, SEBI is in the process of setting up a central Hub for STP which would provide inter-connection among various Closed User Groups (CUGs) (like Exchanges, Depositories, INFINET of the Reserve

Sr. No.	Recommendation	Present Status
1	2	3
		Bank). Fund settlement is envisaged to be completed through establishing a link between the Hub and INFINET. The Reserve Bank may continue to take envisaged action in this regard, in co-ordination with other concerned agencies.
13.	Recent initiatives to tighten regulation of the private placement market need to be complemented by simultaneous efforts to ease some of the regulations governing public issues.	SEBI has, in September 2003, prescribed disclosure guidelines for the private placement market. Regarding public issue of debt, SEBI's Disclosure and Investment Protection (DIP) guidelines provide for an IPO of debt. Prior to August 14, 2003, the guidelines required promoters to bring 20 per cent of the project cost. This requirement was slightly modified without sacrificing the basic intent and the promoters have been given flexibility to bring 20 per cent of the issue size in order to ensure their commitment to the project. However, they are required to arrange for funds from other sources to the extent of 20 per cent of the project cost in order to ensure financial closure of the project.
14.	The disclosure of material information, which could have a bearing on the performance of the company, has to be made available to the public immediately. In terms of contents of corporate disclosure, the following initiatives are necessary: (i) group company disclosures may be limited to top five companies by market capitalisation or turnover, to avoid cumbersome exercise of gathering information from all companies falling under the definition of promoter group; and (ii) risk factors have to be given in greater detail as per international practices, although management perceptions of risks need not be given.	SEBI stipulated in December 2001 that the announcement with regard to disclosure of material information should be made within 15 minutes of the conclusion of the Board meeting in which the decision was taken. Regarding disclosure requirement in offer document, the Committee on Disclosure Requirement in Offer Document (Chairman: Shri Y.H.Malegam), recommended that in case the issuer company has more than five listed group companies, the financial information of five largest listed companies based on market capitalisation one month before the date of filing draft prospectus with the Board, shall be required to be disclosed. SEBI may continue to monitor progress in this regard.
15.	UTI and its schemes should be brought under the regulatory powers of SEBI.	Appropriate action has been taken. On October 2002, the Government issued an ordinance to restructure the UTI by splitting it into two parts: UTI-I comprising US-64 and assured return

## Chapter IV

### Assessment of Adherence to IOSCO Principles

Sr. No.	Recommendation	Present Status
1	2	3
		schemes and UTI-II comprising NAV-based schemes. The scheme was effected in January 2003. UTI-II, renamed as UTI Mutual Fund, has been brought under SEBI Regulation in January 2003.
16.	Introduction and implementation of international accounting principles across the mutual fund industry will help promote fairness and stability of the sector.	Appropriate action has been taken. SEBI has made some modifications in accounting norms pertaining to the mutual funds industry, such as norms for valuation for listed and unlisted securities, uniform method of calculation of sale/repurchase price and other disclosure norms. SEBI continues to track further developments in national and international markets with a view to improving regulatory oversight. This has led to development of a legal and regulatory framework for mutual funds that is comparable to many advanced markets. In particular areas, the level of sophistication is considered to be much more than even in UK (Source: Draft Interim Report (2003): Reform of Mutual Funds in India – prepared by Cadogan Financial, UK). It is noted that all the IOSCO Guiding Principles for Collective Investment Schemes are fully implemented for mutual funds in India. Further, reforms in a large number of areas of mutual funds have been implemented in the last few years, some of which (like comprehensive risk management system, introducing benchmarks for performance measurement, strengthening the accountability of Chief Executives, Fund Managers and Compliance Officers of Mutual Funds, certification and code of conduct for agents/distributors, introducing fund of funds, allowing use of derivative instruments and permitting investments in overseas markets) are based on an extensive review of international practices.

Sr. No.	Recommendation	Present Status
1	2	3
17.	<p>The Reserve Bank has to facilitate the emergence of Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) as self-regulatory organisations (SROs). FIMMDA and PDAI should establish a code of conduct and best practices in security transactions and also have a mechanism to enforce such codes. SEBI to assist Association of Mutual Funds of India (AMFI) to develop it into a full-fledged SRO.</p>	<p>The proposal to accord legal status as an SRO to FIMMDA has been examined in detail by the Reserve Bank and was not found feasible at present. However, FIMMDA has established a code of conduct and undertaken related responsibilities appropriate to an industrial body. According self-regulatory status to PDAI is a non-issue since all PDAI members are also members of FIMMDA.</p> <p>Regarding AMFI, SEBI is assisting AMFI to develop into a full-fledged SRO. AMFI has been designated to issue certificates to agents and distributors under the certification programme. AMFI could be given specific statutory recognition and be vested with legal character under the SC(R) Act also.</p> <p>SEBI has since advised AMFI to take up the role of SRO for mutual funds in India. SEBI has impressed upon AMFI the importance of an SRO for Mutual Funds industry and has advised AMFI to expedite its recommendations on various aspects related to formation and operation of an SRO and also to fix a time-frame. SEBI also obtains policy inputs from AMFI and it has been included as a member of the Advisory Committee for Mutual Funds. The SEBI (Self-Regulatory Organisations) Regulations, 2004 were notified in February 2004 for development of SROs. According to this notification, 'Self-Regulatory Organisation' means an organisation of intermediaries which is representing a particular segment of the securities market and which is duly recognised by the (SEBI) Board under these regulations, but excludes a stock exchange.</p>



## Appendix 4

Detailed Assessment (Principle-by-principle) - Equities,  
Corporate Bond and Derivative Market

## Principles Relating to Regulator

Principle 1.	The Responsibilities of the regulator should be clear and objectively stated.
Description	<p>Securities and Exchange Board of India (SEBI) has been set up under the Securities and Exchange Board of India Act, 1992 (SEBI Act) with a mandate to protect the interest of investors, to regulate and to promote the development of the securities market.</p> <p>The responsibilities of SEBI are clear and objectively stated in the SEBI Act. The power, function and duties of SEBI as the regulator of the securities market are derived from the provisions of the SEBI Act, 1992, Securities Contract Regulation Act, 1956 (SC(R) Act), the Depositories Act, 1996 and the Companies Act, 1956 in respect of listed companies and companies proposed to be listed on the Recognised Stock Exchanges (RSE).</p> <p>The areas of responsibility among SEBI, the Reserve Bank (RBI), Department of Economic Affairs (DoEA) and the Ministry of Corporate Affairs (MoCA) (earlier known as DCA) have been specified in the Acts, and/or notifications.</p> <p>Section 55A of the Companies Act, 1956 divides the responsibility between MoCA and SEBI, which states that the provisions so far as they relate to issue and transfer of securities and non-payment of dividend in case of listed public companies and public companies which intend to get securities listed on any RSE are to be administered by SEBI and in any other case are to be administered by MoCA.</p> <p>In terms of notification No. SO 573 (E) dated July 30, 1992 and F. NO.1/57/SE/93 dated September 13, 1994 issued by CG most of the powers under SC(R) Act have been delegated to SEBI. Further, by notification dated March 1, 2000 issued by CG, under Section (u/s)16 of the SC(R) Act, contracts for sale and purchase of Government Securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities are to be regulated by the Reserve Bank. Such contracts if executed on RSEs are to be regulated by SEBI, besides regulation of contract for sale or purchase of securities and contracts in derivatives.</p> <p>Parliamentary Standing Committee on Finance in its 25<sup>th</sup> Report published in 2005-06 stated that 'there would be two statutes governing derivative</p>

	<p>transactions <i>viz.</i>, the SCR Act for exchange traded derivative transactions and RBI Act for OTC derivatives, which involve a Reserve Bank regulated entity as a party.'</p> <p>In order to ensure co-ordination among regulators, a High Level Co-ordination Committee for Financial Markets (HLCCFM), consisting of Finance Secretary – Ministry of Finance (MOF), the Governor of the Reserve Bank, Chairperson of SEBI and Chairperson of Insurance Regulatory Development Authority (IRDA) are operating since 1995.</p> <p>SEBI regulates equities, debt and derivative markets and also Mutual Funds (MF), Collective Investment Schemes (CIS) and public issue listing and trading of securitised debt instruments. SEBI regulates both issuances of securities to the public and secondary market trading of securities in RSEs and intermediaries in securities market.</p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	<p>The CG continues to have power under SC(R) Act and also have power to make rules in respect of all the matters under the SCR Act.</p> <p>MoCA has concurrent powers under Companies Act in respect of matters relating to capital market such as prospectus, issue of shares to public <i>etc.</i> Even though Section 55A empowers SEBI to administer provisions of the Companies Act in respect of issue, transfer of securities and non-payment of dividend in respect of listed/proposed to be listed companies, SEBI has not been conferred powers to make regulations. Only CG has power to make rule and prescribe schedules including in respect of prospectus, financial statements.</p> <p>Recommended Action -</p> <ol style="list-style-type: none"> <li>i. SCR Act be suitably amended deleting the concurrent power of the CG in respect of capital market related matters under SCR Act. The power of CG to make rules in respect of capital market related issues under SCR Act be also deleted. SEBI may be empowered to make regulation in respect of capital market related matter specified u/s 30 of SCR Act.</li> <li>ii. All capital market related matters in respect of listed companies may be exclusively conferred on SEBI including power to make regulations in respect of matters specified u/s 55A.</li> </ol>
Principle 2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	<p>SEBI is a statutory body established under the SEBI Act, 1992. The powers and functions of SEBI are specified in the SEBI Act, SC(R) Act, Depositories Act &amp; the Companies Act. The constitution of the SEBI Board, terms and conditions of service of the members are as per Sections 3 to 5 of SEBI Act.</p> <p>SEBI is empowered to frame regulations without approval of CG. SEBI can take enforcement action such as impose monetary penalties, file prosecutions without the approval of CG or without the consent of public prosecutor.</p>

	<p>The members and the staff of SEBI have been given statutory protection from prosecution or other legal proceedings u/s 23 of SEBI Act, for action taken in good faith.</p> <p>SEBI is able to operate and exercise its powers given under SEBI Act, SC(R) Act, Depositories Act and Companies Act without external political and commercial interference.</p> <p>SEBI has been empowered to levy fees and other charges for the performance of its functions. SEBI is not dependent on government or any authority for its funds <i>etc.</i> During its initial days, CG had provided interest free loans which are being repaid by SEBI from its fund.</p> <p>The penalties levied under the SEBI Act are credited to the Consolidated Fund of India (CFI).</p> <p>SEBI is accountable to Parliament through Central Government (MOF) for use of its powers and resources.</p> <p>The regulations made by SEBI are required to be laid before the Parliament as per Section 31 of SEBI Act and also reviewed by Parliamentary Committee on Subordinate Legislation. As per Section 18, SEBI has to lay returns and reports on its activities annually before the Parliament. The accounts of SEBI are audited by Comptroller and Auditor General of India (CAG) in terms of Section 15 of SEBI Act.</p> <p>The orders of SEBI are subject to appeal / review by Securities Appellate Tribunal (SAT) as per section 15T of SEBI Act.</p> <p>SEBI being a public authority, is subject to Right to Information Act, 2005 (RTI).</p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	<p>Section 16 of SEBI Act empowers CG to issue directions on question of policy and decision of CG shall be final whether a question is one of policy or not. Further, u/s 17 CG has been given power to supersede the Board, <i>inter alia</i>, on the ground of persistent default in complying with any directions issued by CG.</p> <p>A member can be removed on circumstances (such as on grounds of insolvency, conviction, unsound mind, public interest) as specified u/s Section 6 after being afforded a reasonable opportunity of being heard. However, Section 5(2) gives right to CG to terminate the services of the Chairman or Member at any time by giving a notice of three months.</p>

	<p>Only in cases of grave emergencies or where SEBI is unable to discharge its functions or in public interest can the Board of SEBI be superseded by the CG as per the procedures provided for u/s 17 of SEBI Act.</p> <p><b>Recommended Action</b></p> <ol style="list-style-type: none"> <li>1. Section 16 be suitably amended empowering policy directions to be issued on public interest only.</li> <li>2. Section 5(2) which gives right to CG to terminate the services of the Chairman or Member at any time by giving a notice of three months should be omitted.</li> </ol>
Principle 3.	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	<p>SEBI is legally and administratively equipped to perform its functions and exercise its powers.</p> <p>SEBI has power over intermediaries, products and securities market. SEBI has direct power of regulation and supervision over RSEs under SC(R) Act. SEBI has power of regulation and supervision over intermediaries who deal in securities u/s 11 and 12 of SEBI Act. SEBI has power to regulate the issue of securities to public through offer documents by companies u/s Section 11A, issue of units by MFs u/s 11 and 12 and issue of units by CIS under 11AA and 12 of SEBI Act and issue of securitised debt to public u/s 17A of SC(R) Act.</p> <p>SEBI has power to control and prohibit manipulative and deceptive devices, insider trading and substantial acquisition of securities or takeover u/s 12A of SEBI Act.</p> <p>SEBI has power to make regulations under SEBI Act, SC(R) Act, Depositories Act and Companies Act in respect of matter(s) covered under Section 55A.</p> <p>The income of SEBI from such fees, charges from the above sources are presently sufficient to meet its regulatory and operational needs.</p> <p>The staff of SEBI receives ongoing training at regular intervals including technical, functional and management development. Competency building of regulatory staff is one of the key activities of National Institute of Securities Market (NISM), set up by SEBI in 2006 for imparting training to SEBI staff and also persons associated with securities market.</p> <p>SEBI has proper resources and manpower to perform its functions and exercise its powers.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	SEBI's compensation package for its staff is comparable vis-à-vis other regulators in the financial market. However, the level of attrition is quite high as remuneration or compensation package of the financial service industry is much higher.

	<p><b>Recommended Action</b></p> <p>Special effort be made for capacity building and skill enhancement of SEBI staff. Market related incentive structure may be considered for attracting and retaining talent.</p>
Principle 4	The regulator should adopt clear and consistent regulatory processes.
Description	<p>SEBI has adopted clear and consistent regulatory process. SEBI is subject to reasonable procedural rules and regulations. The regulations and procedures are consistently applied and are comprehensible, fair and equitable. Regulations framed by SEBI are required to be published in the Official Gazette and also required to be laid before Parliament. The power of SEBI to suspend/cancel licence or impose monetary penalty are subject to procedural rules such as SEBI Enquiry Procedure Regulation, 2002 or Adjudication Rules, 1995. SEBI has to give written reasons and pass a reasoned order in case of refusal of grant of registration or taking any penal action.</p> <p>Finding of investigation is made available to the persons against whom proceeding by way of show cause have been initiated based on finding of such investigation.</p> <p>SEBI is transparent in making regulation. It has instituted a consultative approach to framing of regulation, such as putting the draft regulation on SEBI website for seeking comments, holding consultation with industry, investors and public before framing regulations.</p>
Assessment	<b>Fully Implemented</b>
Comments	<p>The regulations made by SEBI, which are in the nature of delegated legislations, are subject to the provisions of the parent Act made by the Parliament and also must be constitutionally valid. All SEBI regulations are also reviewed by the Parliamentary Committee on Subordinate Legislation.</p> <p>While imposing monetary penalty, the Adjudication Officer has to take into consideration the factors given u/s 15J of SEBI Act.</p> <p>An aggrieved person, can file an appeal before Securities Appellate Tribunal (SAT), challenging the order of SEBI both on merit of the decision and also on procedural fairness.</p> <p>The regulatory action taken by SEBI is also posted on the SEBI website which also contains reasons and justifications for such action.</p> <p>SEBI has issued SEBI (Informal Guidance) Scheme 2003. Under this scheme an interested party can seek interpretation on regulatory actions.</p>

	<p>SEBI in its Annual Report is required to give full account of its activities, policy and programme as per Section 18 of SEBI Act.</p> <p><b>Recommended Action</b></p> <p>There could be mix of approaches in adopting an appropriate regulatory model having element of both principles and rules based regulations. Initially, principle based regulations for products and advanced market segment may be introduced.</p>
Principle 5	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.
Description	<p>The professional standards of SEBI are high as it practices sound Human Resource (HR) policies and practices. The HR policies also preclude conflict of interest in discharge of duties.</p> <p>The staff of SEBI is required to observe legal requirement pertaining to avoidance of conflict of interest and restriction on holding and trading in securities <i>etc.</i>, under SEBI (Employee Service) Regulation, 2001 (Service Regulation). SEBI employees are prohibited from dealing in equities. Annual and transaction based reporting of staff are maintained and verified.</p> <p>SEBI staff has to maintain secrecy and should not make use of any information which has come to their knowledge in discharge of their official duties and nor can they communicate any such information to any other persons except in the course of their official duty.</p> <p>SEBI plays an active role in investors education such as through conducting workshops, disseminating investor education materials through advertisements, radio and television and a dedicated website for investor education. SEBI also grants financial assistance to 21 recognised investor association for investor education. Financial literacy has been included as one of the subjects for secondary education by CBSE.</p>
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	<p>Service Regulations lay down in detail conduct and standards as given in Chapter VI of the Regulations. The regulations provide for penalty under Reg. 79 for violation of such standards. SEBI employees are also subject to prohibition under Insider Trading regulation.</p> <p><b>Recommended Action</b></p> <p>There should be a specific conflict rule for the staff relating to investigation or consideration of licensing application of related entities of staff.</p>

### Principles of Self- Regulation

Principle 6.	The regulatory regime should make appropriate use of Self-Regulatory Organisations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.
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### Assessment of Adherence to IOSCO Principles

Description	There are a total of 19 RSEs including Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) which has also been recognised as a RSE under SC(R) Act. The RSEs perform both market regulation and member regulation functions. Membership of RSE is mandatory to act as stock broker as per Regulation 6A(1)(a) of Stock Broker Regulations. There are 9443 brokers and 4076 corporate brokers who are members of RSE. There are two depositories who perform regulation of depository participants as per the bye-laws made by them under the Depositories Act. There are 656 DPs.
Assessment	<b>Fully Implemented</b>
Comments	<p>Section 11(2)(d) of SEBI Act empowers SEBI to promote and regulate SRO. SEBI has framed the SEBI (SRO) Regulations, 2004 (SRO Regulations) to enable organisation of intermediary to be recognised as SRO. As per Reg. 3 &amp; 4 of SRO Regulations any applicant which seeks to be recognised as SRO should have the capacity to carry out the purposes for which it is seeking recognition. Presently there is no recognised SRO under SRO Regulation. SEBI on October 10, 2007 has put up draft regulation on investment advisers for public comments. These regulations make membership of an SRO mandatory to act as investment advisers.</p> <p>There are also other organisations such as Association of National Exchanges Members of India (ANMI), Association of Mutual Funds of India (AMFI), Association of Merchant Bankers of India (AMBI) and Financial Planning Standards Board of India (FPSBI). The organisations like ANMI, AMFI, AMBI, FPSBI <i>etc.</i> at present function primarily as trade or industry associations.</p> <p>AMFI provides certification to mutual fund distributors, lays down code of ethics, benchmarking of schemes for MF industry.</p> <p><b>Recommended Action</b></p> <p>Market intermediaries be regulated by SRO or First Level Regulator. There is need to encourage trade or industry association to become full fledged SRO(s) and bring them gradually under the oversight of SEBI. The problems relating to moral hazard should be mitigated through introduction of appropriate safeguards.</p>
Principle 7.	SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	The SC(R) Act lays down the framework of oversight of RSE by SEBI, criteria for recognition of stock exchange which includes standards for its members.

	<p>SEBI conducts annual inspection of RSE and depositories. The scope of inspection includes organisation structure, trading settlement and risk management, administrative, monitoring systems, financial aspect and compliance with SCR Act, Depositories Act, SEBI Regulations and circulars.</p> <p>SRO Regulations, 2004 lay down framework for oversight of SROs (other than the RSEs), standards of fairness, confidentiality, exercise of delegated responsibilities by recognised SROs.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>The bye-laws, rules and regulations of the RSE prescribe eligibility criteria for admission of members, inspection of members, disciplinary action such as deactivation of trading terminals, suspension of members or levy of fines, mechanism for dispute resolution by way of conciliation and arbitration and formulating trading rules <i>etc.</i></p> <p>As per Reg. 3 &amp; 4 of SRO Regulations any applicant which seeks to be recognised as SRO should have the capacity to carry out the purposes for which it is seeking recognition.</p>

#### **Principles for the Enforcement of Securities Regulation**

Principle 8.	The regulator should have comprehensive inspection, investigation and surveillance powers.
Description	<p>SEBI has comprehensive inspection, investigation and surveillance powers.</p> <p>SEBI can call for information from, undertake inspection, conduct inquiries and audits of stock exchanges, MFs, other persons associated with securities market, intermediaries and SROs. SEBI can investigate without prior notice u/s 11C. Permanent Account Number (PAN) granted by Income Tax Authorities is mandatory for transactions in the securities market. All the transactions in securities market has to be through cheque (i.e. banking channel) and not cash. The intermediary has to comply with KYC and PAN requirement for their clients. The intermediary has to maintain records of identity of clients and their transactions for a period of 5 years. SEBI can access the identity of customer from the intermediary and can call for information and record from intermediary and bank in respect of securities transaction under investigation.</p> <p>SEBI has power of inspection over listed companies u/s 209A of Companies Act.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>Integrated Market Surveillance System (IMSS) has been put in place by SEBI for surveillance of trading and securities transactions in multiple exchanges and depositories.</p> <p>In case of out-sourced inspection, SEBI appoints auditors who are in the Reserve Bank panel as Statutory Central Auditors. The auditors are given detailed guidance note for inspection and are also given a format for preparation of inspection reports. The guidance note includes instruction on maintenance of confidentiality and avoidance of conflict of interest <i>etc.</i> SEBI also holds pre-inspection meeting with auditors.</p>

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Principle 9.	The regulator should have comprehensive enforcement powers.
Description	<p>SEBI has comprehensive enforcement powers.</p> <p>SEBI has the power to call for information, summon and enforce the attendance of persons, to examine them on oath and to issue commissions for the examination of witnesses and documents u/s 11(2)(ii) and 11 (3) of SEBI Act. SEBI has powers of investigation u/s 11C of SEBI Act. SEBI has enforcement powers such as u/s 11(4) (measures), u/s 11D (cease and desist orders), u/s 12(3) (suspension / cancellation of license), Chapter VIA (monetary penalty), and u/s 24 (Prosecution). Similar powers have been given to SEBI under SC(R) Act and Depositories Act. Under the Companies Act SEBI has power of inspection (Sec. 209A) and prosecution (Sec.621).</p>
Assessment	<b>Fully Implemented</b>
Comments	<p>SEBI needs to take approval of Judicial Magistrate for attaching bank account and seizure of documents. There is no specific provision empowering private person to seek their own remedies for misconduct relating to securities law. Only SEBI is empowered to take action for violation of SEBI Act and regulations.</p> <p>Section 15Y and 20A of SEBI Act bars the jurisdiction of civil court in the matters which are within the purview of Adjudicating Officer, SAT or SEBI. Only SEBI can file criminal complaint u/s 26 for violation of SEBI Act and regulation.</p> <p>However, private person can seek remedy such as compensation for deficiency of services against an intermediary before Consumer Forum as per Consumer Protection Act, 1986 or for any claim against broker before Arbitrator under bye-laws of RSE.</p> <p><b>Recommended Action</b></p> <p>Private right of action and/or class action suit may be allowed by law.</p>
Principle 10.	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	The regulatory system of SEBI includes an effective blend of on-site inspection, off-site reporting, investigation and surveillance of the market and regulated entities. SEBI has separate surveillance, inspection, investigation and enforcement departments which carry out such functions.

	<p>There is on-line surveillance of market on real-time basis by RSE.</p> <p>The second level of surveillance is done by SEBI. SEBI has put in Integrated Market Surveillance System (IMSS) to monitor surveillance activities in multiple exchanges and depositories. The IMSS has sophisticated alert engine for detecting potential market abnormality and unfair practice.</p> <p>SEBI conducts routine inspection of intermediaries and exchanges. In some cases SEBI appoints outside auditors for inspection. SEBI conducts investigation u/s 11C where there is a reasonable ground to believe that any person has violated any provisions of SEBI Act or regulation or transaction in securities are being dealt with, in a manner detrimental to the investors on securities market.</p> <p>RSE and depositories are mandated to carry out routine inspections of their members and participants; SEBI conducts risk-based inspection and also carries out surprise inspection of intermediaries. SEBI takes enforcement actions such as suspension/cancellation of license, imposition of monetary penalty, prosecution <i>etc.</i> based on findings of inspection or investigation.</p> <p>The intermediaries are required to set up systems and procedures such as internal mechanism for prevention of Insider Trading, Anti Money Laundering (AML), which are designed to ensure compliance with SEBI regulations and to prevent securities laws violations. Each intermediary is required to appoint a compliance officer who has to report to SEBI the case of any violation of SEBI regulation.</p> <p>SEBI monitors how compliance procedure is executed by intermediaries through inspection, audit and reporting systems.</p> <p>SEBI completed 102 and 169 investigations in the year 2006-07 and 2007-08 respectively. These investigation relates to market/price manipulation (77/115), capital issues related manipulation (4/3), Insider trading (10/28), Takeovers (3/2), Misc. (8/21) for the year (2006-07 / 2007-08) respectively.</p> <p>SEBI has taken action based on inspection against 138 and 86 brokers and sub-brokers in 2006-07 and 2007-08 respectively and against 27 and 9 DPs in 07/08 against 8 &amp; 2 MBs in 2007-08 and 12 RTI in 2007-08 <i>etc.</i></p> <p>SEBI has filed 21 and 39 prosecutions in year 2006-2007 and 2007-2008 respectively in respect of violation of SEBI Act, SCR Act, Depositories Act and Companies Act.</p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	<p>The exchanges carry out inspection of atleast 20 per cent of its active brokers in the cash segment and 50 per cent in the F&amp;O segment every year.</p> <p>SEBI conducts risk based inspection based on the significance of the firm and the risk it poses to market and investors. SEBI also carries surprise inspection on receipt of complaint, information <i>etc.</i> SEBI on its part oversees the quality of such inspections by calling for periodic reports on inspection conducted by RSE, violation observed and action taken by RSE to check whether the quality, content and coverage of inspection are adequate.</p>

	<p>Total prosecution cases filed and pending was 1026 as on 2006-07 which increased to 1065 in 2007-08. 76 and 152 cases were disposed of by the Court in the year 2006-07 and 2007-08 respectively. The criminal courts follow the procedure contemplated in the Code of Criminal Procedure which involves lengthy and detailed procedure from filing of complaint till the disposal of the case on conviction. Out of 1026 cases as shown in the Annual Report, 2007, 545 cases are against unregistered CIS.</p> <p><b>Recommended Action</b></p> <ol style="list-style-type: none"> <li>1. There should be a mechanism for supervision/monitoring of outsourced inspection and also for supervision and monitoring of outsourced activities of the intermediaries.</li> <li>2. A comprehensive inspection policy/programme for all intermediaries may be adopted.</li> <li>3. Overall effectiveness of enforcement efforts may be improved in acting as an effective deterrent.</li> </ol>
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#### Principles for Co-operation in Regulation

Principle 11.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	By virtue of Sec. 11 (2) (1a) of SEBI Act, SEBI has the authority to share both public and non-public information with domestic and foreign counter parts.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	The power given u/s11(2)(1a) of SEBI Act enables sharing of information and there is no specific prohibition in respect of providing information, whether public or non-public, if SEBI thinks it is necessary for efficient discharge of its functions. SEBI can provide information to other domestic authorities on an unsolicited basis. However, in case of foreign counterparts, SEBI shares such information on the basis of reciprocity based on Memorandum of Understanding (MoU) entered into with such foreign counter-parts. SEBI obtains consent of CG before entering into such MoUs as a matter of practice. SEBI can also provide information to foreign regulators in the absence of an MoU if it is felt necessary to do so.
Principle 12.	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

Description	SEBI has established information sharing arrangements with domestic and foreign regulators. SEBI can share such information on receipt of written request from other domestic authorities. As regards foreign counterparts, SEBI has entered into MoUs with the foreign regulators of many countries such as SEC of US, SEC of Malaysia, FSC Mauritius, SFC of Hong Kong and Multilateral MOU (MMOU) with IOSCO <i>etc.</i> SEBI has furnished/exchanged information with other regulators such as SEC, DFIX <i>etc.</i> , in respect of listed companies and intermediaries.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>Arrangements with foreign counter parts are documented by way of MoUs. SEBI takes steps to ensure the confidentiality of information transmitted consistent with its use. It is one of the agreed areas in the MoUs to ensure confidentiality of information and using the same for requested purpose.</p> <p><b>Recommended Action</b></p> <p>There could be formal MoUs in place for information sharing with domestic regulators in respect of markets.</p>
Principle 13.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
Description	<p>SEBI may extend informal assistance to foreign regulators in conducting enquiries or investigations of domestic regulated entities.</p> <p>Sec.11(2)(la) enables SEBI to furnish information to any other agency as may be considered by it for efficient discharge of its functions. Assistance can be given to foreign regulators as per the scope and terms of MoU.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	<p>SEBI can offer such assistance to foreign regulators depending upon scope and terms of MoU.</p> <p>Only aggrieved party can approach Court of competent jurisdiction for obtaining court orders/injunctions. SEBI is not entitled to approach Court to obtain injunction on behalf of foreign regulators.</p>

### Principles of Issuers

Principle 14.	There should be full, accurate and timely disclosure of financial results and other information which is material to investors' decisions.
Description	The regulatory framework has specific disclosure requirements, material to investors decision that apply to public and right offerings of securities such as equity shares and debt instrument by companies, including the conditions applicable to offer for sale, the content and distribution of prospectus or offer documents and supplementary documents prepared in the offering. All these requirements should be fulfilled by the issuers as per SEBI (Disclosure



## Chapter IV

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	<p>and Investor Protection) Guidelines 2000 (DIP Guidelines) and Schedule II of Companies Act and Form 2A of Companies Rules. Continuous disclosure requirement in respect of listed securities is required to be complied with as per the Listing Agreement (LA). In case of mis-statements in prospectus prosecution is filed under Companies. Act or action is taken for failure to exercise due diligence. SEBI has issued SEBI (Issue and Listing of Debt Securities) Regulations, 2008 on June 6, 2008, for issue of debt securities by company and other entities and listing thereof in the RSE.</p> <p>The CG has notified the Companies. (issue of Indian Depository Receipt) Rules and SEBI has specified LA. The disclosure standard specified for IDRs are on par with IOSCO guidelines on cross-border offering and initial listing of foreign issues.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>The regulatory framework has a system in place where disclosure requirements that apply to Annual Reports are specified in Sec. 211 to 219 of Companies Act and clauses 32 and 49 of the LA. U/s 219 of Companies Act, companies should send balance sheet, profit and loss accounts, the auditor's report at least 21 days earlier to the date of general meeting. As per Clause 32 of LA the listed companies also require to include Consolidated Financial Statements, Cash Flow Statements and Related Party Transactions in the Annual Report. Clause 49 of LA requires Management Discussions and Analysis Report to be included in the Annual report. As per clause 43A of Listing Agreement, the company is also required to publish in the newspapers, a statement indicating material deviations, if any, in the use of proceeds of a public or rights issue from the objects stated in the offer document.</p> <p>As per Clause 41 of LA, listed companies are mandated to publish quarterly financial reports within 15 days of last day of every quarter ended in a financial year. Clause 35 requires disclosure of shareholding pattern every quarter. Clause 43 requires quarterly disclosure of variation of projected and actual utilisation of funds and projected and actual profitability.</p> <p>All the listed companies are required to file electronically through Corporate Filing and Dissemination System (CFDS), viz. www.corpfiling.co.in. Material Decision of Board of Directors has to be filed within 15 minutes of Board Meeting.</p> <p><b>Recommended Action</b></p> <p>To impart enforceability, DIP guidelines may be converted into regulations.</p>
Principle 15.	<p>Holders of securities in a company should be treated in a fair and equitable manner.</p>

Description	<p>The legal framework under the Companies Act and securities regulation ensures that holders of securities in a company are treated in fair and equitable manner.</p> <p>Shareholder(s)/member(s) are entitled to vote in the election of directors <i>etc.</i> by virtue of the powers u/s 87 of Companies Act. Sec. 176 of the Companies Act provides for proxy voting. Members are entitled to cast as many votes as their number of shares in polling. Sec. 181 provides for restriction on exercise of voting rights in case of members who has not paid the call <i>etc.</i></p> <p>In case of oppression of minority or mis-management shareholders can move the Tribunal u/s 397, 398 of Companies Act for appropriate relief.</p> <p>Fundamental corporate changes such as merger and amalgamations <i>etc.</i> have to be approved by majority in numbers and <math>\frac{3}{4}</math> in value of shareholders u/s 391 of the Companies Act. Sec. 395 of Companies. Act imposes duty to acquire shares of shareholders dissenting from scheme or contract approved by majority. SEBI (Substantial Acquisition of Shares and Take Over) Regulations, 1997 requires disclosure and exit option to be given to shareholders at same price if there is substantial acquisition or any change in the control of the company or management. SEBI (Buyback of Securities) Regulations, 1998 and SEBI (Delisting of Securities) Guidelines, 2003 give similar exit option.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>Section 192 A of the Companies Act allows passing of resolution through postal ballots.</p> <p>Section 265 of Companies Act provides an option to the company to adopt proportional representation for appointment of director. Proviso to Section 252(1) also provides large companies an option to have directors elected by small shareholders.</p> <p>A director has to inform the Board of Directors his interest in respect of contract or arrangement and cannot participate or vote if he is directly or indirectly interested as per Sec. 299 / 300 of Companies Act. All related party transaction has to be informed in Annual Report and to Audit Committee as per LA.</p> <p><b>Recommended Action</b></p> <ol style="list-style-type: none"> <li>1. It is desirable that there is some regulatory framework for disclosure of voting pattern by institutional shareholders such as MFs, Foreign Institutional Investors (FII) <i>etc.</i></li> <li>2. Interested party transactions may be subject to shareholders approval.</li> </ol>
Principle 16.	Accounting and auditing standards should be of a high and internationally acceptable quality.
Description	The Institute of Chartered Accountants of India (ICAI), a statutory body established under an act of parliament (Chartered Accountants Act of 1949) to regulate accounting profession, is founder member of global body of accounting profession, International Federation of Accountants. ICAI

	<p>establishes accounting and auditing standards and has constituted separate committees, Accounting Standards Board (ASB) and Auditing and Assurance Standard Board (AASB) for this purpose. Both the Committees have wide representation of public interest and have representatives of regulators, industry chambers and educationists besides members of Council of ICAI. SEBI is member of both the Committees.</p> <p>Both these Boards adopt International Standards as a base to formulate standards for accounting and auditing and assurance services.</p> <p>Oversight mechanism, so far as formulation of accounting standards are concerned, was introduced in 2001 through establishment of National Advisory Committee on Accounting Standards (NACAS) under the Indian Companies Act, 1956. This is an independent Committee and accounting standards formulated by ICAI are notified by Government for adoption by companies on the basis of advice of NACAS.</p> <p>CG has issued Company (Accounting Standard) Rules, 2006 vide notification dated December 7, 2006 u/s 211(3C) of the Companies Act, 1956. As per Section 211(3A) it is mandatory for every company to comply with the accounting standards as prescribed under the Accounting Standard Rules, 2006.</p> <p>Clause 50 of LA makes it mandatory for listed companies to follow accounting standards issued by Institute of Chartered Accountants of India (ICAI).</p> <p>ICAI has proposed to move to International Accounting Standards, <i>i.e.</i> International Financial Reporting Standards (IFRS) from April 1, 2011 for public interest entities which includes listed companies. Some companies have prepared financial statements as per IFRS even for financial year ending March 31, 2008.</p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	<p>The financial statements of all companies, whether listed or unlisted, must be audited by members of ICAI who are obliged to perform audit in accordance with Auditing and Assurance Standards issued by ICAI. ICAI is moving fast to pronounce assurance and auditing standards on all subjects on which International Standards are issued and revising standards when International Standards are modified under the Clarity Project undertaken by the International Auditing and Assurance Standards Board of IFAC.</p> <p>There is elaborate disciplinary mechanism under the Chartered Accountants Act for non-compliance with Standards by its members. ICAI initiates disciplinary action <i>suo moto</i> on the basis of information that may have come</p>

	<p>to its notice as also on the basis of complaints filed with it. The role of discipline, which was hitherto entirely with the Council of ICAI, is now externalised through constitution of Disciplinary Board, Disciplinary Committee and Appellate Board which has representation of members appointed by CG besides representatives of ICAI.</p> <p>ICAI has constituted Financial Reporting Review Board (FRRB) which, <i>suo moto</i>, at random, picks up financial statements issued by listed companies to assess compliance with Accounting Standards in preparation and presentation of financial statements. Non-compliance noticed during review are reported to relevant regulatory authority.</p> <p>ICAI established Peer Review Board in 2002 which is presently undertaking peer review of firms carrying out audit and assurance engagements with focus on documentation and processes adopted for the engagements to ensure compliance with technical standards. It issues peer review certificates if the compliance, processes and documentation are found to be satisfactory.</p> <p>CG has recently (June 2007) constituted an independent Quality Review Board to review quality of services provided by chartered accountants, provide guidance to them for improvement in quality of services and to make recommendations to the Council of ICAI in this regard. The Chairman of the Board is appointed by CG and it has equal representation of ICAI Council members and members appointed by CG.</p> <p><b>Recommended Action</b></p> <ol style="list-style-type: none"> <li>1. All the certifying/auditing functionaries such as Chartered Accountants, Company Secretaries <i>etc.</i>, should be made responsible and accountable to the regulators to the extent they are involved in certifying/auditing of regulated entities in the securities market.</li> <li>2. Disciplinary powers over Auditors may be vested with independent regulatory body.</li> <li>3. The report of FRRB is required to be submitted to the Regulator and the it should be empowered to deal with such reports and take steps as may be appropriate in the facts and circumstances of the case.</li> <li>4. When financial statements with qualifications are submitted by regulated entities, mechanism should be established to take steps to resolve the differences and to ultimately, do away with such differences.</li> </ol>
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#### Principles for Collective Investment Schemes

Principle 17.	The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
Description	Collective Investment Schemes in nature of Mutual fund schemes are governed by SEBI (Mutual Fund) Regulations, 1996 (MF Regulations) which sets standards for the eligibility and regulation for those who wish to market or launch or operate a MF Scheme. All scheme offer documents need certain material disclosures as specified in MF regulations. The MF Regulation is

	<p>separate from SEBI (Collective Investment Scheme) Regulations, 1999. The MF Regulation lays down legal and regulatory framework for MFs and framework for floating of schemes by which funds of investors are pooled to invest in securities, Exchange Trade funds (ETF), money market instruments or gold related instruments (Gold ETF) and Real Estate Mutual Fund (REMF). Regulation 7 lays down eligibility criteria for registration of a MF. Regulation 28 lays down procedure for launching of Schemes of MF. There is detailed requirement for avoiding conflict of interest. Trustees act as first level supervisors of schemes of MFs. SEBI conducts periodical inspection of MFs. During later half of FY-07-08 inspection of 30 MFs were carried out by auditors empanelled with the Reserve Bank as statutory auditors. Based on inspection reports 6 warning letters were issued to MFs and 1 to Trustee company.</p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	<p>SEBI (Collective Investment Scheme) Regulations 1999 (CIS Regulations) states/ provides that no person other than a Collective Investment Management Company which has obtained a certificate under the regulations can carry on a collective investment scheme. The CIS Regulation lays down legal and regulatory framework for launching and operating CIS schemes which comes under definition of CIS u/s 11AA of SEBI Act which includes agro-bonds, teak bonds, plantation bonds <i>etc.</i> No entity has been registered with SEBI as CIS.</p> <p>UTI Act was repealed in 2003 and UTI MF was brought under SEBI registration from January 14, 2003.</p> <p>The key channel in bringing the mutual funds to a large number of investors all over the country is the network of distributors. The distributors have to take on the role of financial advisors for investors.</p> <p>SEBI has made mandatory for any entity/person engaged in marketing and selling of mutual fund products to pass AMFI certification test (Advisors Module) and obtain registration number from AMFI. Firms and corporates have to obtain certification of registration from AMFI and all employees of corporate distributors engaged in selling and marketing of mutual fund products have to pass the AMFI certification test (Advisors Module) and obtain registration with AMFI before canvassing business of mutual funds.</p> <p><b>Recommended Action</b></p> <p>Distributors of units of mutual funds and distributors of securities in primary market be brought within the regulatory fold through SRO or direct regulations.</p>
Principle 18.	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

Description	<p>MF Regulation provides framework governing the legal form and structure of MF and segregation and protection of clients assets.</p> <p>As per Regulation 2 (q) and 14 of MF regulations, a MF shall be constituted in the form of trust. A Trust deed shall be executed by a sponsor in favour of trustees. Contents of trust deed are also governed by regulations.</p> <p>As per Regulation 2(z) and (zi) MF Regulations, a unit holder holds units, each unit representing one undivided share in the asset of the scheme.</p> <p>Regulation 16(1) and 20(1) of MF Regulations, 1996 mandates, <i>inter alia</i>, the appointment of Trustees for protection of interest of unit holders and appointment of Asset Management Company for managing the fund according to the regulations/schemes.</p> <p>As per Regulation 18 (12) of MFs Regulations, trustees are accountable for and shall be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for benefit of unit holders in accordance with regulations and provisions of trust deed. The MF assets are held by independent SEBI registered custodians who are separate from assets of AMC.</p> <p>As per Clause 5 of Code of Conduct, Trustees and AMC must ensure scheme-wise segregation of bank accounts and securities accounts.</p> <p>As per Regulation 26 and Clause 10 of Third Schedule, a MF has to appoint a custodian registered with SEBI for safekeeping of asset of schemes.</p>
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	<p>As per Regulation 29(1) of MF Regulations and standard offer document, a MF has to disclose legal form, structure of MF, rights of unit holders as well as investment objective, risk associated with the scheme <i>etc.</i></p> <p>A MF is required to issue Scheme Information Document (SID), Key Information Document (KIM) about the MF and Statement of Additional Information (SAI). In case of changes affecting the matter disclosed in SID and an addendum has to be issued.</p> <p>Custodian in which sponsor of MF or its associate holds more than 50 per cent, cannot be appointed as custodian.</p> <p>No asset management company or its officers can be appointed as trustee.</p> <p>As per regulation 9 (a) of CIS Regulations, 1999 the regulatory framework mandates that the form and structure of a CIS must be a company registered under Companies Act, 1956.</p>
Principle 19.	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	In the context of mutual fund schemes, as per Regulation 29(1) of the MF Regulations, 1996 the offer document shall contain disclosures which are



	<p>adequate in order to enable the investor to make informed investment decision. Further, an abridged form of offer document called 'Key Information Memorandum (KIM)' is issued. Terms of disclosures of KIM are prescribed vide Circular IMD/Cir No 10/16521/04 dated July 28, 2004.</p> <p>As per SEBI circular July 28, 2004, Key Information Memorandum (KIM) has to be updated at least once a year and as per SEBI circular SEBI/MFD/CIR/10/039/2001 dated February 9, 2001 offer document shall be fully revised and updated at least once in two years.</p> <p>Further in order to enhance as well as standardise disclosure standards by MFs in their offer documents, SEBI has issued standard observations vide circular dated MFD/CIR/06/275/2001 dated July 9, 2001. Disclosures in offer documents and KIM of schemes need to conform to standard observations.</p> <p>As per Regulation 30, advertisement in respect of a scheme shall be in conformity with advertisement code as specified in Sixth Schedule. As per clause 1 of advertisement code, advertisement shall be truthful, fair and should not contain untrue and misleading information. Further SEBI has prescribed detailed advertising guidelines vide circulars MFD/Cir/4/51/2000 dated 5<sup>th</sup> June 2000 and MFD/CIR/6/12357/03 dated 26<sup>th</sup> June 2003.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>Reg. 26 of CIS Regulation specifies that offer document shall contain true and fair view of scheme and adequate disclosure to enable the investors to make informed decision. The offer document shall contain such information as specified in the sixth schedule.</p> <p>As per regulation 46 of MF Regulations, every MF shall compute and carry out valuation of investments in its portfolio in accordance with valuation norms specified in Eighth Schedule and guidelines issued by SEBI.</p> <p>As per regulation 49(1), the price at which units may be subscribed or sold and the price at which units may be repurchased has to be made available to the investors.</p>
Principle 20.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
Description	The MF regulation provides proper and disclosed basis for asset valuation and the pricing of units for purchase/redemption of units.

	<p>As per Clause 6 of Eight Schedule in case of NAV of a scheme differs by more than 1 per cent the investor has to be paid the difference in amount by the scheme.</p> <p>Regulations 48 and 49 <i>inter alia</i> lay down provisions for disclosure of NAVs on periodic basis published in newspapers and websites of AMC and AMFI.</p> <p>As per SEBI circular – SEBI/IMD/CIR No.5/96576/2007 dated June 25, 2007, NAV of the scheme shall be displayed on the Association of Mutual Fund of India (AMFI) website by 9 pm of the same day and for funds of fund scheme by 10:00 a.m. of the following day.</p> <p><b>Recommended Action</b></p> <p>Regulatory framework for disclosure on the voting pattern by MF to its unit holders / market may be laid down.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>SEBI has issued guidelines for valuation of unlisted, thinly traded, non-traded securities.</p> <p>Net Asset Value (NAV) of the close ended scheme shall be calculated not exceeding one week and open ended scheme on a daily basis.</p> <p>As per regulation 49(3), the repurchase price shall not be lower than 93 per cent of NAV and sale price not higher than 107 per cent of NAV. The repurchase price of close ended scheme shall not be lower than 95 per cent of NAV. The difference between the repurchase price and sale price of unit shall not exceed 7 per cent calculated on the sale price.</p>

### Market Intermediaries

Principle 21.	Regulation should provide for minimum entry standards for market intermediaries.
Description	<p>As per Section 12 of SEBI Act no market intermediary who may be associated with the securities market shall buy, sell or deal in securities except in accordance with condition of certificate of registration obtained from SEBI. SEBI has made regulations for various intermediaries such as stock broker, share transfer agent, merchant banker, underwriters, portfolio managers, credit rating agencies <i>etc.</i>, which lays down registration requirement, minimum entry standards and condition of operating in such activity.</p> <p>As per SEBI (Certification of Associated Persons in Securities Market) Regulations, 2007 notified on October 17, 2007, associate persons are required to obtain/maintain requisite certificate recognised by SEBI for working/operating in securities market. SEBI has set up National Institute of Securities Market (NISM), <i>inter alia</i>, to implement certification programme, to accredit organisations for administering certification examination and conducting Continuing Professional Education programme. NISM will also maintain a register of persons who hold valid certificate.</p>
Assessment	Broadly Implemented

Comments	<p>Each of the intermediary regulations contain a separate chapter on intermediary registration which provides for minimum standard and a comprehensive assessment of application. Regulations provided for elaborate framework for making application for seeking registration as an intermediary, factors to be taken into account for consideration of application, procedure for grant of certificate, condition for grant of certificate <i>etc.</i> These regulations provide eligibility norms for assessment of net worth, capital adequacy, adequate and competent personnel, internal system and procedure, infrastructure <i>etc.</i> The regulations provide that the applicant should be a fit &amp; proper person. SEBI has issued draft regulation for investment advisor in October 2007.</p> <p><b>Recommended Action</b></p> <ol style="list-style-type: none"> <li>a. Information on market intermediaries, identification of senior management and employees who are authorised to deal on behalf of intermediary needs to be made public.</li> <li>b. Need for regulating investment advisors and research analysts through SRO or directly to be explored.</li> </ol>
Principle 22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake
Description	<p>All the regulations pertaining to market intermediaries specify specific capital adequacy requirements and it is conditional for granting registration that the intermediary has to continuously maintain its capital adequacy requirement at all times, during the period of certificate of registration or renewal thereof.</p> <p>The capital adequacy requirement for brokers includes Base Minimum Capital, Deposit, Trade Guarantee Fund <i>etc.</i> A member of cash segment such as that of BSE has to pay the following :</p> <ol style="list-style-type: none"> <li>i. A deposit of Rs.100,00,000.</li> <li>ii. Base minimum capital Rs.10,00,000.</li> <li>iii. Trade Guarantee Fund Rs.10,00,000.</li> <li>iv. Broker contingency fund Rs.2,50,000.</li> </ol> <p>The prudential requirement in respect of brokers includes initial margin, exposure margin, mark to margin <i>etc.</i></p> <p>In case of other intermediaries who undertake fund based activities such as underwriter, exposure limit, such as, its underwriting obligation shall not exceed 20 times the net worth as per Reg.15(2) of Underwriters Regulation.</p>

	As regards capital adequacy requirements of AMCs of mutual funds undertaking other permitted activities like PMS, pension funds <i>etc.</i> , in line with Regulation 24 of SEBI (MF) Regulations, AMCs are required to continuously and separately maintain capital adequacy for each of the activities. Maintenance of minimum net worth requirements for mutual fund activity is Rs.1,00,00,000. Other permitted activities would require additional capital adequacy at all times.
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	In case of intermediary such as Portfolio Manager (PM), as per regulation 18 the PM shall furnish to SEBI half yearly unaudited financial results with a view to monitor capital adequacy of the PM. In case of brokers real-time monitoring of capital is done by exchanges.  <b>Recommended Action</b> The need for risk related capital requirement for market intermediaries to be explored.
Principle 23.	Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aims to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
Description	All the SEBI regulations relating to market intermediaries provide that SEBI while considering the applications for grant of certificate of registration has to take into consideration whether the applicant is a body corporate; whether the principal officer of the applicant has professional qualification or relevant experience <i>etc.</i>  Market intermediaries are required to maintain systems and procedures for redressal of grievance of investors/clients; for segregating each client's funds and securities separately from his own.  There are detailed business conduct rules such as avoidance of conflict, prevention of misuse of assets of client <i>etc.</i> There are also market conduct rule such as prohibition of market manipulation, insider trading <i>etc.</i> , for intermediaries.  Each intermediary has to lay down internal systems and procedures for prevention of insider trading by its staff and management to avoid conflict of interest and for Anti Money Laundering (AML) measures. The primary responsibility for compliance with securities regulation lies with the whole firm or intermediary company. Every intermediary is required to appoint a compliance officer (such as Reg.23A of PM Reg.) for monitoring compliance of SEBI Regulation and for redressal of investors' grievance. The RSE has to inspect atleast 20 per cent of its active member in cash segment and atleast 50 per cent in derivative segment every year. SEBI has adopted a risk-based approach and it conducts inspection of intermediaries which may be systematically important and based on complaints <i>etc.</i>
<b>Assessment</b>	<b>Partly Implemented</b>

Comments	<p>In case of contravention warranting criminal action, as per section 27 of SEBI Act, an intermediary, its principal officers and other persons who were in charge and were responsible to the intermediary company for conduct of business of the intermediary company as well as intermediary company shall be primarily responsible and liable to be prosecuted.</p> <p>As per regulations, such as Regulation 20(2) of PM Regulations, the books of accounts of PM is required to be audited yearly by a qualified auditor to ensure that the PM has followed proper accounting methods and procedures and that the PM has performed his duties in terms with the law.</p> <p>There is general obligation of intermediary to avoid conflict of interest as per code of conduct. Further, as per SEBI Insider Trading Regulations, the intermediary has to lay down systems and procedures to restrict access to confidential information, segregation and chinese wall, system and procedure for prevention and misuse of price sensitive information. These guidelines require that the employees who have confidential information shall be physically segregated from other employees.</p> <p><b>Recommended Action</b></p> <ol style="list-style-type: none"> <li>1. Guidelines regarding internal controls in respect of market intermediaries as part of good practices may be issued.</li> <li>2. Risk from unlicensed affiliates of the regulated entity to be addressed.</li> <li>3. Management of conflict where research, investment banking or broking are housed under one roof need be addressed.</li> </ol>
Principle 24.	There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.
Description	<p>The reporting system for intermediary serves as an early warning system for potential defaults. In addition, regulatory capital adequacy has been prescribed. Besides, DvP on settlement cycle of T+2 rolling basis and guaranteed settlement by Clearing Corporation mitigate the impact of failure. The clearing and settlement agency of RSE maintains a guarantee fund such as Settlement Guarantee Fund (SGF) to mitigate counterparty and systemic risks.</p> <p>Bye-laws of the stock exchanges contain elaborate provision for dealing with the eventuality of firms' failure or where it is declared as defaulter.</p>

	SEBI may ask the intermediary to transfer their securities business or assets of client to another intermediary or allow the client to withdraw its fund and assets from such intermediary. As per SEBI regulations all the intermediaries are required to file with SEBI a statement showing financial position after the end of each accounting period and also furnish to the Board half-yearly unaudited financial results with a view to monitor the capital adequacy. As regards members of stock exchanges, their position and exposure are monitored on-line and in case of any breach, their trading terminal is automatically disabled. Such information is flashed on the website of the exchange.
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	In case where the member of the exchange is declared a defaulter and as per judgment of the Supreme Court, in the matter of Vinay Bubna vs Stock Exchange, Mumbai 1999 (6) SCC 215, the membership right, deposit and other assets of the defaulter shall vest with the exchange.  <b>Recommended Action</b>  There should be a laid down policy and procedure for dealing with the failure of market intermediary or financial conglomerate to reduce risks to systemic stability.

