REVIEW OF SUPERVISORY PROCESSES FOR COMMERCIAL BANKS

Report of the High Level Steering Committee

Reserve Bank of India

June 2012

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA
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उप गवर्नर
Deputy Governor

Letter of Transmittal

June 11, 2012

Dr. D. Subbarao
Governor
Reserve Bank of India
Mumbai

Sir,

Steering Committee for Review of Supervisory Processes in respect of Commercial Banks

I have immense pleasure in submitting the Report of the Steering Committee appointed vide Memorandum dated August 3, 2011 for **Review of Supervisory Processes in respect of Commercial Banks** in India. The report is intended to transform RBI's approach and processes for supervision of commercial banks for meeting the emerging challenges that the global banking system is faced with and lay down a roadmap for bank supervision for the coming decade. The inclusive nature of the Committee has ensured that the views of all stakeholders have been adequately incorporated. The report has benefitted immensely from the sagacity and expertise of the esteemed members of the Committee. I would like to add that a technical committee under the stewardship of Shri G. Gopalakrishna has helped us in refining the supervisory rating system for banks.

On behalf of the members of the Steering Committee, and on my own behalf, I sincerely thank you for entrusting this responsibility to us.

With kind regards

Yours sincerely,

(K. C. Chakrabarty)
Deputy Governor & Chairman
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हिंदी आसान है, इसका प्रयोग बढ़ाइए

High Level Steering Committee for

Review of Supervisory processes of commercial banks in India

(K. C. Chakrabarty)
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Member

(G. Jaganmohan Rao)
Member Secretary

FOREWORD

"*Until lions have their own historians*, *tales* of the *hunt will always glorify* the *hunter.*"

An African Adage.

The High Level Steering Committee (HLSC) for Review of Supervisory Processes of Commercial Banks in India, chaired by Dr. K.C. Chakrabarty, Deputy Governor, RBI and members comprising Shri B. Mahapatra, ED, RBI, Shri Basant Seth, CMD (Rtd.), Syndicate Bank, Smt. Chanda Kochhar, CEO, ICICI Bank Ltd., Shri Diwakar Gupta, MD & CFO, SBI, Prof. Jayanth R. Varma, IIM Ahmedabad, Shri MBN Rao, CMD (Rtd.), Canara Bank and Shri G. Jaganmohan Rao, CGM-IC, DBS (Member Secretary), gratefully acknowledges the contributions made by the Technical Committee (Chaired by Shri G. Gopalakrishna, ED, RBI) represented by Shri Paresh Sukthankar, Shri Ravi Duvvuru, Shri Shyamal Sinha from banks' side and Shri Ajay Kumar Choudhary and Shri Prakash Baliarsingh, GMs and Shri Prabhat Gupta and Shri N. Suganandh, AGMs from RBI side for providing inputs and suggestions for building a new supervisory rating framework. The HLSC would also like to place on record its sincere appreciation for the invaluable contribution made by Shri P. Vijaya Bhaskar, ED, RBI as a permanent invitee to the meetings of the Committee.

The HLSC also expresses its appreciation for the excellent intellectual and technical inputs provided to the Committee by the officers of Department of Banking Supervision, Reserve Bank of India comprising Shri Hauzel Thangzamuan, GM, Shri Sanjeev Prakash, DGM, Shri Rajesh Sharma and Shri Pronobesh Barua, both AGMs and Kum Archana Shah, Executive Intern. The HLSC acknowledges with gratitude the support provided by the secretarial team throughout the existence of the Committee in organizing the meetings, collating information from various sources and in finalization of the draft Report. Finally, the Committee would like to record its gratitude for the support and encouragement received from Dr. D. Subbarao, Governor, RBI and thank him for addressing the HLSC members during one of the meetings of the Committee.

The report is organized in seven chapters. Chapter 1 provides a perspective on the evolution of the supervisory processes in India over the last two decades and traces the circumstances leading to the constitution of the HLSC. Chapter 2 deals with supervisory approach, its philosophy, objectives and recommends a Risk Based Approach to Supervision of Commercial Banks in India to meet the present and emerging challenges. Chapter 3 describes the extant supervisory processes under the CAMELS framework and approach to supervision under the proposed Risk Based Supervision (RBS) Framework. Chapter 4 covers the supervisory rating mechanism and introduces a risk focused supervisory rating framework for measuring riskiness of the bank vis-a-vis RBI's supervisory objectives. Chapter 5 deals with concepts and processes of supervision for banking groups/ financial conglomerates and enumerates the approaches for appraisal of group governance, group risk management, intra-group transactions and cross-border supervision of foreign banks in India and Indian banks abroad. Chapter 6 examines institutional structure and HR issues relevant for bank supervision and suggests measures for ensuring effective governance in banks and for strengthening the supervisory resources within RBI for facing the new challenges of banking supervision. Major recommendations of the Committee are summarized at the end in Chapter 7.

The Committee expects that the recommendations made in the Report would transform the approach and processes for supervision of banks in India in line with the best supervisory practices & standards in the global arena and facilitate a more efficient and effective supervisory regime ensuring safety and stability of banking system in the coming decade.

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Banks occupy the pride of place in any financial system by virtue of the significant role they play in spurring economic growth by undertaking maturity transformation and supporting the critical payment systems. The specificity of banks, the volatility of financial markets, increased competition and diversification, however, expose banks to risks and challenges. The protection of depositors' interests and ensuring financial stability are two of the major drivers for putting in place an effective system of supervision of banks. In the wake of recurring bank failures and consequent financial crises over the last two decades, there have been resolute attempts by bank supervisors across the globe to limit the impacts of bank failure and contagion through 'safety nets' in the form of deposit insurance and liquidity support by Central Banks/ Governments. An effective supervisory system is, however, critical for preventing bank failures by ensuring the safety and soundness of banks.

Reserve Bank of India is entrusted with the responsibility of supervising the Indian banking system under various provisions of the Banking Regulation Act, 1949 and RBI Act, 1934. Subsequent to the economic liberalization since the 90s which also manifested in greater operational autonomy for banks and Financial Institutions, RBI's approaches to supervision of banks has also gradually shifted from a more intrusive micro-level intervention towards prudential regulation and supervision in line with the international best practices. An expert group (under Shri S. Padmanabhan) also conducted reviews of RBI's supervisory processes viz. systems and procedures relating to the statutory inspections during the 90s and recommended measures for improving the efficiency and effectiveness of RBI's approach to supervision of banks.

The last two decades had been characterized by increased integration of global financial markets and cross-border banking activities, diversification of banks into other financial market segments, increased complexity of products, processes and group structures. Though the banking landscape has changed considerably, the supervisory approaches and processes within RBI have remained more or less stagnant resulting in a mismatch between supervisory responsibilities and available resources necessitating a review of the supervisory processes and rationalization of the organizational structure for bank supervision. The existing supervisory framework for commercial banks in India has fared rather well over the years and drawn praise from peer supervisory agencies, standard setters and the FSAP assessors for the tightly controlled regulatory and supervisory regime. However, in view of the growing complexities in the banking business and lessons from the recent financial crisis that has led a thorough overhaul of the global regulatory and supervisory benchmarks viz. revised prescriptions for more resilient banks and banking systems (Basel III), revised Core Principles for Effective Bank Supervision, Principles for Supervision of Financial Conglomerates and planning for Recovery and Resolution of global systemically important banks, there is a felt need for a relook at RBI's extant supervisory processes and mechanism in order to make it more robust and capable of addressing emerging challanges.

In light of the above, a High Level Steering Committee (HLSC) was constituted under the Chairmanship of Dr. K. C. Chakrabarty, Deputy Governor for Review of Supervisory Processes for Commercial Banks with representation from RBI, commercial banks and the academia. The Committee was mandated to review the extant approaches, methodologies, processes/tools for onsite and off-site supervision, Supervisory Rating & Stress Testing Frameworks and recommend measures for a gradual progression to a Risk Based Supervision Framework. In accordance with the assigned mandate, the HLSC conducted a comprehensive review of the extant approaches, systems and procedures, tools and methodologies for supervision of banks and is making several recommendations as highlighted below:

Objective of Supervision

- ❖ Along with protection of depositors' interests and ensuring financial health of individual banks/FIs, an implicit overarching objective of RBI's supervisory process should also be to ensure financial stability and customer protection.

Approach to Supervision

- ❖ Risk Based Supervision (RBS) which focuses on evaluating both present and future risks, identifying incipient problems and facilitates prompt intervention/ early corrective action should be the approach for bank supervision as against the present compliance-based and transaction testing approach (CAMELS) which is more in the nature of a point in time assessment. RBS benefits the bank supervisor by optimizing its use of supervisory resources and also helps the regulated entities in improving their risk management systems, oversight and controls.
- ❖ Since the success of RBS approach is highly incumbent upon a robust offsite surveillance system, any manual intervention in the flow of supervisory data from the banks to RBI needs to be eliminated in order to ensure quality/integrity of data.
- ❖ Under RBS, the approach to on-site supervision changes whereby probability of failure and the likely impact of failure of a bank rather than the volume of business determines the periodicity/intensity of on-site inspection process. Thus, the banks assessed as having a low risk/impact profile would be inspected only once in a 2 to 3 year cycle. However, irrespective of the supervisory stance/approach determined in respect of a particular bank, a comprehensive report highlighting the financials, level/direction of material risks, risk mitigants and a risk mitigation plan, wherever applicable, would need to be prepared and put up to the Board of Financial Supervision on an annual basis.
- ❖ Thematic reviews should be increasingly used as a tool of supervision whereby review of a particular product, market or practice using a specialized team would be made to assess risks brewing within the sector or at system levels for enabling prompt actions/measures.

Organizational Structure/Processes

- ❖ In view of the fragmented set up for supervising different entities belonging to the same banking group, the supervision of all group entities under the jurisdiction of RBI may be brought under a single supervisory department. This would facilitate effective Consolidated Supervision and also provide a single point interface for the bank within RBI.
- ❖ A single point contact in the form of a ' Supervisory Relationship Manager' should be created within the Department of Banking Supervision to ensure efficient and effective communication between the supervisor and the supervised entities.
- ❖ For clarity of jurisdiction for the supervised entity and making the relationship /dealing desk an effective single point of contact in the Department of Banking Supervision, the domains of regulation and supervision should be firmly demarcated and any entity specific decision should only emanate from the supervisory department.
- ❖ The communication between the supervisor and the supervised entity should be treated as confidential and should not be subject to any public scrutiny.