### The Secondary Market

Principle 25.	The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight.
Description	The SC(R) Act has laid down legal and regulatory framework for recognition / authorisation and operation of the RSE and regulations of contract in securities. Section 19 of SC(R) Act, prohibits stock exchanges (SEs) other than RSEs. Any SE desirous of being recognised as RSE, has to make an application for recognition to SEBI, as per Section 3 of SC(R) Act. The RSE may establish trading floor with prior approval of SEBI, on terms and conditions stipulated by SEBI as per Section 13A of SC(R) Act.  Derivative Exchanges or separate derivative segment of an existing exchange also require approval from SEBI.  SEBI while renewing recognition or approval may impose an on-going condition on the exchange. SEBI may also impose condition on RSE after the findings of inspection.  SEBI vide its circular dated April 13, 2007 permitted RSE having nation-wide access such as BSE and NSE to have in place a corporate bond trading platform by making use of existing infrastructure available with them for operating the trade matching platform for corporate bonds, with necessary modifications.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	The legal and regulatory structure now provides that RSE need to be a corporate entity and should be demutualised. All recognised exchanges have been corporatised and demutualised.



	<p>The system operators such as the Governing Body of the Exchange/Clearing Corporation/house, the Executive Director or the Managing Director of the Exchange and the clearing house/corporation and trade guarantors, which is the Clearing Corporations House of both cash and derivative segment also require approval and are regulated by SEBI.</p> <p><b>Recommended Action</b></p> <p>There should be strong oversight of demutualised exchanges to address potential conflict which may arise due to commercial objectives and regulatory role.</p>
Principle 26.	<p>There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.</p>
Description	<p>The RSE monitors day-to-day operation and trading in the exchanges under overall supervision of SEBI. SEBI supervises the RSE and conducts oversight of RSE and its surveillance activities to monitor compliance by RSE the provision of SC(R) Act, Rules, bye-laws <i>etc.</i> The monitoring also includes, periodic and event driven reporting by RSE and inspection of RSE.</p> <p>SEBI also conducts weekly surveillance meetings with the RSE and depositories to review market movements.</p> <p>SEBI has established IMSS to monitor surveillance activities in multiple exchanges and depositories.</p> <p>Continuous assessment of compliance of RSE is done through various mechanism which include:-</p> <ol style="list-style-type: none"> <li>i. Monthly or quarterly development reports.</li> <li>ii. Risk management certificates on half yearly basis.</li> <li>iii. Inspections – annual or random.</li> <li>iv. Systems audit</li> <li>v. Compliance reports</li> </ol> <p>As per Sec. 9 of SC(R) Act, RSE can make bye-laws only with approval of SEBI. As per Section 4(5) of SC(R) Act, RSE can make rules only with approval of SEBI. SEBI has power u/s 10 of SC(R) Act to make or amend bye-laws of RSE <i>suo moto</i> and to make or amend rules of RSE u/s 8 of SC(R) Act. SEBI ensures that the rules of RSE are fair and equitable.</p>

	SEBI has decided to permit all classes of investors to short sell subject to the broad framework specified in circular dated December 20, 2007. SEBI has put in place a full-fledged securities lending and borrowing scheme for all market participants in order to provide a mechanism for borrowing of securities to enable settlement of securities sold short.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>SEBI is required to approve the rules, bye-laws of the SE and clearing corporation and also approve the proposed derivative contracts before commencement of trading.</p> <p>Under SC(R) Act, SEBI has power to supersede the Governing Board of any RSE u/s 11, power to suspend business of RSE u/s 12, power to issue direction u/s 12A, power to prohibit speculative contracts u/s 16 of SC(R) Act <i>etc.</i> SEBI also has power to suspend office bearer of RSE u/s 11(4)(c) of SEBI Act. SEBI has power u/s 23G of SC(R) Act to impose monetary penalty upto Rs.25 crore on RSE for failure to comply with directives issued by SEBI <i>etc.</i></p>
Principle 27.	Regulation should promote transparency of trading.
Description	<p>RSEs are required to have transparency of trading. The Exchange is required to have arrangements for dissemination of information about trades, quantities and quotes (first five bids) on a real-time basis through atleast two information vending networks which are easily accessible to investors in the country.</p> <p>In 1994 SEBI mandated all the SE to replace open outcry system with transparent automated screen based trading in securities. The SE such as NSE &amp; BSE have set up fully automated screen based trading system having nation-wide access.</p> <p>The SE have adopted anonymous order matching system. The member punches in the system, the details of his order such as the quantities and prices of securities at which he desires to transact. The transactions are executed when such an order finds a matching sale or buy order from a counter party. All the orders are electronically matched on a price / time priority basis. It allows for faster incorporation of price sensitive information into prevailing prices, as the market participants can see the best five bids and offer on real-time basis. BSE has set up real-time data dissemination system <i>i.e.</i> Data feed. NSE displays it live stock quotes at their website (www.nseindia.com) which are updated live. SEBI vide circular dated March 19, 2008 has stipulated that all institutional trades in the cash market would be subject to payment of margins as applicable to transactions of other investors from April 21, 2008.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	SEBI vide circular dated December 12, 2006 authorised BSE to set up and maintain a corporate bond reporting platform to capture all information related to trading in corporate bonds, as accurately and as close to execution as possible. NSE was similarly authorised vide circular dated March 1, 2007.

	<p>Trades executed by the members of BSE or NSE shall be reported on the reporting platforms of their respective SE who would host such information on their websites. In case of Over the Counter (OTC) trades, the parties concerned shall have the freedom to report the deals on the platform of either BSE or NSE.</p> <p>Information disseminated on the websites of BSE and NSE shall display the following essential data: Issuer Name, Maturity Date, Current Coupon, Last Price Traded, Last Amount Traded, Last Yield (annualised) Traded, Weighted Average Yield Price, Total Amount Traded and the Rating of the Bond and any other additional information as the stock exchanges think fit.</p> <p>Further, the following additional details shall be made available through a hyperlink: Ratings including the last change where possible, Call/Put Option Dates, Record Date, Next Coupon Date, Step up Coupons, Day Count Convention, Floating Benchmark if applicable and the spread over the benchmark and any other instrument specific material information.</p>
Principle 28.	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	<p>Section 11(2)(e) and section 12A of SEBI Act prohibits manipulation, fraudulent and deceptive devices in securities transaction.</p> <p>SEBI has enacted SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003, (FUTP Reg.). Regulation 4(2)(a), (b), (c), (d), (e), (n) of the said regulation prohibits market or price manipulation.</p> <p>The regulatory approach to detect and deter manipulation and other unfair practices includes on-line surveillance, inspection, reporting and investigation of abnormal and suspected transactions.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>The on-line surveillance function in RSEs include, detecting potential market abuses at a nascent stage, with a view to minimise the ability of the market participants, to influence the price of the scrip in the absence of any meaningful information.</p> <p>RSEs refer cases of market abnormality or manipulation to SEBI. IMSS has sophisticated alert engine for detecting potential market abnormality and unfair practice.</p> <p>SEBI also investigates abnormal and suspected transactions or manipulations.</p>

Principle 29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	<p>The regulatory framework ensures proper management of large exposures, default risk and market disruption. RSEs have set up a surveillance system to monitor price, position, volume or concentration in order to identify large exposure, concentration, in order to manage the default risk.</p> <p>The exchanges have a well designed risk-management system which <i>inter alia</i>, includes collection of margins from the members such as marked-to-market.</p> <p>There are other trigger levels such as index based market wide circuit breaker systems and also scrip-wise price bands. The exchange has to monitor large exposure by members in case of breaching of circuit breaker level or price band.</p> <p>The Exchange and its Clearing Corporation/house is empowered to compel the trading/clearing member to reduce the exposure limit. The trading/clearing members in turn through an agreement with their client are empowered to reduce the position or exposure of their client or customer. The RSEs can automatically disable the trading terminal in case of breach of exposure limit or concentration <i>etc.</i></p> <p>The RSE are authorised to ask for special or additional margin or reduction of exposure or concentration. In the event of breach of exposure limit, the member is not permitted to take any fresh position.</p> <p>SGF is required to be maintained by the RSE for meeting the shortages arising out of non-fulfilment or partial fulfilment of funds obligations by members in a settlement before declaring the concerned member defaulter.</p> <p>There is a mechanism by which RSE authorities and SEBI consult each other to avoid the adverse market disruption.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>The RSEs closely monitor outstanding position of top buying member-brokers and similarly top selling member broker identifies whether a member-broker has built up excessive purchase or sale position compared to his normal level of business. Further, it is examined whether purchases or sales are concentrated in one or more scrips, whether the margin cover is adequate, whether transactions have been entered into on behalf of institutional clients and even the quality of scrips, <i>i.e.</i>, liquid or illiquid is looked into in order to assess the quality of exposure.</p> <p>The trading terminal of the member can be deactivated for non-payment/late payment of margins or settlement dues or on apprehension of financial difficulties or detection of serious irregularities or for frequent violations of trading restrictions placed on them, to ensure that large or questionable exposure or trading behaviour of a member does not compromise market safety or jeopardise the integrity of the market.</p>

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	<p>For corporate bonds, SEBI vide circular dated April 13, 2007 has stipulated that the system used by BSE and NSE for corporate bond should ensure that they reduce systemic risk. BSE and NSE are also required to devise an appropriate system for margining of trades to be done on the corporate bond market trading platform.</p>
Principle 30.	<p>Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.</p>
Description	<p>The clearing and settlement of securities transactions in RSE is monitored by RSEs themselves under overall supervision of SEBI. The rules and regulations for clearing settlement have been designed to ensure they are fair, effective and reduce systematic risk. Robust, guaranteed and DVP based clearing and settlement system using multilateral netting is undertaken through Clearing Corporation in respect of all deals in securities.</p> <p>The RSEs have screen based on-line trading system, through which the trades between the direct market participants are confirmed on-line at the time of trade.</p> <p>As per the settlement system at the Exchange/Clearing Corporation, the securities' pay out is released only after receipt of the funds pay-in from the concerned trading/clearing member and custodian.</p> <p>The settlement cycle is of T+2 Day on a rolling basis.</p> <p>The Exchange/Clearing Corporation are the counter parties to all the trades done on the on-line trading system of the Exchange.</p> <p>Shortages of delivery are auctioned /closed out (closed out price as computed as per the norms prescribed by SEBI).</p> <p>In the event of trading member failing to meet his settlement obligation, the SGF can be utilised to the extent required for successful completion of settlement.</p> <p>The Exchange/Clearing Corporation have well maintained back-up systems.</p> <p>A comprehensive risk management framework as prescribed by SEBI from time-to-time is followed by the Clearing Corporation/Clearing House.</p> <p>RSEs such as NSE and BSE have put in place an on-line monitoring and surveillance system, whereby exposure of the members is monitored on a real-time basis.</p>

	<p>The derivative segments of NSE and BSE have developed a comprehensive risk containment mechanism for the F&amp;O segment.</p> <p>A separate SGF for F&amp;O segment has been created out of the base capital of the members.</p> <p>The most critical component of risk containment mechanism for F&amp;O segment is the margining system and on-line position monitoring. The actual position monitoring and margining is carried out on-line through Parallel Risk Management System (PRISM). PRISM uses Standard Portfolio Analysis of Risk (SPAN) System for the purpose of computation of on-line margins based on the parameters defined by SEBI.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>The rules and operating procedures for clearing and settlement of corporate bonds has been specified in SEBI circular dated April 13, 2007 which are also available on the websites of BSE &amp; NSE.</p> <p>SEBI vide circular dated April 13, 2007 has advised exchanges having nationwide terminal i.e. BSE and NSE to implement order driven trade matching platform for listed corporate debt securities on following lines:</p> <p>BSE and NSE may make use of the existing infrastructure available with them for operating the trade matching platform for corporate bonds, with necessary modifications.</p> <p>With the introduction of anonymous order matching platform, the clearing and settlement facility shall be provided by BSE and NSE with a multilateral netting facility for trades executed on the platform. The systems used for the purpose shall be designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.</p> <p>For corporate bonds, SEBI vide circular dated April 13, 2007 has stipulated that the system is used to ensure that they reduce systemic risk. BSE and NSE are also required to devise an appropriate system for managing trades done on the corporate bond market trading platform.</p>



## Appendix 5

## Detailed Assessment (Principle-by-principle) - Government Securities Market

## Principles Relating to Regulator

Principle 1.	The Responsibilities of the regulator should be clear and objectively stated.
Description	The regulation of government securities market is entrusted to the Reserve Bank. The authority and responsibilities of the Reserve Bank (RBI) as the regulator of the Government securities market are derived from the provisions of the RBI Act, 1934, Public Debt Act, 1944, Securities Contract Regulation Act, 1956 and the Government Securities Act, 2006. The amendments made to Securities Contract Regulation Act, 1956 extend the regulatory purview of the Reserve Bank to repos also. The powers of the Reserve Bank are enforceable.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	The regulation of corporate debt market is under the purview of SEBI.
Principle 2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	The RBI Act does not provide for any procedure for appointment of Governor or the governing Board. The terms of office are contractual (as specified in the appointment order). The directors (on the governing Board) excluding the Government official nominated to the Board can be removed only on the grounds stated in the RBI Act or on incurring disqualifications mentioned in the RBI Act (Section 10). The continuance of the Government official on the Board is at the pleasure of the Central Government. The Central Government may remove the Governor or Deputy Governors from service for which no specific grounds are stated in the RBI Act.
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There are statutory requirements as well as established conventions to ensure the independence of the Governor and the members of the Central Board of directors of the Reserve Bank. However, the criteria for removal are not explicit.
Principle 3.	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	The Reserve Bank is legally and administratively equipped to regulate the government securities market. As a central bank entrusted with regulatory responsibilities also, the Reserve Bank does not face any constraints in funding.

<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 4	The regulator should adopt clear and consistent regulatory processes.
Description	The Reserve Bank, in its regulatory role, is subject to extensive procedural rules and regulations. The Reserve Bank adopts a consultative approach in policy formulation, by inviting comments from market participants and holding discussions. The Reserve Bank provides elaborate rationale while formulating or amending policy prescriptions.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 5	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.
Description	The professional standards of the Reserve Bank are high by practicing sound Human Resource (HR) policies and practices. The HR policies also preclude conflict of interest in discharge of duties.
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	

#### **Principles of Self- Regulation**

Principle 6.	The regulatory regime should make appropriate use of Self-Regulatory Organisations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.
Description	The government securities market has the (a) Fixed Income Money Market & Derivatives Association and the (b) Primary Dealers Association of India, which act as industry-level representative bodies. However, these are yet to develop into recognised Self-Regulatory Organisations.
<b>Assessment</b>	<b>Not applicable</b>
Comments	FIMMDA and PDAI are yet to be formally acknowledged as SROs.
Principle 7.	SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	
<b>Assessment</b>	<b>Not Applicable.</b>
Comments	Not Applicable in view of reply to Principle No.6

#### **Principles for the Enforcement of Securities Regulation**

Principle 8.	The regulator should have comprehensive inspection, investigation and surveillance powers.
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Description	The Reserve Bank has the powers to inspect a regulated entity's (Primary Dealers) business operations, including its books and records. The Reserve Bank has powers to call for information from regulated entities on a regular basis under RBI Act, 1934 and Banking Regulation Act, 1949.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 9.	The regulator should have comprehensive enforcement powers.
Description	The Reserve Bank derives its investigative and enforcement powers from the provisions of the RBI Act, 1934 and the Banking Regulation Act, 1949. The Reserve Bank has adequate powers to enforce compliance with regulations.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 10.	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	The regulatory system includes an effective blend of on-site inspection, off-site reporting, investigation and surveillance of the market and regulated entities.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	

#### Principles for Co-operation in Regulation

Principle 11.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	<p>There is no specific statutory provision for sharing of information with domestic and foreign counterparts in case of regulated entities. However, in terms of Section 45NB(3) of the RBI Act, the Reserve Bank can in public interest furnish or communicate any information relating to the conduct of business of any non-banking financial company to any authority constituted under any law.</p> <p>In this regard provisions of the Prevention of Money Laundering Act, 2002 may also be seen especially Section 56 which authorises the Central Government to enter into agreement with Government of any country outside India for enforcing provisions of the Act and for exchange of information for prevention of offence under the Act and for investigation.</p>

	The Reserve Bank has the authority to share information on investigation/enforcement with other domestic regulators and authorities. The Reserve Bank extends co-operation to foreign regulators, wherever feasible.
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There are no express provisions under the RBI Act, 1934 and BR Act, 1949 allowing the Reserve Bank to provide assistance to foreign regulators.
Principle 12.	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
Description	<p>There is no specific statutory provision for sharing of information with domestic and foreign counterparts in case of regulated entities. However, in terms of Section 45NB(3) of the RBI Act, the Bank can in public interest furnish or communicate any information relating to the conduct of business of any non-banking financial company to any authority constituted under any law.</p> <p>In this regard provisions of the Prevention of Money Laundering Act, 2002 may also be seen especially Section 56 which authorises the Central Government to enter into agreement with Government of any country outside India for enforcing provisions of the Act and for exchange of information for prevention of offence under the Act and for investigation.</p> <p>The Reserve Bank, by administrative practice, may enter into information-sharing agreements with other domestic authorities.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There are no express provisions under the RBI Act, 1934 and BR Act, 1949 allowing the Reserve Bank to provide assistance to foreign regulators.
Principle 13.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
Description	<p>There is no specific statutory provision for sharing of information with domestic and foreign counterparts in case of regulated entities. However, in terms of Section 45NB(3) of the RBI Act, the Reserve Bank can in public interest furnish or communicate any information relating to the conduct of business of any non-banking financial company to any authority constituted under any law.</p> <p>In this regard provisions of the Prevention of Money Laundering Act, 2002 may also be seen especially Section 56 which authorises the Central Government to enter into agreement with Government of any country outside India for enforcing provisions of the Act and for exchange of information for prevention of offence under the Act and for investigation.</p> <p>The Reserve Bank may extend informal assistance to foreign regulators in conducting enquiries or investigations of domestic regulated entities.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There are no express provisions under the RBI Act, 1934 and BR Act, 1949 allowing the Reserve Bank to provide assistance to foreign regulators.

**Principles of Issuers**

Principle 14.	There should be full, accurate and timely disclosure of financial results and other information which is material to investors' decisions.
Description	Government of India and State Governments are the issuers.
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	The primary auctions of Government securities are governed by the general and specific notifications which contain, in detail, the terms of issue. The disclosures are contained in the annual budget statements. Periodic information on fiscal position is published by the Central and State Governments.
Principle 15.	Holders of securities in a company should be treated in a fair and equitable manner.
Description	This is not applicable in case of government securities market
<b>Assessment</b>	<b>Not Applicable</b>
Comments	The issue is under the jurisdiction of SEBI.
Principle 16.	Accounting and auditing standards should be of a high and internationally acceptable quality.
Description	<p>The principle is primarily intended to assess the accounting and auditing standards for the corporate sector and hence is not applicable to the Government, as the sovereign issuer, in its present focus and structure. However, the spirit of the principle is relevant and hence an attempt is made to assess the position of the issuer, <i>i.e.</i>, Government of India on the relevant points:</p> <ol style="list-style-type: none"> <li>1. The accounting systems followed by the Central and State Governments are currently based on an elaborate department-specific account codes and rules. For historic reasons and considerations of budgetary control and perceived simplicity and certainty of cash-based system, Governments use the cash-based system of accounting and financial reporting. However, road-map has been suggested for moving on to accrual accounting;</li> <li>2. In order to standardise the codal provisions and move from a rules-based system to standards common to all departments within the Government, the Government Accounting Standards Advisory Board (GASAB) has been set up. The GASAB's objective is to identify the principles underlying various accounting rules, address lacunae, if any, in the present rules and</li> </ol>

	<p>improve the quality of Government accounting practices. The GASAB seeks to promote understandability, reliability, relevance, timeliness, consistency and comparability of Government accounts across departments, authorities and organisations in the Central and State Governments. A Technical Committee has been constituted to examine the various related aspects of public finance and development administration while evolving the Government accounting standards;</p> <p>3. To provide a mechanism for ensuring value for money in public expenditure, an Outcome Budget is being presented to the nation beginning 2005. It provides an operational framework through a set of monitorable indicators, and will become effective from the next fiscal year. Together with the Right to Information Act, it is expected to empower civil society to evaluate the performance through benchmarks of achievement that would emerge from various governance structures across the country.</p> <p>The Comptroller and Auditor General of India (CAG), who is the head of the highest audit institution in public finance derives his duties and powers from the Constitution of India. The CAG is the sole auditor of the accounts of the Central Government and the State Governments. The CAG is also responsible for ensuring a uniform policy of accounting and audit in the Government sector as a whole. The CAG lays down for the guidance of the Government departments, the general principles of Government accounting and the broad principles in regard to audit of receipts and expenditure. The reports of the CAG relating to the accounts of the Union and the States are submitted to the President/Governor of the State for being laid before the Parliament/State Legislature.</p>
<b>Assessment</b>	<b>Not applicable</b>
Comments	For the reasons stated above, the principle has no assessment implication for the Government of India at this stage.

#### Principles for Collective Investment Schemes

Principle 17.	The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
Description	<p>Mutual funds can offer schemes which invest in government securities, subject to the guidelines of the SEBI. Debt funds also hold government securities as part of their portfolio. There are dedicated gilts funds also to meet the needs of investors.</p> <p>SEBI (Mutual Fund) Regulations, 1996 (MF Regulations) set standards for the eligibility and regulation for those who wish to market or launch or operate a MF Scheme. The MF Regulations which lays down legal and regulatory framework for MFs and framework for floating of schemes by which funds of investors are pooled to invest in securities, Exchange Trade funds (ETF), money market instruments, gold or gold related instruments (Gold ETF), Real Estate MF schemes <i>etc.</i> Regulation 7 lays down eligibility criteria for registration of a MF. Regulation 28 lays down procedure for launching of Schemes of MF.</p>



<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	Collective Investment Schemes in nature of Mutual fund schemes are governed by SEBI (Mutual Fund) Regulations, 1996 (MF Regulations) which sets standards for the eligibility and regulation for those who wish to market or launch or operate a MF Scheme. The MF Regulation is separate from SEBI (Collective Investment Scheme) Regulations, 1999. The MF Regulation lays down legal and regulatory framework for MFs and framework for floating of schemes by which funds of investors are pooled to invest in securities, Exchange Trade funds (ETF), money market instruments or gold related instruments (Gold ETF), <i>etc.</i> Regulation 7 lays down eligibility criteria for registration of a MF. Regulation 28 lays down procedure for launching of Schemes of MF.
Principle 18.	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
Description	<p>MF Regulation provides framework governing the legal form and structure of MF and segregation and protection of clients' assets.</p> <p>As per Regulation 2 (q) and 14 of MF regulations, a MF shall be constituted in the form of trust. A Trust deed shall be executed by a sponsor in favour of trustees. Contents of trust deed are also governed by regulations.</p> <p>As per Regulation 2(z) and (zi) MF Regulations, a unit holder holds units, each unit representing one undivided share in the asset of the scheme.</p> <p>Regulation 16(1) and 20(1) of MF Regulations 1996 mandates, <i>inter alia</i>, the appointment of Trustees for protection of interest of unit holders and appointment of Asset Management Company for managing the fund according to the regulations/schemes.</p> <p>As per Regulation 18 (12) of MFs Regulations, trustees are accountable for and shall be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for benefit of unit holders in accordance with regulations and provisions of trust deed.</p> <p>As per Clause 5 of Code of Conduct, Trustees and AMC must ensure scheme-wise segregation of bank accounts and securities accounts.</p> <p>As per Regulation 26 and Clause 10 of Third Schedule, a MF has to appoint a custodian registered with SEBI for safekeeping of asset of schemes.</p>
<b>Assessment</b>	<b>Fully Implemented</b>

Comments	As per Regulation 29(1) of MF Regulations and standard offer document, a MF has to disclose legal form, structure of MF, rights of unit holders as well as investment objective, risk associated with the scheme <i>etc.</i> Custodian in which sponsor of MF or its associate holds more than 50 per cent, cannot be appointed as custodian. No asset management company or its officers can be appointed as trustee. As per Regulation 9 (a) of CIS Regulations, 1999 the regulatory framework mandates that the form and structure of a CIS must be a company registered under Companies Act, 1956.
Principle 19.	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	<p>In the context of mutual fund schemes, as per Regulation 29(1) of the MF Regulations, 1996 the offer document shall contain disclosures which are adequate in order to enable the investor to make informed investment decision. Further, an abridged form of offer document called 'Key Information Memorandum (KIM)' is issued. Terms of disclosures of KIM are prescribed vide Circular IMD/Cir No 10/16521/04 dated July 28, 2004.</p> <p>As per SEBI circular July 28, 2004, Key Information Memorandum (KIM) has to be updated at least once a year and as per SEBI circular SEBI/MFD/CIR/10/039/2001 dated February 9, 2001 offer document shall be fully revised and updated at least once in two years.</p> <p>Further in order to enhance as well as standardise disclosure standards by MFs in their offer documents, SEBI has issued standard observations vide circular dated MFD/CIR/06/275/2001 dated July 9, 2001. Disclosures in offer documents and KIM of schemes need to conform to standard observations.</p> <p>As per Regulation 30, advertisement in respect of a scheme shall be in conformity with advertisement code as specified in Sixth Schedule. As per clause 1 of advertisement code, advertisement shall be truthful, fair and should not contain untrue and misleading information. Further SEBI has prescribed detailed advertising guidelines vide circulars MFD/Cir/4/51/2000 dated 5<sup>th</sup> June 2000 and MFD/CIR/6/12357/03 dated 26<sup>th</sup> June 2003.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	Reg. 26 of CIS Regulation specifies that offer document shall contain true and fair view of scheme and adequate disclosure to enable the investors to make informed decision. The offer document shall contain such information as specified in the sixth schedule.
Principle 20.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
Description	The MF regulation provides proper and disclosed basis for asset valuation and the pricing of units for purchase/redemption of units.

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	<p>As per regulation 46 of MF Regulations, every MF shall compute and carry out valuation of investments in its portfolio in accordance with valuation norms specified in Eighth Schedule and guidelines issued by SEBI.</p> <p>As per Regulation 49(1), the price at which units may be subscribed or sold and the price at which units may be repurchased has to be made available to the investors.</p> <p>Regulations 48 and 49 <i>inter alia</i> lay down provisions for disclosure of NAVs on periodic basis published in newspapers and websites of AMC and AMFI.</p> <p>As per SEBI circular – SEBI/IMD/CIR No.5/96576/2007 dated June 25, 2007, NAV of the scheme shall be displayed on the Association of Mutual Fund of India (AMFI) website by 9 pm of the same day and for funds of fund scheme by 10:00 a.m. of the following day.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	SEBI has issued guidelines for valuation of unlisted, thinly traded, non-traded securities. Net Asset Value (NAV) of the close ended scheme shall be calculated not exceeding one week and open ended scheme on a daily basis. As per Regulation 49(3), the repurchase price shall not be lower than 93 per cent of NAV and sale price not higher than 107 per cent of NAV. The repurchase price of close ended scheme shall not be lower than 95 per cent of NAV. The difference between the repurchase price and sale price of unit shall not exceed 7 per cent calculated on the sale price.

#### Market Intermediaries

Principle 21.	Regulation should provide for minimum entry standards for market intermediaries.
Description	Primary Dealers play the role of market intermediaries in the Indian government securities market. They are required to be authorised to conduct primary dealership business. Stringent entry norms have been prescribed for primary dealership activity. Brokers who operate in the over the counter market are required to register with SEBI and they are governed by SEBI guidelines.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake

Description	Primary Dealers and banks have been prescribed minimum capital requirements. A framework of risk-based capital adequacy system is also in place. This is also certified by the statutory auditors in the audited statements. There is also an elaborate framework of prudential norms and guidelines covering various aspects of functioning of Primary Dealers.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 23.	Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
Description	Primary Dealers are required to have an appropriate management and organisation structure. Primary Dealers are required to put in place adequate internal controls. The Board of Directors of Primary Dealers is expected to lay down the overall policy within which the senior management is expected to operate and report to the Board. Primary Dealers are required to have a system of concurrent audit and a system of internal/management audit to assess the management processes.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 24.	There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.
Description	Although there is no documented plan to address events involving a firm's failure in the Government securities' market, the reporting system for Primary Dealers serves as an early warning system for potential defaults. The clearing and settlement agency maintains a guarantee fund to mitigate counterparty and systemic risks. In addition, regulatory capital adequacy has been prescribed. These measures are expected to address failures. Besides, DVP and guaranteed settlement by CCIL mitigate the impact of failure.
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	Risks underlying the trading/financial position of the PDs could be disclosed to the market with sufficient timelag.

### **The Secondary Market**

Principle 25.	The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight.
Description	Trading of government securities take place mostly on the NDS-OM platform, which is operated by the Reserve Bank.
<b>Assessment</b>	<b>Fully Implemented</b>

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Comments	There are no other independent trading platforms. There are, therefore, no regulations in place for authorisation and regulation of independent trading platforms. Only authorised trading platforms and the stock exchanges can be used for trading in government securities. The responsibility of an ongoing oversight of these platforms rests with the Reserve Bank and SEBI respectively.
Principle 26.	There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
Description	Trades on the NDS-OM trading platform are monitored by the market surveillance team of the Reserve Bank. The trading on exchanges is under the purview of stock exchanges and SEBI.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 27.	Regulation should promote transparency of trading.
Description	The trades are largely order matching and anonymous. All trades on the OTC platform are to be reported on NDS within 15 minutes. The trade data is also disseminated on the Reserve Bank website for the benefit of small investors.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 28.	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	There is a Market Surveillance function within the Reserve Bank to attend to this on an ongoing basis.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	Market Participants are required to put in place credit exposure norms, contingency plans to meet operational breakdowns and market disruptions. Credit risk is greatly removed as the settlement is based on DVP mechanism in a guaranteed mode.

<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.
Description	Robust, guaranteed and DVP based clearing and settlement system using multilateral netting is undertaken through CCIL in respect of all deals in government securities. Reporting of OTC interest rate derivatives is expected to commence soon, which would enhance the systemic stability.
<b>Assessment</b>	<b>Fully Implemented</b>



## Appendix 6

## Detailed Assessment (Principle-by-principle) - Money Market

## Principles Relating to Regulator

Principle 1.	The Responsibilities of the regulator should be clear and objectively stated.
Description	The regulation of money market is entrusted to the Reserve Bank. The authority and responsibilities of the Reserve Bank (RBI) as the regulator of the money market are derived from the provisions of the RBI Act, 1934, Banking Regulation Act 1949 and Securities Contract Regulation Act, 1956 . The amendments made to Securities Contract Regulation Act, 1956 extend the regulatory purview of the Reserve Bank to repos also. The powers of the Reserve Bank are enforceable.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	The RBI Act does not provide for any procedure for appointment of Governor or the governing Board. The terms of office are contractual (as specified in the appointment order). The directors (on the governing Board) excluding the Government official nominated to the Board can be removed only on the grounds stated in the RBI Act or on incurring disqualifications mentioned in the RBI Act (Section 10). The continuance of the Government official on the Board is at the pleasure of the Central Government. The Central Government may remove the Governor or Deputy Governors from service for which no specific grounds are stated in the RBI Act.
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There are statutory requirements as well as established conventions to ensure the independence of the Governor and the members of the Central Board of directors of the Reserve Bank. However, the criteria for removal are not explicit.
Principle 3.	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	The Reserve Bank is legally and administratively equipped to regulate the money market. As a central bank entrusted with regulatory responsibilities also, the Reserve Bank does not face any constraints in funding.

Assessment	<b>Fully Implemented</b>
Comments	
Principle 4	The regulator should adopt clear and consistent regulatory processes.
Description	The Reserve Bank, in its regulatory role, is subject to extensive procedural rules and regulations. The Reserve Bank adopts a consultative approach in policy formulation, by inviting comments from market participants and holding discussions. The Reserve Bank provides elaborate rationale while formulating or amending policy prescriptions.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 5	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.
Description	The professional standards of the Reserve Bank are high by practicing sound Human Resource (HR) policies and practices. The HR policies also preclude conflict of interest in discharge of duties.
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	

#### **Principles of Self- Regulation**

Principle 6.	The regulatory regime should make appropriate use of Self-Regulatory Organisations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.
Description	The money market has the Fixed Income Money Market & Derivatives Association which acts as industry-level representative body. However, it is yet to develop into recognised Self-Regulatory Organisations.
<b>Assessment</b>	<b>Not Applicable</b>
Comments	Currently there is no SRO in money market.
Principle 7.	SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	
<b>Assessment</b>	<b>Not Applicable.</b>
Comments	Not Applicable in view of reply to Principle No.6

#### **Principles for the Enforcement of Securities Regulation**

Principle 8.	The regulator should have comprehensive inspection, investigation and surveillance powers.
Description	The Reserve Bank has the powers to inspect a regulated entity's business operations, including its books and records. The Reserve Bank has powers to call for information from market participants on a regular basis.

## Chapter IV

### Assessment of Adherence to IOSCO Principles

<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 9.	The regulator should have comprehensive enforcement powers.
Description	The Reserve Bank derives its investigative and enforcement powers from the provisions of the RBI Act, 1934 and the Banking Regulation Act, 1949. The Reserve Bank has adequate powers to enforce compliance with regulations.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 10.	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	The regulatory system includes an effective blend of on-site inspection, off-site reporting, investigation and surveillance of the market and regulated entities.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	

#### Principles for Co-operation in Regulation

Principle 11.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	<p>There is no specific statutory provision for sharing of information with domestic and foreign counterparts in case of regulated entities. However, in terms of Section 45NB(3) of the RBI Act, the Reserve Bank can in public interest furnish or communicate any information relating to the conduct of business of any non-banking financial company to any authority constituted under any law.</p> <p>In this regard provisions of the Prevention of Money Laundering Act, 2002 may also be seen especially Section 56 which authorises the Central Government to enter into agreement with Government of any country outside India for enforcing provisions of the Act and for exchange of information for prevention of offence under the Act and for investigation.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There is no formal information sharing mechanism with foreign counterparts.

Principle 12.	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
Description	<p>There is no specific statutory provision for sharing of information with domestic and foreign counterparts in case of regulated entities. However, in terms of Section 45NB(3) of the RBI Act, the Reserve Bank can in public interest furnish or communicate any information relating to the conduct of business of any non-banking financial company to any authority constituted under any law.</p> <p>In this regard provisions of the Prevention of Money Laundering Act, 2002 may also be seen especially Section 56 which authorises the Central Government to enter into agreement with Government of any country outside India for enforcing provisions of the Act and for exchange of information for prevention of offence under the Act and for investigation.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There is no formal information sharing mechanism with foreign counterparts.
Principle 13.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
Description	<p>There is no specific statutory provision for sharing of information with domestic and foreign counterparts in case of regulated entities. However, in terms of Section 45NB(3) of the RBI Act, the Reserve Bank can in public interest furnish or communicate any information relating to the conduct of business of any non-banking financial company to any authority constituted under any law.</p> <p>In this regard provisions of the Prevention of Money Laundering Act, 2002 may also be seen especially Section 56 which authorises the Central Government to enter into agreement with Government of any country outside India for enforcing provisions of the Act and for exchange of information for prevention of offence under the Act and for investigation.</p> <p>There are no express provisions under the RBI Act, 1934 and BR Act, 1949 allowing the Bank to provide assistance to foreign regulators.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	There is no formal mechanism to share such information with foreign counterparts.

### Principles of Issuers

Principle 14.	There should be full, accurate and timely disclosure of financial results and other information which is material to investors' decisions.
Description	Information being disclosed by Money Market participants.
<b>Assessment</b>	<b>Fully Implemented</b>

## Chapter IV

### Assessment of Adherence to IOSCO Principles

Comments	<p>1. In the uncollateralised call, Notice and Term Money Market, the participants are banks and primary dealers which are regulated entities and subject to appropriate disclosure norms.</p> <p>2. In the collateralised CBLO and Market Repo segment, there is a wide variety of participants <i>viz.</i> banks, insurance companies, mutual funds, NBFCs and corporates. Since the transactions are fully collateralised, disclosure norms are not necessary. Even though, the respective organisations being corporates (some are regulated) do have statutory disclosure requirements</p> <p>3. In the case of Commercial Papers, there is a requirement of disclosure of rating of issue while in case of CDs issued by banks, the issuer are regulated and subjected to disclosure norms.</p>
Principle 15.	<p>Holders of securities in a company should be treated in a fair and equitable manner.</p>
Description	<p>The issuer of security in the money market includes the Government (Treasury Bills), banks (CDs and other money market borrowings), Mutual Funds, Insurance Companies, NBFCs and corporates (CPs). The Government is constitutionally mandated to treat all in a fair and equitable manner. Similarly, the legal framework comprising several legislations enjoin the other entities to treat all stakeholders fairly and equitably and the respective regulatory authorities (the Reserve Bank, SEBI, IRDA, CLB) are empowered to enforce this.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 16.	<p>Accounting and auditing standards should be of a high and internationally acceptable quality.</p>
Description	<p>Among the issuers of security in the money market, the Government follows a cash based accounting practice which is an internationally accepted accounting practice for Governments world-wide. The other entities follow comprehensive accounting norms framed by the ICAI, a reputed and recognised accounting body. The ICAI has been continuously striving to map the Indian accounting standards to the international standards and best practices. The accounting norms also enjoy endorsement by respective regulators.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	

## Principles for Collective Investment Schemes

Principle 17.	The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
Description	Collective Investment Schemes in nature of Mutual fund schemes are governed by SEBI (Mutual Fund) Regulations, 1996 (MF Regulations) which set standards for the eligibility and regulation for those who wish to market or launch or operate a MF Scheme. The MF Regulation is separate from SEBI (Collective Investment Scheme) Regulations, 1999. The MF Regulation lays down legal and regulatory framework for MFs and framework for floating of schemes by which funds of investors are pooled to invest in securities, Exchange Trade funds (ETF), money market instruments or gold related instruments (Gold ETF), <i>etc.</i> Regulation 7 lays down eligibility criteria for registration of a MF. Regulation 28 lays down procedure for launching of Schemes of MF.
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	SEBI (Collective Investment Scheme) Regulations 1999 (CIS Regulations) states/ provides that no person other than a Collective Investment Management Company which has obtained a certificate under the regulations can carry on a collective investment scheme. The CIS Regulation lays down legal and regulatory framework for launching and operating CIS schemes which comes under definition of CIS u/s 11AA of SEBI Act which includes agro-bonds, teak bonds, plantation bonds <i>etc.</i> No entity has been registered with SEBI as CIS.
Principle 18.	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
Description	<p>MF Regulation provides framework governing the legal form and structure of MF and segregation and protection of clients assets.</p> <p>As per Regulation 2 (q) and 14 of MF regulations, a MF shall be constituted in the form of trust. A Trust deed shall be executed by a sponsor in favour of trustees. Contents of trust deed are also governed by regulations.</p> <p>As per Regulation 2(z) and (zi) MF Regulations, a unit holder holds units, each unit representing one undivided share in the asset of the scheme.</p> <p>Regulation 16(1) and 20(1) of MF Regulations 1996 mandates, <i>inter alia</i>, the appointment of trustees for protection of interest of unit holders and appointment of Asset Management Company for managing the fund according to the regulations/schemes.</p> <p>As per Regulation 18 (12) of MFs Regulations, trustees are accountable for and shall be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for benefit of unit holders in accordance with regulations and provisions of trust deed.</p> <p>As per Clause 5 of code of conduct, trustees and AMC must ensure scheme-wise segregation of bank accounts and securities accounts.</p>



## Chapter IV

### Assessment of Adherence to IOSCO Principles

	As per Regulation 26 and Clause 10 of Third Schedule, a MF has to appoint a custodian registered with SEBI for safekeeping of asset of schemes.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	As per Regulation 29(1) of MF Regulations and standard offer document, a MF has to disclose legal form, structure of MF, rights of unit holders as well as investment objective, risk associated with the scheme <i>etc.</i> Custodian in which sponsor of MF or its associate holds more than 50 per cent, cannot be appointed as custodian. No asset management company or its officers can be appointed as trustee. As per regulation 9 (a) of CIS Regulations, 1999 the regulatory framework mandates that the form and structure of a CIS must be a company registered under Companies Act, 1956.
Principle 19.	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	<p>In the context of mutual fund schemes, as per Regulation 29(1) of the MF Regulations, 1996 the offer document shall contain disclosures which are adequate in order to enable the investor to make informed investment decision. Further, an abridged form of offer document called 'Key Information Memorandum (KIM)' is issued. Terms of disclosures of KIM are prescribed vide Circular IMD/Cir No 10/16521/04 dated July 28, 2004.</p> <p>As per SEBI circular July 28, 2004, Key Information Memorandum (KIM) has to be updated at least once a year and as per SEBI circular SEBI/MFD/CIR/10/039/2001 dated February 9, 2001 offer document shall be fully revised and updated at least once in two years.</p> <p>Further in order to enhance as well as standardise disclosure standards by MFs in their offer documents, SEBI has issued standard observations vide circular dated MFD/CIR/06/275/2001 dated July 9, 2001. Disclosures in offer documents and KIM of schemes need to confirm to standard observations.</p> <p>As per Regulation 30, advertisement in respect of a scheme shall be in conformity with advertisement code as specified in Sixth Schedule. As per clause 1 of advertisement code, advertisement shall be truthful, fair and should not contain untrue and misleading information. Further SEBI has prescribed detailed advertising guidelines vide circulars MFD/Cir/4/51/2000 dated 5<sup>th</sup> June 2000 and MFD/CIR/6/12357/03 dated 26<sup>th</sup> June 2003.</p>
<b>Assessment</b>	<b>Fully Implemented</b>

Comments	Reg. 26 of CIS Regulation specifies that offer document shall contain true and fair view of scheme and adequate disclosure to enable the investors to make informed decision. The offer document shall contain such information as specified in the sixth schedule.
Principle 20.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
Description	<p>The MF regulation provides proper and disclosed basis for asset valuation and the pricing of units for purchase/redemption of units.</p> <p>As per regulation 46 of MF Regulations, every MF shall compute and carry out valuation of investments in its portfolio in accordance with valuation norms specified in Eighth Schedule and guidelines issued by SEBI.</p> <p>As per regulation 49(1), the price at which units may be subscribed or sold and the price at which units may be repurchased has to be made available to the investors.</p> <p>Regulations 48 and 49 <i>inter alia</i> lay down provisions for disclosure of NAVs on periodic basis published in newspapers and websites of AMC and AMFI.</p> <p>As per SEBI circular – SEBI/IMD/CIR No.5/96576/2007 dated June 25, 2007, NAV of the scheme shall be displayed on the Association of Mutual Fund of India (AMFI) website by 9 pm of the same day and for funds of fund scheme by 10:00 a.m. of the following day.</p>
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	SEBI has issued guidelines for valuation of unlisted, thinly traded, non-traded securities. Net Asset Value (NAV) of the close ended scheme shall be calculated not exceeding one week and open ended scheme on a daily basis. As per regulation 49(3), the repurchase price shall not be lower than 93 per cent of NAV and sale price not higher than 107 per cent of NAV. The repurchase price of close ended scheme shall not be lower than 95 per cent of NAV. The difference between the repurchase price and sale price of unit shall not exceed 7 per cent calculated on the sale price.

### Market Intermediaries

Principle 21.	Regulation should provide for minimum entry standards for market intermediaries.
Description	The Reserve Bank does not authorise any entities to operate as intermediaries in the money market. Though a large part of the money market transaction takes place without intermediaries, three segments <i>viz.</i> commercial paper, certificate of deposit and treasury bills are traded OTC as well as in the exchanges. To the extent that trading takes place in the exchanges, it involves brokers registered with the exchanges.

	<p>As per Section 12 of SEBI Act no market intermediary including broker who may be associated with the securities market shall buy, sell or deal in securities except in accordance with condition of certificate of registration obtained from SEBI. SEBI has made regulations for various intermediaries such as stock broker, share transfer agent, merchant banker, underwriters, portfolio managers, credit rating agencies <i>etc.</i> which lays down registration requirement, minimum entry standards and condition of operating in such activity.</p> <p>As per SEBI (Certification of Associated Persons in Securities Market) Regulations, 2007 notified on October 17, 2007, associate persons are required to obtain/maintain requisite certificate recognised by SEBI for working/operating in securities market. SEBI has set up National Institution of Securities Market (NISM), <i>inter alia</i>, to implement certification programme, to accredit organisations for administering certification examination and conducting Continuing Professional Education programme. NISM will also maintain a register of persons who hold valid certificate.</p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	Each of the intermediary regulations contains a separate chapter on intermediary registration which provides for minimum standard and a comprehensive assessment of application. Regulations provided for elaborate framework for making application for seeking registration as an intermediary, factors to be taken into account for consideration of application, procedure for grant of certificate, condition for grant of certificate <i>etc.</i> These regulations provide eligibility norms for assessment of net worth, capital adequacy, adequate and competent personnel, internal system and procedure, infrastructure <i>etc.</i> The regulations provide that the applicant should be a fit & proper person.
Principle 22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake
Description	<p>The Reserve Bank does not authorise any entities to operate as intermediaries in the money market. Though a large part of the money market transaction takes place without intermediaries, three segments <i>viz.</i>, commercial paper, certificate of deposit and treasury bills are traded OTC as well as in the exchanges. To the extent that trading takes place in the exchanges, it involves brokers registered with the exchanges.</p> <p>The capital adequacy requirement for brokers which are set by SEBI include Base Minimum Capital, Deposit, Trade Guarantee Fund <i>etc.</i> A member of cash segment such as that of BSE has to pay the following :</p>

	<p>v. A deposit of Rs.100,00,000.</p> <p>vi. Base minimum capital Rs.10,00,000.</p> <p>vii. Trade Guarantee Fund Rs.10,00,000.</p> <p>viii. Broker contingency fund Rs.2,50,000.</p> <p>The prudential requirements in respect of brokers include initial margin, exposure margin, mark-to-margin <i>etc.</i></p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	In case of brokers real-time monitoring of capital is done by exchanges.
Principle 23.	Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
Description	<p>The Reserve Bank does not authorise any entities to operate as intermediaries in the money market. Though a large part of the money market transaction takes place without intermediaries, three segments <i>viz.</i> commercial paper, certificate of deposit and treasury bills are traded OTC as well as in the exchanges. To the extent that trading takes place in the exchanges, it involves brokers registered with the exchanges.</p> <p>All the SEBI regulations relating to market intermediaries provide that SEBI while considering the applications for grant of certificate of registration has to take into consideration whether the applicant is a body corporate; whether the principal officer of the applicant has professional qualification or relevant experience <i>etc.</i></p> <p>Market intermediary are required to maintain systems and procedures for redressal of grievance of investors/clients; for segregating each client's funds and securities separately from his own.</p> <p>Each intermediary has to lay down internal systems and procedures for prevention of insider trading by its staff and management to avoid conflict of interest and for Anti Money Laundering (AML) measures. The primary responsibility for compliance with securities regulation lies with the whole firm or intermediary company. Every intermediary is required to appoint a compliance officer (such as Reg.23A of PM Reg.) for monitoring compliance of SEBI Regulation and for redressal of investors' grievance.</p>
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	
Principle 24.	There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.
Description	The reporting system for intermediary serves as an early warning system for potential defaults. In addition, regulatory capital adequacy has been prescribed. Besides, DVP on settlement cycle of T+2 rolling basis and guaranteed settlement by Clearing Corporation mitigate the impact of failure. The clearing and settlement agency of RSE maintains a guarantee fund such as Settlement Guarantee Fund (SGF) to mitigate counterparty and systemic risks.