Supervisory Rating

- Under the risk based approach to supervision, the supervisory rating would be a reflection on the risk elements (inherent risk and control) and not an exercise in performance evaluation as is the case under the CAMELS rating Framework. The supervisory rating exercise would aim at determining the overall probability of failure of the bank in light of risks to which the bank is exposed, strength of control/ governance and oversight framework in place and available capital.
- Based on the rating, the bank would be apprised of the direction/ trend of key risk groups along with overall risk faced by it and a risk mitigation plan, comprising of need for improving controls, augmenting capital and/or restructuring business.

Consolidated Supervision

- To improve the effectiveness of Consolidated Supervision of banking groups, it is essential to ascertain and focus on the potential risks arising from the material group entities to the parent bank. In line with the risk based approach to supervision of banks, the consolidated supervision of large and complex banking groups may be conducted by focusing on key risk areas within the group.

Corporate Governance

- To bring in more transparency and for making the Board /Top Management of the bank more accountable, specific measures including recording of "Talking Minutes" of Board deliberations or video/audio recording of the proceedings of Board and its various Committee meetings may be introduced.

Human Resources Development

- With a view to creating a pool of domain experts within RBI, a system of continuous movement of people from RBI to external organizations i.e. commercial banks (in areas like risk management, financial engineering, treasury operations, capital planning etc), accounting firms, academia, capital market, brokerages, legal firms etc. and vice versa should be instituted. This needs to be encouraged through well-defined career progression programme and made an integral part of HRM function within RBI.

CHAPTER 1

INTRODUCTION

1.1 As creators of money, depositories of public savings, allocators of credit and conduits of the payment system, the banks have a unique position in the economy of any country. To bolster the larger public interest, public policy for banks is put in place by the government, the goals of which may vary depending on the nature of economy and priorities of the government.

1.2 Objectives of Supervision

1.2.1 Depositor protection and systemic risk are the two main reasons that are normally cited for putting in place a system of regulation and supervision of banks. In the wake of financial crisis and bank failure during the last two decades, there have been attempts to limit the impacts of bank failure and contagion through 'safety nets' in the form of deposit insurance and the lender of last resort function by Central Banks. While the safety nets are triggered during crisis situations, supervision plays a vital role in preventing the occurrence of a crisis situation or bank failure.

1.2.2 In the context of banking supervision, the policy has to contend with the dilemma in choosing the authority responsible for supervision of banks, the ambit of its supervisory jurisdiction and its autonomy/ independence from the Central Government. Theoretically, each of the possible options and choices has its own merits and demerits, with no clear evidences to suggest that any single option is a better alternative. Different countries have adopted different options best suited to their economic and political environments and India too has adopted its own model wherein bank supervision is entrusted to the Reserve Bank of India (RBI) with adequate functional autonomy. However, there is no unified supervisor for a variety of financial services offered by different entities in the country.

1.2.3 RBI's inspection of banks under section 35 of B.R. Act is undertaken as a follow up of the bank licensing regulation and objectives as laid down in Section 22 of the Act. The substantive objective of the statutory inspections is to verify whether the conditions subject to which the bank has been issued license to undertake banking business [vide sub-section 3, and for foreign banks also 3A of Sec.22] continue to be fulfilled by them. Another implicit objective of bank supervision is to ensure that the various regulatory norms prescribed by the regulatory authorities are being adhered to including financial soundness and operational viability. The stability of the banking system is an oblique aggregation of sound individual banks which is rather altruistic.

1.3 Evolution of Supervision of Commercial Banks in India

1.3.1 Subsequent to the economic liberalization of the 1990's, RBI has been pursuing a steady and cautious approach towards banking liberalisation. This has been evident in the implementation of the report of the Narasimham Committee (1991) which granted operational autonomy to banks and Financial Institutions. Other reforms during the early 1990s included: (a) shift in supervision from intrusive micro-level intervention towards prudential regulation and supervision (b) interest rate and entry deregulation (c) adoption of prudential norms (d) establishment of the Board of Financial Supervision (BFS) in the RBI (e) diversification of activities by banks and (f) private sector ownership of Indian banks. During the last decade, the Indian banking industry has recorded a compounded average growth rate (CAGR) of 18 percent as compared to the country's average GDP growth of 7.2 percent during the same period. The overall development in banking industry has been supplemented with greater efficiency and productivity of the banking sector.

1.3.2 The Indian banking sector has two kinds of scheduled banks i.e. Scheduled Commercial Banks (SCB) and scheduled Co-operative banks. The SCBs can

further be classified into four types based on their ownership and mandate as: i) Public Sector banks ii) Private Sector Banks iii) Foreign Banks in India and iv) Regional Rural Banks. All the SCBs are under the supervisory jurisdiction of the Department of Banking Supervision of RBI and are, thus, the primary subject of deliberations of the Steering Committee.

1.3.3 Until the early 1990s, the focus of RBI's regulation of commercial banks in India was mainly on licensing, minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements. Under such regulatory regime, banking supervision had to focus essentially on solvency issues. Since 1988 Basel-I Accord, however, RBI has been taking steps to realign its supervisory and regulatory standards with international best practices in a phased manner taking into consideration the economic conditions of the country. In this context, few expert groups have conducted reviews of the supervisory processes viz. systems and procedures relating to the statutory inspections, during the last two decades.

Working Group to Review the System of On-site Supervision over Banks (Chairman: S. Padmanabhan, 1995)

1.3.4 The Group, while re-emphasising the primacy of on-site inspection, recommended switching over to a system of ongoing supervision. It recommended a strategy of periodical full-scope 'on-site examinations' supplemented by an in-house 'off-site monitoring system' in between two statutory examinations. The Working Group recommended orienting supervision for enforcement of correction of deviations. It was decided that the periodic and full scope statutory examinations should concentrate on core areas of assessment, *viz.*, (a) financial condition and performance (b) management and operating condition (c) compliance and (d) summary assessment in line with the internationally adopted capital adequacy, asset quality, management, earnings, liquidity and systems (CAMELS), including a CAMEL based rating model with systems and controls added to it for Indian banks and a CACS model (capital adequacy, asset quality, compliance, systems and controls) for foreign banks. Subsequently, examination of 'liquidity' was added to christen the model as CALCS. The periodic statutory examinations were to be supplemented by four types of regular and cyclical on-site assessments, *viz.*, targeted appraisals, targeted appraisals at control sites, commissioned audits and monitoring visits.

Working Group on Consolidated Accounting and Other Quantitative Methods to Facilitate Consolidated Supervision (Chairman: Vipin Malik, 2001)

1.3.5 The Working Group (WG) recommended a framework for Consolidated Supervision which included preparation of Consolidated Financial Statements (CFS) for improving public disclosure, Consolidated Prudential Reports (CPR) for supervisory assessment of risks which may be transmitted to banks (or other supervised entities) by other group members and application of certain prudential regulations like capital adequacy and large exposures / risk concentration on a group-wide basis.

Working Group on Monitoring of Systemically Important Financial Intermediaries (Financial Conglomerates) (Convener: Smt. Shyamala Gopinath, 2004)

1.3.6 The Working Group recommended establishment of a monitoring system for Financial Conglomerates (FCs). The WG laid down norms for identification of a SIFI and its group entities as also a format for capturing financials, Intra-group transactions and exposures amongst group entities, collective exposures on a group-wide basis and a mechanism for inter-regulatory co-operation on issues related to the identified FCs.

Experiment with RBS

1.3.7 As a part of the monetary and credit policy for 2000-01, the Reserve Bank of India had announced its intention to move towards a Risk-based approach to banking supervision. Risk Based Supervision (RBS) envisaged the monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the riskiness of each banking institution. The Department of Banking Supervision conducted two rounds of pilot runs of RBS covering a few banks however, due to lack of adequate Risk

Management Architecture in banks, the RBS experiment was discontinued.

1.4 Bank Supervision Process in India

1.4.1 The Reserve Bank of India has been entrusted with the responsibility of supervising the Indian banking system under various provisions of the Banking Regulation Act, 1949 and RBI Act, 1934. This responsibility is discharged through the Department of Banking Supervision (DBS), which covers 87 commercial banks (including local area banks) and 4 select financial institutions (FIs) through its 16 Regional Offices.

Supervisory Set up

1.4.2 The Board for Financial Supervision (BFS) which came into being in November 1994 is the apex body responsible for Consolidated Supervision of the financial sector under the jurisdiction of RBI (commercial banks, financial institutions and non-banking finance companies). The Governor, RBI is the Chairman of the BFS, and the Deputy Governor in charge of banking regulation and supervision, is nominated as the Vice-Chairman. The other deputy governors of the Reserve Bank are ex-officio members and four directors from the Central Board of the RBI are co-opted as members for a term of two years. DBS acts as the secretariat of the BFS which normally meets once every month to deliberate various supervisory issues and approve the rating of banks.

1.4.3 Prior to 1993, the Department of Banking Operations & Development (DBOD) looked after the supervision and regulation of commercial banks. In December 1993, the Department of Supervision (DoS) was carved out of the DBOD with the objective of segregating the supervisory role from the regulatory functions of RBI. The supervisory role of the Department of Banking Supervision includes:

- Planning for and conducting onsite inspection,
- Off-site surveillance, ensuring follow-up and compliance,
- Determining the criteria for the appointment of statutory auditors and special auditors and assessing audit performance and disclosure standards and monitoring of major financial sector frauds
- Exercising supervisory intervention in the implementation of regulations, which includes recommendation for removal of managerial and other persons, suspension of business, amalgamation, merger / winding up, issuance of directives and imposition of penalties.

While majority of the offsite supervision work is undertaken from central office of DBS, the regional offices of the department at various locations across the country assist the Central Office by undertaking AFI of banks and inspections of branches under their respective jurisdictions.

Supervisory Processes

Offsite Supervision

1.4.4 As a part of the supervisory strategy, an off-site monitoring system for surveillance over banks was operationalized in RBI in March 1996. As a tool for "early warning signals" the Offsite Surveillance and Monitoring System (OSMOS) plays a key role in identification of risks and monitoring banks on a continuous basis. OSMOS consists of a set of 28 structured returns that capture prudential and statistical information of banks at periodical intervals. The information gathered is populated into the OSMOS database , enabling the off-site supervisor to undertake prudential analysis of bank's Capital, Assets, Earnings, Liquidity, etc. on both solo and consolidated basis. Issues of concern arising out of such analyses are flagged for consideration of Top Management and also placed before the BFS. Along with bank specific analysis, certain macro-level analysis of the banking sector are also undertaken periodically to assess and identify the risks and potential concerns. Various statistical tools are deployed to extract and analyse data for use in various RBI publications and for policy inputs.