## Chapter IV

### Assessment of Adherence to IOSCO Principles

	<p>Bye-laws of the stock exchanges contain elaborate provision for dealing with the eventuality of firms' failure or where it is declared as defaulter.</p> <p>SEBI may ask the intermediary to transfer their securities business or assets of client to another intermediary or allow the client to withdraw its fund and assets from such intermediary. As per SEBI regulations all the intermediaries are required to file with SEBI a statement showing financial position after the end of each accounting period and also furnish to the Board half yearly unaudited financial results with a view to monitor the capital adequacy. As regards member of stock exchanges their position and exposure is monitored on-line and in case of any breach, their trading terminal is automatically disabled. Such information is flashed on the website of the exchange.</p>
<b>Assessment</b>	<b>Broadly Implemented</b>
Comments	

#### The Secondary Market

Principle 25.	The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight.
Description	Trading in call, notice and term money market are either OTC or over NDS platforms owned by the Reserve Bank.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	Trading in call, notice and term money market are either OTC or take place on the NDS-CALL platform, which is operated by the Reserve Bank. Though there is no Reserve Bank regulations in place for authorisation and regulation of independent trading platforms, entities interested in establishment of trading system seek permission from the Reserve Bank as a matter of principle. For example, CCIL had sought permission for establishing CBLO trading platform, owned and operated by CCIL.
Principle 26.	There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
Description	Trades on the NDS-CALL trading platform are monitored by the market surveillance team of the Reserve Bank. The trading on exchanges is under the purview of stock exchanges and SEBI.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	

Principle 27.	Regulation should promote transparency of trading.
Description	The trades are largely order matching and anonymous. All trades on the OTC platform are to be reported on NDS within 15 minutes. The trade data is also disseminated on the Reserve Bank website for the benefit of small investors.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 28.	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	There is a Market Surveillance function within the Reserve Bank to attend to this on an ongoing basis for segments of money market in the Reserve Bank's regulatory ambit.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	<p>There are players in money market that can access other markets also; hence cross-market trading may take place. Foreign linkages and cross listings are not there.</p> <p>A High Level Committee on Capital Markets comprising of Governor of the Reserve Bank, Chairman of SEBI and Finance Secretary of the Central Government serves as a forum for discussing common regulatory issues. There is a junior level Technical Committee comprising of representatives from the Reserve Bank &amp; SEBI where matters of operation relevance are discussed. In addition to the above, in the context of supervision of financials conglomerates, the Reserve Bank, SEBI and IRDA are adequately represented/involved and they also hold primary responsibility for supervising specific conglomerates depending upon the predominant/main activity of the conglomerate. These forums are used effectively to discuss common/mutually relevant regulatory issues and for sharing of information. There is also a concept of Integrated System of Alerts. However there is a scope of improvement in this regard.</p>
Principle 29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	Market participants are required to put in place credit exposure norms, contingency plans to meet operational breakdowns and market disruptions. Credit risk is greatly removed as the settlement is based on DVP mechanism in a guaranteed mode. There are no market intermediaries in the market.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.
Description	Robust, guaranteed and DVP based clearing and settlement system using multilateral netting is undertaken for some of the segments of money market.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	



## Appendix 7

## Detailed Assessment (Principle-by-principle) - Foreign Exchange Market

## Principles Relating to Regulator

Principle 1.	The Responsibilities of the regulator should be clear and objectively stated.
Description	The regulation of foreign exchange markets is entrusted to the Reserve Bank. The authority and responsibilities of the Reserve Bank (RBI) as the regulator of the foreign exchange markets are derived from the provisions of the RBI Act, 1934 and the Foreign Exchange Management Act, 1999. The powers of the Reserve Bank are enforceable.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	The Reserve Bank is the sole authority as far as domestic foreign exchange markets are concerned.
Principle 2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	The Reserve Bank has the day-to-day operational freedom to regulate the foreign exchange market without external interference. The Reserve Bank, being a statutory body, is accountable to the Legislature through Parliamentary Committees and the Ministry of Finance.
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	The conditions for removal of the Governor are not spelt out in legislation.
Principle 3.	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	The Reserve Bank is legally and administratively equipped to regulate the foreign exchange market. As a central bank entrusted with regulatory responsibilities also, the Reserve Bank does not face any constraints in funding.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 4	The regulator should adopt clear and consistent regulatory processes.

Description	The Reserve Bank, in its regulatory role, is subject to extensive procedural rules and regulations. The Reserve Bank adopts a consultative approach in policy formulation, by inviting comments from market participants and holding discussions. The Reserve Bank provides elaborate rationale while formulating or amending policy prescriptions.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 5	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.
Description	The professional standards of the Reserve Bank are high by practicing sound Human Resource (HR) policies and practices. The HR policies also preclude conflict of interest in discharge of duties.
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	

#### Principles of Self- Regulation

Principle 6.	The regulatory regime should make appropriate use of Self-Regulatory Organisations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.
Description	The Foreign Exchange Dealers Association of India (FEDAI) acts as industry-level representative SRO. FEDAI frames rules governing the conduct of inter-bank foreign exchange business and liaison with the Reserve Bank for reforms and development of foreign exchange market. They also look after accreditation of brokers in the foreign exchange market. In addition FEDAI also advises/ assists member banks in settling issues in their foreign exchange dealings and also provides training facilities. There is no specific legal framework that governs the activities and oversight of the FEDAI by the Reserve Bank.
<b>Assessment</b>	<b>Not Applicable</b>
Comments	With greater liberalisation of the regulations governing the external transactions and the foreign exchange market operations, the scope of FEDAI's operations has been transformed and it has been focusing more on the current developments and international best practices. For operational matters relating to derivatives, the Reserve Bank consults FIMMDA.
Principle 7.	SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	
<b>Assessment</b>	<b>Not Applicable</b>
Comments	

**Principles for the Enforcement of Securities Regulation**

Principle 8.	The regulator should have comprehensive inspection, investigation and surveillance powers.
Description	The Reserve Bank has the powers to inspect a regulated entity's business operations, including its books and records. The Reserve Bank has powers to call for information from regulated entities on a regular basis.
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	
Principle 9.	The regulator should have comprehensive enforcement powers.
Description	The Reserve Bank derives its investigative and enforcement powers from the provisions of the RBI Act, 1934, the Banking Regulation Act, 1949 and FEMA, 1999. The Reserve Bank has adequate powers to enforce compliance with regulations.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 10.	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	The regulatory system includes an effective blend of on-site inspection, off-site reporting, investigation and surveillance of the market and regulated entities.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	

**Principles for Co-operation in Regulation**

Principle 11.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	The Reserve Bank has the authority to share information on investigation/enforcement with other domestic regulators and authorities. There is no statutory provision enabling such sharing and no formal agreements for the same
<b>Assessment</b>	<b>Partly Implemented.</b>

Comments	The Reserve Bank has the discretion to decide what information it can make available to foreign counterparts.
Principle 12.	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
Description	The Reserve Bank, by administrative practice, may enter into information-sharing agreements with other domestic authorities.
<b>Assessment</b>	<b>Partly Implemented.</b>
Comments	The jurisdiction of the Reserve Bank does not cover substantial cross-border business and the need for information sharing is <i>ad hoc</i> and infrequent.
Principle 13.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
Description	The Reserve Bank may extend informal assistance to foreign regulators who need to make inquiries in the discharge of their functions.
<b>Assessment</b>	<b>Partly Implemented.</b>
Comments	The Reserve Bank does not have a clearly laid out mandate for this function.

#### Principles of Issuers

Principle 14.	There should be full, accurate and timely disclosure of financial results and other information which is material to investors' decisions.
Description	The details of OTC foreign exchange derivative transactions are not publicly available.
<b>Assessment</b>	<b>Not Applicable</b>
Comments	
Principle 15.	Holder of securities in a company should be treated in a fair and equitable manner.
Description	
<b>Assessment</b>	<b>Not Applicable.</b>
Comments	
Principle 16.	Accounting and auditing standards should be of a high and internationally acceptable quality.
Description	
<b>Assessment</b>	<b>Not Applicable.</b>
Comments	

#### Principles for Collective Investment Schemes

Principle 17.	The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
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## Chapter IV

### Assessment of Adherence to IOSCO Principles

Description	
<b>Assessment</b>	<b>Not Applicable.</b>
Comments	
Principle 18.	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
Description	
<b>Assessment</b>	<b>Not Applicable.</b>
Comments	
Principle 19.	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	
<b>Assessment</b>	<b>Not Applicable</b>
Comments	
Principle 20.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
Description	
<b>Assessment</b>	<b>Not applicable.</b>
Comments	

#### Market Intermediaries

Principle 21.	Regulation should provide for minimum entry standards for market intermediaries.
Description	The market intermediaries in foreign exchange business are banks, financial institutions, money changers and brokers. Banks, Financial Institutions and money changers have minimum entry standards prescribed by the Reserve Bank, while foreign exchange brokers have to be accredited by FEDAI, after satisfying eligibility criteria.
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	

Principle 22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake
Description	Banks, Financial Institutions and FFMCS are subject to ongoing capital and other prudential requirements. Fulfilment of these requirements is independently verified during off-site and on-site supervision. As regards, brokers in the foreign exchange market, the eligibility criteria are reviewed annually.
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	
Principle 23.	Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
Description	Code of conduct has been laid down for brokers and authorised persons by FEDAI. In addition, the Reserve Bank has laid down Internal Control Guidelines, suitability & appropriateness Guidelines for ADs when they sell complex derivative products to their customers. Risk management guidelines for authorised persons have been prescribed for foreign exchange business. Comprehensive Guidelines are also in place for FFMCS to conduct money changing business .
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	
Principle 24.	There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.
Description	
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	

### **The Secondary Market**

Principle 25.	The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight.
Description	Any exchange trading currency onshore will be subject to the Reserve Bank regulation. Trading systems which are linked to payments and settlements are regulated by the Reserve Bank under the Payment & Settlement Systems Act, 2007. The trading systems used in foreign exchange markets are in the nature of broking systems and are authorised by FEDAI. Thus, trading systems are subject to the Reserve Bank regulation/ FEDAI accreditation.
<b>Assessment</b>	<b>Fully Implemented.</b>



## Chapter IV

### Assessment of Adherence to IOSCO Principles

Comments	Trading systems are approved by FEDAI, since these are in the nature of electronic broking systems.
Principle 26.	There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
Description	There are no exchanges trading in foreign currency as on date. The trading systems used are proprietary and only serve as electronic communication and order matching platforms. CCIL, the central counterparty for spot trades among banks is regulated and supervised by the Reserve Bank.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 27.	Regulation should promote transparency of trading.
Description	Foreign exchange market is fairly transparent. and spreads are small. With the advent of electronic trading systems there is greater transparency.
<b>Assessment</b>	<b>Fully Implemented</b>
Comments	
Principle 28.	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	FEDAI also plays an active role in framing regulations.
<b>Assessment</b>	<b>Partly Implemented</b>
Comments	
Principle 29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	Banking regulation has laid down appropriate safeguards in the form of exposure norms, prudential guidelines, capital adequacy <i>etc.</i>
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	
Principle 30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.
Description	The Reserve Bank has full powers to regulate payment and settlement systems in the country.
<b>Assessment</b>	<b>Fully Implemented.</b>
Comments	

## Annex 1

**Comments of Peer Reviewer Mr. Shane Tregillis,  
Deputy Managing Director, Monetary Authority of Singapore  
and Stance of the Advisory Panel**

Monetary Authority of Singapore  
10 Shenton Way MAS Building Singapore 079117 Telephone 656225 5577 Facsimile  
6562299229

*Confidential comments by Shane Tregillis on the Draft Report on the Assessment of IOSCO Principles. These comments are based on a review of the Draft Assessment Report attached to the letter of 31 March 2008. These comments are made in my personal capacity.*

CONFIDENTIAL  
Deputy Managing Director

30 April 2008

Mr. K Kanagasabapathy  
Secretary (Committee on Financial Sector Assessment)  
Reserve Bank of India  
Monetary Policy Department  
Central Office Building  
Shahid Bhagat Singh Marg, P.B. No 406  
Mumbai 400 001  
India

Dear Mr. Kanagasabapathy

I set out in the Annexure my comments on the Draft Report on the Assessment of IOSCO Principles ('Draft Assessment Report').

I would like to compliment the Review Team on the quality of the Draft Assessment Report. It is clear that much effort has gone into providing detailed responses for each of the IOSCO Principles across the different securities markets. To provide some context for my comments on the assessments of the individual IOSCO Principles, I outline below the approach that I have adopted in the conduct of this review. I have followed the approach set out in the Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation ("IOSCO Assessment Methodology"). The IOSCO Assessment Methodology sets out the IOSCO Principles, key assessment issues and a list of key questions for the assessor to address. It also contains scoring benchmarks and provides important guidance notes on how an assessor should approach various assessment issues. Based on the practical experience of undertaking assessments in many jurisdictions, the IOSCO Implementation Task Force (ITF) has refined the methodology in recent years. The aim is to ensure consistency in self-assessments, peer reviews and external assessments of the IOSCO Principles.

In reviewing the Draft Assessment Report I sought to check the response provided against each of the key questions in the IOSCO Assessment Methodology. In my comments, I have noted, as far as practicable, any gaps in responses to these key questions. I accept that this may often not

## Chapter IV

### Assessment of Adherence to IOSCO Principles

necessarily suggest the regulatory regime is deficient in addressing the specific question. Another explanation may be that the information is available but has not been included in the Draft Assessment Report. I leave to the Review Team to consider whether it needs to adjust the overall rating for the relevant principle based on the IOSCO benchmark.

As a general suggestion on presentation, you might want to consider showing more clearly how each key question in the IOSCO Assessment Methodology has been addressed for the purposes of arriving at an overall rating for each of the IOSCO Principles.

This would then also make the approach adopted for the self-assessment more clearly consistent with the recently revised IOSCO Assessment Methodology. This is also what would be expected of an external assessor under the revised approach to assessment using the latest version of the IOSCO Assessment Methodology. IOSCO has made available an on-line electronic version of the Assessment Methodology. This is a useful tool for undertaking self-assessments by a jurisdiction.

My review has also been carried out based on the documents provided to me and occasionally other publicly available information. This brings with it the usual caveats and limitations. In an external assessment a review of the documents provides only the starting point for an exercise involving extensive discussions and further testing of information designed to assess the effectiveness of what happens in a jurisdiction. The Indian economy and markets are large, diverse and complex. Along with the range of issues covered under the IOSCO Principles, this makes any assessment of the Indian regulatory framework for securities markets a daunting task. My comments on the Draft Assessment Report should be read subject to these important caveats and limitations.

Finally, where I have not correctly understood or made any errors in characterising either the responses in the Draft Assessment Report or in properly understanding how the Indian securities regulatory regime works in practice, please accept in advance my sincere apologies. I would be happy to correct any such misunderstandings that may be contained in this document based on any further clarifications that may be provided. I have provided these comments in my personal capacity. Accordingly, they are not the views of the Monetary Authority of Singapore. I hope these comments on the Draft Assessment Report are helpful. I would be happy to clarify on any issue.

Yours sincerely  
SHANE TREGILLIS  
DEPUTY MANAGING DIRECTOR  
MARKET CONDUCT GROUP

**Comments of Peer Reviewer Mr. Shane Tregillis,  
Deputy Managing Director, Monetary Authority of Singapore  
and Stance of the Advisory Panel**

**30 April 2008**

**Principles Relating to the Regulator (Principles 1-5)**

**Principle 1 The responsibilities of the regulator should be clear and objectively stated**

1 Most elements of this principle are addressed. However, I note the earlier 2001 **FSAP** report highlights some confusion over the respective jurisdictional responsibilities between SEBI and the Department of Companies Affairs. Since this time there have been enhancements to the regulation of companies involved in capital market offering or other capital market activities. SEBI also has powers of inspection under s209A of the Companies Act in relation to listed companies (p.21 Draft Assessment Report).

This has been appropriately incorporated in Chapter VI of the report under the head regulatory and supervisory mechanism as also Appendix 4 under principle 1.

2 While the inter-relationships and respective jurisdiction of the Reserve Bank and SEBI are set out at pp 25-34 of the Draft Assessment Report for listed government securities, related derivatives and money market instruments, no similar explanation is provided for the respective jurisdiction of SEBI and the DCA for the regulation of listed companies and their capital market activities. Therefore, while it is clear that for Principle 1, Question 1 has been answered, it is more difficult to assess whether Questions 2 (a), (b) and 3(a) and 3(b) have been fully addressed. A fully implemented score requires affirmative responses to all elements for all three questions.

***Stance of the Panel: Accepted. This has been appropriately covered in Appendix 4 under principle 1. Further, the principle has been downgraded from fully implemented to broadly implemented.***

**Principle 2 The regulator should be operationally independent and accountable in the exercise of its powers and functions.**

3 Most elements of the key questions have been addressed in the draft responses. I would, however, note two potential issues relating to Question 2(a) and Question 5 of the IOSCO Assessment Methodology. For Question 2(a), the SEBI Act in s16 (1) provides power for the CG to issue directions to SEBI in writing on questions of policy. The section also provides for the opportunity, as far as practicable, for SEBI to provide its views before any such direction is given. This is consistent with the IOSCO Principle. However, where some ambiguity arises is in the wording in Section 16 (2) which provides that a decision of the CG **whether a question is one of policy or not shall be final**. This could be read to mean that the CG could make decisions on day-to-day regulatory or enforcement matters rather than only on overall policy matters.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 2.***

4 Question 5 of the IOSCO Assessment Methodology refers to mechanisms to protect the independence of the regulator. Section 6 of the SEBI Act sets out the procedures for removal of the Chairman or member for cause. However, under the SEBI Act s5(2) the CG has the right to

terminate the services of the Chairman or member by giving notice of not less than 3 months or 3 months salary in lieu. Best practice would be for the appointment as Chair or member of the Regulator to be for a fixed term where they would only be able to be removed for cause under the procedures set out in Section 6. The current wording of the SEBI Act s 5(2) seems to suggest that the SEBI Chairman or members could be subject to removal for reasons other than cause.

***Stance of the Panel: Accepted. This has been appropriately covered in Appendix 4 under principle 2.***

**Principle 3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.**

5 In general most of the key questions seem to be addressed. I note that it is always a **challenge** to assess whether a regulator has adequate resources relative to the scope of its responsibilities and size of its markets. This is especially challenging given the size of India and its capital markets.

***Stance of the Panel: General observation. No comments.***

6 I am not able to assess this based only on a review of the documents without some other benchmarking information. I also note that Question 4 on whether staff receives enough training has not been directly addressed in the Draft Assessment Report. It would be useful to more clearly set out the nature and extent of training provided to SEBI staff. Again this is a continuing challenge for many regulators given limited resources and dynamically evolving capital markets. However, as some recent reports in other jurisdictions indicate, this remains a critical issue for all regulators.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 3.***

**Principle 4 The regulator should adopt clear and consistent regulatory processes.**

7 In general most of the areas seem to be addressed in the various legislative, policy and procedural safeguards. Question 4 relating to procedures for making reports available is not directly addressed. But I infer from the other responses that it should be covered. It might be useful to address this aspect directly.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 4.***

8 Question 5 asks whether the regulator plays an active role in promoting education for protecting investors. It might be useful to set out some details of the approach adopted and activities undertaken for education of investors in the Draft Assessment Report to address Question 5 of the IOSCO Assessment Methodology.

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 5.*

**Principle 5 The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.**

**9 The Draft** Assessment Report provides details of the various legislation and regulations that govern staff conduct in areas required by Question 1 and Question 2 of the IOSCO Assessment Methodology. I consider it would be useful to supplement this information with details of whether there are any internal guides and procedures, how these issues are dealt with in the training and induction process for SEBI Staff and how these requirements are monitored. For example, in relation to trading restrictions are declarations of trading activity required of SEBI staff or other processes in place in SEBI? Is there any process of audit or other follow up to ensure the requirements and procedures set out in the various rules and regulations are actively reinforced and monitored?

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 5.*

**Principles Relating to Self Regulation (Principles 6-7)**

10 The Act and SRO Regulations provide clear authority for the oversight of any SROs. The Draft Assessment Report notes that while these powers exist, there are currently no self-regulatory organisations approved under the regulation other than the RSEs. Accordingly, I agree the two principles do not technically apply.

*Stance of the Panel: No comments*

**Principles Relating to Enforcement (Principles 8-10)**

**Principle 8 The Regulator should have comprehensive inspection, investigation and surveillance powers.**

11 The Draft Assessment Report sets out the broad general powers that SEBI has in these areas. However, questions 4, 5, 6 and 7 of the IOSCO Assessment Methodology for this Principle are not explicitly addressed in the Draft Assessment Report responses. These questions go to the issues of record keeping, tracing of funds and securities, AML, ability to determine access to the identity of all customers and powers when a regulator out-sources inspection to a third party. It would be useful if the Draft Assessment Report could provide details of current powers and requirements for these specific issues under each of the questions for this Principle as set out in the IOSCO Assessment Methodology

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 8.*

**Principle 9 The Regulator should have comprehensive enforcement powers.**

**12 The** Draft Assessment Report sets out the various enforcement powers of the regulator. In the Explanatory Note to this Principle in the IOSCO Assessment Methodology, it is made clear that part of the assessment of sufficiency of the powers may depend on the ability to demonstrate that they are exercised effectively. This is difficult to assess based only on the documents provided. I note the 2007 SEBI Annual Report provides details of the various forms of enforcement and regulatory action commenced and taken.



***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 9.***

13 Based on the 2007 SEBI Annual Report, one issue that arises on the effectiveness of enforcement is that, while the total number of Prosecution Cases until 31 March 2007 was 1026 involving some 5,044 entities or persons, only 24 of these cases have been decided by the Courts. (See tables 3.22, 3.23, 3.24 and 3.25 SEBI Annual Report 2007). While outside the direct control of the regulators, this would seem to raise some questions on the overall effectiveness of enforcement efforts in acting as an effective deterrent.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 9.***

**Principle 10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.**

14 The Draft Assessment Report sets out the approach to inspection and surveillance. Further specifics are set out in the SEBI Annual Report. The 2007 SEBI Annual Report notes that under the revised SEBI inspection policy, SEBI conducts risk-based inspection and does not normally conduct routine inspections of stockbrokers, sub-brokers and DPs. These are left to Stock Exchanges and Depositories, and SEBI oversees the quality of these inspections. The move to a risk-based approach is in line with trends in many other jurisdictions.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 10.***

15 As the Explanatory Note in the IOSCO Assessment Methodology set out, further information would be required on the overall approach to both risk-based supervision and methods by which SEBI satisfies itself that the exchanges and DPs have an effective on-site compliance program in place. This would involve looking at the inspection cycles, coverage, factors that are included in the risk assessment methodology, numbers of on-site inspections conducted by exchanges and number and nature of remedial actions taken. The large numbers of brokers (some 9,335) and even larger number of sub-brokers (27,541) clearly make this a challenging task.

16 The small percentage of matters where the courts have reached a judgment would also need to be taken into account in assessing the effectiveness of enforcement in response to Question 11 for this Principle.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 10.***

**Principles Relating to Regulatory Co-operation (Principles 11-13)**

17 SEBI is a signatory to the IOSCO Multilateral MOU (IOSCO MMOU) which means it has met the preconditions for sharing enforcement related information under strict confidentiality conditions. The Draft response points out that under the SEBI Act section 1 (2) (la) SEBI has broad powers to share information both domestically and with overseas counterparts.

***Stance of the Panel: The point has been specifically added in the report***

18 The IOSCO methodology sets out some specific questions on the types of information, pre-conditions and assistance to foreign regulators. While the answers in the draft suggests these would all addressed under the current regime, a formal external assessment would need to have specific information on each question before the assessment category would be determined.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 12.***

#### **Principles Relating to Issuers (Principles 14-16)**

##### **Principle 14 There should be full, timely and accurate disclosure of financial information results and other information that is material to the investors' decisions**

19 Detailed disclosure requirements are set out in the Listing Agreement and SEBI (Disclosure and Investor Protection) Guidelines 2000 (DIP Guidelines). Given the DIP Guidelines set out these substantive requirements, one issue that arises is the extent to which as Guidelines they fall within SEBI's investigation and enforcement powers discussed in earlier sections. The issue of enforceability of Guidelines was also noted in the 2001 FSAP report

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 14.***

##### **Principle 15 Holders of securities in a company should be treated in fair and equitable manner.**

20 One issue is whether current requirements provide sufficient protection for minority shareholders in interested party transactions. In many jurisdictions, there are requirements for certain interested person transactions to be put to a vote by shareholders and importantly, for the interested parties to be excluded from those eligible to vote on such matters. As far as I can ascertain, there do not seem to be any similar requirements in the Listing Agreement or SEBI Regulations for approval of material interested party transactions for listed companies.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 15.***

21 The Draft report deals at high-level with the requirements in the IOSCO Assessment Methodology relating to Question 1 and 2- Rights of Shareholders, Question 3- Change of Control transactions, Question 4- Substantial Shareholdings, Question 5- Holdings by Directors and Senior Management and Question 6 -Cross Border Issues. I am aware that many of these issues are covered in the Indian Companies Act and other SEBI regulations and guidelines, but it might be useful for completeness of the self-assessment exercise if the specific questions relating to this Principle in the IOSCO Assessment Methodology were also directly addressed.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 15.***

##### **Principle 16 Accounting and auditing standards should be of high and internationally acceptable quality.**

22 The Draft Assessment Report sets out the requirements and responsibilities for use of and setting of accounting and auditing standards. The IOSCO Assessment Methodology in Question 10 for this Principle seeks information on whether there an adequate mechanism for enforcing compliance with accounting standards and auditor and auditor independence standards. This is reinforced in the discussion in the Explanatory Notes. The Draft Assessment Report does not explicitly discuss how enforcement of these standards occurs and how effective it has been in terms of the number and nature of actions taken to seek rectification or restatement of accounts.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 16.***

#### **Principles Relating to Collective Investment Schemes (Principles 17-20)**

23 The IOSCO Assessment Methodology in Question 1 for Principle 17 refers to standards for those who **market or distribute** a CIS. While operators are covered under the SEBI Regulations, it would appear that market intermediaries involved in marketing of MF schemes do not require a license from the regulator.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 17.***

24 The 2001 FSAP report noted that UTI was not covered by the SEBI regulations for CIS and MF as it is under its own Act of Parliament. While SEBI oversees all the investment schemes launched by UTI since 1994, these seem to be still outside the formal legal framework administered by the Regulator. In particular, the previous 2001 report noted that the UTI does not have a disclosed basis for asset valuation or the pricing of units. In order to assess whether the relevant benchmarking against the IOSCO Principles have been met, it would be important to set out whether these issues have been remedied.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 17.***

25 For Principle 17, Questions 5-19 deal with supervision and ongoing monitoring, conflicts of interests and delegation requirements. The SEBI (Mutual Funds) Regulations, 1996 and guidelines provide, along with other reporting and information requirements, for bi-monthly compliance reports, copies of advertisements to be provided 7 days in advance and Trustees of the MF are required to submit each half year a compliance report. In addition Regulation 61 allows SEBI to appoint a person to inspect the affairs of the mutual fund, the trustees and asset management company. Regulation 66 enables SEBI to appoint an auditor to inspect the books and affairs of these same entities.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 17.***

26 However, the Draft does not provide details of the actual conduct of the on-site inspection regime for Mutual Fund companies and how this fits into SEBI's current risk based approach to supervision. For example, what is the on-site inspection cycle for such entities and how is this determined? Some further information is given in SEBI's 2007 Annual Report (p 95) where it sets out that 9 warning letters were issued to 7 mutual funds during 2006-2007 of which 5 were warnings for violating the advertising code. 3 deficiency letters were issued based on inspection reports for the period July 2003 to June 2005. I consider that any external assessment against these IOSCO Principles for CIS would need to review further information on the details of the inspection regime in order to be able assess the benchmarking for this Principle.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 17.***

27 The Draft Assessment Report does not address the question of conflicts of interests (Principle 17 Questions 12-17 IOSCO Assessment Methodology). However, I am aware there are measures in the SEBI (Mutual Funds) Regulations, 1996 that address investments in associated companies, requirements for disclosure of related party investments, limits on investing in related party unlisted securities or those issued by private placement, limit to 5 per cent total transactions by a broking entity associated with the sponsor. These regulations also impose limits on associate directors constituting more than 50 per cent of the Board of Directors of the AMC and not more than one-third of the Board of the Trustees/Trustee Company. It might be useful if these details were set out in response to each of the relevant questions in the IOSCO Assessment Methodology.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 17.***

#### **Principles Relating to Market Intermediaries (Principles 21-24)**

##### **Principles Relating to Secondary Markets (Principles 25-29)**

28 The Draft identifies a number of areas for improvement in relation to the Principles for Market Intermediaries. The effectiveness of the Regulator's supervision of intermediaries would be key part of any external assessment. For example, in assessing Principle 23, the Explanatory Notes in the IOSCO Assessment Methodology makes it clear that in evaluating Questions 5, 6 and 8 through 13 the assessor should consider whether there is evidence the regulator has programs to aim to ensure the intermediary observes these requirements in practice. An external assessor would want to see information on intensity of on-site inspections, inspection cycles for different types of entities, nature of follow up remedial or other activity to properly assess whether these Principles have been met.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 23.***

29 Similar issues arise for the Principles Relating to Secondary Markets, in particular Principle 26, Question 1 (a) and (b). Footnote 368 in the IOSCO Assessment Methodology states that information on oversight of exchanges can be provided through formal mechanisms, such as written reports and inspections, or through informal mechanisms such as regular meetings. Increasingly, many jurisdictions have moved to a more formal process of on-site review or audit of their exchanges to assess compliance with their obligations as an exchange and, where the

exchange also has SRO functions, how well these SRO functions are being performed in accordance with relevant standards for self-regulatory organisations.

**Principle 30 Systems for clearing and settlement for securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.**

30 As set out in the IOSCO Assessment Methodology, a full assessment of Principle 30 should be made using the CPSS/IOSCO methodology for Recommendations for Securities Settlement Systems, November 2002 and Recommendations for Central Counterparties, November 2004. These reports contain the key recommendations, key questions and relevant assessment benchmarks. The Reserve Bank and SEBI were both members and actively contributed to the IOSCO/CPSS Taskforce that developed these recommendations

***Stance of the Panel: This has been separately addressed by Panel on Institutions and Market Structure which assessed payment and settlements system.***

31 The importance of doing such an assessment against the recommendations in these reports is further highlighted in the recommendation on Transparency in both reports. This sets out the clear expectation that the operator of a securities settlement system or central counterparty and relevant authorities should complete a self-assessment against these recommendations and publicly disclose the answers. Therefore, an external assessor would look to detailed responses and benchmarking against the recommendations in these two CPSS/IOSCO Reports when assessing IOSCO Principle 30.

***Stance of the Panel: This has been separately addressed by Panel on Institutions and Market Structure which assessed payment and settlements system.***

## Annex 2

**Comments of Peer Reviewer Mr. Ranjit Ajit Singh,  
Office of Managing Director, Securities Commission of Malaysia  
and Stance of the Advisory Panel**

**Office of the Managing Director**

11 June 2008

Mr. K. Kanagasabapathy  
Secretary (Committee on Financial Sector Assessment)  
Reserve Bank of India  
Monetary Policy Department  
Central Office Building  
Shahid Bhagat Singh Marg P.B. No 406  
Mumbai 400 001  
India

Dear Mr. Kanagasapathy

I am pleased to enclose my comments on India's Draft Report on the Assessment of IOSCO Principles of Securities Regulation. The comments include a preamble that explains the approach I took in conducting the peer review of the assessment.

I hope the comments provided are helpful. Please contact me if you wish to clarify any issues further.

Yours sincerely



#### *General comments*

I have approached the peer review exercise from a third party perspective, highlighting potential gaps and weaknesses that an assessor may identify in conducting an independent third-party assessment. In arriving at my conclusions, I reviewed the responses against each of the key questions in the IOSCO Assessment Methodology.

The review is based on the draft assessment report, and the responses to the key questions. I note that the responses provided make numerous references to legislations, guidelines, rules and other supporting material in order to support its statements. Without having the benefit of reviewing these supporting materials, it would be difficult to conduct a thorough review as to whether the Principles are met in substance. The comments provided below are therefore broad-based and make certain assumptions.

As a securities regulator in charge of regulating the capital market, I have also focused my comments on the equities and corporate bond markets, and its compliance with the IOSCO principles.

As a general comment, while the responses highlight the powers contained in India's regulations and laws, I would recommend for the report to include detailed explanations on how these powers are implemented. In conducting an assessment, the assessor will not only require the laws to be listed, but the ability of the regulator to demonstrate the effectiveness of the implementation of the laws.

Additionally, a general observation I would like to make is that some of the responses may require further elaboration and clarification in order to further consolidate the assessment.

Finally, I would like to commend SEBI and Reserve Bank on its efforts in preparing a candid assessment of the Indian financial market, and for identifying relevant areas for improvement in the overall regulatory framework. While the report highlights weaknesses in the regulatory framework, it would be useful to perhaps also identify initiatives being taken to address these gaps.

**Principle 1 The responsibilities of the regulator should be clear and objectively stated**

While the responsibilities of the Reserve Bank, SEBI, DCA and MoCA are clearly segregated, SEBI may wish to explain if there are areas of gaps/overlaps with regards to supervision/enforcement of regulation between the different organisations. For example, have there been areas in the corporate bond market and listed companies where there may be gaps and overlaps between the relevant authorities?

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 1. Principle downgraded to Broadly Implemented.*

**Principle 2 The regulator should be operationally independent and accountable in the exercise of its functions and powers.**

A possible issue that may be raised is while SEBI is operationally independent, the assessment will examine issues relating to, for example, whether there is retention of certain powers by the Central Government, whether there is discretionary appointment and termination of its Chairman/members of the Board.

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 2. Principle downgraded to Broadly Implemented.*

**Principle 3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.**

It would seem that there are adequate provisions in place to ensure that the powers and responsibilities of the regulator are commensurate with the nature of the markets it oversees. However, one issue that arises, particularly in the context of a market like India which has a large number of intermediaries, listed companies and RSEs, as well as a growing and complex product segment, is the challenge of effective regulation and supervision. It is not clear from the review how this issue is being addressed, and whether the remuneration and compensation package and the attrition rate has an impact on the adequacy of the regulator's resources, skills and expertise to effectively discharge its functions.

While I note that SEBI ensures that its staff receives ongoing training, it would be useful to elaborate further on the training programmes, industry secondments and any other measures that would help address the issue of skilled resources.

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 3.*

**Principle 4 The regulator should adopt clear and consistent regulatory processes**

It would seem that in most instances the key requirements to meet the Principle are covered. It would however be useful to provide some elaboration on the specific consultation mechanism in place, and whether there is a formal exposure mechanism for policy and rulemaking efforts.

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 4.*

**Principle 5 The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.**

It would be important to effectively demonstrate here, in addition to what has been provided, that there are relevant codes of conduct, confidentiality provisions and disciplinary mechanisms

in place that have been shown to be effective in ensuring that the standards exercised by the regulator are of the highest professional standards, and the integrity of the regulator is beyond reproach. This is an area where feedback on views and perceptions in the market, if available, for example from surveys that are conducted by the authorities, would provide a useful assessment on how external stakeholders perceive the prevailing standards in the authority.

Additionally, in relation to Question 1(a), while areas of potential conflict highlighted include trading in securities or acceptance of gifts, it is useful to highlight whether there are any general conflict rules relating to investigation or submission for licensing application by family members *etc.*

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 5.***

**Principle 6 The regulatory regime should make appropriate use of Self-Regulatory Organisations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.**

The SEBI Act provides for promotion and regulation of self-regulated organisations (SROs) (i.e. stock exchanges), and at present, there are no other recognised SROs. It may however be useful to examine in greater detail the role and functions played by some of the industry associations, and whether any of these entities are exercising quasi-SRO type responsibilities, and if so, whether sufficient oversight is being conducted by the regulator over these entities, as required under Principle 7.

I note also from publicly available information that the Association of Mutual Funds of India (AMFI) provides certification and registration of its mutual fund advisers – which may require it to be treated as an SRO under Principle 6, and therefore assessed under Principle 7 (see definition of SRO under Principle 6 – *i.e.* organisations that establish rules of eligibility *etc.*). It is useful for SEBI to highlight the level of oversight it exercises over this entity in respect of its certification and registration functions.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 6.***

**Principle 7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.**

I note that for the purposes of assessment under Principle 7, 19 RSEs and 2 Depositories have been assessed as SROs as they establish rules of eligibility, establish and enforce binding rules of trading/business conduct and establish disciplinary rules. The responses to certain questions (for example, Question 2(c) in terms of the ability of regulators to take over SRO responsibilities under certain circumstances and Question 3(a) on professional standards) relates to RSEs only.

Providing a response relating to SROs and Depositories in these areas will help clarify the overall position. Additionally, from the responses provided, it would appear that there is also less oversight exercised by SEBI over the Depository. For example, while it states that SEBI can conduct inspection over the Depository or appoint an auditor to conduct inspection, it is not apparent from the response whether inspections are in fact conducted.

While it is also highlighted that SEBI conducts periodic inspections of RSEs, it would be useful to elaborate on how often these inspections are conducted, and what is the focus of the inspections? In particular, the degree to which market operators effectively discharge their responsibilities in ensuring integrity in secondary markets ought to be assessed closely by the regulator.

I note also that SEBI has introduced draft regulations that make membership of an SRO mandatory to act as investment advisers. What is the entity that has been identified as an SRO, and are there checks and balances in place to enable it to perform the functions of an SRO?

I note that on standards of confidentiality, there is a Code of Conduct for staff of RSE. It would be useful to highlight how the Code of Conduct is enforced by the RSEs. This may be of particular significance in situations where the employees of the exchange are allowed to deal in securities.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 7.***

**Principle 8 The regulator should have comprehensive inspection, investigation and surveillance powers.**

I note that SEBI has powers to inspect, conduct enquiries, and obtain records. On Question 7(d), however, it is not clear the source of requirement for external inspectors to maintain confidentiality i.e. whether through regulations, SEBI directive, etc

I note that outsourcing of inspections is given to auditors. It is important to have clear pre-requisites for how the inspections are to be conducted, and the inspections are subject to specific guidance from SEBI.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 8.***

**Principle 9 The regulator should have comprehensive enforcement powers.**

I note that the absence of specific provisions for private person to seek remedies for misconduct relating to securities has led to the assessment of this principle to be assessed as Broadly Implemented. It would, however, be useful to highlight whether there are initiatives undertaken by SEBI to address this gap.

It is unclear what is meant by the response in Question 2(a) that SEBI needs to take approval of the Judicial Magistrate for attaching bank accounts and for seizure of documents.

Clarification to these comments would further consolidate the overall assessment.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 9.***

**Principle 10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective**

#### **compliance programme.**

It would seem from the responses provided that the main pre-requisites required to meet the section on enforcement are in place. However, as noted in my general comments and applicable to these types of Principles, further examples or details of enforcement action taken in respect of market manipulation, insider trading and other market misconduct would strengthen the final evaluation of the Principles.

The Principle provides that it is insufficient for a regulator to simply have the statutory powers identified in the Principles, but that it must demonstrate that it is able to detect suspected breaches of the law in an effective and timely manner, gather relevant information necessary for investigating potential breaches and be able to use such information to take action where a breach of the law has been identified.

In addition, while the assessment report does not discuss the relative advantages and disadvantages to various approaches to supervision, further details on the risk assessment and principles used in the conduct of supervision over the Indian market would be helpful. It would also be useful to highlight the manner in which inspections are carried out, the numbers of inspections conducted relative to the total number of intermediaries in the market, and the types of sanctions imposed against the relevant players.

On the issue of surveillance, it would be useful to highlight what are the types and extent of surveillance conducted for bond markets. Furthermore, are all relevant information to carry out surveillance functions effectively available for the equity, bond and derivatives markets? Are there inter-market surveillance mechanisms in place to address unusual market activity?

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 10. Assessment downgraded to Broadly Implemented.***

#### **Principle 11 The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.**

It would appear rather unusual that the Central Government's consent is required before entering into an MoU, while SEBI does not require the Central Government's approval to frame legislation *etc* (refer to Principle 2). It would be helpful for SEBI to clarify whether the former is a requirement of the law or a matter of practice.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 11.***

#### **Principle 12 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.**

While SEBI has entered into a number of bilateral MoUs and is also a signatory to the IOSCO Multilateral MoU, it would be useful for SEBI to share how many requests it has received and complied with in the past 2-3 years in order to demonstrate that it does in practice, share information when it is requested by another foreign authority.

I also note that SEBI can request for information from domestic authorities for securities transactions that are under investigation or inquiry without a formal information sharing agreement. It would be useful to share how effectively domestic agencies co-operate.

***Stance of the Panel: Accepted. It has been appropriately incorporated in the report.***

**Principle 13 The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.**

I note that the *Partly Implemented* rating is due to the inability of SEBI to offer effective and timely assistance to foreign regulators in obtaining court orders. It would be useful to know whether there are initiatives undertaken by SEBI to address this gap.

***Stance of the Panel: Accepted. It has been appropriately incorporated in the report.***

**Principle 14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.**

In respect of the response to Question 2(a), it would be difficult to comment on whether this question is met without having reference to the Listing Agreement and Code of Corporate Disclosure under Insider Trading Regulations. SEBI may wish to elaborate on the timing imposed on listed companies to notify the RSE/public of material events.

In terms of cross-border issuers, SEBI may wish to address the question whether disclosure requirements for issue of IDRs are consistent with *IOSCO's International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 14.***

**Principle 15 Holders of securities in a company should be treated in a fair and equitable manner.**

The issue of treatment of minority shareholders, and whether their interests are protected are areas that will be scrutinised closely by an assessor, including potentially disparate treatment of majority and minority shareholders, or takeover bids and other change in control transactions where shareholders' rights are affected. In particular, there may be an assessment on the effectiveness of the regulatory systems, processes and institutions in allowing minority shareholders to assert their rights against the majority shareholders and against the company.

Given that the enforcement of provisions affecting companies and shareholders falls under the purview of the Ministry of Corporate Affairs (MoCA), there may be a need to highlight whether co-operative arrangements have been established between SEBI and MoCA, and the effectiveness of MoCA in enforcing provisions of the Companies Act.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 15.***



**Principle 16 Accounting and auditing standards should be of a high and internationally acceptable quality.**

Clarification to the following comments would further consolidate the overall assessment:

- I note SEBI mentions that the Indian accounting standards are of high and internationally acceptable quality. It would be useful to elaborate whether they are convergent with International Accounting Standards. In addition, how are issues of interpretations handled – are there instances of divergence in practice, and does the regulator have authority to allow waiver from compliance? If so, under what circumstances can such waivers take place?
- It would be useful to elaborate how accounting standards are established in India, and how robust is this process in terms of ensuring that there is no undue influence by one particular interest group.
- What are the mechanisms for ensuring compliance with accounting standards? Is compliance mandatory in law (like in Malaysia), or is it through professional standards? Who maintains compliance, and how are actions taken for non-compliance of accounting standards?
- Are there appropriate arrangements in place for auditor oversights, for example, similar to US Public Company Accounting Oversight Board-type structure?
- The reason for *Broadly Implemented* rating here is because the certifying/auditing functionaries such as Chartered Accountants, company Secretary *etc* are not responsible and accountable to regulators to the extent that they are involved in certifying/auditing of regulated entities. However, there seem to be no direct questions relating to this area.
- On Question 8(c)(iii) and Question 9, the responses do not appear to be answering the questions directly. It is not stated if there is an independent institution/body that conducts oversight over auditors and their auditing standards.

***Stance of the Panel: Accepted. It has been appropriately incorporated in the report.***

**Principle 17 The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.**

The Principle requires that the regulatory system provide ongoing monitoring through on-site inspections of entities involved in operating CIS. I note that SEBI perform on-site inspections to monitor the affairs of mutual funds, trustees and AMCs. It would be useful to elaborate on the programme for inspection, frequency of inspections, the number of inspections conducted in the past over the CIS operators.

Similarly, the Principle requires the regulator to proactively perform investigative activities in order to identify suspected breaches with respect to entities involved in the operation of a CIS. While SEBI has stated its powers to investigate suspected breaches, greater emphasis needs to

be placed on the supervision and investigation over CIS operators. This is important because CIS tend to be subscribed by retail investors, which warrant a high degree of protection.

In respect of Question12 and Question13, the responses on the issue of conflict of interest are in relation to mutual funds only and do not include CIS.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 17. Assessment downgraded to Broadly Implemented.***

**Principle 18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.**

The Principle requires the pool of investors' funds should be distinguished from the assets of other entities. While SEBI has highlighted that there is a scheme-wise segregation of bank accounts and securities accounts, it would be useful to elaborate further as to how CIS assets are segregated from the assets of the CIS operators.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 18.***

**Principle 19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme**

IOSCO requires that CIS managers provide up-to-date information in the prospectuses or to inform the market on the occurrence of material events. While SEBI states that key information is to updated at least once a year and that the offer document should be revised once in 2 years, SEBI may wish to clarify where there are changes affecting the matter disclosed in the offer document, would the Asset Management Company or the Collective Investment Management Company be required to issue a supplementary offer document.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 19.***

**Principle 20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme**

The Principle requires rules of practice addressing pricing errors. In addressing pricing errors, SEBI may wish to elaborate on how pricing errors are addressed and rectified. For example, are reimbursements provided for by the asset management companies?

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 20.***

**Principles 21 Regulation should provide for minimum entry standards for market intermediaries**

I note that SEBI conducts risk-based inspections, while the exchanges conduct routine inspections on market intermediaries. It would be useful to highlight how compliance levels in the industry are being raised to ensure standards of market conduct are enhanced.

I note that the weakness is due to the unavailability of information on identity of senior management and names of individuals authorised to act on behalf of intermediaries to the market place, and absence of specific regulations for investment advice. It would be useful to know whether there are initiatives undertaken by SEBI to address this gap.

*Stance of the Panel: Accepted. This has been appropriately incorporated in the report.*

**Principle 22 There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake**

I note there are various types of market intermediaries in the Indian capital market. While the responses focus largely on the requirements for brokers, it would be useful to also highlight the different requirements for other market intermediaries, for example, in relation to capital adequacy requirements, and related risks.

I note that SEBI has prescribed minimum standards and capital requirements for intermediaries, but they are not risk related capital requirements. Given the importance of risk-based capital under the current financial market conditions, this is an area for immediate attention. It would be useful to know whether there are initiatives undertaken by SEBI to address this gap.

*Stance of the Panel: Accepted. This has been appropriately incorporated in the report.*

**Principle 23 Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters**

I note that SEBI has not prescribed any specific requirements on internal control for market intermediaries. It would be useful to know whether there are initiatives undertaken by SEBI to address this gap – for e.g. supervision and control, conflict of interest, and compliance culture.

The issue of management of conflicts should be examined more closely. This is particularly relevant in the situation of investment banks, where research, investment banking, collective investments and broking are housed under one roof. Strictly adhered procedures, for example, rules on Chinese walls, sharing of information, remuneration and fees must be put into place to discourage conflict situations.

*Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 23.*

**Principle 24 There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.**

I note that SEBI has no specific policy in place for dealing with failure of any market intermediary or financial conglomerate. It would also be useful to know whether there are initiatives undertaken by SEBI to address this gap and to have it in a structured plan.

*Stance of the Panel: Accepted. This has been appropriately incorporated in the report.*

**Principle 25 The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight.**

In relation to Question 2(d), the response does not reflect SEBI's ability to impose on-going conditions on the exchange.

***Stance of the Panel: Accepted. This has been appropriately incorporated in Appendix 4 under principle 25.***

**Principle 26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.**

Where exchanges are demutualised as for-profit entities, regulatory oversight and supervision over the exchanges is an area that ought to be examined closely. This is to ensure there is appropriate focus and attention placed in the discharge of the exchange's regulatory functions, including whether it is conducting the function of surveillance of the market effectively, whether it is able to adequately detect disorderly trading or illegal conduct in the market, whether there are potential conflicts which are not monitored and managed, whether the exchange is acting fairly in discharging its duties including its enforcement of rules.

In relation to Question 2, the response does not indicate clearly whether amendments to rules are subject to SEBI's approval.

***Stance of the Panel: Accepted. This has been appropriately incorporated in the report.***

**Principle 27 Regulation should promote transparency of trading.**

The issue of transparency of the bond market may be an area that needs to be carefully considered. While transparency levels vary considerably with regards to the OTC corporate bond market, it would be useful to examine in greater detail the trade-offs between transparency and liquidity. This is particularly important given the developments in the corporate bond markets, including the involvement of retail investors, the increase in complexity of bond structures *etc.*

***Stance of the Panel: Accepted. This has been appropriately incorporated in the report.***

**Principle 28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.**

Further clarification is required in relation to the following:

- In relation to Question 3(d), the response does not indicate clearly whether there is an arrangement in place to provide results of analysis to regulatory officials.
- In relation to Question 4, the response relates to cross-border trading, while the question refers to domestic cross-market trading.

***Stance of the Panel: Accepted. This has been appropriately incorporated in the report.***

**Principle 29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.**

While I note that there are default procedures of RSE, it may be useful to examine more closely the issue of default and whether the processes in place are adequate to manage a default, including the possibility of simulating a default situation.

It is important to take into consideration the need to have a robust systemic risk management framework in place involving relevant aspects of the risks at the exchange, clearing house and the intermediaries.

*Stance of the Panel: Accepted. This has been appropriately incorporated in the report.*

**Principle 30 Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.**

The assessment of Principle 30 should rely on the questions in the CPSS/IOSCO Methodology for Recommendations for Securities Settlement Systems. The report identifies specific recommendations that have minimum standards that securities settlement systems should meet. The degree to which the clearing and settlement arrangements meet the Recommendations for Securities Settlement Systems would provide more insight into the level of implementation for Principle 30.

*Stance of the Panel: This has been separately assessed by the Panel on Institutions and Market Structure which is assessing the payment and settlement systems.*

## Chapter V

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## List of Acronyms

AA	Appointed Actuary	IAC	Insurance Advisory Committee
AIC	Agriculture Insurance Company of India Limited	IBNR	Incurred But Not Reported
ALM	Asset Liability Management	IBNER	Incurred But Not Enough Reported
AML	Anti Money Laundering	ICPs	Insurance Core Principles
ART	Alternate Risk Transfer	IRDA	Insurance Regulatory and Development Authority
CARRMELS	Capital Adequacy, Asset Quality, Reinsurance, Reserves, Management, Earnings, Liquidity and Sensitivity to Market	IT	Information Technology
CA&G	Comptroller and Auditor General	JV	Joint Venture
CEO	Chief Executive officer	KYC	Know Your Customer
CFSA	Committee on Financial Sector Assessment	LIC	Life Insurance Corporation of India
CFT	Combating Terrorist Financing	MCA	Ministry of Corporate Affairs
CG	Corporate Governance	NBFCs	Non Banking Financial Companies
ECGC	Export Credit Guarantee Corporation	PFRDA	Pension Fund Regulatory and Development Authority
ESI	Employee State Insurance	RBC	Risk Based Capital
FATF	Financial Action Task Force	RBI	Reserve Bank
FDI	Foreign Direct Investment	RBS	Risk Based Supervision
GDP	Gross Direct Premium	ROSC	Report on observance of standards and codes
GIBNA	General Insurance Business (Nationalisation) Act, 1972	SEBI	Securities and Exchange Board of India
GIC	General Insurance Corporation	SROs	Self Regulatory Organisations
GOI	Government of India	TAC	Tariff Advisory Committee
HLCCFM	High Level Co-ordination Committee for Financial Markets	TPAs	Third Party Administrators
		WTO	World Trade Organisation



## Chapter V

# Assessment of Adherence To IAIS Core Principles

### Section 1

#### Background

##### 1.1 IAIS Principles as Benchmark

The International Association of Insurance Supervisors (IAIS) has developed the Insurance Core Principles (IAIS 2000) as the key global standards for prudential regulation and supervision for the insurance sector across jurisdictions. IAIS principles, standards and guidance papers expand on various aspects. They provide basis for evaluating insurance legislation and supervisory systems and procedures. The principles apply to insurers and reinsurers, whether private or government controlled insurers that compete with private enterprises wherever the business is conducted.