Onsite Supervision

1.4.5 On-site supervision of banks is a key process in the overall supervisory framework. The on-site

Box 1: OFF-SITE SUPERVISION

Significant changes /modifications to the OSMOS since its inception:

Year	Significant Changes/ Additions	
1994	The setting up of an off-site surveillance function in the Department based on a prudential / supervisory reporting framework.	
1995	**Tranche I Returns**	**Periodicity**
	Report on Asset liability and off balance sheet exposures (ALE)	Monthly
	Report on Capital Adequacy – Basel I (RCA)	Quarterly
	Report on Operating Results (ROR)	Quarterly
	Report on Asset Quality (RAQ)	Monthly / Quarterly
	Report on Large Credits (RLC)	Quarterly
	Report on Connected lending (RCL)	Quarterly
	Report on Ownership and Control (ROC)	Half yearly – March & September
	Other Returns:	
	Bank Profile (RBP)	
1999	**Tranche II Returns**	**Periodicity**
	Statement of Structural Liquidity (STL)	Monthly
	Statement of Interest Rate Sensitivity (IRS)	Monthly
	Statement of Maturity and Position (MAP)	Monthly
	Statement of Interest Rate Sensitivity – Forex (SIR)	Monthly
	Other returns:	
	Balance Sheet Analysis (BSA)	
	DSB (O) returns	
	Report on Asset Liability and Exposures (ALO)	Quarterly
	Report on Structural Liquidity (SSL)	Quarterly
	Report on Problem Credits (PCI)	Quarterly
	Report on Large Exposures (RLE)	Quarterly
	Report on Country exposures (CEM)	Quarterly
	Report on Profitability (ROP)	Quarterly
	Report on Frauds (ROF)	Quarterly
2000	A quarterly return on "Subsidiaries / JV / Associates" under DSB Returns (RIS) (Tranche II) The OSMOS database upgraded to RDBMS environment with built in data-warehousing component.	
2001	Local Area Banks were instructed to submit 7 DSB returns (Tranche I).	

supervision involves an Annual Financial Inspection (AFI) of banks that is presently modeled around the CAMEL (**C**apital Adequacy, **A**sset classification, **M**anagement, **E**arnings appraisal, **L**iquidity) framework with an additional parameter of **S**ystems and Controls (modified as CAMELS for Indian commercial banks and CALCS for Foreign banks). The present CAMELS is a transaction-based examination with a matrix used for arriving at a rating of each of the CAMELS components to give a final adjusted supervisory rating for each bank. Of late, the AFI has been giving considerable importance to risk management system in banks. Based on the concerns highlighted by the AFI reports and discussions with banks, a Monitorable Action Plan (MAP) is drawn for compliance and a memorandum covering supervisory concerns from AFI including supervisory rating is

Box 2: Onsite Supervision	
Year	**Significant Changes**
Pre 1992-93	Financial Inspections (FI) – at intervals ranging from two (for private & foreign banks) to four years (for public sector banks); these included visits to Head Offices, Controlling Offices and a cross-section of branches for making detailed assessment of all aspects of a bank's operations. Annual Financial Reviews (AFR) in respect of public sector banks (except SBI). These visits covered Head Office and a quarter of the Controlling Offices only and relied mostly on the Management Information System (MIS) in banks.
1992-93	Annual Financial Inspections (AFI) with main accent on the assessment of the bank's financial position. Biennial management audits by Senior Officials to look into the non-financial aspects i.e. Management and Systems. The time span of inspection including preparation of reports was reduced to maximum period of 4-5 months.
2011	The format of the inspection report made more focused, by bifurcating into Main report and Explanatory Note. Foreign banks with market share of asset size less than 0.1% and Financial Institutions having no systemic risks to be inspected only once in two years. Formation of twelve financial conglomerates for continuous supervision by Central Office of DBS.

compiled for perusal of the BFS. In addition to AFI, a few need based targeted inspections and scrutinies at the banks are also undertaken.

Supervisory Rating

1.4.6 A rating system for domestic and foreign banks based on the CAMELS model combining financial management, systems and control elements has been in place since July 1998. The present rating of banks is done on a 10-point scale i.e. A+ through D in ascending order.

1.5 Need for revisiting the supervisory processes

1.5.1 The existing supervisory framework for commercial banks in India has fared rather well over the years and drawn praise from peer supervisory

Box 3: Significant changes in Supervisory Rating adopted by the RBI over the years	
Year	**Methodology**
1996	S. Padmanabhan Committee (1995) recommended for Indian banks, six rating factors viz. Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Controls (i.e. CAMELS), and for Foreign banks, four rating factors viz., Capital Adequacy, Asset Quality, Compliance, Systems and Controls (i.e. CACS)
1999	Circular on CAMELS and CACS rating framework including components rating and composite rating issued. As per the circular, each of the component was to be rated separately on a scale of 1 to 100 in ascending order of performance. Each of these six Components was to consist of several parameters with individual weightage i.e. 100 marks distributed among these parameters – depending on their relative importance in that particular Component. Composite rating of 'A' to 'D' to be computed calculating weighted average of Components Ratings.
2002	The rating model of CACS modified to include the component 'Liquidity'.
2006	In order to appreciate nuances between two different banks having the same composite rating and to show granularity in the rating, 3 rating scales each were introduced under A, B and C making a total of ten rating scales including D.
2007	The parameters and markings in respect of 'Earnings Appraisal' component of the rating revised for CAMELS
2009	The parameters and markings in respect of 'Earnings Appraisal' component of the rating revised once again only for CAMELS.

agencies, standard setters and the FSAP assessors for the tightly controlled regulatory and supervisory regime, consisting of higher than minimum capital requirements, frequent hands-on and comprehensive onsite inspection processes. The FSAP assessors have also noted that the Indian banking system remained largely stable during the global financial crisis. However, the growing complexities of the banking business in general and the emergence of a number of large banking groups with significant cross-border and cross-sector presence in particular, are rendering the system increasingly vulnerable to the threat of 'contagion'. Such contagion, arising from within and outside the country coupled with complexities in the structures of the banks, risks from their non-banking businesses and need to comply with the stringent global capital adequacy and risk management standards in a time-bound manner, pose immense challenges before the banking supervisor.

1.5.2 While the banking landscape has witnessed considerable changes over the last two decades, the supervisory resources and processes within RBI have remained more or less stagnant. This has resulted in a mismatch between supervisory responsibilities and available resources necessitating a review of the supervisory processes and rationalisation of the organisational structure for bank supervision. Additionally, lessons from the financial crisis which have manifested in the form of new regulatory and supervisory benchmarks like Basel III, revisions to the Core Principles for Effective Bank Supervision and Principles for Supervision of Financial Conglomerates, Recovery and Resolution Plans for systemically important banks also need to be factored in for making the supervisory processes and mechanism at RBI more robust and capable of addressing emerging issues.

1.5.3 The present supervisory approach / processes followed by RBI are not adequately risk focused nor are these forward looking to the required extent. The present off-site supervision and contacts/ discussion with bank management are not leveraged to gauge the importance/riskiness of the banks in the banking system. Unlike most jurisdictions, supervision in India mostly revolves around the on-site inspection process, which is found to be rather ad hoc i.e. without any documented supervisory action plan for the bank. The outcomes of these supervisions, though shared with the concerned banks as supervisory reports, do not result in an effective and monitorable risk mitigation plan. The present supervision (i.e. transaction based) is generally done independently without adequately utilising the work done by the external /internal auditors of banks, resulting in undue duplication of efforts.

1.5.4 The current supervisory rating framework (i.e. CAMELS /CALCS) while attempting to gauge the performance of the banks, enables the supervisors to understand the micro-perspectives and facilitates arriving at a "rating" for the banks through a scoring pattern, but does not incorporate any forward looking elements thereby not reflecting the true market standing of the entity. Further, the factors influencing the rating awarded to the bank and the implications of the awarded rating are not shared with the banks.

1.5.5 Due to lack of legal framework / bilateral MoUs and also coordination among domestic regulators and overseas regulators /supervisors, the consolidated supervision / cross border supervision of bank group in general and large complex banking groups in particular (SIFIs) has not been carried out to the required extent.

1.6 Constitution of HLSC

1.6.1 With a view to addressing some of the shortcomings mentioned above and also other institutional issues pertaining to the bank supervisory processes, a High Level Steering Committee (Chairman: Dr K C Chakrabarty, Deputy Governor of the RBI) was set up by the Governor, RBI in August, 2011 as per the Monetary Policy announcement of 2011-12, to assess the adequacy of RBI's supervisory policies, procedures and processes and suggest enhancements to the supervisory policies comparable to the global standards. The Committee has been given twelve months time to submit its report.

Terms of Reference:

(i) To review the approach to supervision so as to make the process more effective and useful to the supervised entities as well.

(ii) To examine the extant onsite supervisory examination approach, methodology and processes / tools including review of the Supervisory Rating & Stress Testing Framework.

(iii) To examine the extant offsite supervisory methods including the efficacy of offsite surveillance system.

(iv) To review the adequacy of Prudential Supervisory guidelines and Supervisory Review Process under Pillar 2 and recommend measures for moving over to a forward looking Risk Based Supervision Framework.

(v) To examine the extant methods for conducting Consolidated Supervision and recommend measures for enhancing the intensity and efficacy of supervision of Systemically Important banking groups (SIBs) / conglomerates on a continuous basis as also strengthening cooperation / coordination with domestic regulators.

(vi) To recommend measures of strengthening the extant cross-border supervisory cooperation processes including the provisions / coverage of the bilateral MoUs and outline an approach for establishing Supervisory Colleges for Indian banks.

(vii) To assess the adequacy of the institutional structure for carrying out supervisory function, especially human resources aspects (need for creating specialists with appropriate skill sets for examining specific risk areas viz. credit, market, liquidity etc.) use of technology vis-a-vis supervisory objectives and the extant complexity of banking products / processes.

(viii) To suggest a framework for feedback mechanism and review of supervisory processes and make recommendations to address the gaps identified in the extant supervisory process.

(ix) To consider / make recommendations on any other matters relating to or incidental to the above.

1.7 Benchmarking for future

The Indian financial system will further grow not only in size but also in complexity in the years to come. As competition gains further momentum, banks are expected to get more integrated with the economy- both domestically and globally. As the activities of the banking system expand, there would be a need to focus on the organizational effectiveness of banks. In day to day functioning and operation of the banks, the quality and character of the bank management would play the role of primary line of defense against banks' potential distress. In this context, the supervisors would need to focus on strengthening management and management systems within the banks. In this context, the Committee's recommendations would be a sort of vision document for the supervisory processes and standards to be followed by RBI during the next decade.