The objective of the Insurance Core Principles (ICPs) from the perspective of the standard-setters is to act as a diagnostic tool to assist in improving supervision of the insurance sector globally. ICPs can be used to establish or enhance a jurisdiction's supervisory framework. They can serve as the basis for assessing the existing supervisory framework and in so doing may identify weaknesses, some of which could affect policy holder protection and market stability.

##### 1.2 Earlier Assessments

In order to guide the process of implementation of international standards and

codes in India as also to position India's stance on such standards, Government of India in consultation with the Reserve Bank constituted on December 8, 1999, a Standing Committee on International Financial Standards and Codes. One of the Advisory groups constituted by this Committee looked into insurance regulation. This group evaluated the adherence to Insurance Core Principles in respect of regulation and supervision of insurance markets. The recommendations of the Advisory Group are summarised in **Appendix 1**.

A Review Committee to monitor the progress made in respect of recommendations emanating from the above exercise provided, *inter alia*, in September 2004 a report on insurance regulation. This report covered the applicability, relevance and compliance with international standards in respect of the Insurance Core Principles. The Review Committee's report on the progress made in this regard are summarised in **Appendix 2**.

##### 1.3 Regulatory and Supervisory Mechanism

###### 1.3.1 Evolution

Regulation of the insurance industry was formally initiated in India with the passing of the Life Insurance Companies Act of 1912. The first comprehensive legislation was introduced with the Insurance Act of 1938 that provided for a broad range of regulations over insurance

business. The insurance business grew at a faster pace after independence. Indian companies strengthened their presence in the insurance sector. However, despite the growth that was witnessed during this period, insurance remained an urban phenomenon.

In 1956, the government brought together over 240 private life insurers and provident societies under one nationalised monopoly with the formation of Life Insurance Corporation of India under an Act of Parliament. Nationalisation was justified on the grounds that it would facilitate the flow of funds for rapid industrialisation needed for state led industrialisation. The general insurance business, however, continued in the private sector till 1972, when it too was nationalised. With this, nearly 107 insurers were amalgamated and grouped into four companies – the National Insurance Company, the New India Assurance Company, the Oriental Insurance Company and the United India Insurance Company. These entities were set up as subsidiaries of the General Insurance Corporation (GIC), which also played the role of the re-insurer.

In 1993 the Committee on Reforms in the Insurance Sector, headed by former Reserve Bank Governor R.N. Malhotra, was constituted to evaluate the performance of the Indian insurance industry and to make recommendations for its growth and consolidation. The Committee was set up with the objective of complementing the reforms initiated in the financial sector in the early 1990s, which aimed at creating an efficient and competitive financial system, focused as they

were on the banking sector and the securities markets.

#### 1.3.2 Opening up of the Insurance Sector

The opening up of India's insurance sector for private participation corresponded with the setting up of a regulator for the insurance sector by the enactment of the Insurance Regulatory and Development Authority Act, 1999. The term 'Development' was inserted in the Bill at the last moment as legislators were concerned that with competition both the regulator and the regulated should not lose sight of the more important aspect of 'development' of the insurance market in India. The opening up of the sector was preceded by an intense debate for several years before a consensus that the initiative was justified and necessary to increase insurance penetration in the country.

The opening up of the sector also coincided with relaxations permitting foreign participation in the insurance ventures, set up by the private sector. As a first step, the Government restricted participation of the foreign joint venture partner through the Foreign Direct Investment (FDI) route to 26 per cent of the paid-up equity of the insurance company. The Government has indicated its intention to raise the cap to 49 per cent. But, the measure needs amendments to the Insurance Act, 1938.

Since opening up, the number of participants in the industry has increased from six wholly public owned insurers (comprising Life Insurance Corporation of India (LIC), the four general insurance companies and General Insurance Corporation, the national re-insurer) in 2000 to 37 insurers operating in the life,

general and re-insurance segments. There are seventeen new companies in the private sector and LIC, the public sector insurer, operating in the life segment. In the general segment there are ten new companies in the private sector; the four public sector insurers; two stand-alone health insurance companies in the private sector and two specialised insurers wholly Government owned, *viz.*, Export Credit Guarantee Corporation and Agricultural Insurance Company. In addition, the Government owned General Insurance Corporation (GIC) continues to be the national re-insurer.

The IRDA has exercised utmost care while re-opening the insurance sector to market competition. Strong financial base coupled with an obligation to serve rural areas and the disadvantaged sections of the population are significant features incorporated in the licensing of insurance companies. Foreign participation in the sector has also enabled local players to form joint ventures with foreign insurance partners, and benefit from transfer of technical know-how and increased financial strength. This has also enhanced the local insurers' ability to modernise and expand operations. Insurers are being encouraged to form strategic alliances with other financial sector players, in order to derive synergy in operations and to widen their reach.

### **1.3.3 Objectives, Composition and Regulatory Framework of IRDA**

The objectives of IRDA have been laid down in its mission statement as 'to protect the interests of the policyholders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto'. IRDA has from the inception been working towards the overarching objective of protecting the policyholders' interest in the development of its regulatory and supervisory framework. Given

the mandate as per statute, the IRDA would continue to handle the issues of both development and regulation simultaneously.

The IRDA has since its inception continued to follow the practice of prior consultation with different groups and interested bodies to forge a broad consensus while framing the regulations. Working Groups have been constituted by the IRDA from time to time with the objective of getting the viewpoint of various stakeholders on various emerging regulatory issues/concerns. This has facilitated acceptance of the regulatory framework and has facilitated the growth of the market. The objective of the IRDA is to move towards globally accepted standards pertaining to the insurance industry. The membership of the International Association of Insurance Supervisors (IAIS) has helped in the process of harmonisation of the practices and procedures followed in the Indian market with the international standards.

The IRDA is an autonomous body formed under an act of Parliament, the Insurance Regulatory and Development Authority Act, 1999. The Insurance Act, 1938 and the regulations framed thereunder lay down the regulatory framework for supervision of entities operating in the sector. The members of the IRDA are appointed by the government, and must have expertise and knowledge in the specified fields, *viz.*, life insurance, general insurance, actuarial science, finance, economics, law, accountancy and administration. The chairperson has the powers of general superintendence and direction in respect of all administrative matters of the IRDA. Policy level decisions are taken by the IRDA by a majority vote. IRDA is an independent agency which reports to the Parliament on its activities through the Ministry of Finance. The operations of IRDA are reviewed by the Standing Committee on Finance on an annual basis and IRDA is required to submit the appraisal of the insurance sector to the ministry of finance. In

In addition, IRDA is required to submit to the government a report giving a true and full account of its activities including the activities for promotion and development of the insurance sector during the previous financial year. The accounts of the supervisor are audited on an annual basis by the Comptroller & Auditor General (C&AG).

The framework of the functioning of the IRDA can be categorised into five broad areas, namely, (i) licensing of insurers and insurance intermediaries; (ii) financial and regulatory supervision; (iii) control and regulation of premium rates; (iv) protection of the interests of the policyholders; and (v) promoting growth and development of the insurance sector including reaching the rural and social sectors. With a view to facilitating the development of the insurance sector, the IRDA has issued regulations on protection of the interests of policyholders; obligations towards the rural and social sectors; and licensing of agents, corporate agents, brokers, and third party administrators. This is in addition to the regulatory framework provided for registration of insurance companies, maintenance of solvency margin, investments and reporting requirements.

Since the insurance sector was opened up to private participation after a long period of nationalisation (life industry after more than 50 years and general after over 30 years), the IRDA as a matter of prudence prescribed entry level capital requirement of Rs.100 crore. In case of re-insurance companies the initial capital requirement is Rs.200 crore. In addition, all insurance companies are required to comply with the solvency stipulations at all times. Every

insurer is required to keep a Required Solvency Margin as per the Section 64VA of the Insurance act 1938, whereby an excess of the value of assets over the amount of liabilities is required to be maintained. The regulatory framework prescribes the method of computation of the Required Solvency Margin. IRDA has set a working Solvency Margin Ratio (Ratio of Actual Solvency Margin to the Required Solvency Margin) of 1.5 for all insurers. These stipulations have been put in place to impart a conducive environment for the growth of the sector. It was also intended that only companies with deep pockets and the ability to commit additional funds to the venture over a long-term horizon entered the market.

Under the file & use guidelines issued by the IRDA, all insurers intending to introduce a new product are required to submit an application to the IRDA as per the format furnishing such information as may be prescribed in this regard. The IRDA may seek additional information with regard to the product within a specified time period, and the insurer cannot commence selling the product in respect of which additional information has been sought by the IRDA till such time as the IRDA confirms in writing having noted such information. These guidelines have been put in place with the intent of ensuring protection of the interests of the policyholders.

The IRDA has also helped in establishing a support mechanism to sustain the Insurance Ombudsman system under the Settlement of Public Grievances Scheme, 1998. Twelve ombudsmen have been appointed across the country. This has created vital grievance



settlement machinery for policyholders. Policyholders also have the option of approaching the consumer courts in case of any grievances. The mechanism is in addition to the consumer grievance cells which are required to be set up by all insurers. Complaints of non-settlement/ delayed settlements of claims received from customers and other issues are also addressed by the IRDA's Grievances Redressal Cell.

### **1.3.4 Off and On-Site Monitoring**

IRDA has also taken steps to start building-up the database ensuring that comprehensive authentic and reliable data is captured either under its own aegis or in co-operation with the two Self Regulatory Organisations (SROs) of the life and general industry. A beginning has also been made to put in place systems to facilitate market analyses to enable the supervisor to take action based on the early warning signals. The IRDA analyses the performance of insurance companies on a monthly basis, based on the business figures furnished by life and general insurers. Business trends are also studied at frequent intervals to keep track of developments in the sector and to take regulatory action where necessary. It is also based on the premium figures and other relevant industry statistics. Qualitative analysis is based on the market conduct activities that come to the notice of the IRDA through public/ media and also from the publicity material filed with the supervisor for information and/or for prior approval. Market conduct issues also come to notice through the Grievance Cell which attends to grievances of customer/agencies of the insurer.

When a market-wide event having an impact on the insurers occurs, the supervisor obtains relevant information from the insurers, monitors developments and issues directions as it may consider necessary. Though, there is no specific requirement, events of importance trigger such action. In the past, in cases where

there have been repercussions on the market-wide basis on the happenings of particular events, the supervisor has called for and analysed the data to monitor the impact on market-wide basis.

Given that the insurance sector was opened up to private participation in 2000, and the regulatory framework has been made applicable to existing public sector insurers as well, the IRDA is handling the issue of disclosures in the public domain with some degree of caution. During 2007-08, the periodicity of reporting requirements has been reduced to quarterly filing of financial statements from the prescription of annual financial statements. In addition, while for the present, none of the insurance companies is listed, once the insurance companies go public, the various stipulations under the listing agreement of the stock exchanges, prescriptions of corporate governance and the stipulations of the capital markets regulator (SEBI) would become applicable to them. These stipulations thus enable the market participants to take decisions based on the information available in public domain. Given that the insurance sector was opened up to private participation in 2000, the regulatory framework has been made applicable to the existing public sector insurers as well.

Though IRDA is the regulator for the insurance sector, it works in co-ordination with the other regulators in the financial sector, *viz.*, the Reserve Bank and SEBI on due diligence by promoter companies of the insurance companies where the promoter companies belong to the financial sector. The financial sector regulators also interact and co-ordinate on various conglomerate related issues and group-wide supervision; and also on any operational issues which may arise.

In the above backdrop, Section 2 provides the details of coverage, scope and methodology of assessment. Section 3 details the profile of



Indian insurance companies. Section 4 details the results of the assessment of Insurance Core Principles. Section 5 provides the list of recommendations based on the assessment and Section 6 concludes with a few key observations.

#### Section 2

#### Coverage, Scope and Methodology

As indicated earlier, the International Association of Insurance Supervisors (IAIS) has developed the Insurance Core Principles (IAIS 2000) as the key global standards for prudential regulation and supervision for the insurance sector across jurisdictions. The objective of the IAIS Core Principles (ICPs) from the perspective of the standard-setters is to act as a diagnostic tool to assist in improving supervision of the insurance sector globally. The insurance assessment process in the present context is being carried out as part of the overall financial sector assessment programme with the Reserve Bank being overall in-charge of co-ordinating the exercise. After the opening up of the sector, the assessment of adherence to the Insurance Core Principles with respect to insurance companies in such an elaborate manner has been carried out for the first time. As part of the assessment of compliance with the core principles, IRDA had set up a Technical Group on Status & Implementation of Financial Standards & Codes (IAIS Insurance Core Principles). The technical group comprised eminent persons drawn from the insurance industry, experts in the field of insurance and representatives of the IRDA. The second technical group set up by IRDA took up the assessment of the IAIS Core Principles on insurance supervision. The core principles aim

at assisting in improving supervision globally, and can act as a roadmap for the reforms' agenda in this sector. The assessment by the technical group was restricted to the insurance companies which are registered with the Supervisor and excluded the exempted insurers.

**The Exempted Insurers:** The Central Government has exempted State Government insurance funds under Section 36 of the General Insurance Business (Nationalisation) Act, (GIBNA) 1972. These funds are required to ensure compliance with the provisions of the Insurance Act, 1938 and with the regulations framed thereunder, to the extent applicable to them under Section 110F of the Insurance Act. Further, Section 118 of the Insurance Act, 1938 provides for the exemption of specified entities from the provisions of the Act. The LIC Act, 1956 under Section 44 provides for exemption from the provisions of the said Act to specified insurers/schemes.

Broadly, the exempted insurers fall under the following three categories:

- (a) State Government insurance departments transacting general insurance business in respect of assets owned/ financed by them;
- (b) Exempted insurers transacting health insurance for its members; and
- (c) State Government insurance departments which transact crop insurance .

These insurers fall outside the purview of the present assessment in respect of the financial regulation and supervision of the insurance sector. Similarly, the Postal Life

Insurance Department and the Employees State Insurance (ESI), which are administered by the Central Government, fall outside the purview of the supervisor.

The approach taken by the IRDA in the assessment of the observance of the IAIS Core Principles in relation to the supervision of the insurance companies is as under:

- i Against the prevalent supervisory environment, identify the principles which could be made applicable to the insurance sector. It was observed that the ICPs were relevant and applicable to the supervisory authority and to the companies which have been granted registration to conduct insurance business in the country. However, in certain instances the essential/advance criteria were not applicable to the Indian jurisdiction – such as ICP 6 ECs (e), (f) and (k); ICP 10 EC (h); ICP 23 – EC (i) and ICP 25 EC (g).<sup>25</sup> In certain other instances, the specified criteria were observed in an alternate manner.
- ii The assessment has been made not only on the basis of the presence of the legal

- framework but also their actual implementation/ compliance.
- iii Aim at adherence to the applicable principles by treating them as attainable benchmarks. The adherence has basically been examined against the essential criteria and the advanced criteria have been considered for the purpose of laying down the way forward.
- iv Identify gaps in observance of the essential and advanced criteria.
- v Delineate an action plan for attaining compliance to these benchmarks in the medium-term perspective.

After the opening up of the insurance sector in 1999-2000, regulation and supervision had to carefully balance the competing needs of growth in a free market, protecting the health of the existing state-owned entities, unequal quantitative and qualitative levels of business activities and human resources, apart from significantly different efficiency levels on account of the technological changes. The task of the supervisor was therefore different, and the regulatory role had to be approached in a

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<sup>25</sup> ICP6 E(e) The insurance legislation determines the method by which a foreign insurer can carry on business in the jurisdiction. This may be by way of a local branch or subsidiary that must be licensed, or on a services basis only.  
 EC(f) If a foreign insurer is allowed to carry on business in the jurisdiction, the supervisory authority must be provided with the following data:  
 - confirmation from the home supervisory authority that the insurer is authorised to carry on the types of insurance business proposed  
 - information from the home supervisory authority that the insurer is solvent and meets all the regulatory requirements in the home jurisdiction  
 - in the case of a branch office: the name and address of the branch  
 - the name of the authorised agent in the local jurisdiction in the case of insurance offered on a services basis (i.e., where a local branch or subsidiary is not established)  
 - the information and documentation normally required to be licensed in the local jurisdiction, when appropriate  
 These information requirements might be waived if insurance is offered on a services basis only.  
 EC(k) As necessary, after an insurer has been licensed, the supervisory authority evaluates and monitors the degree to which the insurer satisfies the relevant licensing principles and requirements of the jurisdiction.  
 ICP10 EC(h) The supervisory authority requires oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the normal standards of internal controls.  
 ICP23 EC(i) The solvency regime addresses the requirements placed upon an insurer operating through a branch.  
 ICP25 EDC(g) The supervisory authority gives information to the public about whether and how local legislation applies to the cross-border offering of insurance, such as e-commerce. The supervisor issues warning notices to consumers when necessary in order to avoid transactions with unsupervised entities.

graduated fashion. In addition, the following factors have had a bearing on the assessment of observance of the core principles:

- i. A comprehensive process of review of the insurance legislation has been carried out by IRDA. The details of the review are covered in Para 12. While laying down the way forward/action points, IRDA has taken care to identify the essential criteria laid down which were largely/partly observed. With the amendments to the legislation, the observance level would be upgraded. It is a matter of great degree of comfort that these issues have been already taken forward by the supervisor.
- ii. As indicated above, at the time of opening up of the sector, the insurance sector was a state monopoly. Both the owner and the Controller of Insurance (the supervisor for the insurance sector) were one entity. The legislative framework vested the owner with additional powers. While granting statutory powers to IRDA through the IRDA Act in 1999, some of these powers were transferred to the supervisor. However, some dichotomies continue to exist. These issues are being addressed through the proposed amendments to the law; and
- iii. Having for long operated in a monopolistic environment, the public sector companies require time to

transform themselves. They need to respond to the requirements of the competitive environment. The supervisor has adopted a cautious and consultative approach in sequencing the various elements of structural reforms of the regulatory framework that aim at not only providing a level playing field but also taking into account the constraints under which companies were operating.

While making the assessment, it is also acknowledged that the various initiatives have to be taken in a manner so as to ensure the stability of the nascent sector keeping in view the ability of the various stakeholders to move forward towards compliance at the same pace. The assessment has been carried out as per the methodology laid down in the World Bank – IMF FSAP document in this regard.

The ICP assessment is based on a set of essential and advanced criteria, as well as on the assessment methodology which has been laid down under the FSAP document. In addition, where considered necessary, the advanced criteria has also been assessed in some cases. IRDA has prepared the report on the observance of the standards by considering the essential criteria and has made further comments by using the advanced criteria to lay down the way forward. The essential criteria are those components that are intrinsic to the implementation of the core principles. While assigning the observed status to a core principle, it has been ensured that all the

essential elements have been met to demonstrate "observed"<sup>26</sup> status for the said principle. The advanced criteria are those components that are considered to improve upon the essential criteria and thus enhance supervisory efforts. Thus, the advanced criteria have not been used prima facie for assessing observance with a principle, but rather to evaluate IRDA's supervisory framework and to lay down further course of action.

Based on the above mentioned assessment process, the observance of the ICPs has been categorised as under:

1. Observed
2. Largely Observed
3. Partly Observed
4. Not Observed
5. Not applicable.

The assessment process has assessed each of the criteria first. Thereafter each of the ICPs has been assessed after considering the overall situation with respect to the underlying criteria.

### Section 3

#### Profile of Insurance Companies

**3.1 Life Insurance Industry:** The post-liberalisation period has been witness to tremendous growth in the insurance industry, more particularly so in the life segment. The total premium underwritten by the industry has grown from Rs.34898.50 crore in 2000-01 to Rs.156041.60 crore in 2006-07. The first year premium, which is a measure of new business secured, underwritten by the life insurers

during 2006-07 was Rs.75617.30 crore as compared to Rs.9707.40 crore in 2000-01. The highlights of the growth of the life insurance industry over the period are as under:

- A notable feature of the de-regulation of the insurance market has been that the size of the insurance pie itself is expanding.
- The life insurance industry has reported average annual growth of 47.1 per cent in first year premium from 2000-01 to 2006-07. During 2006-07, the growth was 95.0 per cent.
- The private insurers and LIC reported growth in first year premium of 89 per cent and 97 per cent respectively in 2006-07.
- LIC has continued to report impressive growth, particularly in 2004-05, 2005-06 and 2006-07, showing a substantial recovery as compared to the earlier years.
- The market share of the first year premium underwritten by the new insurers increased to 25.7 per cent in 2006-07.
- A significant component of growth in life insurance industry has been the savings linked insurance products in the last few years. This shift has also occurred on account of the unbundling of the products whereby the policyholders are given the option to exercise their choice on the investments component based on their risk appetite.

The growth trends between 2000-01 to 2006-07 years clearly establish the growth impetus provided to the industry with the opening up of the sector.

<sup>26</sup> The observance status of individual essential criteria and the overall core principles has been examined as under:

1. Observed	When stipulations/ framework exist and are practiced by the insurers/ supervisor.
2. Largely Observed	Gaps have been identified and steps are being taken to fill in the gaps
3. Partly Observed	Compliance observed in case of few of the requirements of the criteria and absence of compliance in case of certain requirements which are critical to ensure compliance with the principle.
4. Not Observed	No stipulations exist, no initiation of process of filling up the gaps as on date
5. Not Applicable	Stipulations prohibit the requirements indicated in the criteria <i>ab initio</i>
6. Observance Not Tested	Stipulations exist but there were no instances to observe compliance
7. Observance in alternative manner	Though not stipulated by the legislation/supervisor, the principle/criteria is complied within an alternative manner

## Chapter V

### Assessment of Adherence to IAIS Core Principles

(Amount in Rs. crores)								
Insurer	First Year premium				Renewal premium		Total premium	
	2005-06		2006-07		2005-06	2006-07	2005-06	2006-07
	Regular	Single	Regular	Single				
1	2	3	4	5	6	7	8	9
LIC	13728.03	14787.85	29886.34	26337.21	62276.35	71599.28	90792.22	127822.84
Private Sector	7526.88	2742.78	15472.58	3921.11	4813.87	8825.06	15083.54	28218.75
Total	21254.91	17530.63	45358.92	30258.32	67090.22	80424.34	105875.76	156041.59

**3.2 General Insurance Industry:** The general insurers (excluding specialised institutions like ECGC and AIC) underwrote premium within India of Rs.24905.47 crore in 2006-07, as against Rs.9807 crore in 2000-01. The salient features of growth in the industry are the following:

- The general industry has reported average annual growth of 16.9 per cent over the period 2000-01 to 2006-07.
- The private sector has reported a higher rate of growth.
- While there was a slowdown in the premium underwritten by the public sector insurers in the year 2004-05, recovery was witnessed in the year 2005-06 and 2006-07, with the public sector insurers reporting growth of 8.4 per cent in 2006-07.
- The public sector insurance companies have also started re-orienting their strategy to retain their market share and to meet the competition.
- Two of the fastest growing segments are motor and health, accounting for 43.0 and 13.3 per cent of the premium underwritten in India in 2006-07. The premium underwritten in these two segments in 2006-07 was Rs.10696.70 crore and Rs.3310 crore respectively, reporting growth of 22.5 and 49.0 per cent over 2005-06.
- In addition, the public sector insurers are also underwriting premium outside India. The premium underwritten by them in 2006-07 was Rs.1024.50 crore (Rs.979.40 crore in 2005-06).

### Gross Direct Premium Income in India

(Amount in Rs. crores)												
Insurer	Fire		Marine		Motor		Health		Others		Total	
	2005-06	2006-07	2005-06	2006-07	2005-06	2006-07	2005-06	2006-07	2005-06	2006-07	2005-06	2006-07
	2	3	4	5	6	7	8	9	10	11	12	13
Public Sector	2515.94	2606.91	1002.29	1137.69	6654.44	6993.88	1724.56	2158.65	3099.82	3361.77	14997.06	16258.90
Private Sector	1258.59	1525.47	281.80	490.15	2078.94	3702.78	496.19	1151.36	1247.15	1776.81	5362.66	8646.57
Total	3774.53	4132.38	1284.09	1627.84	8733.38	10696.66	2220.75	3310.01	4346.97	5138.58	20359.72	24905.47



## Box 5.1: Impact of liberalisation

Entry of the private players, supported by their foreign joint venture partners, has brought about significant changes in the insurance sector over the last seven years:

**1 Introduction of Innovations:** The opening up has augured well for the sector which has been witness to introduction of new products. Today, a wider choice is available to the customer, with products being tailor-made to the needs of the insured. [Availability of riders, particularly health riders, has been a positive development] Insurers are putting in much more research into development of products both in the life and general segments. The customer perspective has also undergone a change in recent times with a significant component of the first year premium accruing to pension products. Approximately 30 per cent of the first year premium in 2006-07 accounted for pension products. Some of the innovative products, which have been introduced by the life insurers, include Unit Linked Products, Health Insurance Products and Micro-Insurance Products. The initiatives taken by the general industry include weather insurance; index based crop insurance; mutual fund package policy; pollution liability package Policy and export credit (short-term) policy; coverage for pre-existing diseases based on the recommendations of the health sub-committee set up by the IRDA; health insurance plans such as hospital cash, and critical illness insurance policies. The General insurance industry is also examining the feasibilities of introducing 'Savings Linked Insurance products'. The general and health insurance companies are providing state-wide cover for citizens under Group policies in collaboration with the respective State Governments, towards health, accident, death, etc.

**2 Health insurance:** One of the benefits of opening up of the insurance sector has been the extension of health cover, with the segment reporting growth of over 25 per cent over the last four years. It accounted for 13.29 per cent of the gross premium underwritten by the general insurance industry in 2006-07 as against 10.91 per cent in 2005-06. As against this, at the time of opening up of the sector in 2000-01, the health premium was Rs.519 crore, *viz.*, the 5.29 per cent of the gross premium underwritten. The industry has recognised both the huge potential and the need for providing health insurance cover to the populace. While a number of initiatives have been taken to promote health insurance in the country, some of the innovative features proposed to be offered through health insurance products include (i) inclusion of cervical cancer and hysterectomy in the critical illness cover specially designed for women; and (ii) Offering of telemedicine consultations as a rider to the stand alone health insurance policy. In addition, some initiatives have already been taken in the context of offering cover for pre-existing diseases. The definition of 'pre-existing disease' has been rationalised in some of the products by bringing in a cooling-off or a waiting period. Also rather than excluding 'pre-existing conditions such as hypertension and diabetes per se, certain specific complications arising out of such conditions have been excluded.

The health segment has also witnessed the entry of Third Party Administrators (TPAs) post opening of the sector to facilitate extension of cashless hospitalisation services;

and to enable insurance companies to utilise their services for customer servicing and claims processing.

**3 Increased penetration in the rural and social sectors:** Recognising the potential of the rural and semi-urban markets, particularly in the context of these markets having exhibited the purchasing power to take insurance cover as also the need for insurance in these areas, the new players are also making an effort to tap these markets. Coverage of lives in the social sectors has also shown a positive trend. Not only have the insurance companies complied with the obligations as stipulated under the Regulations framed by the IRDA in this regard, but are also developing it as a business opportunity. Globally, insurance is sold rather than bought. Recognising the tremendous opportunity waiting to be tapped in the semi-urban and rural areas, branch and satellites offices have been opened.

**4 Investment in Infrastructure and social sectors:** Investment in infrastructure and social sectors has been mandated for insurance companies. In fact, given the liability profile of insurance companies, more particularly the life insurers, they are the ideal source of long-term debt and equity for infrastructure projects. Simultaneously, long-term infrastructure projects are ideal avenues for parking the resources available for investment with the insurers. In addition, these avenues offer market related returns on investments made. It is expected that as the premiums in the insurance sector grow, additional funds will be channelised to finance infrastructure and social sector projects. The Investment Regulations prescribe that not less than 15 per cent of the controlled fund and 10 per cent of the total assets of the life and general insurance companies must be kept invested in infrastructure and social sector investments. The contribution of the insurance industry to infrastructure and social sector projects stood at Rs.75939.12 crore as at 31<sup>st</sup> March, 2007 as against Rs.54620.33 crore in 2005-06, *i.e.*, a growth of around 39 per cent. In addition, funds are also directed towards these sectors through the various investments in government securities under the Pension and General Annuity business.

**5 Growth of intermediaries:** Post-opening up of the sector, a number of new channels of distribution have been tapped to expand insurance coverage. These include bancassurance, corporate agents and brokers. Over the last seven years, there has been growth in the number of agents (with more 0.2 crore agents and nearly 5000 corporate agents), brokers (258) surveyors, third party, administrators (26), increase in the number of agents training institutes. Opportunities in the information technology sector are on a rise on account of insurance sector relying heavily on IT both for its internal processing and for the customer servicing requirements. This, of course, is in addition to direct employment being generated by the private sector post-opening up. The number of persons directly employed by the industry exceeds 0.026 crore.

Overall, the reach of the sector has increased since opening up with a wider choice available to the policy holder. Simultaneously, the increase in resource mobilisation has resulted in the investment in the infrastructure and social sectors.



#### Box 5.2: Detariffing on General Insurance Sector

After the nationalisation of the sector in 1972, rating guidelines in case of tariffed business segments were issued under the administered system by the Tariff Advisory Committee (TAC). This mechanism continued even post-opening up of the sector in 1999-2000 and the tariffs were determined on the basis of the guidelines issued by the TAC. The road map for de-tariffing was notified by the IRDA on 23rd September, 2005, based on the demand from various stakeholders that continuance of tariff regime was inconsistent with the opening of the sector to provide healthy competition. The road map laid down the systems to be put in place to ensure a smooth transition from tariffs to a free market. Various milestones were identified indicating time schedules in relation to underwriting functions, rating support, file & use compliance and corporate governance. The process of opening up has been scheduled to be carried through in a phased manner. As a first step, de-tariffing has been confined to de-control of rates only and terms & conditions of the policy will not be changed till 31st March 2008. De-tariffing of the non-life industry has been notified w.e.f., 1st January 2007. In order to moderate the impact of tariff increase on commercial vehicle owners, the IRDA has retained the powers to determine the rates of motor – third party premium and to ensure that all insurers take commensurate exposure to this line of business, a motor pool has been created under Section 34 of the Insurance Act, 1938. All general insurers are required to collectively participate in a pooling arrangement to share in all motor third insurance business underwritten by them w.e.f. 1st April, 2007.

Detariffing has been the eagerly awaited reform in the general insurance industry ever since the Malhotra Committee recommended gradual removal of tariffs in the general insurance sector. Since then, tariffs on quite a few portfolios such as Marine Cargo, Personal Accident, and Bankers' Indemnity were withdrawn in the 1990s. The detariffing of Marine Cargo business in 1994 especially left in its wake certain valuable lessons on the pitfalls that a general insurance market could face when tariffs are withdrawn without proper regulatory guidance.

The IRDA carried out the imminent process of de-tariffing with a sense of urgency coupled with caution to ensure a

smooth transition to tariff free regime. The thrust was to make the insurers responsible for their action, and to put in place certain internal capabilities, procedures and controls. The emphasis was on more effective self regulatory and corporate governance norms. It was a prerequisite that the insurers set up the systems to do technically sound underwriting and to cope with competition in the absence of tariffs. The IRDA issued a road-map in September 2005 for ushering in a tariff free regime, followed by a series of discussions to ascertain the pulse of the insurance industry's state of preparedness. The following core areas were identified for focus:

- Existence of a broad corporate underwriting philosophy for each line of business;
- Identification of the responsibilities of the Board of Directors and the senior management of the company;
- Accountability – not only to the regulator, but also to the policyholders by way of disclosures and transparency;
- Identification of reporting channels and putting them in place to ensure that the Board gets timely and accurate information;
- Board approved philosophy for reinsurance programme.
- Existence of a strong internal audit machinery to ensure that the underwriting remained on a technically sound footing.
- Role of Appointed Actuary, Moderator and Compliance Officer of the company for designing and proper pricing of products.
- Establishing an IT system capable of capturing data on every policy, endorsement, claim and risk factors for rating of products.

The IRDA's circular on File & Use guidelines specified that the report to the Board should cover the following points:

- i) The underwriting philosophy and the underwriting profit expectation;
- ii) Whether each product should be self-supporting or cross subsidy will be acceptable;

- iii) If the insurer will write any business on a planned underwriting loss, how will the loss be funded;
- iv) The margins to be built into the rates to cover acquisition costs, promotional expenses, expenses of management, catastrophic reserve and profit. Whether credit will be taken for investment income in rating;
- v) The list of products that will be class rated, individually rated or rated by reference to reinsurance support;
- vi) The delegation of IRDA for quoting rates and terms and for underwriting to various levels of management;
- vii) The Appointed Actuary or Chief Financial Officer or other senior officer not having business development responsibility who will act as a moderator of very thin rates;
- viii) Involvement of the Appointed Actuary in the review of statistics to determine rates, terms and conditions of the cover for class-rated risks;
- ix) Setting up of the Internal Technical Audit machinery to ensure quality in underwriting and compliance with corporate underwriting policy; and
- x) The procedure for reporting to the Board on the performance of the management in underwriting the business.

The de-tariffing exercise has two components (stages). The first component is the withdrawal of tariff premium rates. The second component is permitting changes in the existing policy coverage wordings, terms and conditions. When the tariffs were withdrawn in the Fire, Engineering and Workmen's Compensation businesses with effect from 1<sup>st</sup> January, 2007, the IRDA took the further step of moderating the reduction in rates so that the fall was not too steep in comparison to the tariff premiums keeping in view the incurred claims ratio at the tariff rates. The Inspection Team of the IRDA had conducted inspection of all general insurers and identified areas requiring IRDA's intervention. As expected, there were initial teething problems in the market, but this step of moderating the reduction in rates proved to be a blessing to keep the overall market in a balanced state.

The IRDA, however, took the decision of regulating the rates relating to Motor Third Party business in exercise of its powers under Section 14 (2) (i) of the IRDA Act 1999. The main reasons for this decision were i) this class of insurance being mandatory under the Motor Vehicles Act and ii) the non-viability of this class of business resulting in complaints of non-availability of statutory cover to policyholders. The creation of Motor Insurance Pool for underwriting third party business for commercial vehicles

also seems to have gone down well with the insurers as the business seems to have soared with collective participation. However, it is too early to comment on the claims experience of the motor pool.

The next stage in the transition is to remove all price restraints again in a well regulated manner. The IRDA may not put any restraints when reviewing the filed rates unless they appear untenable.

However, as freedom comes with responsibility, the IRDA will continue to monitor the self regulatory measures and corporate governance norms of the companies. The IRDA has asked the insurers to strengthen the corporate governance controls as a simultaneous measure to the further freeing of rate controls. The most important control being the re-inforcement of the control of the Board of Directors on the company's underwriting policy. The insurers have been advised to put before their Boards a detailed statement of underwriting policy taking note of the developments so far and the concerns of the IRDA expressed from time to time. A clear statement of the operating ratio that the insurer will work on has been sought along with the procedures and controls being put in place to ensure compliance with the underwriting policy. The IRDA has specified the minimum extent of reporting that the management should place before their Boards on a periodical basis to enable the Board to discharge its corporate responsibility of overseeing the underwriting health of the insurer.

To remove the subsisting price controls, what is required of the insurers is a demonstration of a satisfactory level of preparedness on the 'barometers' mentioned above. This entails -

- A clearly defined manual of delegation of underwriting authority to different levels of management or specific persons based on skills and responsibilities;
- Establishing detailed underwriting manuals and distributing them to the persons concerned;
- Ensuring the ability of the Compliance Officer, Moderator and Appointed Actuary to discharge their responsibilities;
- Establishing a good IT system with capability for rating support, analysis of experience, review of underwriting and management support;
- Establishing an efficient internal technical audit department.

The insurers were also advised to submit proposals for changes in terms and conditions of the cover and policy wordings which were to be allowed after 31<sup>st</sup> March 2008.

### 3.3 General Insurance Corporation (GIC):

GIC is the sole insurer of the domestic re-insurance market, providing re-insurance to insurance companies in India. The Corporation's re-insurance programme has been designed to meet the objectives of optimising retention within the country, ensuring adequate coverage for exposure and developing adequate capacities within the domestic market. GIC receives statutory cession within the country subject to certain limits; and leads domestic companies' treaty programmes and facultative programmes. GIC is also the manager of the Third Party Motor Pool. The gross reinsurance premium written by GIC during 2006-07 was Rs.7404.17 crore as compared to Rs.4880.77 crore in 2005-06. Simultaneously, with the de-tariffing of the general insurance industry, IRDA directed setting up of Indian Motor Third Party Insurance Pool by all General Insurers in India to collectively service Commercial Vehicle Third Party insurance business. This arrangement has become effective from April 1, 2007. The share of GIC in the multilateral re-insurance arrangement has been indicated at 15 per cent (i.e. same as the share of statutory cessions.) The balance share of pooled business is being shared by all other member insurers. GIC is the administrator of the pool. The Pool Administrator will be paid fees of 2.5 per cent plus service tax on the total premium of the pooled business. In addition, the Corporation is also underwriting foreign re-insurance business.

**3.4 Paid-up Equity:** At the time of opening up of the sector, the paid-up equity capital of the six public sector insurers stood at Rs.620 crore.

Significant capital has been added to the insurance industry during the last seven years with Rs.9625.28 crore being brought in by the private players, of which the contribution of the foreign partners was Rs.2174.28 crore. The total paid-up equity of all insurance companies as at 31<sup>st</sup> March, 2007 stood at Rs.11610.28 crore.

**3.5 Penetration and Density:** The potential and performance of the insurance sector is universally assessed in the context of two parameters, *viz.*, insurance penetration and insurance density:

- Insurance penetration is defined as the ratio of premium underwritten in a given year to the gross domestic product (GDP).
- Insurance density is defined as the ratio of premium underwritten in a given year to the total population (measured in US\$ for convenience of comparison).

The insurance penetration was 2.32 (Life 1.77 and General 0.55) in the year 2000 when the sector was opened up for private sector, and has increased to 4.80 in 2006 (Life 4.10 and General 0.6). The increase in the levels of insurance penetration has to be assessed against the average growth of over 8 per cent in the Gross Domestic Product between 2004-05 and 2006-07. Insurance penetration in some of the emerging economies in Asia, i.e., Malaysia, Thailand and China during the same period was 4.9, 3.5 and 2.7 respectively.

The insurance density was US\$9.9 in 2000 which has increased to US\$38.4 in 2006. The comparative figures for Malaysia, Thailand and China during the same period were US\$292.2, 110.1 and 53.5 respectively.

## Section 4

### Assessment of IAIS Core Principles (ICPs)

The IAIS core principles comprise 28 principles which need to be in place for a regulatory and supervisory system to be effective. These core principles have been grouped into seven categories as under:

- I Conditions for Effective Insurance Supervision – these set out the elements of the environment where supervision can be most effective;
- II The supervisory system – which deals with the mandates and responsibilities of the supervisor;
- III The supervised entity – which deals with the form and governance of insurers;
- IV On-going supervision – which outlines the actual practice of supervisor;
- V Prudential requirements – these addresses the key financial and risk management practices that should be imposed on and be in place within the insurance companies;
- VI Markets and Consumers – which deal with distribution, customer protection, disclosures and fraud; and
- VII Anti-money Laundering, Combating Financing of Terrorism – which should aid in combating the financing of terrorism.

Each principle is elaborated through the essential and advanced criteria. It is in the criteria that the full meaning of each principle is found in considerable detail. Although the criteria are not reproduced here, they need to be carefully reviewed in order to gain a full understanding of the meaning and intention of each core principle. The IAIS emphasises that the criteria are intended to be implemented both in form and in practice.

**Assessment of the ICPs:** The methodology indicated in section 2 above has been applied

to make an assessment of the compliance with the Insurance Core Principles. Based on the said approach, and taking into account the criticality of the essential criteria which were not complied with, an overall assessment has been made on the status of observance.

The group-wise assessment of compliance with the core principles is elaborated upon below:

#### (i) Principle 1 (Conditions for Effective Insurance Supervision)

The regulatory framework for insurance supervision is placed against the background of the statutory framework which encompasses the legislative, regulatory and institutional framework both for the financial sector and the economy at large. Various professional bodies further facilitate the process of oversight of the financial sector.

Although the framework for accounting, actuarial and auditing standards has been provided for the industry, these are evolving concepts and are presently under examination by both the supervisor and various professional bodies to ensure that these are adequately strengthened. The Institute of Chartered Accountants of India (ICAI), the statutory body that sets accounting standards for the institutions in India after extensive consultations has in the meantime, drawn the road map to move towards the International Financial Reporting Standards (IFRS) effective 2011.

The regulatory framework provides enough flexibility to keep the current practices up to date to meet the needs of the industry. However, since some of the provisions of the Act are outdated and need to be reviewed in the context of the changing economic environment, the proposals for amendments to the Insurance Act, 1938 and the Life Insurance

**Box 5.3: Insurance' Core Principles**

The IAIS Insurance' Core Principles comprise of 28 principles that need to be in place for a regulatory and supervisory system to be effective (IAIS 2003a). The principles relate to the following:-

- Conditions for effective insurance supervision help set out elements of the environment where supervision can be most effective.
- ICP 1: Conditions for effective insurance' supervision include broad requirements in financial policy and financial market infrastructure to support effective supervision.
- The supervisory system deals with the mandates and responsibilities of the supervisor.
  - ICP 2: Supervisory objectives seek clarity in law.
  - ICP 3: Supervisory authority seeks adequate powers, resources, and legal protection.
  - ICP 4: Supervisory process seeks transparency and accountability.
  - ICP 5: Supervisory co-operation and information sharing cover co-operation within the insurance sector and across the financial services sector, as well as nationally and internationally.
- The supervised entity deals with the form and governance of insurers.
  - ICP 6: Licensing calls for requirements for licensing to be clear, objective, and public.
  - ICP 7: Suitability of persons requires ongoing assessment of fitness and propriety of significant owners and key functionaries.
  - ICP 8: Changes in control and portfolio transfers require supervisory approval of changes in significant ownership and control, in mergers, and in portfolio transfer.
- ICP 9: Corporate' governance requires prudent management of an insurer's business on the basis of standards that stress the role of board and senior management.
- ICP 10: Internal control states the requirements for internal control systems, including internal audit and reporting, as well as compliance' functions.
- Ongoing supervision outlines the actual practice of the supervisor.
  - ICP 11: Market analysis requires macro-prudential surveillance of the sector.
  - ICP 12: Reporting to supervisors and conducting off-site monitoring require comprehensive reporting that is done on a solo and a group basis, plus maintenance of an ongoing monitoring framework.
  - ICP 13: Onsite inspection requires comprehensive inspection powers for both the insurer and outsourced companies, plus clarified scope of inspections.
  - ICP 14: Preventive and corrective measures require an adequate, timely, and graduated spectrum of remedial measures.
  - ICP 15: Enforcement or sanctions will require measures that are based on clear objective criteria.
  - ICP 16: Winding-up and exit from the market will require criteria and procedures for insolvency and calls for priority with respect to policyholders.
  - ICP 17: Group-wide supervision calls for consolidated – group-wide–supervision of the insurance group or conglomerate.
- Prudential requirements address the key financial and risk management processes that should be imposed on and in place within insurance companies.



- ICP 18: Risk assessment and management state the requirements for risk management systems and their review by supervision.
  - ICP 19: Insurance activity requires underwriting and pricing policies as well as limits on risk retained through reinsurance.
  - ICP 20: Liabilities specify supervisory requirements to assess adequacy of technical provisions held against the policy liabilities.
  - ICP 21: Investments require compliance with standards on investment policy, asset mix, valuation, risk management, and asset-liability management.
  - ICP 22: Derivatives and similar commitments cover restrictions on their use and on the requirements for disclosures.
  - ICP 23: (capital adequacy and solvency) covers sufficiency of technical provisions to cover expected claims and expenses as well as sufficiency of capital to cover significant unexpected losses.
- Markets and consumers deal with distribution, customer protection, disclosures and fraud.
    - ICP 24: Intermediaries cover licensing and business requirements for insurance intermediaries.
    - ICP 25: Consumer protection covers requirements on the providing of information to consumers before and during the contract.
    - ICP 26: Information, disclosure, and transparency toward the market call for adequate disclosure by insurance firms.
    - ICP 27: Fraud calls for measures to prevent, detect, and remedy insurance fraud.
  - Anti-money-laundering should aid in combating the financing of terrorism.
    - ICP 28: Anti-money laundering and combating the financing of terrorism [AML-CFT] requires effective measures to deter, detect, and report AML-CFT offences in line with FATF standards.

Corporation Act, 1956 have been forwarded to the Central Government.

**(ii) Principle 2 to 5 (The Supervisory System (Mandates and Responsibilities of the Supervisor))**

The functions and powers vested with the supervisor to discharge its role are clearly laid down in the legislation and can be broadly categorised into the following four heads:

- (i) Registration of insurers and licensing of insurance intermediaries
- (ii) Financial and regulatory supervision
- (iii) Control and regulation of premium rates
- (iv) Protection of policyholders' interests.

The legislative framework for the insurance sector is contained in the Insurance Act, 1938 and the IRDA Act, 1999. In addition to the statutory framework as laid down under the Acts of Parliament, the supervisor notifies regulations covering specific areas of operations

of insurance companies. Till date 38 regulations (including amendments thereto) have been issued by the supervisor. The process of issue and/or amendment of regulations is based on a two stage approach. The approach note with respect to any notification is, after industry-wide discussions, placed before the IRDA for its approval. Simultaneously/thereafter the views/recommendations of the Insurance Advisory Committee (IAC) are also taken. The IAC comprises industry experts drawn from both public and private sector insurance companies and various other stakeholders. The regulations/amendments to the regulations are notified incorporating the views of the IRDA and the IAC. This could lead to some delays. But, the process ensures that the views of all the stakeholders are taken into account and there is industry-wide exposure prior to notification.

Decisions on major policy issues are taken by the Board of the IRDA. In practice, matters which require immediate decision are dealt with



by the Chairman and whole time members within the IRDA. Even on major policy matters, discussion among full-time members is immediately possible and where a meeting of the full Board is required, it can be convened at short notice. In addition, the Chairman is authorised to take decisions in consultation with the full-time members. These decisions are subsequently ratified by the Board.

While overall, IRDA firmly believes in providing a level playing field to all industry participants, there have been certain legacy issues due to which the state-owned insurers have been unable to ensure compliance, particularly during the initial period post opening up of the sector. Thus, there have been instances of relaxations being extended to the public sector insurers including grant of additional time for ensuring compliance.

Although the legislation vests IRDA with the powers to enforce the observance of the law and regulations framed for effective discharge of its supervisory responsibilities, some of the powers still rest with the government. In addition, there are some exempted insurers who do not come under the purview of the supervision of IRDA. In addition, the state-owned insurers continue to be governed by certain provisions of the specific legislations (that regulate their activities) apart from the insurance legislation governing the entire industry. These gaps in the supervisory set-up have been identified and the issues of adequacy of powers are being addressed through the proposed amendments to the Insurance Act, 1938.

IRDA interacts with other supervisors / supervisors of other jurisdictions to draw upon

their experiences on regulatory supervision or to gain insights on issues which do not have precedence in the host country. There is also co-operation amongst regulators within the country both at the policy level and for administrative matters (sharing information/concerns on specific insurers on operational matters). Any information shared between regulators whether within the jurisdiction or between regulators across borders is under strict terms of confidentiality. However, although the legislative framework does not prohibit co-operation, it does not provide for same (as in the case of the securities market regulator – SEBI).

#### **(iii) Principle 6 to 10 (The Supervisory Entity (Form and Governance of Insurers))**

IRDA considers and issues the certificate of registration to insurance companies. It registers the applicant as an insurer if it is satisfied that (i) the financial condition of the promoters and the general character of management of the applicant are sound; (ii) the volume of business likely to be available to and the capital structure and earning prospects of the applicant will be adequate; (iii) the interests of the general public will be served if the certificate of registration is granted; and, (iv) the applicant has complied with the applicable provisions of the Act. No insurance company is permitted to carry on any business other than insurance. Further, the regulatory framework does not provide for composite insurance companies. As indicated above, in addition to the insurance companies which have been granted registration by the supervisor, the exempted insurers are also carrying on operations.

The regulations on the registration of insurance companies lay down the criteria for licensing of companies. Foreign insurance companies can set up operations in India only as a joint venture, with the participation of the foreign partner through Foreign Direct Investment (FDI) route, capped at 26 per cent. Foreign establishments on a stand alone basis can set up liaison offices in the country. Under the present framework, setting up branch offices by foreign insurance companies is also not permitted. Re-insurance companies are, however, permitted to set up representative offices.

Promoters of the applicant company (and on a continuing basis post registration of the insurance company), directors, key persons including the senior management and appointed actuary have to undergo due diligence process as part of "fit and proper" criteria. IRDA is empowered to remove a functionary/seek disinvestment by a shareholder under specified circumstances. The overall corporate governance framework as provided for in the corporate law is applicable to the insurance companies. In addition, specific provisos as applicable to these companies are contained in the regulatory framework applicable to the insurance companies.

IRDA approves the shareholding pattern at the time of grant of registration to an insurance company. Further, approval of IRDA is required in cases where after the transfer of shares, the total paid-up holding of the transferee is likely to exceed 5 per cent of the paid-up capital. Where the transferee is banking or an investment company, such approval is required if the holding is likely to exceed 2.5 per cent of the paid-up capital. Approval is also required where the nominal value of the shares intended to be transferred exceeds one per cent of the paid-up equity capital of the insurer. Transfer of business or amalgamation of a life insurer with any other life insurer can only be made in accordance with a scheme prepared under the legislation and approved by the supervisor.

IRDA relies on professional bodies like the Institute of Chartered Accountants of India and the Institute of Actuaries of India to set and enforce standards of professional conduct. It has prescribed a system of joint audit of insurance companies. The role of such professionals as the statutory auditors and the appointed actuary is also laid down in the regulatory framework.

The appointed actuary is assigned a significant role in the regulatory framework and for ensuring the health of an insurance company and is required to ensure compliance with the manner of computation of the actuarial liabilities of the company. The solvency statement and the valuation report are required to be submitted to IRDA as per prescription. In case of a general insurance company, the claims provisioning is required to be certified by the appointed actuary, who must ensure that the provisioning is made as per the guidelines of IRDA.

In view of the recent removal of tariffs in the general segment, general insurers are required to establish clearly defined Board approved manual for delegation of authority for underwriting business.

IRDA does not allow any core functions of an insurer to be outsourced. However, where functions are outsourced, the requisite agreements must be in place; should be at arms' length; IRDA also reserves the right to seek information from the entity to whom activities may have been outsourced.

Adherence to the requirements of internal controls and systems duly supervised by the Board of Directors needs to be verified through comprehensive on-site supervision. There is also a need to ensure that the insurers have put in place adequate internal controls. All these aspects are being addressed by putting in place a robust on-site inspection mechanism. The initiative in this regard was taken about two years back.