CHAPTER 2

SUPERVISORY APPROACH

2.1 Introduction

2.1.1 It is universally agreed that there is no optimal structure or process for supervising banks and consequently the approach and processes for bank supervision differ considerably from country to country. The approach for supervising banks is determined primarily on the stage of development of the financial system, number of banks, their size and complexity of the banking system. Few other factors which influence the supervisory approach in a particular jurisdiction are the ownership pattern, reliability of the public disclosures by the banks and the availability of technological and human resources for conducting supervision.

2.1.2 The Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS) provides an implicit framework for the regulation and supervision of banks. The recently revised "Core Principles for Effective Banking Supervision" put up for comments by the BCBS succinctly set the benchmark for the bank supervision process under its Principle 8:

> *"An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable."*

2.1.3 On the approaches to supervision, the BCBS paper delineates that supervisory objectives could be achieved through a greater focus on effective risk-based supervision, early intervention and timely supervisory actions. The paper further suggests that the supervisors should assess the risk profile of banks in terms of the risks they run, the efficacy of their risk management and the risks they pose to the banking and financial systems. As per BCBS, the risk-based process targets supervisory resources where they can be utilised to the best effect, focusing on outcomes as well as processes moving beyond passive assessment of compliance with rules.

2.1.4 Whatever approaches the bank supervisors follow or the tools they use, the underlying objective is to ensure that the banks operate in a safe, transparent and efficient manner and the broader goal of financial stability is achieved. While the protection of depositors /customers is subsumed in this broader objective, sometimes, it is specifically tasked as such.

2.2 Elements of good supervisory practices

2.2.1 The approaches adopted by the supervisors in various jurisdictions differ broadly on the basis of degree of intrusiveness and intensiveness. An IMF Staff Note "The Making of Good Supervision: Learning to Say No" has identified being **intrusive, skeptical but proactive, comprehensive, adaptive and conclusive** as some of the attributes of a good supervisor. The note has also identified **the ability and the will to act** as two pillars that support good supervision.

2.2.2 The essential features of an effective bank supervisory regime could be summarized as under:

- Assesses compliance with rules and regulations and adherence to safe and sound banking practices;
- Sensitive to evolving macro-economic and regulatory changes;
- Responsive to the emerging risks at individual banks;
- Clearly diagnoses the risk profile of each bank and ensure that banks have appropriate risk management systems

with a strong internal control and external audit mechanism;

- Conducts supervision on a consolidated basis – Appropriately assessing the risks posed by all significant lines of business, including those subject to the primary supervision of another regulator and maintain effective coordination with the other sectoral regulators;
- Efficient use of available supervisory resources by allocating the greatest resources to the areas of highest risk; and
- Maintains an adequate pool of trained supervisory personnel with appropriate skill- sets.

2.3 Supervisory Methods/Tools

2.3.1 Ongoing banking supervision typically consists of a differentiated mix of off-site surveillance and on-site examinations. Off-site monitoring involves analysing and reviewing periodic financial and other information relating to banks' activities by the supervisor. These regulatory reporting requirements generally cover balance sheet and profit and loss statements, information on capital and liquidity levels, asset quality and loan loss provisions, profitability etc. The on-site inspections traditionally involve examinations by specialized supervisory staff for a hands-on assessment of qualitative factors such as management capabilities and internal control procedures that cannot be adequately captured in regulatory returns. In aggregate, it culminates in assessment of risks and suggestion of a risk mitigation plan.

2.3.2 The most commonly used approach in supervising banks has been transaction testing and compliance checking with a focus on ensuring that the rules laid down for safety and soundness are adhered to. An excessive focus on detecting non-compliance, however, could undermine the efforts required for understanding the key risk drivers and the flaws in risk management practices of banks. Further, this approach is invariably backward looking and tends to be unmindful of the risks brewing in the bank in particular and the economy in general.

2.3.3 While this approach worked well when the banking business remained more traditional - taking deposits and making loans, the spectacular change witnessed over the last decade on account of financial innovation, increased globalisation and the growing use of modern technology as service delivery channels - has undermined its relevance. New products and services embedding technological innovations are some of the complexities that the bank supervisors have to increasingly contend with. The exponential growth of the off-balance sheet items and introduction of complex products such as derivatives and securitization has complicated the turf for the supervisors and banks alike. Another development that has necessitated a review of the supervisory stance has been the emergence of financial conglomerates with considerable cross-border and cross-sector activities. Thus, while on the one hand the boundaries between financial sectors have become increasingly blurred, the inter-linkages between various markets have increased on the other.

2.3.4 In view of these developments, the traditional approach to banking supervision has become inadequate both in context and focus. In order to counter these growing challenges efficiently, the bank supervisors needed to evolve robust and effective processes in order to continually discharge their assigned mandate. The supervisory response to these growing challenges has been to develop a risk-focused approach that enables them to assess and track changes in a bank's risk profile on an ongoing basis and to generate early warning signals for enabling timely supervisory intervention. This response has been supplemented by underscoring the need for developing effective risk-management systems and structures in banks for management and oversight of risks. The underlying philosophy of the risk-focused, risk-based, or risk-oriented approach to supervision is to make a rigorous assessment of risks in the banks' books and as far as practicable assign supervisory resources to the entities and part of their businesses which pose the biggest risks. To effectively identify and measure the risks emerging from cross-border and cross-sector operations of the banks, the

supervisors have embarked on a consolidated supervision approach, the efficacy of which, however, came under serious questioning during the recent global financial crisis.