**(iv) Principle 11 to 17 (On-going Supervision (Actual Practice of the Supervisor))**

IRDA analyses the performance of insurance companies on a monthly basis based

**Box 5.4: Challenges in Financial Regulation and Supervision**

The insurance sector' regulation had initially followed the basic form of preventive regulation. The preventive regulation first takes care of the entry requirements and follows generally the international approach for licensing. This is combined thereafter with further requirements of post-licensing operational issues such as financial strength as reflected by solvency ratio, prudent investment pattern prescriptions, proper underwriting approaches etc. All the other requirements of internal control and risk managements on day-to-day operations (such as reinsurance, preparation of accounts, licensing of intermediaries etc) also get prescribed. In addition to the above, market conduct' regulation is a very important block for this sector as it involves policyholders' protection. Besides specific regulations for the purpose, regulatory measures are embedded in all the preventive regulations.

In the initial stages of opening up of the sector, the regulations have been broadly drawn based on the powers vested in the Insurance Act, 1938 with certain additional powers vested in the IRDA Act, 1999. In the context of the growth that had followed the opening up of the sector and also the dynamic changes in the financial sector outside the insurance, amendments are required to the insurance legislation since the Act is of an earlier era with obvious limitations. The ability to carry out changes consistent with the other developments is, to some extent, constrained by lack of flexibility in the Act (For e.g. the Insurance Act prescribes in detail the pattern of investments of insurers who cannot override these requirements despite widespread changes in the financial markets).

Consequently, it could be argued that the regulations are not sufficiently progressive and perhaps also conservative. It may, however, be too early to make such a judgment or an assessment of the effect of the extant regulation on the growth of the sector at the current stage of evolution of the insurance market. Since there has been a huge untapped potential, the new companies have exploited these advantages and the insurance penetration has virtually trebled in the last six years. With entry of more players and the most accessible of the markets having been tapped, the growth momentum could well be different in the longer term. In the medium-term, sustained growth in volumes of business, coinciding with the ever increasing capital requirements could project inadequacies in regulation with calls for further deregulation. The biggest challenge in the sector would be to bring up the quality of regulation to a much higher level to keep pace not only with the domestic financial sector development, but also to bridge a gap with international practices specific to the insurance sector. Preventive regulation would be able to take care of any adverse changes in the short run but could lead to inefficiencies in capital utilisation and competition in the long run. This needs to be addressed within the next decade.

Within the sector, there are disparities in the levels of information flow and skill availability between the public and private sector players. The regulatory body is also new and has to quickly address the requirements of adoption of technology, higher skills and sophistication of the other regulators etc., within a very short time span even as it is not possible to match the compensation levels of the private sector.

on the business figures furnished by life and general insurers. Qualitative analysis is based on market conduct issues that come to light in the publicity material filed with IRDA for information and/or for prior approval and also the information that come to notice through the Grievance Cell which attends to grievances of customer/agencies of the insurer.

Insurers are required to submit various returns: (i) on an annual basis including financial statements duly accompanied by the auditors' opinion on statement on the annual accounts; reports of valuation of assets, valuation of liabilities and solvency margin; actuarial report and abstract and annual valuation returns giving information about the financial condition for life insurance business; Incurred But Not Reported (IBNR) claims in case of general insurance business; re-insurance plans; and Investment policy (to be reviewed on a six-monthly basis) and returns on Investments ; (ii) on a quarterly basis including statement of the list of products cleared by the supervisor; un-audited financial statements and position of solvency; returns on investments; and details of capital structure *etc.*, and, (iii) on a monthly basis the statement on underwriting of large risks in case of general insurance companies; all products to be marketed by life insurers; details of capital market exposure; and monthly statistics on premium underwritten. These returns enable effective off-site monitoring and in evaluation of the financial condition of each insurer. Additional statistics/data / reports are also sought at shorter intervals as and when the market-wide situations so warrant. Information received is analysed and action taken where called for.

On-site inspections have been carried out by IRDA over the last two years for financial / comprehensive inspections; and focused/specific inspections - targeted exams focus on operational areas of an insurance company such as business procurement, policy issuance,

claims settlement and other servicing aspects of insurance business.

IRDA can suspend or cancel the license of insurers and insurance intermediaries besides imposition of monetary penalties. Failure to comply with the directions may ultimately result in cancellation of registration. Minor procedural irregularities are normally rectified by the insurer on being pointed out to obviate the need for a formal order or action. IRDA can also bar an insurance promoter who withdraws from an insurance venture from re-entering into the insurance business. Similarly, where persons in positions of responsibility have been found to be delinquent, they may not be given regulatory clearance. In certain instances, as laid down, IRDA in consultation with the Consultative Committee exercises its powers to issue directions to prevent the affairs of an insurer being conducted in a manner prejudicial to the interests of the insurer or generally, to secure the proper management of an insurer. This can result in delays in taking regulatory decisions. It should be mentioned that a formal Preventive and Corrective Action (PCA) framework is not yet in place, although, for the present, the absence of a formal system of PCA does not hinder the process of initiating corrective measures where required in a timely manner.

With specific reference to group-wide supervision, the legislation does not vest IRDA with requisite powers to ensure protection of an insurance company in case of the group to which it belongs encounters any financial difficulties. Under the Insurance Act, every company registered to carry on insurance business is regulated on a stand-alone basis and not on a group-basis even if the insurer belongs to a group as defined under the Company Law. There is, however, monitoring of the performance of the financial conglomerates through processes established among regulators in the financial sector through inter-regulatory coordination. As such, the system of group-wide supervision is evolving.

Box 5.5: Solvency

Solvency is "having enough money to meet all pecuniary liabilities." In the context of insurance, this definition gives rise to two concepts – relating to two extremes possibilities (i) liabilities paid on an immediate liquidation of the company (break-up or run-off approach) and (ii) to pay all its debts as they mature (*going-concern* approach). This means that a company is solvent when its solvency margin is positive. There are other ways of looking at solvency.

1. From the point of view of the management, the continuation of the function and existence of the company must be secured.
2. From the point of view of the supervisory authority, the benefits of the claimants and policyholders must be secured.

The IAIS defined solvency as follows: "An insurance company is solvent if it is able to fulfill its obligations under all contracts, under all reasonably foreseeable circumstances" (IAIS 2002). The definition was later slightly modified as "the ability of an insurer to meet its obligations (liabilities) under all contracts at any time" (IAIS, 2003a). In the definition it is also stated:

Due to the very nature of insurance business, it is impossible to guarantee solvency with certainty. In order to come to a practical definition, it is necessary to make clear under which circumstances the appropriateness of the assets to cover claims is to be considered, e.g., is only written business (run-off basis, break-up basis) to be considered, or its future new business (*going-concern* basis) is also to be considered. In addition, questions regarding the volume and the nature of an insurance company's business, the time horizon to be adopted, and an acceptable degree of probability of becoming insolvent should also be considered.

One of the principal concerns underlying regulation of both life and general insurance companies is the

protection of policyholders and claimants. Life insurers are custodians and managers of substantial investments of individuals; and general insurance policyholders need to be confident that their insurer will be able to meet its promised liabilities in the event that claims are made. Regulatory authorities therefore seek to ensure that insurers' finances are in a sound condition and are properly managed. One of the most important tools at their disposal for this purpose is the solvency requirement imposed on insurers. The insurance directives set out minimum standards which insurers must comply with, as regards the adequacy of their finances. In particular, they impose common standards for the determination of the minimum required solvency margin for an insurer and set out the types of assets which can count towards that margin. In the last few years, many countries have moved from the mandated solvency margin regime to the risk-based capital where various risks are measured and capital is provided according to various risks.

The Solvency I directives provided the regulatory authorities in member states of Europe with certain powers to intervene if the rights of policyholders were threatened because of the adverse financial position of an insurer. In particular, they had the power to oblige an insurance undertaking to maintain a higher margin of solvency in order to protect against further deterioration in its financial position in the near future. This higher margin was related to the financial recovery plan that the insurer was obliged to submit to the regulator. At present European countries are working towards Solvency II. The following are some of the key considerations of this:

- Identification of key risks to the financial position, *viz.*, underwriting risk, asset risk, credit risk and operational risk;



- Assessment of interaction and overlap of these risks and their modeling for decision-making purposes;
- Requirements for insurers to disclose information to enable the regulators to assess the strength of technical provisions in more detail, such as the methodologies, assumptions in determining claims, sensitivity analysis and details of the development of the claims run-off;
- Introduction of a more consistent approach to asset valuation and applying a more risk-based approach to account for volatility and resilience;
- Integration and harmonisation of the approach to the treatment of re-insurance in the solvency calculations;
- Assessment and incorporation of advanced risk reduction techniques, such as Alternate Risk Transfer, into the prudential supervision regime; and
- Consideration of the application of a 'three pillar' approach to the supervision of insurance undertakings. The three pillars are
  - Pillar 1: Financial resources – to include a risk based approach to minimum capital requirements and the valuation of assets and liabilities, including assessment of liabilities at the group level.
  - Pillar 2: Supervisory Review – assessment of strength and effectiveness of risk management systems and internal controls.
  - Pillar 3: Market Discipline – Obligations for insurers to make disclosures to allow policyholders to assess key information about the financial strength of insurers.

The following table gives the international practice in this area.

**Table 1 - Solvency margin, international practice:**

**Australia** The ideas are similar to those behind Solvency II. Liability valuation, risk categories, a factor-based prescribed method, and internal models

<b>Canada</b>	A factor-based system. Risk categories, the minimum capital test, dynamic capital adequacy testing, and minimum continuing, capital and surplus requirements on ratings.
<b>Denmark</b>	Fair valuation and a traffic light test system.
<b>Finland</b>	A risk theoretical transition model and equalisation reserve.
<b>Netherlands</b>	Fair valuation and minimum solvency and continuity analysis.
<b>Singapore</b>	Valuation of assets and liabilities, risk categories, and two requirements in a risk-based system.
<b>Sweden</b>	Valuation of assets and liabilities, risk categories, and a simple model.
<b>Switzerland</b>	Valuation of assets and liabilities, risk categories, standard model, scenario tests determining the target capital, and internal model.
<b>UK</b>	A twin peaks' approach under Pillar I, individual capital adequacy standards under pillar II.
<b>U.S</b>	Risk-based capital model, correlation structure, and different intervention levels.

In India, IRDA had prescribed the solvency ratio of 1.5. This is the ratio of available solvency margin to that of required solvency margin. If this ratio is more or equivalent to 150 per cent, then the insurer is considered to be solvent. The available solvency margin is the difference between the total value of assets at a specified date and amount of liabilities on that date. In working out the liability, the actuary has to consider all policies which are in the books of the insurer on the valuation date. The required solvency margin is either Rs.50 crore or Rs.X whichever is higher. Rs.X is an amount arrived at using a formula which combines some percentage of mathematical reserves and some percentage of sums at risk. It is important to note that these percentages are prescribed by the IRDA and they vary depending upon the type of insurance product.



If there are any indications of a life insurance company failing, IRDA can arrange for compulsory transfer of policies from the failing company to another insurer taking adequate steps to ensure that the interests of the policyholders are protected. Provisions of the general commercial law and insurance law apply to an insurance company on matters relating to insolvency and winding up. IRDA can apply to the Tribunal for winding up on an insurance company under specified circumstances. This includes insolvency of the company or if the continuance of the company is prejudicial to the interest of the policyholders or to the public interest generally. The legislation also prohibits an insurer from voluntarily winding up except for the purpose of amalgamation or reconstruction or on the ground that by reason of its liabilities it cannot continue its business. As regards insurance business carried on by provident societies being transferred to or amalgamated with another insurance business, such a scheme needs to be sanctioned by IRDA.

With specific reference to the protection of the interests of policyholders, the legislation does not provide for establishing priority of claims of the policyholders in the event of the insurer becoming insolvent and winding up.

**(v) Principle 18 to 23 (Prudential Requirements (Financial and Risk Management Processes))**

The regulatory framework for the preparation of financial statements requires the management of respective companies to disclose their overall risk exposure and the strategy adopted to mitigate the same. Similarly, when an insurer has operations in other

countries, the management is required to estimate and disclose the country risk and exposure risk and the hedging strategy adopted by the insurer. The statutory auditors are required to comment on the internal control systems in place being commensurate to the size of the operations of the insurance company.

In the case of life insurance companies, the appointed actuary have the responsibility to ensure that the solvency of the insurer is maintained at all times and also to monitor the premium charged to ensure its adequacy. Detailed analysis of company's internal practices on risk assessment and management is made through the appointed actuary's annual report. The regulatory framework requires general insurance companies to determine the valuation of liabilities and provide adequate reserve for unexpired risks, outstanding claims and claims incurred but not reported (IBNR). Further, the appointed actuary of a general insurance company is required to certify the truth and fairness of IBNR reserves. The role of the appointed actuary (AA) is clearly laid down in the regulatory framework. The regulations provide for the manner of appointment, cessation, powers, duties & obligations and the absolute privileges of the AA.

In view of the recent de-tariffing of the general insurance sector, companies underwriting general insurance business are required to have in place Board approved underwriting policy detailing product design, rating, terms and conditions of cover and underwriting activity.

In the life insurance business, the basic underwriting strategy and guidelines are

required to be submitted to IRDA on the commencement of operations. IRDA reviews the methodology adopted by insurance companies to set premium rates and also reviews that adequate systems are in place for risk transfer arrangements consistent with the overall capital position. As part of this process, IRDA reviews the adequacy and effectiveness of re-insurance arrangements of insurers and analyses the re-insurance statistics. While the regulatory requirement for approving the underwriting policy is in place in the case of non-life insurance companies, the same needs to be extended to the life insurance companies as well.

IRDA requires the management of investments to be within the insurer's own organisation. In order to ensure a minimum level of security of investments, the regulations prescribe certain percentages of the funds to be invested in government securities and in approved securities. The regulatory framework lays down norms for the mix and diversification of investments in terms of types of investment and limits on exposure to group company insurer's promoter group company. The regulations provide for the constitution of the investment committee and various aspects to be covered in the investment policy are required to be framed by the respective insurance

companies on an annual basis. These include issues related to asset mix, valuation, diversification, asset liability matching, risk management and putting in place internal controls to ensure compliance with both the legal & regulatory framework and the internal systems in place within the organisation. The risk management system is required to cover all the risk associated with investment activities which could possibly impact the coverage of the technical provisions and thus the solvency margin of the company. The manner of valuation of investments is also laid down in the regulations.

While the regulatory framework provides for the assessment of various associated risks, there is a need for setting up a comprehensive risk management system. This is proposed to be stipulated by IRDA as part of the overall corporate governance guidelines. It is also intended to put in place stipulations for setting up of a Risk Management Committee.

Currently, IRDA is examining its own solvency regulations in relation to other jurisdictions through the information available from IAIS. It is also considering the advantages and disadvantages of moving to a risk-based capital model in the current state of development of the Indian insurance market.

#### Box 5.6: Framework For Risk Focused Surveillance

Every insurance company is exposed to various kinds of risks which can be categorised into three components, i.e., technical risks, investment risks and non-technical risks. While the technical risks may vary between life and general insurers, the other two are universally applicable. While, technical risks cover the liabilities side of insurance companies, investment risks relate to the assets. The risks facing an insurance company would broadly comprise of:

- **Insurance risks:** risk due to inappropriate underwriting strategy if chosen strategy is inadequately implemented, or unexpected losses arise even when an appropriate strategy is in place. These risks could include

underwriting risks, catastrophe risks and deterioration of technical reserves.

- **Market risks:** risks that arise primarily due to adverse movements in the value of an insurer's assets, both off and on balance sheet and the corresponding movement in the value of liabilities. The adverse movements could be on account of changes in interest rates, foreign exchange rates, equity values, *etc.*
- **Credit risks:** risks which arise when a counter party fails to perform its obligations.
- **Liquidity risks:** risks which relate to the possibility that an insurer will be unable to

realise the assets to fund its obligations as and when they arise.

- **Operational risks:** risks arising from failure of systems, internal procedures and controls leading to financial loss.
- **Group risks:** The group members of an insurer can be a potential source of strength to the insurer, but it can also pose risks particularly as a result of contagion.
- **Systemic risks:** could result on account of failure or downgrading of one or more insurers who are significant in the market. Similarly, the failure or downgrading of other financial institutions such as banks, could affect an insurer's operations.

Insurance companies put in place risk management framework to review and to handle risks pertaining to operations, investments and Asset Liability Management (ALM). Having placed strategies for risk mitigation, companies set up systems to monitor their performance with the changes in the environment and may review these strategies where necessary. An important aspect of managing risks is the regulatory stipulations on the investment portfolio which has a spill-over effect on technical provisions and solvency margin.

One of the significant sources of risk mitigation is re-insurance. Based on their assessment of the capacity to bear risk, insurers buy cover for the business underwritten. Traditionally, insurers and re-insurers managed their capital according to their core business of taking on financing risk.

From the regulator's angle, the cover against the risks borne by the insurers is the availability of sufficient assets to honour their liabilities (net of re-insurance) as and when these may arise. An insurance company is considered solvent if it is able to fulfill all its obligations at all points of time. The regulators, in order to protect the interests of the policyholders,

have stipulated minimum capital requirements at the entry level and also for the maintenance of adequate capital/assets at all points of time. Across the globe, the approach towards adequacy of capital is three pronged, i.e., minimum capital, supervisory review and enhanced disclosures. The regulatory regime provides for intervention by the supervisor or imposition of certain restrictions in case of the available solvency margin falling below the specified threshold. Moving forward, based on their assessment of the capital requirements, insurers could inject more capital. The supervisor through regulatory pro-active intervention takes adequate preventive measures to curtail/ contain risks, laying down prudent controls and guidelines for undertaking specific activities, and provide for methodologies for computing various critical parameters and formats for reporting on a periodic basis. Prudential principles are usually embedded in the regulatory framework to provide for the technical risks, which could include provisioning for technical reserves, sufficiency of new business and 'file and use' procedures. Investment guidelines and admissible assets help in diversification and spreading of investment to minimise the related risks. The non-technical risks are controlled through various initiatives aimed at corporate governance. In the Indian context, the supervisory framework requires insurers to disclose their overall risk exposure and the strategy adopted to mitigate the same. In cases where the insurer has operations in other countries they are also required to disclose details of the country risks and strategy adopted to hedge such risks.

The need for regulatory supervision stems from the fact that there are economic costs attached to failure of financial markets which could lead to systemic failures with corporates operating as financial conglomerates and the spiraling impact of the same. The approach adopted by insurers to evaluate and prioritise risks and finally mitigate them, find roots

in their desire to align these with the overall strategic decisions to optimise shareholder' value which again is not possible without optimising the benefits of all stakeholders.

Of particular significance is the need for the Indian insurance industry to pay due attention to operational risk issues and address them in an adequate manner so that these risks are suitably identified at an early stage and risk mitigating measures are put in place. The compelling reasons for this are: (i) Unlike other risk factors, operational risk takes a long time to surface; (ii) The contagion effect of operational risk from one insurer to another insurer needs to be recognised; and (iii) In a similar vein, if an insurer who has higher operational risks and transfers risks to a financial intermediary belonging to another financial system say banks / NBFCs, there could be a systemic impact which will destabilise the financial system.

Regulators across the globe are putting in place various processes involved in risk focused surveillance framework. These include (i) risk focused examination; (ii) off-site risk focused financial analysis; (iii) review of internal/external changes; (iv) supervisory rating systems (CARRMELS); and (v) Supervisory Plan. The risk focused examination includes identification of various functional activities and assessing the inherent risks associated with those activities. The process covers identification and evaluation of control processes in place to monitor the identified risks. The off-site risk focused financial analysis

includes examining aspects as frequency and scope of the examination, meetings with company management, follow-up on the recommendations made and continuous monitoring of financial analysis and the actuarial analysis. Given the limitation of the resources available, supervisory bodies prioritise their regulated entities for the purpose of monitoring their performance. The "off-site" or "desk audit" is based on ratio analysis which covers Capital Adequacy, Asset Quality, Reinsurance, Reserves, Management, Earnings, Liquidity and Sensitivity to Market – CARRMELS. The risk assessment based approach thus facilitates a more efficient use of resources at the disposal of the supervisor. The challenges to the supervisor while following the risk based approach are tackling concerns relating to "Confidentiality"; Competence – which encompasses the regulatory resources and expertise; and Consolidated approach of regulating from a group-wide perspective.

Overall, the changing equations in the financial markets and emergence of financial conglomerates have only increased the contingencies and uncertainties. The risks associated in such a scenario have put further pressures on the need for transparency, disclosures and corporate governance. Risk disclosure is critical to the operation of a sound market. When provided with appropriate timely information, the market participants can act efficiently, rewarding those companies that manage risk efficiently and penalizing those that do not. This brings in market discipline and acts as an adjunct to supervision.

**(vi) Principle 24 to 27 (Markets and Consumers (Distribution, Consumer Protection, Disclosure and Fraud))**

The legislation permits only licensed intermediaries to transact any insurance business. IRDA issues a license to an applicant who is compliant with the minimum prescribed qualifications and training requirements as indicated for respective intermediary or an insurance intermediary. In case of corporate intermediaries, the regulations also specify the minimum capital and infrastructure requirements for the applicant. Corporate entities are licensed after a thorough due

diligence process to assess the reputation of the promoters and only when they comply with the basic minimum requirements specified under the legislation/regulations. Though the broker, as an intermediary, is not a risk carrier, a minimum capital requirement has been prescribed for direct life and/or general brokers and for composite brokers. The regulatory framework prescribes that in the process of sale, the insurer or intermediary should adhere to the code of conduct prescribed by IRDA, and the respective Councils of the life and general insurers and the self regulatory organisations (e.g., Brokers' Association of India). Thus, all



intermediaries are also governed by the provisions of the code of conduct as laid down in the regulatory framework. In addition,

powers are vested with the supervisor to apply sanctions as prescribed under the Act/Regulations.

#### Box 5.7: Self Regulatory Organisations for Insurance Industry

Ineffective market discipline is one of the issues identified by the International Association of Insurance Supervisors (IAIS) as a potential threat to the emerging markets, and needs to be tackled to ascertain the healthy growth of the insurance industry. While the regulator has to play a key role in ensuring market conduct, the industry too has to enforce market discipline. Globally, regulators are moving towards building up mechanisms for corporate governance within the regulated entities. Sound market practices combined with putting in place a "fit and proper" management can facilitate evolution of best management practices while strengthening the regulator's role of "management by exception". This, combined with self regulatory mechanism, can help the industry weed out unhealthy market practices. Self regulation supported by a quick market response for over-stepping can have an effective deterring impact.

As the Indian market develops, the role of the Self Regulatory Organisations (SROs) will take on greater significance. The empowerment of the SRO essentially gives greater rights and responsibilities to market participants who, on their part, must be capable of ensuring effective regulation to meet the challenges. Failure to regulate effectively could lead to a deterioration of market integrity and stability, and would ultimately result in intervention by the IRDA as the 'supervisory regulator with oversight responsibilities'. It is envisaged that, in time, much of the developmental role currently played by the IRDA will be taken over by the SROs. In an environment of growth and expansion, it is the SRO which can best facilitate innovation and adjustment to seize competitive opportunities and meet the challenges ahead. These associations can draw upon the experiences and best practices evolved in other countries. The industry associations can generate a consensus on contentious issues like introducing concepts of additional disclosures; pool statistical data to facilitate pricing of products; evolve better risk management system; and set codes of best practice for market conduct.

The Life Insurance Council and the General Insurance Council envisaged by the Insurance Act, 1938 were revived in February 2000, with membership drawn from the industry and are at present performing the role of SROs in a limited manner by setting up market conduct standards for insurers. The industry councils - the Life Insurance Council and the General Insurance Council of the Insurance Association of India constituted under section 64 C of the Insurance Act - are playing a catalytic role in evolving opinion on issues of concern in the area of market conduct and adoption of ethical practices that are of relevance to the industry. CEOs of all registered insurers of the life and non-life companies find representation on the respective councils. The Councils are the platforms available for the industry participants to interact and to set up practices for the healthy growth of the industry. Development of these self regulatory bodies augurs well for the industry to put across its view point on critical areas for the growth of the industry.

The Life Council has constituted the Intermediary Education Sub-Committee to look into the emerging issues in training and examination of agents. The Sub-Committee on insurance awareness is co-ordinating IRDA in creating insurance awareness among the public across the country. During 2006-07, the Council adopted a code of best practice for members and approved its implementation thereof.

In the same context, a broker licensed by the IRDA is necessarily required to be a member of the Insurance Broker Association of India. The Association is functioning as a Self Regulatory Organisation (SRO) with a Disciplinary Committee in place. A representative of the IRDA is also a member of the Committee.

The Government of India notified the Actuaries Act, 2006 in the official gazette on 28<sup>th</sup> August, 2006. As a result, the actuarial profession would get a fillip with the grant of statutory status. As per provisions of the Act, in place of existing Actuarial Society of India, "Institute of Actuaries of India" has been constituted with the objectives of (i) promoting, upholding and developing the standards of

professional education, training, knowledge, practice and conduct amongst actuaries; (ii) promoting the status of the actuarial profession; (iii) regulating the practice by the members of the profession of actuary; (iv) promoting, in the public interest, knowledge and research in all matters relevant to actuarial science and its application; and (v) to do all such other things as may be incidental or conducive to the above objects.

The Government of India and the IRDA, have established Indian Institute of Insurance Surveyors and Loss Assessors to promote self-regulation and professionalism amongst the surveyors. The Institute, at present, has a limited mandate of establishing the necessary

Publicity material of insurance products is vetted at the product clearance stage to ensure that advertisements are not deceptive or misleading. The information to be stated in a life insurance policy and a general insurance policy have also been stipulated by the supervisor. The regulations mandate benchmarks for settlement of claims and also stipulate payment of penal interest for delayed settlement. It is further mandated that the insurer shall have proper procedures and mechanisms for grievance redressal. The agency licensing regulations specifies that agents should render assistance in settlement of claims. The regulations governing brokers prescribe that the functions of a direct broker shall include providing requisite underwriting information as required by an insurer in assessing the risk to decide the pricing terms and conditions for cover. The regulations stipulate disclosures to be made at the point of sale with regard to the insurance product, its benefits, limitations, extent of insurance cover etc. It is further stipulated that the insurer shall inform the policyholder while forwarding the policy document that he has a period of 15 days from the date of receipt of the document to review the terms and in case of disagreement return the policy stating his objection. This period is referred to as the free-look period. The code of conduct applicable to intermediaries requires them to disclose the commission structure if asked for by the prospect.

infrastructure, to inculcate professionalism, discipline, and disseminate information relating to the profession of surveyors and loss assessors amongst its members. The code of conduct regarding the professional and ethical requirements for conduct of their professional work is specified in Chapter VI of the IRDA Regulations for Surveyors and Loss Assessors, 2000. Surveyors & Loss Assessors should strive for objectivity in professional and business judgment while behaving ethically and with integrity in their professional pursuit, acting impartially and complying with due diligence, care and skill with regard to technical and professional standards expected of them.

Insurance Ombudsman offices have been set up across the country whose decisions are binding on insurance companies. IRDA has taken up awareness campaigns through the media – both print and electronic, educating consumers on the need and advantages of both life and general insurance. It has also issued notices of caution on the need to avoid transactions with un-supervised entities and in cases where there is a mis-sale reported.

As part of the disclosure requirements, the financial statements filed by insurers are publicly available. Copies of the annual accounts can also be obtained from the supervisor's office. Insurance companies are also voluntarily placing details about their performance and the financials on their respective websites. The Ministry of Corporate Affairs dedicated website MCA 21, too, contains the published annual reports of all companies including the insurance companies. While none of the insurance companies is a publicly listed entity at present, if and when they opt for listing, the stipulations of SEBI will also be applicable to them, resulting in greater transparency and disclosure of information.

IRDA issues guidelines as and when the situation warrants on the market conduct activities of insurer/intermediary to check possible fraud. Stipulations need to be put in place on the reporting of the same to the supervisor's office, once these are detected.



There are gaps in the mechanisms available to detect various frauds and on sharing of information between insurers and with the regulator. This needs rectification.

#### **(vii) Principle 28 (Anti-Money Laundering, Combating the Financing of Terrorism)**

The supervisor has issued guidelines on an Anti-Money Laundering Programme for both life and general insurance companies. Life insurance companies are advised to carry out Know Your Customer (KYC) norms on an ongoing basis right from the initial entry stage until the pay-out stage, including at the time of additional top up remittances especially when these are inconsistent with the customer's known profile. General insurance companies are required to ensure compliance with KYC norms at the pay out stage. The obligations, however, apply only to insurance companies and not to their agents, and other intermediaries. Since the agents of insurers act on behalf of the insurer, the responsibility for compliance rests solely with the latter. The guidelines broadly cover "Customer Due Diligence, Record Keeping, Reporting of Suspicious Transactions and Compliance."

The enforcement powers as required by the applicable legislation are, however, not in place. This is required to be provided for in the legislation governing the supervisor.

Based on the above assessment, the overall position of observance of the 28 core insurance principles is indicated as under:

The detailed principle-wise assessment in respect of ICPs is given in **Appendix 3**. Based

on the assessment of the core principles, the way forward or action points under each ICP has been laid down. The various initiatives include those required to be taken at the legislative level, for the supervisory mechanism and to put in place systems at the offices of the insurance companies. These initiatives, which are outlined broadly as under, are aimed at enhancing supervisory framework to achieve protection of policyholders' interest; expansion of market; market stability:

1. Stipulations on 'fit & proper' on continuing basis;
2. Corporate governance stipulations;
3. Strengthen market analysis & supervision;
4. Strengthen risk assessment processes;
5. Enhance disclosure stipulations in a phased manner;
6. Re-visit framework for investment in derivatives;
7. Systems to track frauds;
8. Winding up and mergers & acquisitions – protection of policyholder' rights; and
9. Legislative amendments to strengthen enforcements & sanctions.

The supervisor is currently also benchmarking its own solvency stipulations against the solvency/Risk Based Capital (RBC) models of other jurisdictions and is also assessing the impact of moving to a risk-based capital model in the current state of development of the Indian insurance market.

## Summary Assessment of IAIS Principles

Sr. No.	Principle	O	LO	PO	NO	NA
	<b>Conditions for Effective Insurance Supervision</b>					
1.	Conditions for Effective Insurance Supervision		√			
	<b>The Supervisory System</b>					
2.	Supervisory Objectives		√			
3.	Supervisory Authority		√			
4.	Supervisory Process		√			
5.	Supervisory Co-operation and Information Sharing		√			
	<b>The Supervised Entity</b>					
6.	Licensing		√			
7.	Suitability of Persons		√			
8.	Changes in control and Portfolio Transfers	√				
9.	Corporate Governance			√		
10.	Internal Control			√		
	<b>On-going Supervision</b>					
11.	Market Analysis			√		
12.	Reporting to Supervisors and Off-site monitoring		√			
13.	On-site Inspection		√			
14.	Preventive and Corrective Measures		√			
15.	Enforcement of sanctions			√		
16.	Winding-up and exit from the market			√		
17.	Group-wide Supervision			√		
	<b>Prudential Requirements</b>					
18.	Risk assessment and Management			√		
19.	Insurance Activity			√		
20.	Liabilities	√				
21.	Investments		√			
22.	Derivatives and Similar Commitments			√		
23.	Capital Adequacy and Solvency	√				
	<b>Markets and Consumers</b>					
24.	Intermediaries	√				
25.	Consumer Protection	√				
26.	Information, Disclosure & Transparency towards the Market		√			
27.	Fraud			√		
	<b>AML, Combating Financing of Terrorism</b>					
28.	Anti-money laundering, Combating and Financing of Terrorism(AML/CFT)		√			
	<b>Total</b>	<b>5</b>	<b>13</b>	<b>10</b>	-	-

O-Observed; LO-Largely Observed; PO-Partly Observed; NO-Not Observed; NA- Not Applicable

### Section 5 Recommendations

Based on the assessment of the compliance with the Insurance Core Principles, the gaps in compliance have been identified. To bridge these supervisory gaps and to improve compliance, the recommendations are indicated as under:

#### 1. Amendments to Legislative Framework for Effective Insurance Supervision:

Some of the provisions of the Insurance Act, 1938 are outdated and need to be reviewed in the context of the changing economic environment. The proposals for amendments to the Insurance Act, 1938 and

**Box 5.8: Amendments to the Insurance Legislation:**

The Supervisor took the initiative to approach the Law Commission of India for review of the Insurance Act, 1938. The review was initiated for consolidating the insurance related legislations into a single codified Act of Parliament, with the legislative powers resting with the Government of India and the regulatory mechanism for the professional supervision and development of the insurance industry vested with the IRDA.

The Law Commission submitted its Report to the Government of India, vide letter D.No.6(3)(75)/2002-LC(LS) on 1st June, 2004 indicating the amendments/ modifications to the Insurance Act, 1938. While submitting the report to the Government of India, the Law Commission opined that in respect of a few areas, detailed examination by experts was needed. Consequently, the Commission did not indicate any amendments or modifications to those sections of the Insurance Act, 1938 which required inputs from domain experts. The IRDA constituted a Committee under the Chairmanship of Shri K. P. Narasimhan on 7th March, 2005 to give its recommendations on the following:-

1. Areas suggested by Law Commission which required domain inputs.
2. Areas in which the Commission had not recommended any modifications, but which required changes.
3. Suggestions if any, on the recommendations made by Law Commission.
4. Any new sections, which may be created to address the needs of the various industry stakeholders.

The Committee submitted its Report on 26th July, 2005.

Based on the recommendations of the 190<sup>th</sup> report of the Law Commission and the report of the Committee, the IRDA has made recommendations to the Government of India for amendments to various provisions of the Insurance Act, 1938. Broadly, the recommendations have been made on issues relating to (i) repudiation of life insurance policy - Section 45 of the Insurance Act, 1938; (ii) Assignment & Transfer; (iii) Nomination; (iv) provisions relating to penalties; and (v) Grievance Redressal Mechanism. In addition, the proposed amendments would remove redundancies, modify definition of Indian insurance company and rationalise certain other sections in the light of the past experience.

With regard to the imposition of penalties, the IRDA has recommended the enhancement of penalties imposed under Sections 102 to 105C of the Insurance Act, 1938 on the lines of SEBI Act, 1992. The penalties, it has been proposed, should be imposed based on the recommendations of the adjudicating officer of the IRDA.

The IRDA has also recommended amendments to LIC Act, 1956, including removal of sovereign guarantee extended to the policies issued by the LIC so as to provide for a level playing field. The IRDA has also recommended creation of a separate Statutory Reserve Fund by the LIC. Alternatively, it has been suggested that compulsory distribution of 95 per cent or above of the surplus to the policyholders may be deleted leaving it to the discretion of the Corporation which will enable the Corporation to create a free reserve out of the surplus.

the LIC Act, 1956 have been forwarded to the Government.

## **2. Strengthening the Powers vested with IRDA:**

Under the existing legislative framework, some of the powers pertaining to the supervision of the sector still rest with the Government, such as the constitution of a consultative committee, the enforcement of criminal penalties, and in matters of winding up of an insurance company. For effective supervision these need to lie with the IRDA.

## **3. Bringing the Exempted Insurers under IRDA:**

The regulatory position with respect to the exempted insurers is not clear. With a view to ensuring that all entities carrying on insurance business are supervised by the IRDA, clarity of their reporting to the supervisor needs to be reinforced. A roadmap needs to be laid down by IRDA, in consultation with Government of India, for the continuance or otherwise of these entities to address the concerns relating to protection of the interests of the policyholders covered by them.

## **4. Specific Provisions Applicable to the State Owned Insurance Companies:**

Government owned insurers continue to be governed by certain provisions of the specific legislations (that regulate their activities) apart from the insurance legislation governing the industry. Some of these provisions cover aspects such as capital structure, notification of higher limits on investments, free permission for opening of operating offices. This dichotomy, goes against the basic premise of a level playing field for all entities operating in the sector. It is a deterrent to effective supervision. The proposed amendments to the legislative framework would address these concerns.

## **5. Financial Independence:**

The funds' requirement of the supervisor for its budgetary allocations is met from the

registration/renewal fees received from the insurance companies and intermediaries. With respect to the financial independence, an issue has been raised by the Government of India on transfer of the supervisor's funds to the exchequer. While the request has not been acceded to and is under examination, any action in this regard would be detrimental to and raise serious concerns relating to the supervisor's stature as an autonomous regulator.

## **6. Capacity Building:**

While the supervisor has been initiating a number of measures to increase and empower its manpower to discharge its functions, given the fact that the insurance sector is fast expanding a number of new issues are required to be addressed, there is a continuing need for enhancing their skill sets. Similarly, there could be issues related to retention of skilled staff. While globally, regulators are unable to match their remuneration structure with those at the industry levels, within the supervisor's office there is still scope for improvement in the remuneration structure for the overall organisation, including at the top management levels.

## **7. Consultative Committee:**

The Act prescribes that the supervisor can issue directions on specific matters as laid down in the Act after consultations with the Consultative Committee constituted by the Government.

Amendments intend to do away with the stipulation for the constitution of the Consultative Committee. A recommendation to this effect has been made by IRDA.

## **8. Fit and Proper Stipulations on an On-Going Basis:**

The regulatory framework does not stipulate that in case the insurer is aware of instances where the fitness and propriety of its key functionaries is in question (particularly where criminal charges have been framed), it

should inform the IRDA about the same. The IRDA is to lay down the guidelines on reporting on 'fit and proper' compliance applicable to both the members of the Board and to the key management functionaries. These stipulations would form part of the corporate governance framework.

#### **9. Corporate Governance Guidelines:**

While IRDA has not laid down the framework for corporate governance, being part of the corporate set up all insurance companies are required to comply with the stipulations as laid down in the general corporate laws. Although for the present none of the insurance companies are listed on the stock exchanges, post-listing the stipulations on corporate governance as provided by the securities market' regulator would become applicable to them. Simultaneously, the covenants of the listing agreement would also be required to be complied with. In addition, the various provisions of the Insurance Act, 1938 and the various regulations do address issues relating to corporate governance in insurance companies. With a view to making a comprehensive set of guidelines, and given the specific requirements of the insurance sector, the IRDA has taken the initiative to put in place a corporate governance framework. The focus is on issues relating to risk management and laying down of stipulations on setting up of a Risk Management Committee to address various issues related to risks associated at the enterprise-wide level.

#### **10. Framework for Internal Control**

IRDA reviews the "internal controls and checks" at the offices of insurance companies,

as part of on-site inspection. In addition, the it relies upon the certifications which form part of the Management Report, confirming that an internal audit system has been put in place commensurate with the size and nature of its business and that it is operating effectively. The appointed actuary has been assigned a significant role. While in case of life companies he/she must be a full-time employee, in case of the general insurance companies he/she can be a consultant. He/she is a significant link between the supervisor and the regulated entity. However, there are no formal stipulations from the IRDA on the internal controls to be in place at the offices of insurance companies. As a way forward these are proposed to be formalised as part of the corporate governance framework.

#### **11. Strengthening Off-Site Monitoring:**

After opening up the sector, the IRDA initiated steps towards setting up the regulatory framework and the process of registering the new entrants was also initiated. Steps were also taken to start building up the database to enable the supervisor to conduct market analysis. Given the competitive conditions prevailing in the industry, there is a need for accurate and reliable data both at the industry and company level. Concerted efforts are being made by the regulator, the SROs and the insurance companies in this direction. Systems are proposed to be put in place to facilitate development of early warning signals and taking policy level decisions. Steps have already been initiated in this direction for appointment of consultancy firms to take up the assignment to develop the Informatics System for off-site monitoring.



## **12. Framework for Preventive and Corrective Measures:**

The IRDA is vested with powers to suspend or cancel the licence of insurers and insurance intermediaries besides imposing monetary penalties. However, a formal preventive and corrective action framework needs to be put in place. Also, as part of the framework for enforcement or sanctions, the supervisory framework requires clarity to ensure that all sanctions imposed are enforced.

## **13. Group-wide Supervision:**

Under the Insurance Act, every company registered to carry on an insurance business is regulated on a stand-alone basis and not on a group basis even if the insurer belongs to a group as defined under company law. The definition of what constitutes an insurance group and financial conglomerate and its supervision is not laid down under the insurance law. There is, however, monitoring of the performance of the financial conglomerates through processes established among regulators in the financial sector. Meanwhile, the system of group-wide supervision is evolving. For the present, this is being done on the basis of inter-regulatory co-ordination and not on a stand alone basis.

The legislation also does not vest the IRDA with requisite powers to ensure protection of an insurance company, in case of the group to which it belongs, encounters financial difficulties.

Systems need to be put in place to ensure effective group-wide supervision. This would also require co-operation and interaction between various regulators, both within the financial sector and outside. To formalise the systems, the legislation needs to provide for entering into Memoranda of Understanding between both the home and foreign regulators. The exchange of information could also facilitate market analysis on developments both in the domestic and international markets.

## **14. Issues relating to Financial Prudence by the Insurance Companies:**

Although the regulatory framework provides for the manner of distribution of surpluses in case of life companies, the IRDA does not have the necessary powers to direct the suspension of dividends to shareholders in case of general insurance companies under adverse conditions. However, provisions of corporate laws are required to be complied with by the general insurance companies. On lines similar to the banking sector, prudent guidelines need to be put in place to ensure that earnings are retained within the insurance companies under specified circumstances including underwriting losses.

## **15. Framework for Risk Assessment and Management**

Though specific regulations or tools have not been prescribed for the insurers on risk assessment and risk management, periodic reports like the actuarial reports, annual reports, etc., submitted to the IRDA provide the framework which enable insurers to assess internally the risks faced by them and to state the strategies to manage the same.

There is, thus, a need for setting up comprehensive risk management systems in the offices of insurance companies. This is proposed to be stipulated as part of the overall corporate governance framework. The stipulations would include provisions for the risk management framework being all pervasive, with the Chief Risk Officer being part of the Board of the insurance company. It is also intended to put in place the stipulation for setting up of a Risk Management Committee.

## **16. Involvement of the Boards of Respective Companies:**

The IRDA reviews the methodology adopted by insurance companies to set premium rates and also assumes that adequate systems



are in place for risk transfer arrangements, consistent with the overall capital position. While the regulatory requirement for the underwriting policy being approved by the respective Boards of the companies is in place in case of general insurance companies, the same needs to be extended to the life insurance companies as well.

#### **17. Accounting Treatment of Risk Transfer Mechanisms:**

Insurers are required to submit a copy of all re-insurance arrangements made with the re-insurers to the IRDA. Any deviation or abnormality identified at the IRDA's end is required to be immediately addressed. There is, however, a need for further clarity on manner of accounting of the various risk transfer mechanisms.

#### **18. Relaxations in the Guidelines on Derivatives and similar Commitments:**

Currently, IRDA has allowed limited use of derivatives in relation to management of risk relating to movements in interest rates. The IRDA proposes to broaden the scope of use of derivatives by the industry based on the experience gained in a phased manner. This is particularly so since the industry has not started taking an exposure to the avenues already available under the regulatory framework. Interest derivatives have been permitted by the supervisor as a hedging instrument. However, insurance companies have not yet made use of this option available to them.

As part of the overall risk management procedures, the policy framework to address the

risks associated with dealing in derivatives by the insurers needs to be addressed by IRDA.

#### **19. Framework for Detection of Fraud:**

The legislation vests power with IRDA to prevent the affairs of any insurer being conducted in a manner detrimental to the interests of the policyholders or in a manner prejudicial to the interests of the insurer; or generally to secure the proper management of any insurer. The regulations have been framed to ensure the protection of policyholders which *inter alia* lay down prescriptions relating to market conduct of an insurer/intermediary. IRDA has further issued guidelines as and when the situation warrants on the market conduct activities of insurer/intermediary to check possible insurance frauds.

There are, however, no specific requirements at present on the allocation of resources by the insurance companies to combat fraud. Similarly, stipulations need to be put in place on the reporting of the same to IRDA once these are detected. Thus, there are gaps in the mechanisms available for detection of various frauds and on sharing of information between insurers and with IRDA, although some effort has been made on declined lives.

#### **20. Enforcement Powers with respect to AML/CFT:**

IRDA has issued guidelines on anti-money laundering, combating the financing of terrorism (AML/CFT), programme for both life and general insurers. However, the enforcement powers as required by the applicable legislation are not in place. This is required to be provided for in the legislation governing IRDA.

## 21. Dissemination of Information to a wider cross-section:

IRDA could consider some stipulations for a more effective dissemination of information on the financial performance by the insurance companies through other accessible media. This will provide transparency on the operations of insurance companies.

## Section 6

### Summary and Conclusions

The overall assessment of compliance with the Insurance' Core Principles in the Indian jurisdiction has brought out the areas in which further initiatives are required or have already been initiated to upgrade compliance from 'partly' or 'largely' observed to fully observed. The initiatives in this regard are broadly categorised as under:

1. **Legislative Amendments:** As indicated above, the process of amendments to the legislative framework governing the insurance sector is already underway. The recommendations of the supervisor on the requisite amendments to the insurance laws have been forwarded to the government for its consideration. On these amendments being in place, the observance' status on the autonomy of the supervisor, strengthening the supervisory processes through sanctions and enforcements, and the ability to levy penalties directly in proportion to the non compliances will be strengthened.
2. **Development of Effective Supervisory Framework:** The supervisor has taken the initiative to put in place systems to analyse the performance of the supervised entities. These initiatives are of a recent origin as the initial efforts were aimed at putting in place a regulatory framework and to grant licences to insurance entities in the private sector. Having built up a sound foundation for the insurance companies to start

operations on a level playing field, the next phase is of robust supervision. The supervisor is putting in place systems to develop early warning systems to initiate actions where required and to have the requisite market-wide database to take policy level decisions. Measures are also being taken to strengthen the regulator's office to enable it to discharge its responsibilities effectively.

While the supervisor has been initiating a number of measures to increase and empower its manpower to discharge its functions, there is a continuing need for enhancing skill sets. Similarly, there could be issues related to retention of skilled staff. While globally, regulators are unable to match their remuneration structure with those at the industry levels, within the supervisor's office there is still considerable scope for improvement in the remuneration structure for the overall organisation, including at the top management levels.

3. **Risk Based Supervision:** Initially, on the opening up of the sector to private participation, the supervisor put in place a fairly strong framework for entry level supervision. Since the sector had opened up to private participation after more than 50 years of nationalised operations, it was natural that the process was initiated with some degree of caution. Overall, the systems which were put in place were conventional with stipulations for entry level minimum capital requirements and maintenance of solvency at 150 per cent of the required solvency. The regulatory framework has served its purpose well during the last eight years. While it is accepted that IRDA would need to move towards the more sophisticated risk-based capital (RBC) model and risk based supervision (RBS), such initiatives would

require changes in the statute and the overall approach towards supervision. There would also be the need for databases with both the supervisor and the supervised entities. In the context of the supervisor's office, particularly there would be a need for upgrading the supervisory skills to put in place the supervisory framework and to develop skills to assess operational risks and to evolve benchmarks on capital adequacy and solvency. While these issues are not being addressed in the immediate future, steps are proposed to be initiated to lay down the action plan to move in this direction. While RBS as the underlying principle for supervision pre-supposes existence of a large number of entities which are required to be supervised and the limited availability of resources in terms of trained manpower at the supervisor's office which need to be prioritised, this is not the position in the Indian context. Initiatives are needed in this direction. But given the present stage

of development of the sector and the number of players in the industry, these are not a hindrance to supervision at present.

Operationally, there are no immediate signs of major vulnerability given the fact that the solvency requirements are even higher than the statutory requirement and is currently pegged at 150 per cent. No major systemic issues are anticipated as the sector has been reporting healthy growth. Strong domestic promoters have also been enthused at the prospects of adequate returns after a gestation period of 7 to 10 years. The enhancement of the ceiling of FDI in insurance sector is subject to parliamentary approval. However, as a positive development, the earlier apprehensions on possible constraints on the part of domestic promoters to raise capital in the absence of hike in the FDI limits have not materialised. Hence, no adverse impact on the health of an individual company is anticipated regardless of the stance that may be taken by the foreign joint venture (JV) partners.

### **Review of the Recommendations of the Advisory Groups constituted by the Standing Committee on International Financial Standards and Codes –Summary of Observations**

- Regarding the legal form of insurance companies, in India, the joint stock company route is followed, which is not inconsistent with the international practice. However, with a view to spreading insurance business in rural areas, the role of co-operatives may not be ruled out in future.
- Superannuation business comes under the definition of life insurance business in India. To protect the interests of the members of the superannuation funds, it is, therefore, necessary to bring these funds under some form of clear regulatory arrangements/mechanisms. There are many methods of achieving this. One such method could be through the formation of the Occupational Pension Board, as in the UK.
- An insurance company can be a domestic or a foreign company. The foreign company can operate either through a branch or on a service basis. This is the practice in most of the countries. Even though foreign companies are not allowed to operate directly, they are permitted through joint venture arrangements with an Indian company with a shareholding not exceeding 26 per cent in the paid-up capital of the company. Hence, this departure from the standard international practice of allowing foreign companies to operate either through a branch or a service basis need not be considered as a material one.
- Regarding the location of head/corporate office, at present, India's position is consistent with international practice although with globalisation, integration of markets and developments in communication networks, this stipulation may not be effectively implementable in future.
- With a view to conform to the international practice, a section similar to Section 6(2)(h) of the LIC Act could be considered for incorporation in the Insurance Act 1938, which would enable Indian insurance companies to provide similar allied services to their customers
- In the field of specialisation, "life" and "non-life" businesses are to be conducted by separate companies. IRDA has also decided not to permit formation of composite companies. However, it would be advisable to place an explicit restriction on the formation of composite companies.
- It may be desirable to take a fresh look at the developments in other countries and consider introduction of a more elaborate classification of life and non-life insurance business.
- At present, the minimum capital requirement is more than adequate as compared with best international practices. The minimum capital levels may be fixed for each class of business on a scientific and on a more transparent basis.
- The Indian practice in respect of deposit requirements is in conformity with the best international practice.
- The business plan required to be submitted along with the application for licence is quite comprehensive in India at present and is consistent with the international best practice.
- With a view to enhancing transparency, the regulator may, as a general rule, ascertain the names of the natural and legal persons holding a direct or indirect qualifying participation in the applicant company and more importantly, make this knowledge public while granting the licence.

- With regard to suitability of owners, the sound reputation of owners may be ensured on a continuous basis.
- While discussing the suitability of directors and/or senior management, although the present position in India is different from that of the current international practice, necessary steps could be taken, in future, to ensure the fulfilment on a continuing basis. Accordingly, the information system needs to be modified and maintained.
- Regarding outsourcing, it would be desirable to follow the international practice as also other Indian industrial practices, by considering outsourcing of various functions of an insurance company in view of the economies of scale and scope.
- There is no uniform international practice as regards the design of products. Hence, the certificate, including the basis of premium, given by the actuary may be treated as a public document and be made available, on demand, to other companies and any practising actuary. Further, the premium rate table and the benefit design may also be treated as "Published Information". A similar procedure could be considered for group business and also for general insurance business.
- With a view to ensuring uniformity in the design of products, terms and conditions and marketability and also to bring about a level playing field between insurance companies and mutual funds, there is a need for co-ordination between regulators of these two segments of the financial sector.
- It is recommended that the regulator may make available a recommendatory standard format of articles of incorporation.
- A firm of consulting actuaries may be considered for acting as appointed actuaries as per the practice obtaining in most countries. Furthermore, the condition that a "certificate of practice" has to be obtained each year from the professional body is not present in respect of any other profession. The Group feels that this needs a re-look.
- In the field of reinsurance, it is felt that i) the stipulations regarding re-insurance appear to be adequate for ensuring healthy re-insurance arrangements and are mostly in line with international practices; ii) the possibility of reinsuring only on risk premium basis may be explored; iii) the Indian prescription of having compulsory cession of risks to local reinsurers may appear to be against the recommendation of the IAIS. However, this prescription may be continued till a satisfactory solution is found for the problem of international reinsurers converting local insurance companies into brokers; and iv) since it would take quite some time to develop necessary international contact and build a reliable database on the activities and strengths of various re-insurers, the existing domestic expertise could be nurtured and strengthened for this purpose.

## Appendix 2

### Review of Recommendation of the Committee on International Financial Standards and Codes – Report on the Progress (Dr. Rakesh Mohan Committee 2004)

Sr. No.	Recommendation	Present	Status
1	The taxation of shareholders' share of surplus could be at the corporate rate and the balance below the current rate. <sup>27</sup>	Since life insurance business is long-term and shareholders do not envisage immediate returns, a view can be taken that taxation of shareholders' share of surplus can be at a rate marginally lower than the corporate rate. GOI could consider this through amendment to First Schedule of Income Tax Act, 1961.	
2	Role of co-operatives in spreading insurance business in rural areas to be considered in future.	The Insurance Act has been amended permitting co-operatives, as defined in Section 2C of the Insurance Act, 1938 to register as Indian insurance companies and underwrite insurance business. Necessary safeguards like Rs. 100 crore capital requirement, solvency requirements, deposits, investments, annual accounts, file and use procedures have been put in place. As such, no further action appears to be necessary.	
3	The superannuation business needs to be brought under regulatory arrangements.	The definition of life insurance business provided in the Insurance Act, 1938 does cover pension and superannuation business. Accordingly, the registration regulations notified by the Authority under Section 114A of the Insurance Act, 1938 and Section 26 of the IRDA Act, 1999 has specified the definition to mean "business of effecting contracts to manage investments of pension funds or superannuation schemes or contracts to pay annuities that may be approved by the Authority in this behalf". By virtue of this legislative mandate, life insurers are carrying on this business. However, with the notification of the interim Pension Fund Regulatory Development Authority of India (PFRDA), a clearer distinction in legislation and regulations needs to evolve in the overlapping areas.	
4	Amending Insurance Act, 1938 to enable insurance companies to provide allied services to their customers.	The insurance legislation has not specifically defined business of insurance, contracts of insurance and insurance <i>per se</i> . The Act defines insurance businesses such as life insurance, general insurance, fire insurance, marine insurance and miscellaneous insurance. Though	

<sup>27</sup> Since life insurance business is long-term and shareholders do not envisage immediate returns, a view can be taken that taxation of shareholders' share of surplus can be at a rate marginally lower than the corporate rate. GoI could consider through this amendment to First Schedule of Income Tax, 1961.



		the activity of insurance is on a stand-alone basis, it has to take into account the matters connected therewith or incidental thereto which may not be completely pertaining to insurance. To carry out the development mandate and to protect the interest of the policyholders and the inbuilt jurisdiction where the insurance contracts and insurance business is not defined, the allied services pertaining to rendering advice to insurers, insurance education, risk management and such other allied and actuarial services as detailed in WTO agreements could be permitted on the lines of Section 6(2)(h) of the LIC Act, 1956 on specific permission granted by the Authority. A view could be taken by GOI on the same.
5	Elaborate classification of life and non-life business.	No change in the provision may be considered as the current classification takes into account the needs of the insurance companies.
6	Minimum capital levels may be fixed for each of business on a scientific and transparent basis.	Section 6 of the Insurance Act could be suitably amended. No change in the provision is necessary as IRDA would like to move towards Risk Based Capital Approach over a period of 3-4 years.
7	Co-ordination among the regulators for an efficient unit-linked insurance business. If regulation of unit-linked insurance is vested with SEBI, both SEBI Act and IRDA Act could require a provision to ensure the co-ordination of regulators. Co-ordination should also provide for level playing field between insurance companies and mutual funds.	A High Level Committee, in which the Reserve Bank, SEBI and IRDA are represented, provides for co-ordination on such issues. The unit-linked business is transacted by the life insurers in terms of the defined parameters of the 'linked business' which means 'life insurance contracts or health insurance contracts under which benefits are wholly or partly to be determined by reference to the value of underlying assets or any approved index' and the products marketed by such insurers are filed with the IRDA before its clearance for sale in the market. Investment parameters of such unit linked products in the life insurance business are provided in the investment regulations to ensure that 75 per cent of the funds arising out of linked business are invested in approved investments with the discretion of the insurer to invest in other investments.

8	Supervisory authority should protect the interest of both policy holders and shareholders. Review Section 27 of Insurance Act and IRDA (Investment) Regulations to ease out the restriction on investment relating to shareholders' funds.	Uniform set of rules for shareholder funds and investments of assets would protect the interests of both, the policyholder and the shareholder. Section 27 and other sections relating to investments of insurers do not distinguish between shareholders' funds and policyholders' funds for the purposes of investments to protect the interest of the policyholders which is the mandate given to the regulator in the IRDA Act, 1999. All the controlled funds and the assets of the insurer, whether generated by the policyholders' funds or the shareholders' funds, are required to be invested in terms of the investment regulations already notified by the IRDA.
9	Transfers to the Unexpired Risk Reserve and Catastrophe Reserve in case of general insurance companies.	The suggestion to grant exemption to the Catastrophe Fund has not found favour with GOI for the time being. It could be reconsidered at an appropriate time.
10	Explicit restriction on the formation of composite companies doing both life and non-life business.	The nature of life business and non-life business is completely different. The liabilities of life business are long-term while that of non-life short-term. Therefore, the two businesses cannot be combined and explicit restrictions are already in place on the formation of composites.
11	Regulator, as a general rule, should ascertain names of natural and legal persons holding direct or indirect qualifying participation in the applicant company and, more importantly, make this knowledge public while granting the license. IRDA could issue the relevant regulations in line with Section 3 of Insurance Act.	IRDA's (Registration of Indian Insurance Companies) Regulations, 2000, provides for the same and IRDA is ascertaining this at the time of consideration of application in a rigorous manner. As such this could be treated as complied with.
12	System of detailed information about the Directors/ Senior Managers for registration of new insurance companies. Acceptable guidelines of IAIS could be brought into the IRDA regulations.	Under the present regulations, the company is required to take formal approval of the IRDA at the time of appointment of new director/ chief executive officer or their change. It is also obtained at the time of renewal of certificate of registration. As such, no further action appears necessary.
13	Consider outsourcing of various functions of an	IRDA regulations cover not only marketing but certain core activities of the insurance companies like

	insurance company. Amend IRDA (Registration of Indian Insurance Companies) Regulations 2000, in consonance with Section 40 (1) of the Insurance Act, which places restrictions only in respect of the marketing function.	underwriting, claims servicing, investment, reinsurance and IT, which cannot be out sourced. This policy is to prevent shell companies and is considered necessary to protect the policyholders. The area of claims settlement also cannot be outsourced since it is a core activity of an insurance company.
14	For new products, the certificate of product design could be treated as published information. IRDA could issue suitable guidelines.	IRDA regulations require file and use procedure that requires all such information to be given to it. Adequate care for protection is, therefore, taken. The procedure covers all new products and any modifications to existing products. <sup>28</sup>
15	IRDA can issue suitable standard formats of Articles of Incorporation.	IRDA has not advised any standard formats so far, as the companies coming into the insurance business are big and possess the necessary expertise.
16	IRDA (Appointed Actuary) Regulation 2000 could be modified to provide for the firm of consulting actuaries.	Appointed actuary system is considered better for life insurance companies and has already been applied as such for these companies. In these cases, the person acts as eyes and ears of the IRDA by reporting irregular practices to it. For general insurance business, the firms can have consulting actuaries, and hence, meet with the requirements of having a firm of consulting actuaries.
17	The marginal gaps between the Indian and international standards for the calculation of unearned premium reserves may be addressed in due course.	IRDA's Accounting Regulations permit calculation of unexpired risk reserves on 1/365 method. Additional safeguards have been built into the system wherein under Section 64 v(ii)(B) if by 1/365 method the unexpired risk reserves are lower than the statutory minimum, then the company will have to keep the higher of the two. As such, no further action appears necessary.
18	Amend IRDA (Assets, Liabilities and Solvency Margin) Regulations 2000 and position	New private players already have sophisticated MIS system capable of generating statistics. Old players are also putting in place such MIS systems. IRDA could

<sup>28</sup> No further action is required in the matter. Particularly, there is no intent to treat this as published information.

	appropriate data base systems so that deficiencies with regard to collection of claims statistics relating to the estimation of the 'loss reserves' could be filled.	consider implementing this.
19	Suitable standards for setting up catastrophe reserves should be evolved over next 2-3 years. IRDA regulations should be amended.	This would require tax incentives and has not found favour with GOI for the time being. GOI and IRDA could review this at an appropriate time.

## Appendix 3

## Principle by principle assessment

Principle 1.	<p>Conditions for effective insurance supervision Insurance supervision relies upon a policy, institutional and legal framework for financial sector supervision a well developed and effective financial market infrastructure efficient financial markets.</p>
Description	<p>The Government/the Reserve Bank has established and disclosed publicly its intention to ensure financial stability. The Policy statements are announced in the Parliament and are also available on the official website of the Ministry of Finance. The broad policy frameworks for the financial sector regulations have been spelt out and are laid down in the preamble of the relevant Acts promulgated to set the supervisors' offices for the banking, capital markets and the insurance sector. The financial market infrastructure is well developed and is regulated by the financial regulators for the banking, insurance and securities markets.</p> <p>Insurance supervision relies on the statutory framework which encompasses the legislative, regulatory and institutional framework both for the financial sector in general and the insurance sector in particular. Insurance Regulatory and Development Authority (IRDA), the insurance supervisor is an autonomous body formed under an Act of Parliament, i.e., Insurance Regulatory and Development Authority Act, 1999. The Insurance Act, 1938 and the Regulations framed thereunder lay down the regulatory framework for supervision of the entities operating in the sector, i.e. the insurance companies and the intermediaries. In addition, the provisions of the corporate laws, including the Companies Act, 1956, the Foreign Exchange Management Act, 1999 and all other relevant laws and rules and regulations framed there under are applicable to the insurance companies.</p> <p>The judicial system in the country is robust with a reliable, efficient and fair legal and court system. The country has a strong and robust judiciary at various levels – local, state and central, for judicial review of administrative action and for other matters. The Bar Council of India and the bar associations at the state levels function as the self regulatory body for the members of the legal profession.</p> <p>With specific reference to the insurance sector, rules for redressal of public grievances have been formulated in 1998 which provides for creation of</p>

	<p>Ombudsman with the governing body comprising of the Chairman from the supervisor's office and representatives from the Insurance Councils and the Central Government. The powers, territorial jurisdiction and the entire legal framework within which an Ombudsman works, are clearly laid down in the legislation.</p> <p>Accounting standards are formulated by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI). Auditing and Assurance Standards Board (AASB) set up by ICAI reviews the existing auditing practices in India and develops statements on Standard Auditing practices giving due consideration to the corresponding Standards if any, issued by the International Auditing and Assurance Standards Board (IAASB). It is intended that the accounting and auditing standards prescribed are integrated, to the extent possible, to the international standards against the background of the conditions and practices prevailing in India. The Actuarial Standards are set out by the Institute of Actuaries of India (IAI). The IAI also issues Guidance Notes for its members. These are formulated adapting the international standards taking into account the ground realities in the Indian environment, the legal and regulatory practices and requirements. The standards are comparable to the international standards and are reviewed on a dynamic basis to reflect the changing environment in the financial sector. The accountants, actuaries and auditors are competent professionals, having obtained their qualifications from the established statutory professional bodies. They are also governed by the code of conduct of the respective professional bodies. In addition, the joint venture partners have also been deputing actuarial personnel to the Indian ventures.</p> <p>The economic, financial and social statistics are available to the supervisory authority, industry and the general public as they are published in various government publications and are available on the websites of relevant ministries. Both the annual data and time series data are available on various aspects of the Indian economy.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>With specific reference to the insurance sector, the industry was opened up in 2000. While the framework for accounting, actuarial and auditing standards have been provided for the industry, these are evolving concepts and are presently under examination by both the supervisor and various professional bodies to ensure that these are adequately strengthened.</p> <p>While the parliamentary process to bring about changes in the legislation is a long drawn process, critical issues are addressed through issue of notifications/ Government orders/mid-term announcements etc. The regulatory framework provides enough flexibility to keep the current practices up to date to meet the needs of the industry. However, since some of the provisions of the Act and the regulations are outdated and need to be reviewed in the context of the changing economic environment, the proposals for amendments to the Insurance Act, 1938 and the LIC Act, 1956 have been forwarded to the Central Government.</p>



## Chapter V

### Assessment of Adherence to IAIS Core Principles

	From the perspective of the insurance industry, particularly, the life industry, investment instruments are not available for the long-term investment purposes to suit the requirements of life insurance industry.
Principle 2.	Supervisory objectives The principal objectives of insurance supervision are clearly defined.
Description	<p>The objective of supervision is clearly laid down in the preamble to the IRDA Act which is 'to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry'. Overall, the objectives of the supervisor as spelt out in the mission statement are cohesive and not mutually exclusive.</p> <p>The legislation vests the supervisor with the powers to enforce observance of the law and regulations framed for effective discharge of its supervisory responsibilities.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>Under the legislative framework some of the powers still rest with the Government of India such as the setting up of the Consultative Committee, enforcement of the criminal penalties and in case of winding up of insurance companies. In addition, the regulatory position with respect to the exempted insurers is also not clear. State-owned insurers continue to be governed by certain provisions of the specific legislations (that regulate their activities) apart from the insurance legislation governing the entire industry. These provisions are not only ownership driven but also have implications for the regulatory stance of IRDA on their day-to-day operations. Some of these provisions cover aspects such as capital structure, notification of higher limits on investments, free permission for opening of operating offices. This dichotomy requires to be addressed.</p> <p>On compliance with the regulatory framework by the existing insurers, the IRDA has adopted the approach of implementation in a phased manner. This has been on account of both issues of legacy and the need to give these companies time to make a smooth switch over to the new regulatory framework.</p>
Principle 3.	Supervisory authority The supervisory authority has adequate powers, legal protection and financial resources to exercise its functions and powers;

	<p>is operationally independent and accountable in the exercise of its functions and powers; hires, trains and maintains sufficient staff with high professional standards; and treats confidential information appropriately.</p>
<p>Description</p>	<p>The supervisor is an independent agency which reports to the Parliament on its activities through the Union Ministry of Finance.</p> <p>The functions and powers vested with the IRDA to discharge its role are clearly laid down in the legislation and can be broadly categorised into the following four heads:</p> <ul style="list-style-type: none"> <li>● Registration of insurers and licensing of insurance intermediaries</li> <li>● Financial and regulatory supervision</li> <li>● Control and regulation of premium rates</li> <li>● Protection of policyholders' interests.</li> </ul> <p>The funds requirement of the supervisor is met from the various fees received from the insurance companies and intermediaries. The annual budget for expenses is adopted every year depending on projected and estimated requirements. The IRDA's budget is approved by its Board and it has complete discretion in the manner of utilisation of its resources to meet its expenses or for capital expenditure as may be required to meet its objectives or to protect against any risks as may be perceived by it.</p> <p>The accounts of the supervisor are subject to audit by the Comptroller &amp; Auditor General of India on an annual basis. Internal audit systems are also in place.</p> <p>The supervisor is required to report to the Central Government on its operations on an annual basis.</p> <p>The pay packages offered are on par with the other regulators of the financial sector but lag behind the industry. As such, there are issues regarding attracting and retaining qualified staff. The officials in the supervisor's office are imparted training on an on-going basis. The conditions of service for officers and staff are laid down as part of the regulatory framework.</p> <p>The chairperson of IRDA is appointed by the Cabinet Committee on Appointments. The manner of appointment and dismissal of the members of the board is clearly spelt out. The institutional relationship between IRDA, the Central Government and the judiciary are clearly defined, including the circumstances under which the Central Government has overriding powers in public interest. All actions of the IRDA can be challenged in the court of law. IRDA and its staff are free from any form of political, government or industry interference in the performance of supervisory responsibilities; and are also provided protection due to their status as "public servants" and are protected from legal action for acts done in good faith.</p>

	<p>The supervisor follows the process of consultation with the industry stakeholders in framing various policies/ regulations. The manner of framing the regulations is transparent. This enables the views of all the stakeholders to be given due consideration prior to finalisation of the regulatory framework and the practical difficulties in implementation being given due regard.</p> <p>All regulations and circulars issued by IRDA are placed on its website. In addition, IRDA falls under the purview of the Right to Information Act, whereunder its activities come under public scrutiny. The office procedures of the IRDA require that every decision is well supported by written office notes setting out the reasoning for the decisions. Decisions taken in other similar cases are also taken into account to ensure consistency in decision making.</p> <p>The conditions of service for officers and staff are laid down as part of the regulatory framework. The code of conduct and other obligations are provided for and each employee is required to maintain strictest confidentiality regarding the affairs of the supervisor. There are also restrictions on certain types of employment and activities to guard against conflict of interest. All employees in the supervisor's office are governed by the requirements of confidentiality. These stipulations are equally applicable to the outside experts whose services are utilised for various outsourced functions.</p> <p>As a general policy, the supervisor does not outsource its supervisory functions. However, at times, services of outside experts are utilised to carry out specific assignments. The services of Chartered Accountants and industry experts have been utilised to carry out investment inspections and targeted inspections in the past. The function of licensing of agents is delegated to specified officers of insurance companies subject to compliance with the procedure laid down and utilisation of the central database under the control of the IRDA. The supervisor reserves the right to review the arrangement at periodic intervals.</p> <p>Information specific to an insurer other than its annual accounts that are published and statistics of new business are treated as confidential. Even the Right to Information Act recognises the need for confidentiality of information that is not of general public interest. External specialists hired by the supervisory authority are subject to the same confidentiality and code of conduct requirements as the staff of the supervisory authority.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	Given the fact that the insurance sector was opened up to private participation in 2000, and the regulatory framework has been made applicable to the existing

	<p>public sector insurers as well, the IRDA has taken note of the market realities and has adopted a consultative approach, taking due cognizance of the difficulties faced by the insurers in ensuring compliance.</p> <p>The issues of adequacy of powers are being addressed through the proposed amendments to the Insurance Act, 1938.</p> <p>With respect to the financial independence, an issue has been raised by the Government of India on transfer of the supervisor's funds to the exchequer, which has not been acceded to and is under examination.</p> <p>With regard to publicly making available information about failed / problem insurers, observance has not yet been tested.</p> <p>While the IRDA has the power to take immediate action to achieve its objectives, especially to protect policyholders' interests, in certain specified instances, the action is to be initiated after the due consultative process through the Consultative Committee, which could lead to delays and could result in serious problems for the sector.</p> <p>With regard to the availability of trained manpower at the regulator's office, training requirements need to be addressed. In addition, there could be issues related to retention of skilled staff.</p> <p>In certain instances, with specific reference to supervision of the public sector insurance companies constraints have been observed. This has been primarily on account of legacy issues and the inability of these insurers to implement the requisite changes in their operations within the time-frame specified resulting in relaxations being extended to them.</p>
Principle 4.	<p>Supervisory process</p> <p>The supervisory authority conducts its functions in a transparent and accountable manner.</p>
Description	<p>As a matter of practice the supervisor issues guidelines in consultation with the industry.</p> <p>All decisions of the IRDA are based on properly recorded notes that take into account any precedents that are relevant to the issue under consideration.</p> <p>Though the administrative decisions of the supervisor are subject to appeals as in the normal course of natural justice, they do not impede the ability of the supervisor to carry on with its mission.</p> <p>The role of the supervisory authority is prescribed in the legislation governing the supervisor and also the insurance industry. The mission statement and applicable legislations are published on the website of the supervisor and are available to the public.</p> <p>The legislative framework for the insurance sector is contained in the Insurance Act, 1938 and the IRDA Act, 1999. In addition, the IRDA notifies regulations covering specific areas of operations of insurance companies. Till date, 38</p>

## Chapter V

### Assessment of Adherence to IAIS Core Principles

	<p>regulations (including amendments thereto) have been issued by the IRDA. The process for issue and/or amendment of regulations is based on a two stage pre-defined approach. Decisions on major policy issues are taken by the Board of the IRDA. In practice, the matters which require immediate decision are dealt with by the Chairman and whole time members within the IRDA. Even on major policy matters, discussion among the full-time members is immediately possible and where a meeting of the full board is required, the meeting can be called at short notice. There has been no occasion when action in a timely manner could not be taken due to the decision making process. In addition, the chairman is authorised to take decisions in consultation with the full-time members. These decisions are subsequently ratified by the Board.</p> <p>The Insurance Act, however, prescribes that the supervisor cannot issue directions on specific matters as laid down in the Act without consulting the Consultative Committee constituted by the Central Government. The meetings of the Consultative Committee can be called at short notice. This provision is however, sought to be deleted by the supervisor.</p> <p>The supervisor publishes the annual report covering appraisal of the insurance market, review of various policies and programmes, working and operations and detailed performance of the IRDA and the insurance industry.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>All decisions of the IRDA are based on properly recorded notes that take into account any precedents that are relevant to the issue under consideration. This ensures that the decisions are consistently applied. There have, however been instances of relaxations being extended to the public sector insurers including grant of additional time for ensuring compliance.</p> <p>Other than the cases where the Consultative Committee must be consulted prior to taking a decision, the IRDA can take immediate decisions in the interests of policyholders, which can result in some delays (although the meetings of Consultative Committee can be called at short notice).</p> <p>Under the process of insurance legislation amendments, it is intended to do away with the stipulation for constitution of the Consultative Committee.</p>
Principle 5.	<p>Supervisory co-operation and information sharing</p> <p>The supervisory authority co-operates and shares information with other relevant supervisors subject to confidentiality requirements.</p>

Description	<p>The authority approaches its counterparts in other countries as part of the due diligence process of the foreign joint venture partners of proposed new insurers while considering applications for registration of such insurers in India. In addition, the IRDA also interacts with other supervisors to draw upon their experiences on regulatory supervision or to gain insights on issues which do not have precedence in the host country. There is also co-operation amongst regulators within the country both at the policy level and for administrative matters, i.e., on various issues relating to the operations of insurance companies.</p> <p>Any information shared between regulators whether within the jurisdiction or between regulators across borders is under strict terms of confidentiality.</p> <p>Currently, foreign insurers can operate in India only under a joint venture arrangement with Indian Insurance companies with a maximum of 26 per cent shareholding. The home supervisor is therefore not required to take specific supervisory action against foreign establishments operating in its jurisdictions (in other words there are no insurance entities which are either branches or wholly owned subsidiaries operating in the country).</p>
<b>Assessment</b>	<b>Largely Observed</b>
Comment	<p>A formal arrangement for sharing of information does not exist. There is a need for putting in place Memoranda of Understanding between the financial sector regulators both within the country and between regulators at the international levels, covering not just the insurance sector regulators but also those in the securities markets and in the banking sector.</p> <p>In instances such as informing the home regulator in advance of taking action that affects the parent company, observance has not been tested.</p>
Principle 6.	<p>Licensing</p> <p>An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.</p>
Description	<p>Any person can carry on any class of insurance business in India only if he has obtained a certificate of registration from the supervisor, for the particular class of insurance business. The supervisor is the competent authority to consider and issue the certificate of registration for insurers. The supervisor may register the applicant as an insurer if it is satisfied that:</p> <ul style="list-style-type: none"> <li>● the financial condition of the promoters and the general character of management of the applicant are sound;</li> <li>● the volume of business likely to be available to and the capital structure and earning prospects of the applicant will be adequate;</li> <li>● the interests of the general public will be served if the certificate of registration is granted; and</li> <li>● the applicant has complied with the applicable provisions of the Act.</li> </ul>



	<p>The regulations on registration of insurance companies which are available on the public domain lay down the criteria for licensing of the companies. the promoters of the applicant company, directors, key persons including the senior management and appointed actuary have to undergo due diligence process as part of "fit and proper" criteria.</p> <p>No insurance company is permitted to carry on any business other than insurance. Further, no insurance company can operate as a composite insurer.</p> <p>In addition to the insurance companies granted registration by the supervisor, the exempted insurers are also carry on operations. Further, no insurance company can operate as composite insurer.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>While overall the position is observed for the registered insurers, in case of the exempted insurers the regulatory stance is not clear.</p> <p>Foreign establishments can only set up liaison offices in the country. Foreign insurance ventures can set up operations in India only through the joint venture route. Under the present framework setting up branch offices by foreign insurance companies is also not permitted. Re-insurance companies are, however, permitted to set up representative offices.</p>
Principle 7.	<p>Suitability of persons</p> <p>The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.</p>
Description	<p>Appointment, re-appointment or termination of appointment of managing director, manager or a chief executive officer requires prior approval of the IRDA. While considering requests for such approval, the IRDA applies the test of "fit and proper" person. The process of due diligence is exercised with respect to appointment of key persons of an insurance company, which includes interaction with the relevant authorities/ previous employers. The key functionaries include the Chief Executive Officer, Chief Marketing Officer, Appointed Actuary, Chief Investment Officer, Chief of Internal Audit and Chief Finance Officer. The supervisor is also empowered to remove a functionary / seek disinvestment by a shareholder under specified circumstances.</p> <p>The regulations prescribe the qualifications and the procedure for appointment of an 'appointed actuary'. All life insurance companies are required to have a full time appointed actuary while the non-life insurance companies can appoint</p>

	<p>a consultant actuary. Such appointments must have the approval of the supervisor.</p> <p>The supervisor does not appoint or approve the appointment of statutory auditors of insurers, but the eligibility norms for appointment of statutory auditors have been laid down. IRDA has also prescribed a system of joint audit of insurance companies. There are also stipulations on minimum qualifications, experience and number of partners for an audit firm to take up statutory audit work for an insurance company.</p> <p>The supervisor relies on the professional bodies like Institute of Chartered Accountants of India and the Institute of Actuaries of India to set and enforce standards of professional conduct.</p> <p>The fit and proper status of the promoters of the applicant company seeking certificate of registration is enquired into. This includes carrying out due diligence of the promoters. The process of due diligence includes exchange of information with authorities both within India and other jurisdictions.</p> <p>The functionaries cannot hold dual position as this could result in a material conflict of interest.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>While some of the prescriptions are specified for only the life insurance companies, their observance is ensured for both life and non-life insurers.</p> <p>The regulatory framework does not stipulate that in cases where the insurer is aware of instances where the fitness and propriety of its key functionaries is in question (particularly where criminal charges have been framed), it should inform the IRDA about the same. As the way forward, the IRDA is to lay down the guidelines on reporting on 'fit and proper' compliance.</p>
Principle 8.	<p>Changes in control and portfolio transfers</p> <p>The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer.</p> <p>The supervisory authority approves the portfolio transfer or merger of insurance business.</p>
Description	<p>The supervisor approves initial participation of shareholders when the insurance company is floated. Further transfers need approval of the supervisor where after the transfer, the total paid-up holding of the transferee in the shares of the company is likely to exceed 5 per cent of its paid-up capital. Where the transferee is banking or an investment company, if it is likely to exceed 2.5 per cent of such paid-up capital, approval of the IRDA is required. Approval is also required where, the nominal value of the shares intended to be transferred exceeds one percent of the paid-up equity capital of the insurer.</p> <p>Transfer of business or amalgamation of one life insurer with any other life insurer can only be made in accordance with a scheme prepared under the legislation and approved by the supervisor.</p>

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	<p>The thorough process of due diligence is in place both at the time of registration of the insurance company and at the time of subsequent transfer of shares. Both stand alone and group-wide due diligence is carried out.</p>
<b>Assessment</b>	<b>Observed</b>
Comment	<p>While the term 'control' is not defined in the insurance legislation, the provisions of the Companies Act are applicable.</p> <p>With respect to assessing the insurers' application for transfer of all or part of the insurance business, its observance has not been tested.</p>
Principle 9.	<p>Corporate governance</p> <p>The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.</p>
Description	<p>Separate corporate governance guidelines for insurance companies are not in place. However, they are required to comply with the general commercial law with respect to this provision. Compliance with the stipulations is verified through both on and off-site supervision.</p> <p>However, regulations on preparation of financial statements require insurance companies to submit management report which forms part of annual financial statements that confirms compliance with the regulatory and statutory stipulations, systems in place for internal controls, overall risk exposure and strategy adopted to mitigate the same.</p> <p>As a way forward, the corporate governance guidelines are to be put in place, specifically focusing on issues relating to risk management.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	<p>Although the provisions of the corporate legislation are applicable, the IRDA is considering issuance of detailed guidelines on corporate governance for insurance companies.</p> <p>Further, adherence to the requirements of internal controls and systems duly supervised by the Board of Directors needs to be verified through comprehensive on-site supervision. On account of the gaps in ECs (b) and (c) the observance has been indicated as 'partly observed'.</p> <p>Stipulations on Risk Management Committee to address various issues related to risks associated at the enterprise wide levels need to be put in place.</p> <p>The stipulations on the Appointed Actuary having direct access to the Board of Directors or committees of the Board are however not in place.</p>

Principle 10.	<p>Internal control</p> <p>The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.</p>
Description	<p>The supervisor reviews the "internal controls and checks" at the offices of insurance companies, as part of on-site inspection. In addition, the IRDA relies upon the certifications which form part of the management report. The Board is required to certify that the management has put in place an internal audit system commensurate with the size and nature of its business and that it is operating effectively.</p> <p>The statutory auditors are required to express an opinion in the audit report on the internal controls in place in the insurance company. The supervisor has access to these opinion statements which are filed as part of annual financial statements. The actuarial reports too form the basis for the finalisation of the accounts.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	There is a need for putting in place adequate internal controls. The audit reports have on a number of occasions drawn attention to the inadequacy of internal controls. There are no stipulations from the IRDA on the internal controls to be in place at the offices of insurance companies.
Principle 11.	<p>Market analysis</p> <p>Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurers and insurance markets. It draws the conclusions and takes action as appropriate.</p>
Description	<p>The supervisor analyses the performance of insurance companies on a monthly basis, based on the business figures furnished by life and general insurers. Business trends are also studied at frequent intervals to keep track of developments in the sector and to take regulatory action where necessary. Quantitative analysis is based on the premium figures. Qualitative analysis is based on the market conduct activities that come to the notice of the IRDA through public/ media and also from the publicity material filed with the supervisor for information and/or for prior approval. Market conduct issues also come to notice through the Grievance Cell which attends to grievances of customer/agencies of the insurer. Supervisor also has the power to call for any information required from the insurer from time-to-time. When a market-wide event having an impact on the insurers occurs, the supervisor obtains relevant information from the insurers, monitors developments and issues directions as necessary.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	As indicated above, the insurance sector was opened up to private participation only in the year 2000. Prior to this, the insurance companies operating in

	<p>India were all government owned and there was no felt need for putting in place systems to data compilation and analysis. With the opening up of the sector and the competitive conditions prevailing in the industry there is a felt need for accurate and reliable data both at the industry and company levels. Concerted efforts are being made by the regulator, the SROs and the insurance companies in this direction. Systems are proposed to be put in place to facilitate development of (i) early warning signals and (ii) taking policy level decisions.</p> <p>Although the regulatory framework does not require market-wide systematic reporting to analyse and monitor particular market-wide events of importance for the financial stability of insurance markets, in the past, in cases where there have been repercussions on the market-wide bases on the happenings of particular events, the supervisor has called for and analysed market-wide data to monitor the impact and to initiate further action.</p> <p>In so far as assessment of international relationships and their effect on the internal insurance and financial markets, these factors have not been examined at the regulator's office. However, these aspects are examined by the insurance companies and their impact is taken into account while taking policy level decisions.</p>
Principle 12.	<p>Reporting to supervisors and off-site monitoring</p> <p>The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.</p>
Description	<p>Insurers are required to submit various returns (i) on an annual basis including financial statements duly accompanied by the auditors' opinion on statement on the annual accounts; reports of valuation of assets, valuation of liabilities and solvency margin; actuarial report and abstract and annual valuation returns giving information about the financial condition for life insurance business; Incurred But Not Reported claims in case of general insurance business; reinsurance plans; and investment policy (to be reviewed on a six monthly basis) and returns on investments ; (ii) on a quarterly basis including statement of the list of products cleared by the supervisor, un-audited financial statements and position of solvency; returns on investments; and details of capital structure on quarterly basis etc., and (iii) on a monthly basis statement on underwriting of large risks in case of general insurance companies; all products to be marketed by life insurers; details of capital market exposure; and ;, monthly statistics on premium underwritten.. These returns enable effective</p>

	<p>off-site monitoring and in evaluating the financial condition of each insurer. Additional statistics/data / reports are also sought at shorter intervals as and when the market-wide situations so warrant. Information received is analysed and action taken where called for.</p> <p>These returns facilitate effective off-site monitoring and evaluate the condition of each insurer. Additional statistics/data / reports are also sought at shorter intervals as and when the situation so warrants. Information received is analysed and action taken where called for.</p> <p>There are specific stipulations for reporting on extraordinary events which could have a material adverse impact on the investment portfolio and consequently on the security of policyholder benefits or expectations. Similarly, the insurer is required to bring to the notice of the supervisor if the solvency falls below the stipulated level of 1.5 times the regulatory requirement of solvency margin.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	Given the fact that the insurance sector was opened up to private participation only in 2000, the processes for reporting to supervisor and off-site monitoring are being scaled up in a phased manner. While the initial efforts in the first phase were aimed at putting in place a regulatory framework and to grant registration to the insurance companies, more recently the focus has shifted to setting up systems to carry out off-site monitoring. The scaling up is being done taking into account the systems in place at the offices of insurance companies and their capabilities to meet the regulatory requirements. Post opening up significant progress has been made particularly taking into account the scenario at the time of opening up of the sector.
Principle 13.	<p>On-site inspection</p> <p>The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.</p>
Description	Legislation empowers the supervisor to call for information from, undertake inspection of, conduct enquiries and investigations including audit of insurers. The inspections are carried out for both insurance companies and intermediaries. The coverage of the on-site inspection includes functional areas pertaining to investments, market conduct, underwriting issues and other matters as may be considered necessary. Post inspection, issues of concern, if any, are circulated to the respective departments for follow up.
<b>Assessment</b>	<b>Largely observed</b>
Comment	As indicated earlier, the insurance sector was opened up to private participation in 2000. Prior to this, the insurance business was carried out by the government owned companies. Simultaneously with the opening up of the sector, the Insurance Regulatory and Development Authority was set up. The mission statement of IRDA assigns it the dual responsibility of both development of



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	<p>the insurance market and protection of the interests of the policyholders. The supervisor has followed a step-by-step approach in the regulation of the insurance sector. While the initial steps involved setting up of the regulatory framework, the IRDA has set up the Inspection Dept about a year back. Prior to the setting up the Dept., the supervisor was carrying out the on-site inspection (Investment Inspections, Market Conduct and other targeted inspections) where the officials of the supervisor led the teams with the support of professional accountants and industry experts.</p>
Principle 14.	<p>Preventive and Corrective Measures</p> <p>The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.</p>
Description	<p>The supervisor exercises the administrative powers to advise the insurer in any matter where it is operating in a manner not consistent with sound business practices. Where such moral suasion does not work, the supervisor has the power to escalate the action as follows:</p> <ol style="list-style-type: none"> <li>1. Call for information;</li> <li>2. Carry out inspection; or</li> <li>3. Order an investigation.</li> </ol> <p>The supervisor is vested with powers to suspend or cancel the license of insurers and insurance intermediaries besides, imposition of monetary penalties. Failure to comply with the directions may ultimately result in cancellation of registration</p> <p>The range of prescribed corrective action provides for differential approach. Past history of any regulatory infraction is a factor which is taken into consideration while imposing any penalty. In case of repetitive nature of default, the penalty would be more deterrent and higher. Minor procedural irregularities are normally rectified by the insurer on being pointed out to obviate the need for a formal order or action.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>The IRDA in consultation with the Consultative Committee exercises its powers to issue directions to prevent the affairs of an insurer being conducted in a manner prejudicial to the interests of the insurer or generally, to secure the</p>

	<p>proper management of an insurer. The observance can, however, be considered to be partial in view of the fact that a formal Preventive and Corrective Action (PCA) framework is not yet in place. It may, however, be mentioned that despite the formal PCA system not being in place, it has not been a hindrance in taking timely action where required to ensure compliance with the legislative and regulatory framework, and to protect the interests of the policyholders.</p>
Principle 15.	<p>Enforcement or sanctions</p> <p>The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.</p>
Description	<p>The IRDA, in public interest, has the powers to prevent the affairs of any insurer being conducted in a manner which is detrimental to the interests of the policyholders or prejudicial to the interests of other insurer(s). Directions can be issued to insurers generally or to any insurer in particular. Failure to comply with such directions can lead to cancellation of registration.</p> <p>The supervisor, at its discretion, can bar an insurance promoter who withdraws from an insurance venture from re-entering into the insurance business. Similarly, persons in position of responsibility who have been found to be delinquent may not be given regulatory clearance. Specific penal provisions which include monetary penalty and/or imprisonment are available under the legislation for failure to comply with the filing requirements, mis-statements, falsification of returns etc. Based on the intensity and extent of default/non-compliance, there are specific penalty stipulations for offences besides the possible cancellation of registration.</p> <p>The supervisor is empowered to remove managerial persons from office and/or appoint additional directors where it is satisfied that the public interest so demands or to prevent the affairs of an insurer being conducted in a manner detrimental to the interest of the policyholders or for securing the proper management of any insurer. If the supervisor has reason to believe that a life insurer is acting in a manner likely to be prejudicial to the interests of the policyholders, a report may be filed with the Central Government, and the Government may appoint an administrator to manage the affairs of the insurer under the direction and control of the supervisor.</p> <p>If there are any indications of a life insurance company failing, the supervisor can arrange for compulsory transfer of policies from the failing company to another insurer taking adequate steps to ensure that the interests of the policyholders are protected.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	<p>With respect to certain aspects such as arranging for compulsory transfer of obligations under the policies from a failing insurer, restricting the ownership or activities of a subsidiary, etc., observance has not been tested. Similarly issues with regard to addressing the management problems of insurers, the</p>

	<p>observance has not been tested. (In certain cases the issue of formal directions is required to be routed through the Consultative Committee).</p> <p>There are no specific provisions on suspension of dividends to shareholders especially in case of general insurance companies.</p> <p>The supervisory framework requires clarity to ensure that all sanctions imposed are enforced.</p> <p>However, the legislation does not vest the supervisor with requisite powers to ensure protection of an insurance company in case of the group, to which it belongs, encounters any financial difficulties.</p>
Principle 16.	<p>Winding-up and exit from the market</p> <p>The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.</p>
Description	<p>Provisions of the General Commercial law and the Insurance law apply to an insurance company on matters relating to insolvency and winding up. The supervisor may apply to the Tribunal for winding up on an insurance company under specified circumstances which includes insolvency of the company, continuance of the company being prejudicial to the interest of the policyholders or to the public interest generally. The legislation further provides that an insurer shall not be wound up voluntarily except for the purpose of amalgamation or reconstruction or on the ground that by reason of its liabilities it cannot continue its business.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	<p>The legislation does not categorically provide for priority of claims of the policyholders in the event of the insurer becoming insolvent and winding up.</p>
Principle 17.	<p>Group-wide supervision</p> <p>The supervisory authority supervises its insurers on a solo and a group-wide basis.</p>
Description	<p>Under the Insurance Act, every company registered to carry on insurance business is regulated on a stand-alone basis and not on a group basis even if the insurer belongs to a group as defined under the Company Law. There is, however, monitoring of the performance of the financial conglomerates through processes established among regulators in the financial sector.</p>

	The system of group-wide supervision is evolving. Presently, it is done based on inter regulatory co-ordination and not on stand-alone basis.
<b>Assessment</b>	<b>Partly observed</b>
Comment	Although the definition of what constitutes an insurance group and financial conglomerate and its supervision is not laid down under the insurance law, the system for detailed monitoring of operations at the group level is evolving. At present the observance is ensured through inter-regulatory co-ordination.
Principle 18.	Risk assessment and management The supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively.
Description	As part of the overall operations insurers review the market environment at periodic intervals to ensure that appropriate action is taken to manage the adverse impact.  Though specific regulations or tools have not been prescribed for the insurers on risk assessment and risk management, periodical reports like the actuarial reports, annual reports submitted to the IRDA provide the framework which enables insurers to assess internally the risks faced by them and to state the strategies to manage the same.  The accounting regulations require the management to make a disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same. Similarly when an insurer has operations in other countries the management is required to give a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted by the insurer. The statutory auditors are required to comment on internal control systems in place being commensurate to the size of the operations of the insurance company.
<b>Assessment</b>	<b>Partly observed</b>
Comment	There is a need for setting up the risk management system. This is proposed to be stipulated as part of the overall corporate governance framework. The stipulations would include provisions for the risk management framework being all pervasive, with the Chief Risk Officer being part of the Board of the insurance company. It is also intended to put in place the stipulation for setting up of Risk Management Committee.
Principle 19.	Insurance activity Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through re-insurance, and to have the tools to establish an adequate level of premiums.
Description	The general insurance companies are required to have in place Board approved underwriting policy detailing product design, rating, terms and conditions of cover and underwriting activity.

	<p>In life insurance business, the basic underwriting strategy and guidelines are required to be submitted at the beginning of the business operations. Subsequently, the underwriting policy of each product is examined to ensure that the insurer is aware of the risks that are being accepted while clearing the products under file and use procedure where details of the product including the assumptions for pricing, the methodology adopted for pricing, and the valuation assumptions made at the time of pricing are provided. As part of this process, re-insurance arrangements are also analysed for each product taking into account the underwriting criteria, the design of the product etc.</p> <p>The supervisor reviews the methodology adopted by insurance companies to set premium rates and also reviews that adequate systems are in place for risk transfer arrangements consistent with the overall capital position. While the regulatory requirement for the underwriting policy being approved by the Board is in place in case of non-life insurance companies, the same needs to be extended to the life insurance companies as well.</p> <p>Further, the supervisor reviews the adequacy and effectiveness of the re-insurance arrangements of insurers and analyses the re-insurance statistics.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	<p>The stipulations for Board approval of the underwriting policy in case of life companies needs to be put in place.</p> <p>There is a need for further clarity on manner of accounting of the various risk transfer mechanisms.</p>
Principle 20.	<p>Liabilities</p> <p>The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities, and making allowance for reinsurance recoverables. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary.</p>
Description	<p>Life insurance companies are required to actuarially value the liability for the life insurance business in force as at end of every year. Such valuation should be made on a basis no less rigorous than the basis set out in the Act. If it appears that the valuation does not properly reflect the condition of the affairs of the insurer, the supervisor may cause an investigation to be made by another actuary approved by the IRDA.</p> <p>The accounting regulations require general insurers to establish reserves for outstanding claims including provisions for IBNR and IBNER claims. The</p>

	<p>estimation of the provision for IBNR and IBNER claims is required to be made by the Appointed Actuary. The general insurers are required to establish reserves for unexpired risks using a technically sound basis subject to such reserve being no less than the specified percentages of the net premium. In addition, general insurers are also required to provide for premium deficiency based on past experience.</p> <p>The actuarial valuation of life insurance business and the actuarial estimation of the provision for IBNR and IBNER claims in general insurance business are examined off-site by the supervisor and points of concern are suitably taken up with the insurers. The supervisor is vested with the powers to reject the returns filed if it is satisfied with the provisions made are not adequate.</p> <p>The regulatory framework provides for the manner of recognition of re-insurance cover while finalising the accounts of an insurance company, with a view to ensuring that credit is not taken for an arrangement where there is no actual transfer of risk.</p>
<b>Assessment</b>	<b>Observed</b>
Comment	<p>While the supervisor does review the technical reserves created by the insurance companies, there have not been instances of companies being required to be advised to increase the technical provisions.</p> <p>Though insurers are not required to submit regular stress testing reports for a range of adverse scenarios at the time of submitting the valuation returns, life insurers are required to submit the volume of new business expected, expected new business strain, sensitivity analysis and the resultant profitability for each product at the time of submitting the product for clearance. On a stand-alone basis, such form of compliance is not provided for under the regulatory framework.</p>
Principle 21.	<p>Investments</p> <p>The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management.</p>
Description	<p>The supervisor requires management of investments to be within the insurer's own organisation. In order to ensure a minimum level of security of investments, the regulations prescribe certain percentages of the funds to be invested in government securities and in approved securities.</p> <p>The regulations provide for constitution of the Investment Committee and various aspects to be covered in the investment policy required to be framed by the respective insurance companies on an annual basis. These include issues related to asset-mix, valuation, diversification, asset-liability matching, risk management and putting in place internal controls to ensure compliance with both the legal &amp; regulatory framework and the internal systems in place within the organisation. The risk management system is required to cover all the</p>



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	risks associated with investment activities which could possibly impact the coverage of the technical provisions and thus the solvency margin of the company. The manner of valuation of investments is also laid down in the regulations.
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>While the supervisor has in place systems to inspect the investment operations of insurance companies, it does not prescribe that the key staff involved with the investment activities have the appropriate levels of skills, experience and integrity. However, insurance companies are required to have in place a code of conduct for dealing in securities at personal levels.</p> <p>While the supervisor does not require insurers to undertake regular stress testing for a range of market scenarios and changing investment and operating conditions in order to assess the appropriateness of asset allocation limits, this does form part of the exercise for determination of premium rates.</p>
Principle 22.	<p>Derivatives and similar commitments</p> <p>The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.</p>
Description	<p>Currently, the supervisor has allowed limited use of derivatives in relation to management of risk relating to movements in interest rates. Fixed Income derivatives (Forward Rate Agreements, Interest Rate Swaps and Exchange Traded Interest Rate Futures) have been permitted by the supervisor. The disclosure requirements to the extent applicable have also been laid down, including the reporting requirements to the respective Boards. The details of the policy in place on derivatives are required to be laid down as part of the Investment policy covering all the operational aspects. As part of the overall systems for internal control, all insurers are required to put in place rigorous procedures for internal controls with respect to derivatives as well.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	<p>Based on the needs and preparedness of the insurance market, the limits on derivatives can be relaxed. As part of the overall risk management procedures, the policy framework for risks associated with dealing in derivatives by the respective insurers' offices needs to be addressed by the supervisor.</p> <p>The insurance companies in India are not permitted to use 'Over-the-Counter' derivatives as part of their investment policy.</p>

Principle 23.	<p>Capital adequacy and solvency</p> <p>The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and requires suitable forms of capital that enable the insurer to absorb significant unforeseen losses.</p>
Description	<p>Regulations on actuarial report and assets, liabilities &amp; solvency margin requires all the insurers (both life and general) to maintain the minimum required solvency margin. In case the stipulation of 1.5 is breached, the IRDA steps in to ensure that the insurance company lays down the action plan for ensuring compliance by bringing in additional capital.</p> <p>The various factors prescribed for computing the solvency margin take into account the inherent risk the respective line of business poses to the insurer. Thus higher requirements are placed for lines of business where the risk undertaken by the insurer is higher when compared to others. In case of general insurance business, the regulations have been laid down for valuation of liabilities and provisions related to reserve for unexpired risks, premium deficiency reserve and provision for IBNR claims. The manner of valuation of assets is laid down in the regulations for preparation of financial statements. Further, provision is required to be made for assets based on their quality (performing or other wise). In addition, some of the assets are not admitted for the purpose of arriving at the solvency margin. A limited allowance is provided to the re-insurance arrangement. Balances due from re-insurers that are outstanding for more than 90 days are not recognised. The tests of realisability of assets and the conservative basis of valuation of liabilities are strict.</p> <p>Equity is the only form of capital for meeting the financing requirements of insurance companies. The supervisor does not permit any form of capital other than equity share capital. Thus, there is no tier-2 capital in the balance sheet of insurance companies. The supervisor has prescribed the minimum capital requirements for insurance companies, which is pegged at Rs.100 crore in respect of insurance companies, and Rs.200 crore in case of a re-insurance company. Additional requirements of capital are met while ensuring compliance with the solvency requirements. The capital is required to be held in the respective insurance companies.</p>
<b>Assessment</b>	<b>Observed</b>
Comment	<p>The stipulations on solvency margin are applicable to all insurance companies. The factors considered for the purpose of computation of the solvency margin take into account the nature of the business underwritten by them. The manner of computation of solvency margin also takes into account the 'admissible assets'.</p> <p>With specific reference to double or multiple gearing, under the registration regulations the supervisor does not permit the Indian promoter company of an Indian Insurance company to be a subsidiary company. In addition, the IRDA does not favour an insurance company setting up a subsidiary. Some</p>

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	<p>state-owned companies which have been in existence prior to opening up of the sector have floated subsidiaries. Under the circumstances, the situation of inflation of capital does not arise.</p> <p>The supervisor has stipulated quarterly reporting of maintenance of solvency ratio to provide a measure of the solvency position during the year and to provide an early warning signal on the insurer's financial condition. In addition, many of the life insurers are undertaking dynamic solvency testing voluntarily. There is, however, no stipulation for the supervisor for forward looking analyses and for stress testing.</p> <p>Currently, the supervisor is examining its own solvency regulations in relation to other jurisdictions through information available from IAIS. It is also considering the advantages and disadvantages of moving to a risk-based capital model in the current state of development of the Indian insurance market.</p>
Principle 24.	<p>Intermediaries</p> <p>The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.</p>
Description	<p>The legislation permits only licensed intermediaries to transact any insurance business in India. The supervisor issues license to an applicant who meets the minimum prescribed qualifications to act as an intermediary or an insurance intermediary. Intermediaries are also governed by the provisions of the code of conduct, including disclosures of their status to the prospective policyholders. In addition, powers are vested with the supervisor to apply sanctions as prescribed under the Act/ Regulations.</p> <p>Legislation specifies the minimum academic and technical qualifications for a person to act as an intermediary. Mandatory hours of training have been specified under the regulatory framework.</p> <p>In case of corporate intermediaries, the regulations also specify the minimum capital and infrastructure requirements for the applicant entity.</p> <p>Corporate entities are licensed after a thorough due diligence process to assess the reputation of the promoters and only when they comply with the basic minimum requirements specified under the legislation/regulations.</p> <p>Though the broker is not a risk carrier, minimum capital requirement has been prescribed for direct life and/or general brokers and for composite brokers. A composite broker is permitted to arrange insurance, with insurance and /or re-insurance companies.</p>

Assessment	Observed.
Comment	Nil
Principle 25.	<p>Consumer protection</p> <p>The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied.</p>
Description	<p>Entry level qualifications, training requirements and code of conduct are clearly laid down in the regulations framed for licensing of intermediaries. The code of conduct lays emphasis on providing a need based analysis while recommending an insurance plan, indicate the premium to be charged by the insurer and inform the prospect promptly about acceptance or rejection of a proposal.</p> <p>The regulatory framework prescribes that the prospect should be provided all material information with regard to the insurance cover to take a decision to protect his interest. It also stipulates that in the process of sale, the insurer or intermediary should adhere to the code of conduct prescribed by the supervisor, and the respective councils of the life and general insurers and the Self Regulatory Organisations (e.g., Brokers Association of India). Publicity material of the insurance products is vetted at the product clearance stage to ensure that advertisements are not deceptive or misleading. The matters to be stated in a life insurance policy and a general insurance policy have also been stipulated by the supervisor. The regulations mandate the benchmarks for settlement of claims and also stipulate payment of penal interest for delayed settlement. It is further mandates that the insurer shall have proper procedures and mechanisms for grievance redressal. Further, the agency licensing regulations specify that agents should render assistance for settlement of claims.</p> <p>The regulations governing brokers prescribe that the functions of a direct broker shall include providing requisite underwriting information as required by an insurer in assessing the risk to decide pricing terms and conditions for cover. The regulations stipulate the disclosures to be made at the point of sale with regard to the insurance product, its benefits, limitations, extent of insurance cover etc. It is further stipulated that the insurer shall inform the policyholder while forwarding the policy document that he has a period of 15 days from the date of receipt of the document to review the terms and in case of disagreement return the policy stating his objection. This period is referred to as the free-look period. The code of conduct applicable to intermediaries requires them to disclose the commission structure if asked for by the prospect. The regulations on insurance advertisements and disclosure requirements stipulate that advertisements should be clear and not unfair or misleading.</p>

	<p>Insurance Ombudsman offices have been set up across the country. Their decisions are binding on the insurance companies.</p> <p>The supervisor has taken up awareness campaigns through the media – both print and electronic, educating consumers on the need and advantages of both life and general insurance.</p>
<b>Assessment</b>	<b>Observed</b>
Comment	<p>Cross-border offering of insurance in respect of insurance of property situated in India is not permitted.</p> <p>The supervisor has issued notices of caution on the need to avoid transactions with un-supervised entities and in cases where there is a mis-sale reported.</p>
Principle 26.	<p>Information, disclosure &amp; transparency towards the market</p> <p>The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.</p>
Description	<p>The regulations on preparation of financial statements prescribe the formats for the presentation of financial statements and various disclosures to form part of the management report including compliance with the regulatory prescriptions and the strategy towards risk mitigation. There is also a stipulation of disclosure of actuarial assumptions and the significant accounting policies underlying preparation of the annual accounts to be provided as part of notes to accounts. The statements are made available to both the shareholders and the supervisor.</p> <p>The accounts filed by insurers with the supervisor are open for inspection. Copies of the accounts can also be obtained from the supervisor's office. Insurance companies are also voluntarily placing details about their performance and the financials on their respective websites.</p>
<b>Assessment</b>	<b>Largely observed</b>
Comment	<p>The Ministry of Corporate Affairs dedicated website MCA 21 contains the published annual reports of all companies including the insurance companies. As in the case of filing with the supervisor, the filings with the ministry are also mandatory. With insurance companies opting for listing, the stipulations of Securities &amp; Exchange Board of India shall be applicable resulting in greater transparency and disclosure of information. In addition, on a voluntary basis, companies are making disclosures on their respective websites.</p>

	<p>With a view to making the reporting to the supervisor more meaningful, the regulatory framework is also re-visited at periodic intervals to prescribe additional disclosure requirements. Only recently, the frequency of reporting has been made quarterly (which was previously only annual). The insurance sector was opened up to private participation in the financial year 2000-01. The IRDA is handling the issue of disclosures in the public domain with some degree of caution.</p>
Principle 27.	<p><b>Fraud</b></p> <p>The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.</p>
Description	<p>The legislation vests power with the supervisor to prevent the affairs of any insurer being conducted in a manner detrimental to the interests of the policyholders or in a manner prejudicial to the interests of the insurer; or generally to secure the proper management of any insurer.</p> <p>The regulations have been framed to ensure protection of interest of policyholders which <i>inter alia</i> prescribe regulations relating to market conduct of an insurer/intermediary. The supervisor has further issued guidelines as and when the situation warrants on the market conduct activities of insurer/intermediary to check possible insurance frauds.</p> <p>Various regulations framed to monitor the activities of insurance intermediaries lay down 'code of conduct' applicable to them to ensure high standards of integrity of their business.</p>
<b>Assessment</b>	<b>Partly observed</b>
Comment	<p>There are no specific requirements at present on allocation of resources by the insurance companies to combat fraud. Similarly, stipulations need to be put in place on the reporting of the same to the supervisor's office once these are detected. Thus, there are gaps in the mechanisms available to detect various frauds and on sharing of information between insurers and with the regulator, although some effort has been made on declined lives.</p>
Principle 28.	<p><b>Anti-money laundering, combating the financing of terrorism (AML/CFT)</b></p> <p>The supervisory authority requires insurers and intermediaries to take effective measures to deter, detect and report money laundering and the financing of terrorism.</p>
Description	<p>Supervisor has issued guidelines on Anti-Money Laundering Programme for both life and non-life insurers. Life insurance companies are advised to carry out the Know Your Customer (KYC) norms on an on-going basis right from the initial entry stage until the payout stage. They are required to carry out compliance even at the time of additional top up remittances especially when they are inconsistent with the customer's known profile. The non-life insurance companies are required to ensure compliance with KYC norms at the payout stage. The obligations, however, apply to insurance companies and not to their agents, and other intermediaries. Since the agents of insurers act</p>



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	on behalf of the insurer, the responsibility for compliance rests solely with insurers. The guidelines broadly cover 'Customer Due Diligence, Record Keeping, Reporting of Suspicious Transactions and Compliance.'
<b>Assessment</b>	<b>Largely observed</b>
Comment	The enforcement powers as required by the applicable legislation are not in place. This is required to be provided for in the legislation governing the supervisor.

## Annex 1

### Comments of Peer Reviewer Mr. Michael Hafeman and Stance of the Advisory Panel

Not enough information was provided to enable me to fully understand some issues and assess their importance. Examples include:

Comments of peer reviewer	Principle and criteria	Comments of the Advisory Panel
Request that IRDA transfer funds to the government	ICP 3, EC (h) & (i)	The funds requirements of IRDA are met from the various 'Fees' received from the insurance companies and intermediaries. These are primarily for licensing of insurers, brokers and agents initially and from subsequent future renewals thereof. Besides, penalties for non-compliance with Act/Regulations are also added to the overall funds. The IRDA's expenses are mainly towards those related to its establishment & operation. The funds received are adequate for the requirements of the IRDA for its efficient functioning. IRDA does not rely upon government grants to finance its activities. The IRDA's budget is approved by its Board and it has complete discretion in the manner of utilisation of its resources to meet its expenses or for capital expenditure as may be required to meet its objectives or to protect against any risks as may be perceived by it. The Government of India, has however made a demand that the funds received as above be transferred to the Government funds and to seek budgetary allocation for IRDA's operations. The issue raised by the Government of India on transfer of the supervisor's funds has not been acceded to and is under examination. Please also see point-wise clarifications below on issues relating to transfer of funds.
Extent to which public sector insurers are subject to regulations and supervision	ICP 2 EC (d)	By and large the application of Insurance Act and Regulations are ownership neutral. However, LIC continues to be governed by certain provisions of the

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		<p>specific legislations under which it was set-up (LIC Act, 1956) apart from the insurance legislation governing the entire industry. The provisions of LIC Act are mostly only ownership driven but a few of them have implications for the regulatory stance of IRDA on their day-to-day operations. These cover capital structure, investments, free permission for opening of operating offices etc. The government is examining the issues. Though LIC is willing to comply with IRDA, this dichotomy is required to be addressed for clarity. The IRDA has already taken up the need for repeal / amendment to the specific provisos of the said Act.</p>
<p>The status of accounting, auditing and actuarial standards</p>	<p>ICP 1 EC (d)</p>	<p>Accounting and Auditing standards are formulated by the Institute of Chartered Accountants of India (ICAI). The Institute is one of the founder members of the International Federation of Accountants (IFAC) which has a broad objective of development and enhancement of a co-ordinated worldwide accountancy profession with harmonised Standards. Auditing and Assurance Standards Board (AASB) set up by ICAI reviews the existing auditing practices in India and develops statements on Standard Auditing practices giving due consideration to the corresponding standards, if any, issued by the International Auditing and Assurance Standards Board (IAASB). It is intended that the auditing standards prescribed are integrated, to the extent possible, to the international standards against the</p>

		<p>background of the conditions and practices prevailing in India. To ensure transparency in the formulation of auditing standards, the ICAI has representatives from bodies like the Reserve Bank Securities &amp; Exchange Board of India, Insurance and Regulatory Development Authority and Indian Institute of Management.</p> <p>The ICAI works with regulators for such changes as are necessary in application of some Accounting Standards to meet certain peculiar requirements of regulated entities in financial sector. These are notified after extensive discussions.</p> <p>The Actuarial Standards are set out by the Institute of Actuaries of India (IAI). The IAI also issues Guidance Notes for its members. Both the Standards and the Guidance Notes are placed in public domain. The standards are comprehensive and well documented. These are formulated adapting the international standards taking into account the ground realities in the Indian environment, the legal and regulatory practices and requirements. The standards are comparable to the international standards and are reviewed on a dynamic basis to reflect the changing environment in the financial sector.</p> <p>With specific reference to the insurance sector, the industry was opened up in 2000. While the framework for accounting, actuarial and auditing standards have been provided for the industry, these are evolving concepts and are presently under examination by both the supervisor and various professional bodies to ensure that these are adequately strengthened. The financial sector should however be in alignment with the Indian Accounting Standards as developed by ICAI. There could be a lag</p>
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		in respect of these vis-à-vis International Accounting Standards/Financial Statements Standards, pending the evolution of relative domestic standards.
Legislative provisions on priority of policyholders on winding-up	ICP 16 EC (c)	<p>Where supervisor has a reason to believe that an insurer carrying on life insurance business is acting in a manner likely to be prejudicial to the interests of holders of life insurance policies, it makes a report to the Central Government. The Central Government may appoint an administrator to manage the affairs of the insurer under the direction and control of the supervisor. The administrator reports to the supervisor on the most suitable course of action keeping in view the general interests of the holders of life insurance policies <i>viz.</i>, transfer of business; winding up of the insurer; or any other advisable course of action. Supervisor takes appropriate action, keeping in view the interests of the holders of life insurance policies and passes an order accordingly.</p> <p>In the winding up of a life insurer, the value of the assets and the liabilities in respect of life business are required to be ascertained separately from the value of any other assets or any other liabilities of the insurer and no such assets shall be applied to the discharge of any liabilities other than those in respect of life insurance business except in so far as those assets exceed the liabilities in respect of the life business. This provision basically aims at protection to policyholders interests.</p>

		Where an insurance business carried on by provident societies is to be transferred to or amalgamated with another insurance business, such scheme needs to be sanctioned by the supervisor. The supervisor in such a situation may direct that such an intention of transfer/ amalgamation be sent to every policy holder and be published giving them an opportunity to be heard of any objection to such transfer/amalgamation. The legislation, however, does not categorically provide for priority of claims of the policyholders in the event of the insurer becoming insolvent and winding up.
The supervisory powers that still lie with the government	ICP 2 EC (b)	<p>These powers rest with the Central Government to a very limited extent. For example, under section 110G, the Central Government sets up the Consultative Committee and in respect of certain sections of the Insurance Act, 1938, the IRDA is required to consult the said Committee before making any order. However, it is felt necessary to bring this out in the assessment of the core principles to ensure that the factual position is accurately stated.</p> <p>Implications that may have an adverse impact on companies on changes in the foreign participation limit</p> <p>There is a proposal for increase in the limit of foreign participation from 26 per cent to 49 per cent. The possible impact of such holding when the companies go for public issue equity to get listed is as yet unclear. In the meantime, the proposed hike in foreign equity ceiling is still held up as part of amendments to the insurance legislation.</p>
<b>Observations in the report</b>	<b>Comments of peer reviewer</b>	<b>Comments of the Advisory Panel</b>
Existence of strong and effective self regulatory organisations (SROs) is one	Why are SRO's a prerequisite	In this context, however, the concerns over potential conflicts of interest need to be addressed. The Panel feels that the



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<p>of the important prerequisites</p>		<p>bodies, if designated to be SROs, might either require to suspend their functions as trade/industry associations (e.g. Investment Dealers' Association, Canada) or change their governance structure ensuring separation of operations as trade organisations and SROs (e.g. Japan Securities Dealers Association, Japan). Properly functioning SROs could act as unbiased interpreters and monitors ensuring due adherence to the laid down principles of regulation. Further, regulatory principles need to evolve with the changing time and background of regulation. SRO's role lies also in ensuring that in the course of such contextualisation and evolution, the spirit behind the principle remains protected.</p>
<p>With respect to financial independence, an issue has been raised by the Government of India on transfer of IRDA's funds to the exchequer (Public Account of India).</p>	<p>What is the legal basis for the request? How has IRDA built up funds that might be transferred?</p>	<p>The funds requirements of IRDA are met from the various 'Fees' received from the insurance companies and intermediaries. These are quite adequate for the requirements of the IRDA for its efficient functioning. IRDA does not rely upon government grants to finance its activities. The IRDA's budgetary allocations are approved by its Board and it has complete discretion in the manner of utilisation of its resources to meet its expenses or for capital expenditure as may be required to meet its objectives or to protect against any risks as may be perceived by it.</p> <p>The Government of India had invoked the provisions of Article 266 (2) of the</p>

		Constitution of India to direct the IRDA to make the said transfer. The IRDA has taken the stand that it is not carrying out the sovereign functions on behalf of the GoI and as such is not covered under the said Article.
The Panel identifies that capacity building of the regulators as a serious issue and recommends market related incentive structure to attract and retain talent and added attention to training and development.	Why not match industry remuneration	It recognises that every effort has to be made to match industry level remuneration in order to attract and retain best available talent for regulation. While in the Indian context it would never be easy for the regulator to match the ever-increasing remuneration levels of the industry, it will have to be ensured that the gap between the two remains manageable and the efficacy of the system is not undermined.
The objectives of IRDA have been laid down in mission statement as "to protect the interests of policy holders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto.	IRDA must balance protection with promotion of growth	This is being done. While there is a view that the roles of development and protection of the interests of the policyholders can be clearly demarcated to ensure that a position of conflict does not arise, given the fact that the sector was opened up to private participation only in the year 2000, it is felt that such a separation may be too early at this nascent stage of development.
Certain instances the essential/advanced criteria were not applicable to Indian jurisdiction.	Which criteria are not applicable	These have been spelt out in the detailed document such as ICP 6 ECs (e), (f) and (k); ICP 10 EC (h); ICP 23 – EC (i) and ICP 25 EC (g).
Two of the fastest growing segments are motor and health accounting for 42.95 and 13.29 per cent of the premium growth in India in 2006-07.	It would be useful to see growth with single premium weighted at 10 per cent	The First year premium details have been segregated into single and regular premium to facilitate interpretation.
Investment in infrastructure and social sectors has been mandated for insurance companies. In fact, given the liability profile of insurance companies, more particularly the life insurers, they are the	How do returns compare to the market rates	These avenues offer market related returns on investments made.

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<p>ideal source of long term debt and equity for infrastructure projects. Simultaneously, long term infrastructure projects are ideal avenues for parking the resources available for investment with the insurers.</p>		
<p>The IRDA however took the decision of regulating the rates relating to Motor Third Party business in exercise of its powers under Section 14 (2) (i) of the IRDA Act 1999. The main reasons for this decision were i) this class of insurance being mandatory under the Motor Vehicles Act and ii) the non-viability of this class of business resulting in complaints of non-availability of statutory cover to policyholders. The creation of Motor Insurance Pool for underwriting third party business for commercial vehicles also seems to have gone down well with the insurers as the business seems to have soared with collective participation.</p>	<p>How is the claims experience Motor – TP</p>	<p>The Motor Pool has been in operations for only one year. It is too early to comment on the claims experience. Prior to the Pool arrangements the claim ratio was 175 per cent in case of public sector insurers in 2006-07.</p>
<p>At the time of opening up of the sector, the paid up equity capital of the six public sector insurers stood at Rs.62,000 crore. Significant capital has been added to the insurance industry during</p>	<p>Public Sector insurers have much lower capital ratios than private sector insurers. This is a competitive bias.</p>	<p>The capital requirements of the new entities have been much higher since they had to set up operations right from scratch. However, at the time of opening up of the sector, the new players were fully aware of the fact that in order to raise the scale of operations they would</p>

<p>the last seven years with Rs.9,62,528 crore being brought in by the private players, of which the contribution of the foreign partners was Rs.2,17,428 crore. The total paid up equity of all insurance companies as on March 31<sup>st</sup>, 2007 stood at Rs.1,16,10,280 crore.</p>		<p>be required to inject additional capital. As regards the public sector non-life insurers, taking into account the reserves and surplus which have accumulated out of the retained earnings, the capital position is comparable. In addition, these insurers maintain the minimum capital requirement of Rs.100 crore. There is, however, a bias in case of Life Insurance Corporation (LIC) which draws its position from the LIC Act, 1956. The IRDA is already pressing for the amendments to the Act to ensure a minimum capital of Rs.100 crore.</p>
<p>The opening up of the sector was preceded by an intense debate for several years before consensus could emerge on the reforms process. It was realised that the initiative was justified and necessary to increase insurance penetration in the country and it ultimately led to the passage of the Insurance Regulatory and Development Authority Act, 1999. It is pertinent to mention that the word 'Development' was inserted in the Bill at the last moment as legislators were concerned that with competition both the regulator and the regulated should not lose sight of the more important aspect of 'development' of the insurance market in India.</p>	<p>Dual role of Development and protection of the interests of the policyholders.</p>	<p>This is being done. While there is a view that the roles of development and protection of the interests of the policyholders can be clearly demarcated to ensure that a position of conflict does not arise, given the fact that the sector was opened up to private participation only in the year 2000, it is felt that such a separation may be too early at this nascent stage of development.</p>
<p>The IRDA is handling the issue of disclosures in the public domain with some degree of caution.</p>	<p>(Why? Are the companies financially weak?)</p>	<p>Owing to the typical nature of life insurance business which incurs losses in the initial seven or eight years of operations, caution has been exercised in public dissemination of data. It needs to be also appreciated that the sector was</p>

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		opened up only recently and an unfair or less informed comparison between the existing public sector insurers' profitability as against the losses of the new insurers by an intermediary or competitor could impact the industry in its nascent stage of opening up.
The regulatory framework has been made applicable to the existing public sector insurers as well.	Inconsistent with earlier statements	There is no inconsistency – the framework for the insurance industry is equally applicable to all insurers – the dichotomy as regards the capital in case of LIC and certain provisos of the LIC Act, 1956 are being addressed with the recommendation for the repeal of the relevant sections.
With specific reference to the insurance sector, the industry was opened up to private and foreign participation in 2000. Against this background, although the framework for accounting, actuarial and auditing standards has been provided for the industry, these are evolving concepts and are presently under examination by both the Supervisor and various professional bodies to ensure that these are adequately strengthened.	Accounting and Auditing Standards – Extremely vague	<b>The Institute of Chartered Accountants of India (ICAI) has meantime, drawn on the roadmap to move towards the International Financial Reporting Standards (IFRS) effective 2011.</b>
The legislative framework for the insurance sector is contained in the Insurance Act, 1938 and the IRDA Act, 1999. In addition to the statutory framework as laid	Simultaneously thereafter, the concurrence of the Insurance Advisory Committee (IAC) is also taken.	IAC's role is advisory in nature. The decisions are not binding. However, given the fact that the Committee has representation of various stakeholders, it provides the platform for detailed discussion on the amendments to the

<p>down under the Acts of Parliament, the Supervisor notifies regulations covering specific areas of operations of insurance companies. Till date 38 Regulations (including amendments thereto) have been issued by the Supervisor. The process of issue and/ or amendment of Regulations is based on a two stage approach. The Approach Note with respect to any notification is, after industry wide discussions, placed before the Board of IRDA for its approval. Simultaneously /thereafter the views/ recommendations of the Insurance Advisory Committee (IAC) are also taken.</p>	<p>(Is Concurrence required)</p>	<p>regulations or on framing of new regulations.</p>
<p>While, overall the Supervisor firmly believes in providing a level playing field to all industry participants, there have been certain legacy issues due to which the State owned insurers have been unable to ensure compliance, more particularly so during the initial period post opening up of the sector. Thus, there have been instances of relaxations being extended to the public sector insurers including grant of additional time for ensuring compliance.</p>	<p>Seems like public sector insurers are supervised</p>	<p>No comment required</p>
<p>The Supervisor interacts with other supervisors /supervisors of other jurisdictions to draw upon their experiences on regulatory supervision or to</p>	<p>There is also co-operation among regulators within the country both at the policy level and for</p>	<p>Administrative matters include sharing of information/concerns on specific insurers on operational matters.</p>



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<p>gain insights on issues which do not have precedence in the host country. There is also co-operation amongst regulators within the country both at the policy level and for administrative matters</p>	<p>administrative matters. (does 'administrative matters' mean information on specific insurers).</p>	
<p>In the initial stages of opening up of the sector, the regulation have been broadly drawn based on the powers vested in the Insurance Act, 1938 with certain additional powers vested in the IRDA Act, 1999. In the context of the growth that had followed the opening up of the sector and also the dynamic changes in the financial sector outside the insurance, amendments are required to the insurance legislation since the Act is of an earlier era with obvious limitations. The ability to carry out changes consistent with the other developments is, to some extent, constrained by lack of flexibility in the Act, in certain cases (for e.g. Insurance Act prescribes in detail the pattern of investments of insurers with precise detail, and regulation cannot normally override these requirements entirely despite widespread changes in the financial markets).</p>	<p>Too much detail is in the Act itself, creating inflexibility</p>	<p>No comment required. The IRDA issues directions through Circulars where considered necessary.</p>

<p>The regulatory body is also new and has to quickly address the requirements of adoption of technology, higher skills and sophistication of the other regulators etc., within a very short time span</p>	<p>(Why no discussion of this in the assessment summary itself?)</p>	<p>There is reference to this issue in the assessment summary at description/comment under Principle 3</p>
<p>The regulations on registration of insurance companies lay down the criteria for licensing of companies. Foreign insurance companies can set up operations in India only through the joint venture route, with the participation of the foreign partner through Foreign Direct Investment (FDI) capped at 26 per cent.</p>	<p>Threshold is too low</p>	<p>No comment required</p>
<p>Adherence to the requirements of internal controls and systems duly supervised by the Board of Directors needs to be verified through comprehensive on-site supervision. There is also a need to ensure that the insurance have put in place adequate internal controls. All these are aspects which are being addressed by putting in place a robust on-site inspection mechanism.</p>	<p>(Sounds like it is not yet operational) (since when? How often?)</p>	<p>The on-site inspection department has been operational for about two year now. Steps are being taken to further streamline the systems put in place. (IV. On-going Supervision)</p>
<p>In India, IRDA had prescribed the solvency ratio of 1.5. This is the ratio of available solvency margin to that of required solvency margin. If this ratio is more than equivalent to 1.5, then the insurer is considered to be solvent.</p>	<p>No asset related requirements??</p>	<p>The manner of valuation of the underlying assets and the non-admitted assets has been indicated in the regulatory framework. No comments are required.</p>

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<p>Insurers are required to submit various returns (i) on an annual basis including financial statements duly accompanied by the Auditors' opinion on statement on the annual accounts; reports of valuation of assets, valuation of liabilities and solvency margin; actuarial report and abstract and annual valuation returns giving information about the financial condition for life insurance business; Incurred But Not Reported claims in case of general insurance business; reinsurance plans;</p>	<p>Would be easier to follow if sorted by annually, quarterly and monthly basis.</p>	<p>Sorted accordingly.</p>
<p>It may further be mentioned that a formal Preventive and Corrective Action framework is not yet in place</p>	<p>(Any plans to do so? What controls are in place to ensure consistent treatment)</p>	<p>Plans to put in place the requisite mechanism have been included under the way forward. However, for the present, the absence of a formal system of PCA does not hinder the process of initiating corrective measures where required in a timely manner.</p>
<p>In case of life insurance companies, the appointed actuary has the responsibility to ensure that the solvency of the insurer is maintained at all the times and also to monitor the premium charged to ensure its adequacy. Further the appointed actuary of a general insurance company is required to submit 'truth and fairness' of IBNR reserves.</p>	<p>Implies presence of protection of the interests of policyholders – be more specific</p>	<p>The detailed framework for protection of the interests of policyholders' interests has already been covered in the document. The intent under the specified head is to provide information on the gaps in the regulatory framework in the specific context of the winding up proceedings.</p>

<p>Detailed analysis of company's internal practices on risk assessment and management is made through the appointed actuary's annual report. The Regulatory framework requires general insurance companies to determine the valuation of liabilities and adequately reserve for unexpired risks, outstanding claims and claims incurred but not reported (IBNRs). Further, the appointed actuary of a general insurance company is required to certify on the truth and fairness</p>	<p>What powers does the AA have</p>	<p>The role of the AA is clearly laid down in the regulatory framework. The regulations provide for the manner of appointment, cessation, powers, duties &amp; obligations and the absolute privileges of the AA.</p>
<p>The Supervisor requires management of investments to be within the insurer's own organisation</p>	<p>(Some allowance for outside management could provide access to additional expertise).</p>	<p>While NAV calculations are permitted to be outsourced, with a view to enabling insurers to stabilise their operations, the supervisor permits insurers to seek investment advice during the initial two years of operations or till the Assets under Management (AUM) reach the Rs.500 crore mark (whichever is earlier). The intent is to ensure that as the size of operations grow; the insurer develops in-house expertise to manage its investments. Moreover, investment functions are considered to be core and integral to the operating activities of an insurance company in the context of the policyholders' interest.</p>
<p>Under the legislative framework some of the powers in the context of supervision of the Insurance sector still rest with the Government of India.</p>	<p>Which of the powers rest with the Government</p>	<p>e.g., the setting up of the Consultative Committee, enforcement of the criminal penalties and in case of winding up of insurance companies.</p>
<p>Under the Insurance Act, every company registered to carry on insurance business</p>	<p>What changes have been proposed – Group wide</p>	<p>The exact details are still to be worked out. There is a recommendation (No. 14) on group-wide supervision as way</p>

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### Assessment of Adherence to IAIS Core Principles

<p>is regulated on a stand alone basis but not on a group basis even if the insurer belongs to a group as defined under the Company Law. The definition of what constitutes an insurance group and financial conglomerate and its supervision is not laid down under the insurance law. There is, however, monitoring of the performance of the financial conglomerates through processes established among regulators in the financial sector although the system of group wide supervision is evolving. For the present, this is being done on the basis of inter Regulatory co-ordination and not on stand alone basis. The legislation also does not vest the Supervisor with requisite powers to ensure protection of an insurance company in case of the Group, to which it belongs, encounters any financial difficulties.</p>	<p>supervision</p>	<p>forward. Systems need to be put in place to ensure effective group-wide supervision. This would also require co-operation and interaction between various regulators both within the financial sector and outside.</p>
<p>Although the regulatory framework provides for manner of distribution of surplus in case of life companies, the Supervisor does not have the requisite powers to direct suspension</p>	<p>Financial prudence – distribution of dividend</p>	<p>For the present no changes are envisaged. However, recommendation has been added as way forward. On the lines similar to the banking sector, prudent guidelines need to be put in place to ensure that earnings are retained within the insurance</p>

<p>of dividends to Shareholders in case of general insurance companies under adverse conditions. It may, however, be mentioned that the provisions of the corporate laws are required to be complied with by the general insurance companies.</p>		<p>companies under specified circumstances including underwriting losses.</p>
<p>Currently, the Supervisor has allowed limited use of derivatives in relation to management of risk relating to movements in interest rates. The Supervisor proposes to broaden the scope of use of derivatives by the industry based on the experience gained in a phased manner. This is particularly so since the industry has not started taking an exposure to the avenues already available under the regulatory framework.</p>	<p>Derivatives - Provide more clarifications.</p>	<p>Interest derivatives have been permitted by the supervisor as a hedging instrument. However, insurance companies have not yet made use of this option available to them.</p>
<p>While globally, regulators are unable to match their remuneration structure with those at the industry levels, within the Supervisor's office there is still scope for improvement in the remuneration structure for the overall organisation, including at the top management levels.</p>	<p>What actions are being proposed.</p>	<p>Revision of pay structure at the top management level of the supervisor is pending before Parliament. As regards the rest, the proposals for de-linking still need to be framed and considered.</p>
<p>While it is accepted that the Supervisor would need to move towards the more sophisticated Risk based Capital (RBC) model and Risk based Supervision (RBS), such initiatives would</p>	<p>Even more important will be to develop supervisory skills for understanding industry risks.</p>	<p>Modified to read as under : Particularly, in the context of the supervisor's office there would also be a need for upgrading the supervisory skills to (i) put in place the supervisory framework and to develop skills to assess</p>



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<p>require (i) changes in the statute and (ii) the overall approach towards supervision. There would also be a need for having in place requisite databases with both the supervisor and the supervised entities. Particularly, in the context of the Supervisor's office there would also be a need for upgrading the supervisory skills to evolve benchmarks on capital adequacy and solvency.</p>		<p>operational risks; and (ii) to evolve benchmarks on capital adequacy and solvency.</p>
<p>While initiatives are required in this direction, these are not a hindrance to supervision in the present scenario.</p>	<p>– Confusing</p>	<p>Modified to read as under : While initiatives are required in this direction, given the present stage of development of the sector and the number of players in the industry, these are not a hindrance to supervision in the present scenario.</p>
<p>Operationally, there are no immediate signs of major vulnerability given the fact that the solvency requirements are even higher than the statutory requirement and are currently pegged at 150 per cent. No major systemic issues are also anticipated as the sector has been reporting healthy growth; and strong domestic promoters have also been enthused at the prospects of adequate returns after the gestation period of 7 to 10 years.</p>	<p>This assumes that the statutory requirement is reasonable and that all insurers are comfortably above the control levels</p>	<p>Yes, all insurers have maintained the solvency above the statutory requirements. In a few instances where the solvency requirement of 150 per cent stipulated by the supervisor was breached by an insurer, steps were taken to ensure that the same was restored within the stipulated time-frame through injection of additional capital by the shareholders.</p>

<p>The enhancement of the ceiling of FDI in Insurance sector is subject to Parliamentary approval</p>	<p>Concerns on the health of the companies in the absence of enhancement in the FDI limit to 49 per cent</p>	<p>Modified to read as under: However, as a positive development, the earlier apprehensions on possible constraints on the part of domestic promoters to raise capital in the absence of hike in the FDI limits have not materialised. Hence, no adverse impact on the health of individual company is anticipated regardless of the stance that may be taken by the foreign Joint Venture (JV) partners.</p>
<p>Principle 1: Conditions for effective insurance supervision</p>	<p>ICP 1: a, c, d, e and g not covered. Comment on Indian Courts Limited no. of actuaries</p>	<p>Additions made. Even assuming delays in the settlement of court cases, there is no impact on the sector assessment since in case of emergent issues impacting the financial sector, the matters can be expedited.  The professionals available are comparable at international levels in terms of expertise. In addition, the joint venture partners have also been deputing actuarial personnel to the Indian ventures.</p>
<p>Principle 2: Supervisory objectives</p>	<p>ICP 2: Powers which rest with the Government. Lack of clarity on the exempted insurers.</p>	<p>See comment relating to ICP2. Already dealt with above. Also have a recommendation on the exempted insurers.</p>
<p>Principle 3: Supervisory authority</p>	<p>ICP 3: Inconsistency with regard to pay packages</p>	<p>Modified to read as under : The pay packages offered are on par with the other regulators of the financial sector but lag behind the industry. As such, there are issues regarding attracting and retaining qualified staff.</p>
<p>Principle 3: Supervisory authority</p>	<p>ICP 3: e, f, g, l, j, q, r, s, t, u Assessment should not consider proposed amendments Consultative Committee – could result in potentially serious problems</p>	<p>Incorporated. The assessment is based on the present position and not on the proposed amendments. Yes, that is why recommended the abolition of the Consultative Committee. It is because of the gaps that the assessment has been indicated as 'largely observed' and not as 'observed'.</p>

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Principle 4: Supervisory process	ICP 4: Certain points not covered.	Incorporated to cover all points. Thus assessment has been fully substantiated
Principle 5: Supervisory co-operation and information sharing.	Are the MoUs in place? If this means ongoing exchange of information regarding licensed insurers, say so explicitly. If not, then there is a significant weakness.	The law does not say anything on the sharing of information. Being incorporated as recommendation on information sharing. The following text under the head 'Comments' has been added to read as under: <b>A formal arrangement for sharing of information does not exist. There is a need for putting in place memoranda of understanding between the financial sector regulators both within the country and between regulators at the international levels, covering not just the insurance sector regulators but also those in the securities markets and in the banking sector. The observance has accordingly been downgraded to 'Largely Observed'.</b>
Principle 5: supervisory co-operation and information sharing	Assessment observed Needs more substantiation.	In case the foreign regulator seeks any information on the foreign subsidiaries of Indian insurance companies, it is provided. On the other hand there are no foreign insurance entities operating in India as such no instance of taking supervisory action against them arises. See also point right above.
Principle 6: Licensing	Should mention the prohibition of composite insurers. Is there the power to restrict licenses?	The law clearly says that an insurance company can carry on either life or non-life insurance business. Composite insurers are not permitted.
Principle 6: Licensing	The position about exempted insurers	In view of the position regarding the exempted insurers not being clear the observance has been reduced to 'Largely observed'.

Principle 7: Suitability of persons	Nothing said about EC e and f.	Added
Principle 7: Suitability of persons	What criteria are applied to assess suitability	The thorough process of due diligence is in place both at the time of registration of the insurance company and at the time of subsequent transfer of shares. Both stand-alone and group-wide due diligence is carried out.
Principle 9: Corporate governance	How is compliance monitored	Compliance with the stipulations is verified through both on and off-site supervision. However, on account of the gaps in ECs b and c the observance has been indicated as 'partly observed'
Principle 10: Internal control	Is actuarial report required to be placed before the Board.	As per the stipulations, it is mandatory for the actuarial report to be placed before the Board in case of general insurance companies. However, as a matter of practice, the actuarial reports form part of the documents placed before the Boards while approving the financial statements on quarterly/annual basis.
Principle 14: Prompt and corrective measures	ICP 14: EC d and e	As regards (d) – observance has not been tested on any major issue of concern where under an insurer could have been asked to develop an acceptable plan for correction of problems. On minor issues the supervisor has directed insurers to take steps to rectify the position within a specified time-frame to resolve issues of non-compliance. As regards (e) non-compliance has not been observed on prevention of breach of legislation.
Principle 15: Enforcement or sanction	Considering the number of shortcomings downgrade assessment	Assessment lowered to 'Partly observed'.
Principle 17: Group wide supervision	Address issues relating to foreign operations of Indian group and those of foreign groups	There is no issue regarding significant holding of foreign groups in the Indian insurance companies as the foreign JV partners are not permitted to hold more than 26 per cent equity in an Indian insurance company. Further, issues regarding co-operation with other

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		regulators have been dealt with separately and also form part of the recommendations.
Principle 23: capital adequacy and solvency	If solvency position is not related to size of business, nature of business, and nature of assets	Comment modified to read as under: <b>"The stipulations on solvency margin are applicable to all insurance companies. The factors considered for the purpose of computation of the solvency margin take into account the nature of the business underwritten by them. The manner of computation of solvency margin also takes into account the 'admissible assets'".</b>
Principle 24: Intermediaries	What is the difference	Intermediary and insurance intermediary are used interchangeably under the IRDA Act (Section 2(1)(f)). There is no difference between the two.
Principle 24: Intermediaries	Does it also deal with the disclosure of status to the customers	Yes. Modified in the description to indicate as such.
Principle 25: Consumer protection	What about access by consumers who do not use internet	Copies of the annual reports are also available at the office of the supervisor. Recommendation has also been made on public disclosure of financial performance through the print media.
Principle 25: Consumer protection	What about IRDA co-operation with other supervisors and law enforcement authorities	Comments and recommendations on co-operation amongst supervisors have been made in the document. The co-operation with enforcement authorities is mandatory for all.
Principle 27: Fraud	Fraud related to motor vehicle insurance is perhaps the most common. Mechanism	Certain initiatives have been taken to facilitate sharing of data amongst industry participants, particularly against the background of the de-tariffed

	to share information through central database can be quite useful in combating this type of fraud.	scenario.
Principle 28: Anti money laundering, combating and financing of terrorism	What about supervisory monitoring, on-site inspection and supervisory co-operation? More information is needed to substantiate the assessment	Assessment is based on the detailed criteria-wise assessment provided as back papers to the summary of assessment. Supervisor has carried out on-site inspections of all life insurance companies to check for implementation of proper systems and procedures in place to comply with their AML policy. On-site inspection of all non-life insurance companies is scheduled for shortly.



Annex 1

**Comments of Peer Reviewer Mr. Carl Hiralal, Inspector of Financial Institutions,  
Trinidad and Tobago and Stance of the Advisory Panel**

**ASSESSMENT OF IAIS PRINCIPLES FOR INSURANCE REGULATION**

**Peer Reviewed by Carl Hiralal**

The document titled "Assessment of IAIS Principles for Insurance Regulation" was reviewed in order to independently assess the appropriateness of the ratings assigned to the Insurance Core Principles (ICPs), both individually and collectively. It should be noted, however, that in the absence of having reviewed original source documents, and not being able to interview IRDA officials, as well as industry officials, it is somewhat challenging to express informed and comprehensive views on the effectiveness of the regulatory practices that are in place. Therefore the comments that follow could only be made in the context of the supervisory elements that are reported as being in place without regard to how effectively they are implemented.

An overall comment with the ICP assessments is that the rationale provided for each assigned rating is not always sufficient to justify the rating. Specifically, comments on compliance with the essential criteria are limited. This makes it difficult for a third party to determine whether the assigned ratings are appropriate. Comments on specific ICPs follow.

The assessment was well thought out and very comprehensive. IRDA is to be commended for taking this important self-assessment initiative.

**Principle 1: Conditions for effective insurance supervision: Insurance supervision relies upon**

- **a policy, institutional and legal framework for financial sector supervision**
- **a well developed and effective financial market infrastructure**
- **efficient financial markets.**

**Assessment:** Largely observed

**Comment:** The report indicates that "the framework for accounting, actuarial and auditing standards...are evolving concepts". It is normal for these critically important standards to constantly evolve with a view to meeting international best practice and other local requirements. However, the bases from which each of these different standards are evolving are important considerations and need to be carefully considered and compared with what is desirable in order to identify the gaps. From what is written in the document it is not possible to precisely ascertain the gaps.

The comments also note that "some of the provisions of the Act and Regulations are outdated" and legislative changes take a long time to effect. However, it is noted that the regulatory framework provides enough flexibility to keep the current practices up to date". The concern with this is

whether changes in regulatory practices have the force of law in light of outdated legislation. In other words, is IRDA relying on moral suasion to effect needed changes in practices and behavior on the part of management of insurers. Again, the gaps in the legislation and regulations need to be known as the existence of an appropriate legislative framework is equally critical.

For various reasons such as lack of funding or unavailability of technical resources or inaccessible training facilities, Regulators globally usually do not have the adequate numbers of and/or adequately trained staff to fully and effectively carry out the supervision mandate. As a result, the ability to rely on the applicable professional bodies is essential.

Based on the above, it is clear that gaps in professional standards (accounting, actuarial and auditing) as well as gaps in the legislative framework (Act and Regulations) need to be critically assessed before the appropriateness of the assigned rating can be evaluated.

***Stance of the Advisory Panel:*** *As rightly pointed out by the reviewer, the related concepts are constantly evolving to meet international best practice and other local requirements. The comment is thus general and applicable to all jurisdictions. As such, no gaps exist which could possibly affect the ratings assigned to the principle. The position has been elaborated upon in the point-wise responses and also in the assessment document.*

*It is only certain provisions of the law which have outlived their relevance in the context of the conditions under which the Indian insurance sector is operating. At the time of opening up of the sector considerable amendments were carried out to the Insurance Act, 1938; the Life Insurance Corporation Act, 1956 and General Insurance Business (Nationalisation) Act, 1972. These amendments were carried out while setting up the Authority under the IRDA Act, 1999.*

*However, this is not to imply that the regulatory framework is outdated. In fact, the regulations have been framed taking into account the realities of the present date scenario.*

*Broadly, the legislative amendments have been recommended to provide for additional provisions relating to penalties and for strengthening the Grievance Redressal Mechanism. The other proposals relate to amendments to remove redundancies, modify definition of Indian insurance company and rationalise certain other sections in the light of past experience. In addition, the dichotomies with regard to some of the provisions of statutes that govern state-owned insurers are being addressed. This, however, does not imply that the regulatory framework under which the sector is operating does not have the force of law or would be inhibited in any manner in its operations.*

**Principle 2: Supervisory Objectives: The principal objectives of insurance supervision are clearly defined.**

**Assessment:** Largely observed

**Comment:** IRDA states that one of its objectives is to "promote and ensure orderly growth of the insurance industry". A potential conflict of interest can exist. The supervisor should not normally be responsible for promoting the market. Instead, the supervisor should focus on promoting stability and confidence of the market. If done effectively, growth will be a natural by-product, in other words, it should not be a principal stated objective.

In addition, some legislative 'powers still rest with the Government of India'. This is inconsistent with established international best practices which call for the regulator to be independent.

Furthermore, the existence of exempted insurers which are also subject to their own legislation creates an unacceptable playing field and are inconsistent with international practices and rules surrounding free trade.

The above comments would suggest that the assigned rating is optimistic.

**Stance of the Advisory Panel:** *The insurance sector was opened up in the country after a long period of nationalisation. One of the objectives of opening up was to spread the reach of insurance. As such the objectives of IRDA to develop the insurance sector is as per the public policy.*

*In the context of the development of the insurance sector as at present it is not considered feasible to segregate the two roles.*

*These issues have been brought out upfront in the assessment document, and are also being addressed through the legislative amendments which are presently being considered by the Government of India. The IRDA has also made recommendations to address these issues.*

*The existence of exempted insurers has been flagged in the assessment. It may, however, be pointed out that these insurers do not have a significant market share.*

**Comment:** *Rating: The rating of largely observed has been given in view of the compliance with a significantly large number of criteria. Secondly, the process of addressing the issues of concern has already been initiated.*

**Principle 4: Supervisory Process: The supervisory authority conducts its functions in a transparent and accountable manner.**

**Assessment:** Largely observed

**Comment:** The process for making decisions on supervisory action appears to be cumbersome and time-consuming. The self assessment seems to indicate that expectations of the public sector companies are less stringent than the private sector. This may defeat the purpose of maintaining an orderly market and stifle competition in the private sector.

The relevance and materiality of the points raised above cannot be evaluated strictly from the description in the self assessment. Nevertheless they need to be reconsidered to see if the rating of Largely Observed still applies.

**Stance of Advisory Panel:** *Both public sector and private sector are governed by the same legislation/regulations. Public sector is further governed by some specific statutes. Constraints faced by the public sector has been primarily on account of legacy issues and the inability of these insurers to implement the requisite changes in their operations within the time-frame specified resulting in relaxations being extended to them (as a result of which these insurers were given additional time to be compliant with the requisite stipulations). This is not to imply that the requirements for the two set of insurers are at variance. The Act and Regulations to a*

*very large extent are ownership neutral. The sustained growth of market share of private insurers at the cost of the market share of public sector, endorses this point.*

*As regards the process of decision making being long and time consuming, it is but natural that where the legislation is to be enacted through an Act of Parliament, it would take some time. However, insofar as the decisions of the IRDA are concerned, the decisions are quickly taken.*

*Description in the self assessment needs to be read with the back papers which provide detailed assessment criteria-wise. Ratings have been based on the detailed assessment carried out criteria wise and hence hold good.*

**Principle 6: Licensing: An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.**

**Assessment:** Observed

**Comment:** The criteria for registration seem appropriate and consistent with international rules. However, exempted insurers may receive some sort of forbearance and the degree to which this is extended to them is not clear from the self assessment.

In addition, companies are not allowed to operate through branches in India. Generally branches are allowed globally. Branches are attractive to companies because they do not fragment capital. Consumer interests may be protected by requiring a ring fenced portfolio of assets although this would approximate a capital requirement.

In light of the above IRDA may wish to consider whether the rating of Observed is still applicable.

**Stance of Advisory Panel:** *The existence of exempted insurers is a matter of legacy which needs to be addressed. They continue to fall outside the regulatory and supervisory processes.*

*Foreign insurance companies are not allowed to operate either directly or through branch offices in India. This is more a matter of public policy.*

*The presence of exempted insurers and the absence of permissions to foreign companies are not issues which are so significant as to impact the rating of observance with the ICP. While the former is a legacy issue, in case of the latter, the opening up of a sector is normally a process of evolution over a period of time.*

**Principle 7: Suitability of persons: The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.**

**Assessment:** Largely observed

**Comment:** From the description given in the self assessment, fit and proper requirements for Board members were not mentioned as being mandatory. I assume that this is an oversight and that IRDA requires all Board members to meet fit and proper requirements. If this is not the case, the rating of Largely Observed is not correct.

**Stance of the Advisory Panel:** *Accepted. A fit and proper requirement for Board Members is mandatory. Description in the self assessment is the summary of the detailed assessment of individual criteria of each ICPs. The points have been incorporated in the detailed assessment. Recommendations on the same have also been made in the assessment document.*

**Principle 13: On-site inspection: The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.**

**Assessment:** Largely observed

**Comment:** The description in the self assessment document is silent on whether a risk-based supervisory methodology is in place. Given the fact that supervisors generally do not have adequate resources and that the risk profile of insurers differ, sometimes considerably, the need to focus on the higher risk companies or higher risk operations of individual companies, becomes all the more important.

Risk-based supervision is as much a qualitative exercise as it is a quantitative one. If the accounting, auditing and actuarial professions have adequate standards of practice in place that meet international best practice and are appropriately monitored for compliance and competency by their own professional associations, the supervisor can usually focus more on the quality of the insurer's risk management and governance systems.

The degree to which IRDA is able to employ risk-based supervision could impact the assigned rating.

***Stance of Advisory Panel:** While the supervisor had been conducting on-site inspections with the support of outside experts till 2005-06, in the year 2006-07, a separate department has been set up to carry out on-site inspections. While the full financial examination has not yet been commenced examination of companies with specific target areas has been carried out. The periodicity/ frequency of inspections are however not prescribed.*

*While selecting companies for on site inspection, the IRDA is guided by the risk profile of the individual insurers and the related issues of regulatory concern. While formally a pre-defined risk-based supervisory methodology is not in place, it is not considered to be a hindrance at the present juncture.*

**Principle 14: Preventive and corrective measures: The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.**

**Assessment:** Largely Observed

**Comment:** The supervisory actions taken by the regulator when companies get into financial difficulties should be proportional to the seriousness of problems. Preventive and Corrective Measures are best effected when employed in a manner that encourage insurers to independently identify solutions to their own problems. It is difficult to assess the appropriateness of the assigned rating based on the information provided.

**Stance of the Advisory Panel:** *Given the fact that the sector was opened up only recently and also that the entry level capital and on going solvency requirements have been kept high, there have been no instances of insurance companies facing financial difficulties. However, the trigger for regulatory action is the fall in solvency position below the stipulated 1.50, in which case the regulator steps in to direct the company to ensure that the position is rectified within a specified time-frame. Failure to ensure compliance would result in escalation of regulatory action. There have, however, been no instances of such non-compliance.*

**Principle 15: Enforcement or sanctions: The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.**

**Assessment:** Largely observed

**Comments:** The regulator should be able to take prompt and corrective action on its own initiative, but with attendant checks and balances. However, the regulator must also be able to demonstrate that it makes independent, impartial and well informed decisions especially where intervention is concerned. From the information contained in the self assessment report it appears that if a company is deemed to be operating in an unsound manner, "the Central Government may appoint an Administrator to manage the affairs of the insurer". This seems to be an arbitrary process. There seem to be no appeals mechanism for the industry. This is inconsistent with international best practice. If this is correct, the assigned rating should be lowered.

**Stance of the Advisory Panel:** *Where supervisor has a reason to believe that an insurer carrying on life insurance business is acting in a manner likely to be prejudicial to the interests of holders of life insurance policies, it makes a report to the Central Government. The Central Government may appoint an administrator to manage the affairs of the insurer under the direction and control of the supervisor. The Administrator reports to the supervisor on the most suitable course of action keeping in view the general interests of the holders of life insurance policies viz., transfer of business; winding up of the insurer; or any other advisable course of action. Supervisor takes appropriate action, keeping in view the interests of the holders of life insurance policies and passes an order accordingly.*

*The position with regard to appointment of an administrator is only extreme position of the situation going completely out of control.*

*The administrative decisions of the supervisor are subject to appeals as in the normal course of natural justice.*

**Principle 16: Winding-up and exit from the market: The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.**

**Assessment:** Partly observed

**Comment:** The IRDA position seems to be based largely on company law. The first essential criteria states that there should be legal or regulatory point beyond which it is not permissible for an insurer to continue in business. This is interpreted to mean a breach of regulatory capital requirements, but could also mean a lack of proper accounting records or unacceptable number of consumer complaints.



A ladder of intervention is important and does not seem to be evident in IRDA's regulatory practices. The assigned rating, however, seem appropriate.

*Stance of the Advisory Panel:* Yes, there is a need for putting in place a system of regulatory intervention which gets more stringent with the escalation of the problems/ breach. This is why the rating assigned is lower than observed.

**Principles 18-23: Prudential Requirements**

**18 – Risk assessment and management**

**19 – Insurance activity**

**20 – Liabilities**

**21 – Investments**

**22 – Derivatives and similar commitments**

**23 – Capital adequacy and solvency**

**Assessment:** 18&19 – Partly observed; 20 – Observed; 21 – Largely observed; 22 – Partly observed; 23 – Observed

**Comment:** It is very difficult to assess these important prudential ICPs based on the information provided. This is where interaction and interviews with supervisors, supervised companies, professional bodies, etc. would be critical. The issue here is that having the policies, procedures and other necessary requirements in place are important, but the more relevant issue, is to be able to assess the effectiveness of their applications.

*Stance of the Advisory Panel:* Detailed criteria-wise assessment may also be reviewed for more clarity. The actual ground level reality has been taken into account while making the assessment.

**Principles 24 & 25: Markets and consumers**

**24 – Intermediaries**

**25 – Consumer protection**

**Assessment:** Observed

**Comment:** IRDA seems to have an effective system in place to deal with the requirements of these ICPs.

*Stance of Advisory Panel:* No comments.

**Principle 26: Information, disclosure & transparency towards the market**

**Assessment:** Largely observed

**Comment:** Market discipline is increasingly important in an environment where consumers are becoming better informed and educated about their financial needs. Transparency imparts credibility and promotes market confidence. The fact that financial returns of insurers are available for public inspection at the supervisor's office is commendable. However, companies should also be required to make their financial results publicly available. At the moment this is voluntary. IRDA may wish to reconsider whether the assigned rating of Largely Observed is still appropriate.

**Stance of the Advisory Panel:** *Company-wise financial results are also available on website of Ministry of Company Affairs, which is a mandatory stipulation. These are also available at the supervisor's office.*

**Principle 28: Anti-money laundering/Combating the Financing of Terrorism**

**Assessment:** Largely observed

**Comment:** The fact that AML guidelines apply only to insurers and not agents and intermediaries is unacceptable and could expose the regulator and by extension, the country to reputation risk. Also, IRDA has no enforcement powers. As a result the assigned rating of Largely Observed should be lowered.

**Stance of the Advisory Panel:** *The obligation to set an Anti-Money Laundering programme lies on the insurance company. As insurance business is carried out through trained agents and various alternate distribution channels, AML guidelines are equally applicable to agents and corporate agents.*

*Rating is based on detailed criteria wise assessment and can be retained.*



## Chapter VI

### Summary of Recommendations

#### 1. Overarching Issues

##### Applicability of Principles Based Regulations in the Indian Context

- Given the stage of India's development, the maturity of its markets, the availability of expertise, the level of compliance, etc., there could be a mix of approaches in adopting an appropriate regulatory model comprising elements of both the principles and the rules-based methods of regulation. Thus, a regulatory regime could be adopted in which the principles-based approach is applied only to products, thus creating a conducive atmosphere for product development, and continue otherwise with a rules-based approach. Another approach could be to apply the principles-based approach only in respect of the advanced market segments in the country such as equity and forex markets. But considering the variety of segments, differing levels of their development and regulation, defining a threshold level for this purpose would be a formidable task at this stage. Before any large scale migration to an alternative regulatory regime is preferred, therefore, the relevant issues need to be examined

thoroughly as it might also require significant amendments to existing legislations governing regulatory framework of the financial system.

##### Independence of Regulatory and Supervisory Authority

- The Central Government, *de jure*, is empowered to remove the Governor of the Reserve Bank without assigning any reason. But such power has never been exercised and, over time, the Reserve Bank has come to be perceived as one of the most independent and autonomous institutions in the Indian financial sector. The government will run a huge reputational risk if ever it decides to remove the Governor/Deputy Governor of the Reserve Bank without sufficient reason. Considering Reserve Bank's success as a regulator amidst its diverse activities, there is no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/Deputy Governor could be removed. Such changes are not likely to add or make any material difference to the autonomy Reserve Bank already enjoys as a regulator.

- Section 5(2) of the SEBI Act gives right to Central Government to terminate the services of the Chairman or Member at any time by giving a notice of three months. Section 5(2) should be omitted.
- While, as per the precedent and practice, the Government of India has always recognised and fostered the independence to the IRDA, there are no doubt legacy issues arising from the provisions of the Insurance Act which vests several powers with the Government of India (GoI) in the context of the Insurance Sector. However, these would largely be addressed in the proposed amendment Bill which is now under consideration of the Government. With respect to financial independence of IRDA, as regards transfer of IRDA's funds to exchequer, there is a move to issue instruction by Government by invoking Article 266(2) of Constitution of India. IRDA is not carrying on sovereign functions on behalf of the government and as such these provisions are not applicable to it. While the matter is under examination, any action in this regard would be detrimental to and raise serious concerns relating to the supervisor's stature as an autonomous regulator.

#### **Capacity Building and Skill Enhancement**

- The Panel identifies that capacity building of the regulators as a serious issue and recommends market related incentive structure to attract and retain

talent and added attention to training and development. It recognises that every effort has to be made to match industry level remuneration in order to attract and retain the best available talent for regulation. While in the Indian context it would never be easy for the regulator to match the ever-increasing remuneration levels of the industry, it will have to be ensured that the gap between the two remains manageable and the efficacy of the system is not undermined.

- The recruitment and development of a specialised cadre to cater to the impending requirements of the implementation of Basel II in banks is a must. Lateral recruitment of specialists with requisite skill sets should also be considered. There is also a need to examine the HR policies, including transfer policies, in the banking sector (particularly of public sector banks).

#### **Co-operation Between Regulators**

- A system of unified regulator is not entirely suited to the present state of country's overall financial system and its markets. For the present it would be best not to go beyond giving common guidelines. Depending on its primary function, the regulated entity should be regulated by a 'lead regulator' who would exercise regulatory and supervisory authority in relation to the entity's primary function, and as part of this supervision of entities having

multifarious activities cutting across regulatory domains could be conducted collaboratively with other jurisdiction regulators. In order to make such collaborative supervision effective, every effort should be made to ensure that parameters of such co-ordination are well defined and ground rules are specified.

- There exists a formal information sharing platform in the form of a High Level Co-ordination Committee on Financial Markets (HLCCFM) comprising the Governor of the Reserve Bank, Chairmen of SEBI, IRDA and PFRDA as also the Finance Secretary, Government of India, which serves as a forum for discussing common regulatory issues. It is necessary that HLCCFM should be given responsibility of ensuring close co-ordination and monitoring of the markets by the respective regulators and the functioning of conglomerates. The HLCCFM needs to be strengthened. The HLCCFM should be supported by a formal institutional mechanism enabling it to give direction to regulatory authorities on issues cutting across regulatory domains. The role of the HLCCFM and its functions should be clearly delineated and placed in the public domain. The membership of the HLCCFM should be made more broad-based and diversified and market participants should also be represented. As representation by market participants could sometimes lead to a conflict of interests, such participation should be through representative bodies of the industry or the SROs, to ensure that it remains objectively constructive. The frequency of the meetings of the HLCCFM needs to be increased.

- The Reserve Bank has initiated a move to insert a new clause 29 A under the Banking Regulation Act, 1949 which would give it powers to inspect the books of accounts and other records of all entities that are subsidiaries/associates of a bank, irrespective of whether the subsidiary/associate is under any other regulator. As a corollary, similar regulations may also be appropriate for the other regulators (specifically SEBI and IRDA) who may require inspecting the books of accounts and other records of subsidiaries/associates of the regulated entity.

- During the initial phase of growth of the insurance sector, Unit Linked Insurance Plans (ULIPs) were seen to be somewhat analogous to the equity linked savings scheme (ELSS) and similar mutual fund schemes. ULIPs are issued by insurance companies (regulated by IRDA), mutual fund schemes are issued by mutual funds (regulated by SEBI). Thus, insurance companies and mutual funds operate under different regulatory regimes with separate prudential norms. New guidelines issued by IRDA in 2006 have stopped ULIPs from being positioned as short-term investment product. In order to ensure that these two different saving instruments with short and long-term investment objectives are positioned appropriately to reflect the respective position, steps are being taken towards inter regulatory co-operation on an on-going basis.

#### **Home-Host Country Co-operation**

- There should be specific provisions in the RBI Act, 1934 and Banking Regulation Act, 1949 and IRDA Act, 1999 on lines of SEBI Act, 1992 so that MoUs can be entered into with foreign

supervisors establishing a formal communication mechanism.

**Reducing the Scope of Regulatory Arbitrage**

- The possibility of bringing non-financial entities which have financial subsidiaries/associates within the scope of supervision of financial conglomerates needs to be examined. Same is the requirement in respect of financial companies which are sister concerns within the same holding company. Regulatory and supervisory reach has to extend to all those unsupervised entities whose condition could affect the supervised entities.
- There could be arbitrage issues in respect of both institutions and markets across the regulatory jurisdictions of the Reserve Bank, SEBI and IRDA. If a level playing field and a competitive environment need to be maintained across markets and institutions, duly taking into account the operational objectives and differences in nature, the present arrangement of inter-regulatory co-ordination needs to be strengthened and made transparent. The Panel strongly feels that a well established co-ordinating mechanism for the financial system as a whole would be most beneficial and our best bet in the current circumstances. Inter-regulatory co-operation and a collaborative approach would result in most of advantages available in unified regulation without exposing the system to its pitfalls.

**Synergies Between Regulation and Supervision and Promotion of Financial Stability**

- The Panel admitted that though the dual roles of being monetary authority and regulator and supervisor of banks and FIs have inherent seeds of conflict, in Indian context, the issue has been resolved to a great extent as within the Reserve Bank. A separate Board for Financial Supervision (BFS), a committee of the Bank's Central Board of Directors is specifically entrusted with the responsibilities of financial supervision, including banking supervision. The BFS ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban co-operative banks and primary dealers. The Panel feels that the current structure of the Reserve Bank which is the monetary policy maker and LoLR as also the regulator and supervisor, though quasi-independent, is appropriate and may continue. It reduces the information risk that would otherwise be embedded between the monetary authority and the regulator and supervisor.

**Institutional Infrastructure**

- The recent global financial turmoil has necessitated the need to have a re-look at the conventional role of LoLR. The existing provisions in RBI Act, 1934, empower the Reserve Bank to provide liquidity in times of crisis. Given the



increasing integration of global markets as also the innovations that are taking place, conventional methods of LoLR may not be sufficient, as is evident from the recent crisis. Accordingly, it recommends that the Reserve Bank may consider constituting a Working Group to look into the whole gamut of issues relating to liquidity with a specific mandate to look into (i) the powers available as per extant provisions with the Reserve Bank as regards its role of LoLR (ii) the scope for putting in place a mechanism whereby the same can be activated at the shortest possible notice and (iii) the scope for expanding the instruments that can be permitted for providing liquidity.

- Delays in the recovery proceedings before the Debt Recovery Tribunals results in the locking up of huge amount of public money. Necessary steps to address the issue of delay in the recovery process before the DRT/DRAT are needed by increasing DRTs/DRATs. The SARFAESI Act has given a major boost to the recovery process of the banks and has helped them reduce NPAs. But pendency of litigations remains a major concern. There is also a need to keep the insolvency procedures for entities with systemic risk like the banks/insurance companies separate from the insolvency relating to ordinary companies. The law should provide for a time-frame to conclude the liquidation proceedings.
- The Reserve Bank has issued detailed guidelines on accounting and disclosure norms and it is also satisfied that banks maintain adequate records drawn up in accordance with these accounting policies. As regards derivative accounting, the accounting standards on lines of IAS 30 and 32 would be

recommendatory from April 1, 2009 and mandatory from April 1, 2011. In order to encourage corporates to adopt the revised Accounting Standards at an early date, it would be desirable that banks enter into derivative contracts with only those corporates who adopt the revised Accounting Standards.

- In the adoption of the Accounting Standards, there is no major separate distinction for insurers. As regards the evolving standards on fair value accounting, insurance contracts are still outside the purview of the proposed AS30. Against the background of the Council of the ICAI to achieve full convergence towards the International Financial Reporting Standards (IFRS) by 1st April, 2011, the IRDA is examining the issues in the particular context of the insurance sector and has initiated steps to lay down the way forward.

## 2. Basel Core Principles

The assessment of Basel Core Principles had revealed certain gaps in respect of commercial banks, urban co-operative banks, State/District Central Co-operative Banks, Regional Rural Banks, Non-Banking Finance Companies and Housing Finance Companies. There were also some issues which arose during the course of the assessment which are overarching in nature. The Panel had deliberated upon these gaps/issues and given their recommendations which are summarised below.

### 2.1 Broad issues

#### Regulatory Accountability of the Reserve Bank

- A more transparent framework of understanding with the Government of India regarding the way the Reserve Bank is made accountable for its supervisory functions may be developed.

#### Ownership Issues

- Undue governmental influence can lead to poor governance and render regulation ineffectual. This also has direct bearing on the regulator's ability to enforce compliance with the Basel Core Principles. In interest of proper regulation and growth of the sector and to resolve the inherent conflict of government owning the major portion of banking system, the government should consider urgently giving up its role as majority shareholder in the public sector banks.

#### Implementation of Basel norms in the Co-operative Sector

- As some of the scheduled Urban Co-operative Banks are equivalent in size and systemic importance to medium sized commercial banks, it is necessary to assign duration based capital charge for market risk for these entities.
- In respect of rural co-operatives, the migration to Basel I can be considered after the implementation of the revival package based on the Vaidyanathan Committee's recommendations.
- In respect of RRBs, the implementation of Basel I norms relating to capital adequacy could be considered after the completion of the amalgamation and recapitalisation process of these entities. The banks could be categorised and a differential time-frame and roadmap could be prescribed for operationalising the norms.

#### Duality in Regulation of Co-operatives

- From the long-term perspective the government influence in the co-operative sector requires to be minimised and its regulation and supervision should be brought within the ambit of a single regulatory organisation. Till this is achieved efforts should be continued to sign MoUs with all State Governments and chalk out a revival path for potentially viable institutions and a non-disruptive exit route for the non-viable ones.

#### Licensing of Co-operative Institutions

- The continued existence of unlicensed co-operative institutions is a matter of concern as these entities pose a risk to depositors' interests. There is a need to draw up a roadmap whereby 'banks' which fail to obtain a license by 2012 would not be allowed to operate. This would expedite the process of consolidation and weeding out non-viable entities from the co-operative space.

#### Enhancement of Off-Site Monitoring through close co-ordination of On-Site Supervision

- There is need to enhance co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising out of the complementarity of these two forms of supervision. Suitable measures to achieve this objective are needed as these will add substantially to effective supervision.

### **Regulatory Independence of NABARD and NHB**

- NABARD and NHB are not independent but are being regulated by the Reserve Bank. The present dispensation regarding the removal of heads of these institutions can continue.

## **2.2 Commercial Banks**

### **Constitution of Bank Boards**

- As per Section 10A (2) (b) of the Banking Regulation Act, 1949, directors on the banks' Board should not have substantial interest in a company or a firm. As per Section 5 (ne) of the Act, substantial interest means an amount paid up exceeding Rs. 5 lakh or ten per cent of the paid-up capital of the company, whichever is less. However, the ceiling of Rs.5 lakh acts as a constraint for having directors with requisite expertise on banks' boards. The guidelines need to be reviewed, and the limits defining 'substantial interest' revised upwards so that the banks can attract individuals with requisite expertise on their Boards.

### **Internal Capital Adequacy Assessment Process**

- The Panel notes that the Reserve Bank has since issued guidelines on the internal capital adequacy assessment process as part of the supervisory review process under Pillar II of Basel II which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009.

### **Risk Modelling**

- A rigorous model building exercise is important to the banks that adopt more advanced Internal Rating Based (IRB) approach in respect of credit risk and Advanced Measurement Approach (AMA) in respect of operational risk. If a bank intends to take recourse to the

IRB or the AMA approach for assessing credit and operational risks respectively, it should have appropriate forward-looking models in place which should be validated periodically. Capacity building in respect of banks and the Reserve Bank, is the prime precondition in this regard.

### **Credit Risk and Provisioning Norms**

- The issuance of suitable guidelines on credit risk requires inclusion of counterparty risk arising through various financial instruments.
- Keeping in view the cost of compliance, the stipulations for provisioning of sub-standard assets for commercial banks may continue for the present. However, considering the very large number of low value NPAs which are sub-standard, if at all provisioning has to be done individual account-wise, a cut-off level should be set above which all accounts can be provided for individually. This cut-off level above which all sub-standard assets have to be provisioned for may be lowered in a phased manner.
- As per existing guidelines on provisioning, banks are required to make a two per cent provision on standard assets, while NBFCs need not make any provision on standard assets. A review of norms should be made to reduce the possibility of regulatory arbitrage across categories of financial institutions.

### **Exposure to Capital Market**

- A review of the limits on capital market exposure should be made keeping in view the associated risks arising out of such exposures.

### **Liquidity Risk**

- The effect of other risks (credit, market and operational risks) on a bank's

overall liquidity strategy is not covered in the existing guidelines. This could be mandated for banks which have the appropriate skill sets. Banks should initially concentrate on knowledge and quantitative skill enhancement and fix a timeframe of two years after migration to Basel II before undertaking such forward looking analysis of contagion risk.

- The Reserve Bank should consider issuing guidelines on liquidity risk which covers the foreign exposures of the bank.

#### **Operational Risk**

- Though the Reserve Bank has issued guidelines to address operational risk, it should put in place a mechanism whereby banks are required to report the developments affecting the operational risk in the banks to the supervisor.

#### **Interest Rate Risk in the Banking Book**

- The Panel notes that the Reserve Bank has since issued guidelines on interest rate risk in the banking book as part of supervisory review process under Pillar II of Basel II which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009. This is in consonance with the recommendation made by the Panel of issuance of guidelines on management of interest rate risk in banking book.

#### **Notification of Adverse Information**

- There are no guidelines issued by the Reserve Bank which explicitly provide

for the supervisor to ensure that banks notify the Reserve Bank as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management. This is being done on voluntary basis. To ensure full compliance to the Basel Core Principles, the Reserve Bank needs to issue separate guidelines in this regard.

#### **Appropriate skills in the back office of Bank Treasury**

- The Reserve Bank may issue appropriate guidelines to banks laying stress on the maintenance of balance in the skills and resources of the back office and control functions relative to the front office/business origination. The Panel also recommends amendment of the on-site inspection manual mandating the on-site inspectors to compulsorily comment on the same in their reports.

#### **Risk Based Supervision**

- A quicker adoption of techniques and methodology of Risk Based Supervision is recommended. This will appropriately profile the bank, highlighting the risks and vulnerability faced by the entity. Based on its assessment, the supervisory cycle for the banks can be determined. There is a need for further strengthening of off-site surveillance which is a pre-condition for effective adoption of techniques and methodology of risk based supervision.

### **Qualitative Disclosure**

- Guidelines has been issued for mandating Indian banks with foreign operations and foreign banks from March 31, 2008 and for other banks from March 31, 2009 to have a formal Board approved disclosure policy post implementation of Basel II in respect of these entities. This in line with the Panel recommendation of expeditious implementation of guidelines regarding qualitative disclosures, concurrent with full migration to Basel II.

### **Prompt Corrective Action**

- Guidelines on the PCA framework should provide for an appropriate timeline for initiating mandatory and discretionary actions to follow the identified triggers. If necessary, this could be finalised in consultation with the Government.

### **Consolidated Supervision**

- The insertion of Section 29 A (power in respect of associated enterprise) in the Banking Regulation Act (Amendment) Bill, 2005, would empower the Reserve Bank to conduct consolidated supervision. The Panel recommends the expeditious passage of the Amendment Bill in the Parliament.

### **Information Sharing with Foreign Regulators**

- Given the increasing overseas presence of domestic banks, a formal mechanism needs to be put in place by the Reserve Bank for inspecting overseas branches. There should be specific provisions in the RBI Act, 1934 and the Banking Regulation Act, 1949 on the lines of SEBI Act, 1992 so that an MoU can be entered into with the foreign supervisors establishing a formal communication mechanism. There can be a clause in the

MoU enabling the foreign regulators to inspect branches of foreign banks in India, subject to specific approval of the Reserve Bank and reciprocity.

## **2.3 Urban Co-operative Banks**

### **Memorandum of Understanding**

- MoUs with Central and State Governments are appropriate from the medium-term perspective. The Reserve Bank should promptly take steps to sign MoUs with the remaining State Governments. From a longer term perspective and in the interest of strengthening the sector, the regulatory and supervisory powers relating to UCBs should be vested with the Reserve Bank.

### **Capital Adequacy**

- The Panel feels that it would be premature for full migration of UCBs to Basel II norms at the present juncture. But given the increasing importance of interest rate risk in the banks' balance sheets, there is a need to assign capital charge for market risk through the application of the Basel approach of quantifying 'specific risk' and duration based 'general risk' for banks' trading book at least for the scheduled UCBs.

### **Risk Management**

- The Reserve Bank needs to review the current system of corporate governance, risk management and internal control in place for UCBs and issue appropriate guidelines. If necessary, specific clauses could be inserted in the MoUs with the State Governments.
- The existing guidelines do not require the UCBs to notify the Reserve Bank / Registrar of Co-operative Societies as soon as they become aware of any material information which may negatively affect the fitness and



propriety of any Board member or member of the senior management. Necessary guidelines should be issued.

**Market Risk**

- The Reserve Bank may issue guidelines on capital charge for market risk and the usage of sensitivity and VaR limits as risk mitigation techniques to the scheduled UCBs.

**Liquidity Risk**

- The Reserve Bank needs to revise the ALM guidelines on structural liquidity issued to larger scheduled UCBs to take into account undrawn commitments and other off-balance sheet items. There is also a need for extending the ALM guidelines to larger non-Scheduled UCBs.

**Operational Risk and Interest Rate Risk in the Banking Book**

- Given their size and the fact that UCBs have not yet fully implemented Basel I, it would be premature to issue guidelines related to earmarking capital for operational risk based on the Basel II approach to these entities. Likewise, it would be premature to issue guidelines on interest rate risk in banking book to these entities. However, basic guidelines on operational risk management can be considered to be issued to larger UCBs.

**Balance of skills in the back and front office of Treasury**

- It is desirable that the Reserve Bank issues guidelines to larger UCBs on the

segregation of duties and responsibilities in the front office, mid-office and back-office for treasury operations in respect of scheduled UCBs. Further, the Reserve Bank should also make it necessary for its on-site inspection team to look into this aspect in greater depth and comment about the same in their reports.

**Notification to Regulator of Substantive Changes**

- There is no requirement for the UCBs to notify the Reserve Bank of any substantive changes in their activities, structure and overall condition or as soon as they become aware of any material adverse developments. The Reserve Bank should issue requisite guidelines in this regard.

**Abuse of Financial Services**

- The Reserve Bank has issued detailed guidelines on Know Your Customer to Urban Co-operative Banks. However, there are no guidelines in place which give protection to bank staff who report suspicious activity in good faith either internally or directly to relevant authority. Appropriate guidelines should be issued.

**Appointment of Auditors**

- The Reserve Bank in consultation with the State Governments and ICAI should explore the possibility of making it mandatory for the external auditors to notify Reserve Bank about any adverse



developments that have come to their notice during the course of their audit. From a longer term perspective, however, the powers similar to those vested with the Reserve Bank under Section 30 of BR Act as applicable to commercial banks should form part of the MoU with the State Governments so as to alleviate the problems relating to auditors faced by the Reserve Bank (like the appointment or removal of an auditor with the prior consent of the Reserve Bank, conducting a special audit of a bank if necessary in the interest of depositors, *etc.*)

#### **Disclosure in Balance Sheet**

- An enhancement in disclosure norms for UCBs should be introduced, which could include quantitative disclosures regarding Tier I and II capital, non-SLR investments, exposure to capital market (direct and indirect exposure), loans subject to restructuring for larger UCBs, etc. Furthermore, given the fact that some of the larger scheduled UCBs have made forays into derivatives segment, there could be additional disclosure requirements on reporting of derivatives and ALM for these entities.

#### **2.4 State Co-operative Banks/District Central Co-operative Banks**

##### **Memorandum of Understanding**

In order to circumvent the regulatory disharmonies arising out of dual control of StCBs and DCCBs, MoUs have been entered into between the NABARD, the State Governments and the Central Registrar of Co-operative Societies. NABARD has been discharging duties of supervision of StCBs and DCCBs while Reserve Bank has been regulating these entities. The Panel recommends that NABARD should take steps to sign MoUs with the remaining State Governments

At the same time, it also feels that while MoUs are appropriate from the medium-term perspective, in the interest of strengthening the sector, the regulatory powers in respect of StCBs/DCCBs should be divested from the Government and ultimately vest with a single regulator.

#### **Capital Adequacy**

- As suggested by the Vaidyanathan Committee, risk based capital requirements of 7 per cent may be introduced for StCBs/DCCBs and increased in a phased manner to 9 per cent as in case of commercial banks.

#### **Risk Management**

- Once the concept of risk based capital adequacy is introduced for StCBs/DCCBs, issuance of guidelines on risk management on the lines of urban co-operative banks should be considered. The Panel also recommends that basic guidelines regarding the management of market risk, operational risk and liquidity risk should be stipulated. There is, however, no requirement for the stipulation of any capital charge for market risk and operational risk. It is also premature to consider measurement and capital augmentation to mitigate interest rate risk in banking book.

#### **Notifying to Regulator of Substantive Changes**

- There is no requirement for the StCBs/DCCBs to notify the Reserve Bank / NABARD of any substantive changes in their activities, structure and overall condition or as soon as they become aware of any material adverse developments. The Reserve Bank / NABARD should issue requisite guidelines in this regard.

#### Abuse of Financial Services

- The Reserve Bank has issued detailed guidelines on Know-Your-Customer to StCBs and DCCBs. However, there are no guidelines in place which give protection to bank staff who report suspicious activity in good faith either internally or directly to relevant authority. Appropriate guidelines should be issued.

#### Appointment of Auditors

- The Reserve Bank /NABARD in consultation with the State Governments and ICAI should explore the possibility of making it mandatory for the external auditors to notify any adverse developments that come to their notice during the course of their audit to the Reserve Bank /NABARD. From a longer term perspective, however, powers similar to those vested with the Reserve Bank under Section 30 of BR Act, 1949 as applicable to commercial banks should form part of the MoU signed with the State Governments so as to alleviate the problems relating to audit function faced by the Reserve Bank/NABARD (like the appointment or removal of auditors with the prior consent of Reserve Bank /NABARD, carry out a special audit of a bank if necessary in interest of depositors, etc.).

### 2.5 Regional Rural Banks

#### Capital Adequacy

- The Panel urges the introduction of CRAR which is envisaged along with the

recapitalisation of RRBs in a phased manner on completion of consolidation process of these entities.

#### Risk Management

- Once capital adequacy norms are made applicable to RRBs, guidelines on risk management related to market and operational risks can be introduced.
- Given the fact that RRBs are currently in a non-Basel regime, the assessment of market risk can be implemented only after CRAR is introduced. This is envisaged along with the recapitalisation of RRBs. As commercial banks are stakeholders in RRBs, it would be easier to implement some of the guidelines issued by them on liquidity risk and operational risk. Accordingly, as regards assessment of operational risk, the issuance of guidelines (on the lines of commercial banks) to RRBs regarding operational risk can be considered. As regards liquidity risk, the concept of Asset Liability Management for RRBs can be introduced on the lines applicable to commercial banks. However, stipulating capital charge for such risks will be premature at this stage. Given that RRBs are yet to migrate to Basel I mode, the concept of interest rate risk in banking book may not be considered for these entities in medium-term.

#### Internal Control and Audit

- Since the composition of the Board of RRBs is in accordance with the provisions of the RRBs Act, 1976,

wherein nomination to the board is made with due approval from the Government of India, any change in this regard would require an amendment to the Act. However, the Panel feels that there is no need for any change at the current juncture.

- Though directors are nominated to RRBs, it would be desirable to make them accountable for their omissions and commissions. There should be formal Board approved policy in this regard. Further, over the medium-term, the Government could consider having independent nominees on the Board of these banks.
- NABARD does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination. NABARD should comment on this aspect during the on-site examination of RRBs.
- NABARD has issued guidelines on compliance function for RRBs including appointing a designated compliance officer. This is in consonance with the recommendation made by the Panel.

#### **Abuse of Financial Services**

- The clientele of RRBs mainly comprise those under relaxed KYC norms. So, rigorous supervision may not be necessary. Given the size of operations, they must continue with existing practice and once their operations grow in volume and coverage, the issuance of detailed guidelines on the lines issued to commercial banks like customer acceptance policy, customer identification policy, etc., can be considered.
- Due diligence policies and processes in respect of correspondent banking are

yet to be put in place, because the correspondent banking is in a nascent stage in RRBs. Once these banks enter into full-fledged correspondent banking, the issuance of guidelines on due diligence policies could be considered.

- NABARD in consultation with Reserve Bank should issue guidelines advising RRBs to put in place measures for preventing, identifying and reporting of potential abuse of financial services, including money laundering.
- NABARD should determine, during on-site examinations, that RRBs have policies and processes whereby the staff can report any problems relating to the abuse of banks' financial services to either local management or to the relevant dedicated officer or to both. The Panel also recommends that NABARD should in consultation with Reserve Bank issue guidelines whereby staff who reports suspicious activity is not held liable by the relevant authority.

#### **Accounting and Disclosure**

- NABARD should consider doing away with exemption to RRBs for publication of balance sheet and profit and loss account together with auditors' report from year ending March 31, 2009 and require them to publish balance sheet and profit and loss account with auditors' report.

### **2.6 Non-Banking Financial Companies**

#### **Sharing of Information with Domestic and Foreign Regulators**

- There is a need for formalisation of the relationship with foreign regulators. It should encapsulate a transparent method of information sharing. There should be specific provisions in the RBI Act, 1934 along the lines of the SEBI Act,

1992, so that MoUs can be entered into with foreign supervisors for establishing a formal communication mechanism for NBFCs.

- Though policy initiatives have been taken to recognise the role of co-operation between home-host regulators, but no guidelines have yet been issued. Reserve Bank may expedite issuing guidelines in this regard.

#### **Ownership Issues**

- The Reserve Bank needs to explore the option of examining the suitability of the major shareholders and senior management of NBFCs.
- The RBI Act does not delegate any power to bring about changes in the composition of the Board and senior management of NBFC to address prudential concerns. Reserve Bank should explore the option of legally acquiring powers in this regard.
- The Reserve Bank should explore the option of obtaining periodic information on names and holdings of significant shareholders of NBFCs who exert controlling influence through off-site returns.
- The Reserve Bank needs to explore the possibility of defining 'significant ownership' or 'controlling interest' in respect of NBFCs. Further, the Reserve Bank should issue necessary guidelines to NBFCs advising them to intimate the Reserve Bank of any change in 'significant ownership'.

#### **Major Acquisitions**

- The developmental role in promoting new companies in the form of subsidiaries/associates should not be constrained through any specific mandated criteria regarding acquisition. However, the Reserve Bank could consider obtaining information relating to cross-border operations and corporate affiliations as a part of the off-site surveillance.

#### **Reporting of Material Concentration to the Board**

- There is a need to issue guidelines to NBFCs for establishing thresholds depending on their respective scales of operation and reporting the exposures above this threshold to the Board. This aspect can also be verified by the Reserve Bank during the on-site inspection of the NBFCs.

#### **Exposure to Related Parties**

- The requirement of issuance of guidelines on arms length relationships and stipulations on mitigating risks arising out of related party exposures be examined in the context of the developmental role played by NBFCs in the promotion of green field projects, which they do often, through subsidiaries and associates.

#### **Market and Liquidity Risk**

- The Reserve Bank may consider feasibility of implementing guidelines on market risk along lines of commercial

banks to deposit taking NBFCs (having deposits above Rs.20 crore) and NBFCs-ND-SI. A phased and calibrated implementation of capital charge for market risk in respect of these entities can be considered. However, the Panel feels that NBFCs not having any outstanding borrowing by way of deposits or by any other form of borrowing including preference shares could be considered to be exempted from these guidelines.

- Prudential norms for NBFCs particularly relating to ALM and liquidity risk management, need to be strengthened in a non-disruptive manner.

#### **Operational Risk**

- Capital adequacy requirements for NBFCs capture only credit risk. However, the capital adequacy requirements for NBFCs are higher than those for banks. So, the Panel feels that there is no need for issuing any guidelines on capital charge for operational risk to NBFCs. However, guidelines on management of operational risk without stipulating specific charge can be issued.

#### **Balance of skills in front and back office**

- The Reserve Bank does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination of NBFC. The Reserve Bank may look into the same during the on-site inspection of NBFCs. Specific provisions in the NBFC inspection manual are needed in this regard. As regards NBFCs-ND-SI the same may be seen during the on-site scrutiny.

#### **Abuse of Financial Services**

- The Reserve Bank has issued detailed guidelines on Know-Your-Customer to

NBFCs. However, there are no laws in place which give protection to NBFC staff who report suspicious activity in good faith either internally or directly to relevant authority. Appropriate guidelines on the lines of one introduced for private sector banks and foreign banks (Introduction of 'Protected Disclosures Scheme for Private Sector and Foreign Banks') may be issued.

- The Reserve Bank should have in place formal due diligence policies and formal processes at the time of granting permission to foreign entities in setting up a liaison office in India.
- The Panel recommends that there can be confirmation that NBFCs have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services including money laundering through on-site inspection.

#### **Notification to Regulator of Substantive Changes**

- There is no requirement of notifying the Reserve Bank of any substantive changes in their activities, structure and overall condition or as soon as they become aware of any material adverse developments. The Reserve Bank may issue requisite guidelines in this regard.

#### **Appointment of Auditors**

- The issuance of appropriate guidelines to empower the Reserve Bank regarding the appointment, rejection and rescinding appointment of external auditors. This may be done in consultation with ICAI.

#### **Increased Disclosure**

- The Reserve Bank could consider increased disclosures in case of NBFCs in respect of ownership structure, significant holdings and nature and types of activities and products.



## 2.7 Housing Finance Companies

### Information Sharing and Due Diligence in respect of Foreign HFCs

- There is a need for co-ordination and information exchange between home supervisors and the NHB. A formalisation of the relationship with foreign regulators is needed, which should encapsulate a transparent method of information sharing. There should be specific provisions in the NHB Act, 1987 on lines of the SEBI Act, 1992 so that MoUs can be entered into with foreign supervisors for establishing a formal communication mechanism. NHB should obtain a no-objection certificate from the home supervisor before issuing the Certificate of Registration to a foreign HFC to establish branch/es in India. Further, they may also assess as to whether the home supervisor practices global consolidated supervision. There is a need for reckoning FII as part of foreign shareholding of HFCs.

### Permissible Activities

- Builders/construction companies should be precluded from using the term 'housing finance' in their names. The Ministry of Corporate Affairs should issue the necessary guidelines to registrars of companies in this regard. Furthermore, the activities that can be taken up by HFC/HFI needs to be clearly defined in the NHB Act.

### Ownership Issues

- NHB should issue guidelines that establish responsibilities of the Board

and the senior management with respect to corporate governance to ensure that there is an effective control over a HFC's entire business.

- The scope of fit and proper test by NHB for HFCs should be expanded to cover criminal activities. Further, NHB needs to formulate guidelines to ensure that the Board of HFC collectively has sound knowledge of each of the type of activity that is undertaken by them.
- NHB does not have the power to bring about changes in the composition of the Board and senior management to address prudential concerns. It should consider amending the Act or issue appropriate guidelines whereby it would be empowered to initiate such action, if necessary.
- NHB may in consultation with the Reserve Bank examine the issue relating to 'significant ownership' or 'controlling interest' and provide for a clear definition of the same. Based on an approved definition of ownership and control it may be explored whether NHB's powers regarding requirements of obtaining supervisory approval for change in ownership, reporting of significant shareholders etc., needs be enhanced.

### Major Acquisitions

- NHB needs to lay down norms for acquisition or investment by a HFC taking into account the entity's financial and organisational resources and the risks that could emanate from such an acquisition. Accordingly the NHB may



issue appropriate guidelines in this direction.

#### **Provisioning Norms**

- The off-balance sheet items of HFCs should also be covered under the Income Recognition and Asset Classification norms issued by NHB.

#### **Large Exposure Limits**

- Though NHB has prescribed ceilings of different kinds of concentrations for HFCs, it has not advised that HFCs should establish thresholds for acceptable concentration of credit. NHB should issue necessary guidelines to HFCs in this regard.

#### **Exposure to Related Parties**

- NHB should monitor related party exposures to avoid conflict of interest and ensure that the exposure of HFCs to related companies and individuals is on an arms-length basis. Furthermore, NHB needs to take steps to mitigate the risks that arise from exposure to related parties. The first step in this direction would be for NHB to define and capture information on related parties from HFCs and also put in place a mechanism to review the same. On the basis of the review, the potential risk areas may be identified and suitable guidelines may be contemplated to mitigate such risks.

#### **Market Risk**

- The NHB may issue guidelines on market risk along the lines of commercial banks for HFCs. This can be done in a phased manner. At the outset notional risk weights can be stipulated for instruments susceptible to market risk. In the second stage, the assets can be segregated into banking book and trading book. Capital charge on market

risk for items in the trading book may be considered.

#### **Liquidity Risk**

- Guidelines on liquidity risk should be more exhaustive covering aspects like the existence of a contingent plan for handling liquidity problems etc. It should also obtain information to identify institutions undergoing significant liquidity transformation.

#### **Operational Risk and Interest Rate Risk in Banking Book**

- The capital adequacy requirements for HFCs capture credit risk. Furthermore, the minimum stipulated risk based capital requirement for HFCs is higher than that for banks. NHB could issue guidelines for management of operational risk to HFCs. But, capital charge for operational risk need not be earmarked at this stage. Issuing guidelines relating to measurement and mitigation of interest rate risk in the banking books of HFCs may also be premature.

#### **Internal Control and Audit**

- NHB does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination. Considering the level of operations of most of HFCs, such prescription may not be warranted. The feasibility of introduction of such practice needs to be explored by NHB.
- NHB does not determine whether HFCs have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the HFC. It should explore the possibility to introduce appropriate guidelines in this regard.

#### **Abuse of Financial Service**

- NHB does not satisfy itself that HFCs have adequate screening policies and processes to ensure high ethical and professional standards when hiring staff.
- NHB does not determine whether the HFCs have clear policies and processes for staff to report any problems related to the abuse of the HFCs' financial services to either local management or the relevant dedicated officer or to both. It needs to explore the feasibility of introduction of such a policy.
- NHB has issued detailed guidelines on Know Your Customer to HFCs. However, there are no laws in place which give protection to HFC staff who report suspicious activity in good faith either internally or directly to relevant authority. Appropriate guidelines in this regard may be issued.
- NHB should appropriately determine that the system of risk management and internal controls & detection/prevention of criminal activities are in place by issuing suitable guidelines..

#### **Notification of Regulator of Substantive Changes**

- At present, HFCs are not required to notify NHB of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal

or prudential requirements. NHB needs to put in place a structured mechanism in this regard.

#### **Accounting and Disclosure**

- The issuance of appropriate guidelines is needed to empower NHB regarding the appointment, rejection and rescinding of appointment external auditors. This may be done in consultation with ICAI.

#### **Consolidated Regulation and Supervision**

- Issuance of guidelines is needed for (i) mandating the housing finance companies to submit consolidated financial statements and consolidated prudential returns; and (ii) empowering NHB to conduct consolidated supervision through appropriate amendment to the NHB Act.

### **3. IOSCO Principles**

The assessment has revealed certain gaps in respect of the equities/corporate bond markets, the government securities market, the money market and the foreign exchange market. There are also some broad issues cutting across market segments. The Panel deliberated on these and has given its recommendations summarised below.

#### **3.1 Broad issues**

##### **Development of Exchange Traded Foreign Exchange Transactions**

- As a result of preponderance of OTC transactions, the level of transparency

is not adequate in the foreign exchange markets. Despite recognising that the OTC is the more popular mode of foreign exchange transactions the world over, there is a need to encourage the development of exchange traded foreign exchange operations both in the cash and derivatives segments as it would augment the process of price discovery. The report of the RBI – SEBI Standing Technical Committee on Exchange Traded Currency Futures needs to be implemented expeditiously. The Panel notes that the RBI-SEBI Standing Technical Committee on Exchange Traded Currency Futures on 29th May 2008 recommended introduction of currency futures contract on US Dollar - Indian Rupee (US\$-INR). On 6<sup>th</sup> June, 2008 SEBI laid down guidelines on trading in currency futures in RSE or new exchanges. Currency futures/ derivatives has been introduced in NSE from 29th August 2008, in BSE from 1st October 2008.

#### **Introduction of Foreign Currency Hedging Without Underlying**

- There has been a significant increase in the size of the foreign exchange market in terms of volume. The market has also matured in terms of the types and complexities of the instruments being used. Consequently, the foreign exchange exposure of Indian companies has increased manifold. Unhedged corporate exposure entails a systemic risk and it is in the interest of the entire financial sector to add further options for hedging. In the interest of systemic stability all restrictions regarding underlying should be abolished in a phased manner.

#### **Self Regulatory Organisations**

- Various trade or industry associations may be encouraged to become SROs and

should gradually be accorded an SRO status by defining their jurisdiction and the delegation of appropriate powers. They should also be brought under the regulatory ambit of the SEBI. Effective steps also require to be taken to address the conflict of interest and moral hazard issues that may arise in this regard.

- FEDAI should be made a full fledged SRO by giving it more powers and should be brought under the regulatory purview of the Reserve Bank.
- The government securities and money markets do not have any SROs. FIMMDA should be accorded SRO status by defining its jurisdiction and the delegation of appropriate powers. It should also be brought under the regulatory ambit of Reserve Bank.

#### **Enhancement of Regulatory Coverage**

- The Investment Advisers and Research Analysts be brought within the regulatory ambit through SRO or directly by prescribing licensing and registration requirements, apposite credentials, appropriate returns, etc.

#### **Responsibility of Auditors**

- To enhance the efficacy of regulation and augment accountability, the certification authorities/auditors should be accountable to the respective regulatory authorities. The matter should be discussed with ICAI/ICWAI/ICSI or any other similar body for the issuance of appropriate directions.

### **3.2 Equities/corporate bond market**

#### **Overlap of Jurisdiction between Central Government and SEBI**

- Central Government continues to have powers to make rules in respect of all the matters relating to securities market under the SC (R) Act. The Ministry of Corporate Affairs has concurrent powers

under the Companies Act in respect of matters relating to the capital market such as the prospectus, the issue of shares to public etc. Even though Section 55A empowers SEBI to administer the provisions of the Companies Act in respect of the issue, transfer of securities and non-payment of dividend in respect of listed / proposed-to-be-listed companies, SEBI has not been conferred powers to make regulations. Only Central Government has the power to make rules and prescribe schedules including in respect of prospectus, financial statements. The power of the Central Government to make rules in respect of capital market related issues under SC(R) Act should be deleted. SEBI should be empowered to make regulations in respect of capital market related matters specified under Section 30 of the SC (R) Act. All capital market related matters in respect of listed companies should be exclusively conferred on SEBI, including the power to make regulations in respect of matters specified under Section 55A.

#### **Conflict Rule for Staff**

- There should be a specific conflict rule for the staff relating to investigation or consideration of licensing application of related entities of staff.

#### **Comprehensive Inspection Programme for Intermediaries**

- In case of outsourced inspection, SEBI appoints auditors who are in the Reserve

Bank panel as Central Statutory Auditors. The auditors are given detailed guidance note for inspection and are also given a format for preparation of inspection reports. There should be a mechanism for the supervision / monitoring of out-sourced inspection and also for supervision and monitoring of out sourced activities of the intermediaries. A comprehensive inspection policy /programme for all intermediaries should be adopted to increase overall effectiveness of enforcement.

#### **Private Right of Action**

- Private right of action and / or class action suit by investors should be allowed by law.

#### **Disclosure and Investment Protection**

- Along with Schedule II of Companies Act and Form 2A of Companies Rules, the disclosure requirements are based on Disclosure and Investor Protection (DIP) Guidelines issued by SEBI. To impart enforceability, the guidelines should be converted into regulations.

#### **Related Party Transactions**

- All related party transactions have to be informed in the Annual Report and Audit Committee as per Listing Agreement. Interested party transactions should be subject to shareholders approval.
- All the certifying / auditing functionaries such as Chartered Accountants, Company Secretaries etc. should be

made responsible and accountable to the regulators to the extent they are involved in certifying / auditing of regulated entities in the securities market.

- Disciplinary powers over auditors may be vested with independent regulatory body.
- The report of Financial Reporting and Review Board (FRRB) be required to be submitted to the regulator and the regulator should be empowered to deal with such reports and take steps as may be appropriate given the facts and circumstances of the case.
- When financial statements with qualifications are submitted by regulated entities, mechanism be established to take steps to resolve the differences and to ultimately, do away with such differences.

#### **Transparency**

- At present there is no disclosure of voting pattern on significant shareholders by companies. As a part of transparency and good corporate governance it is desirable that the voting pattern on important decisions by institutional investors be disclosed to public.
- Information on market intermediaries, the identity of senior management and employees who are authorised to deal on behalf of intermediary should be made public to enhance transparency and investor protection.

#### **Regulation of Distributors**

- As per the IOSCO principles the operators and distributors of mutual funds require to be regulated / licensed. Distributors of units of mutual funds as well as distributors of securities market

should be brought within the regulatory fold through SROs or direct regulations.

#### **Market Intermediaries**

- The need for risk-related capital requirements for market intermediaries should be explored.
- As there are no separate or specific requirements for adequate internal control for market intermediaries, the Panel feels that guidelines in this regard should be issued as a part of good practice.
- The Panel recommends that policy and procedure should be laid down for dealing with the failure of market intermediaries and financial conglomerates to reduce risks to systemic stability.
- While SEBI has a process for registering and inspecting brokers, there is no such mechanism currently available for unlicensed affiliates of these entities. Hence, risk arising from the unlicensed affiliates of the regulated entity should be addressed.

#### **Management of Conflict**

- As the issue of management of conflict is relevant in a situation where research, investment banking, mutual fund and broking are housed under one roof, the Panel feels that this issue should be addressed.

#### **Secondary Markets**

- The legal and regulatory structure now provides that RSE needs to be a corporate entity and should be demutualised. Though, all RSEs have been corporatised and demutualised, there should be strong oversight of demutualised exchanges to address potential conflicts which may arise due to their commercial objectives and regulatory roles co-existing.

### 3.3 Government Securities Market

#### Market Intermediaries

- To mitigate systemic risk, risks underlying the trading/financial positions of PDs should be disclosed with a sufficient time-lag. Such disclosure could be encouraged but only after taking into account the effect of such disclosure on financial stability.

#### Trading Platform

- Given that Reserve Bank manages the public debt and regulates the government securities market, its owning of trading platforms increases the possibility of a conflict of interest. The ownership of trading platforms should be hived off by Reserve Bank in a phased manner to a separate agency.

#### Transparency

- There is a need for enhancing the transparency in disclosures of the financial results of the government going forward. Central/State Governments should also consider reducing the time-lag in the publication of audited financial results and increase in the frequency of their financial disclosures.

### 3.4 Foreign Exchange Market

#### Authorisation of Trading Platforms

- The entity setting up a trading platform should seek permission of Reserve Bank. Specific provisions in the FEMA Act should be incorporated in this regard.

### Capital Adequacy Norms

- Risk-based capital requirements should be in place as a prudential requirement for FFMCs though they do not pose systemic risk. The Reserve Bank should review this aspect. As regards RRBs and rural co-operative banks, the concept of capital adequacy would be made applicable after consolidation of RRBs and implementation of Vaidyanathan Committee norms respectively.

### 4. IAIS Principles

The assessment of IAIS Principles had revealed certain gaps in respect of insurance sector. The Panel had deliberated upon these gaps/issues and given their recommendations which are summarised below.

#### Amendment of Legislation

- Some of the provisions of the Insurance Act, 1938 are outdated and need to be reviewed in the context of the changing economic environment.
- Under the legislative framework some of the powers pertaining to the supervision of the sector still rest with the government, such as the constitution of the consultative committee, the enforcement of criminal penalties, and in matters of winding up of an insurance company. These powers need to lie with the IRDA for effective supervision.
- Government owned insurers continue to be governed by certain provisions of the specific legislations (that regulate their activities), apart from the insurance



legislation governing the industry. This dichotomy goes against the basic premise of a level playing field for all entities operating in the sector. It is a deterrent to effective supervision. The proposed amendments to the legislative framework would address these concerns.

#### **Exempted Insurers**

- The regulatory position with respect to the exempted insurers is not clear. With a view to ensuring that all entities carrying on an insurance business are supervised by the IRDA, clarity of their reporting to it needs to be reinforced. A roadmap needs to be laid down by the government /supervisor for the continuance or otherwise of these entities to address the concerns relating to protection of the interests of the policyholders covered by them.

#### **Financial Independence**

- The funds requirement of the supervisor for its budgetary allocations is met from the registration/renewal fees received from the insurance companies and intermediaries.
- With respect to the financial independence, an issue has been raised by the Government of India on transfer of IRDA's funds to the exchequer. While the request has not been acceded to and is under examination, any action in this regard would be detrimental to and raise serious concerns relating to IRDA's stature as an autonomous regulator.
- While IRDA's has been initiating a number of measures to increase and empower its manpower to discharge its functions, given the fact that the insurance sector is fast expanding, a number of new issues are required to be addressed therefore, there is a continuing need for enhancing skill sets of the staff. Similarly, there could be

issues related to retention of skilled staff. While globally, regulators are unable to match their remuneration structure with those at the industry levels, within the supervisor's office there is still scope for improvement in the remuneration structure for the overall organisation, including at the top management levels.

#### **Consultative Committee**

- Amendments to do away with the stipulation for the constitution of the Consultative Committee which has been recommended by the IRDA. The same need to be expedited.

#### **Composition of the Board**

- IRDA is to lay down the guidelines on reporting on 'fit and proper' compliance applicable to both the members of the Board and to the key management functionaries in insurance companies.

#### **Corporate Governance**

- With a view to making a comprehensive set of guidelines, and given the specific requirements of the insurance sector, IRDA is in the process of putting in place a corporate governance framework. The focus is on issues relating to risk management and laying down stipulations on setting up of a Risk Management Committee to address various issues related to risks associated at the enterprise-wide level. The framing of the guidelines require to be expedited.
- There are no formal stipulations from IRDA on the internal controls to be in place at the offices of insurance companies. These need to be formalised as part of the corporate governance framework.

#### **Supervisory Initiatives**

- The system for off-site monitoring should be developed expeditiously to facilitate development of (i) early

warning signals and (ii) taking policy level decisions.

- Formal Preventive and Corrective Action framework needs to be in place.
- As part of the framework for enforcement or sanctions, the supervisory framework requires clarity to ensure that all sanctions imposed are enforced.
- On lines similar to the banking sector, prudent guidelines need to be put in place to ensure that earnings are retained within the insurance companies under specified circumstances including underwriting losses.
- IRDA would need to move towards more sophisticated risk-based capital (RBC) model and risk based supervision (RBS). Such initiatives would require change in statutes and the overall approach towards supervision.

#### **Risk Management**

- There is a need for setting up comprehensive risk management systems in the offices of insurance companies. This should be stipulated as part of the overall corporate governance framework. The stipulations would include provisions for the risk management framework being all pervasive, with the chief risk officer being part of the Board of the insurance company.
- While the regulatory requirement for the underwriting policy being approved by the respective Boards of the companies is in place in case of general insurance

companies, the same needs to be extended to the life insurance companies as well.

- There is a need for further clarity on manner of accounting of the various risk transfer mechanisms.
- As part of the overall risk management procedures, issues relating to putting in place the policy framework for risks associated with dealing in derivatives by the respective insurers' offices need to be addressed by IRDA.

#### **Abuse of Financial Services**

- There are no specific requirements at present on the allocation of resources by the insurance companies to combat fraud. Similarly, stipulations need to be put in place on the reporting of the same to the supervisor's office once these are detected. Thus, there are gaps in the mechanisms available for detection various frauds and on sharing on information between insurers and with IRDA. These gaps need to be addressed expeditiously.
- The enforcement powers regarding AML/CFT are not with IRDA. This is required to be provided for in the legislation governing IRDA.

#### **Transparency**

- IRDA should consider some stipulations for a more effective dissemination of information on the financial performance by the insurance companies through other accessible media. This will provide transparency on the operations of insurance companies.