2.4 Approaches to Bank Supervision in India

2.4.1 The Banking Regulation Act, 1949 (BR Act) provides the legal framework for regulation and supervision of banks in India. This statute, together with some provisions in the Reserve Bank of India Act, 1934, State Bank of India Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959 and Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 & 1980, empowers the Reserve Bank of India (RBI) to prescribe standards and monitor liquidity, solvency and soundness of banks, so as to ensure that depositors' interests are protected at all times.

2.4.2 An annual on-site financial inspection of banks under Section 35 of the BR Act has been the main instrument of supervision employed by RBI. The supervisor also conducts an off-site monitoring of the banks through the Offsite Monitoring System (OSMOS) and various other returns prescribed (under Section 27 of the BR Act).

2.4.3 The on-site inspection of banks is meant as a follow-up of the bank licensing regulation laid down in section 22 of the BR Act. Section 11 of the BR Act prescribes a minimum level of paid-up capital and reserves to be maintained by banks in India and RBI's inspections evaluate the real net worth or real/ exchangeable value of paid-up capital and reserves held by the banks as on a reference date. The substantive objective of the statutory inspections is to verify whether the bank continues to fulfill the conditions subject to which the bank has been issued license to undertake banking business. These conditions include:

- the bank has the "ability to pay its present or future depositors in full as their claims accrue" (i.e. it is solvent and has adequate liquidity);
- the bank "has adequate capital structure and earning prospects";
- "the affairs of the (banking) company are not being, or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors"; and
- "the general character of the management of the bank is not prejudicial to the public interest or the interest of its depositors" (i.e. it has sound operational systems and adequate controls operated by a prudent management).

2.4.4 Besides the provisions for inspection of banks contained in Section 35 of the BR Act, certain other sections of the said Act also empowers the RBI to carry out inspection of banks for specific purposes viz. for determining a bank's eligibility for a license to carry on banking business in India [Section 22(3)], for certifying that the concerned banking company is unable to pay its debts preceding its winding up [Sections 38(4) and 44(1)], for determining the intrinsic or realistic value of shares preceding the amalgamation of two banks and for verifying whether the amalgamation arrangement is detrimental to the interests of depositors or to the affairs of the bank and conduct of directors in the event of such amalgamation [Sections 44A and 44 B].

2.4.5 A review of the system of on-site supervision of the banks by RBI was undertaken by a Working Group headed by Shri S. Padmanabhan in 1995. On the basis of the recommendations of the Working Group, a modified supervisory rating mechanism for the banks was introduced. While for the banks incorporated in India, six factor rating namely CAMELS (i.e. Capital adequacy, Asset quality, Management, Earnings, Liquidity, Systems and controls) was used, for the foreign banks operating in India the rating factors were CALCS (i.e. Capital adequacy, Asset quality, Liquidity, Compliance and Systems and controls).

2.4.6 As a strategy for moving towards continuous supervision, the 1995 review had also recommended that by way of supplementary vehicles collateral to and in between statutory, full-scope inspections, following types of on-site assessment and review exercises may be carried out:

- Targeted appraisals: detailed examination of specific portfolios at periodic intervals;

- Targeted appraisals through examination of books, records, management information system (MIS) at the control site for the Indian operations & appraisal of overseas branches through a visit to the International Banking Division of the bank's Head Office in India;
- Commissioned audits: examinations of specific areas by external auditors; and
- Monitoring visits: short visits to banks by RBI inspectors for follow-up or review of selected areas of concern.

However, these four supplementary vehicles have sparingly been used.

2.5 RBI's experience with Risk Based Supervision

2.5.1 Reserve Bank of India has continuously aimed at improving the efficiency and efficacy of its supervisory processes in line with the changes in the operating environment. Realizing the need for a continuous monitoring of the banks through off-site analysis of critical data impacting their risk profiles, conducting targeted on-site inspections and making early supervisory interventions, Reserve Bank of India initiated a pilot program for supervision of select banks under the Risk-based approach during the supervisory cycle of 2003-04. The pilot studies were also continued during supervisory cycles of 2004-05 and 2005-06. The main objectives of these pilot studies were:

- To assess the level and direction of various risks in the bank concerned and compare the position with the CAMELS based- AFI findings;
- To study the level of preparedness of the banks in regard to risk management practices;
- To build a pool of experienced inspecting officers well conversant with the Risk based approach of supervision; and
- To back-test the efficacy of the RBS framework.

2.5.2 These pilot studies were conducted in addition to the normal CAMELS based Annual Financial Inspection process. Some of the major findings of these pilot studies were the following:

i) Banks had gained considerable experience in preparation of risk profile document which was central to the RBS process as it enabled the supervisors to focus on target banks or targeted areas of banks.

ii) The quality and integrity of data inputs was an area of concern.

iii) The senior management of the banks had not fully appreciated the importance of risk management systems as an integral part of business processes in their banks. While some of the banks had risk management framework for various risks, identification/ measurement/ controlling of risks and use of the risk assessment was not made an integral part of the decision making function in most banks.

iv) Although an implementation of Risk Based Internal Audit (RBIA) system had happened in all banks covered under pilot study , the system which was extremely crucial for the success of RBS, had not stabilized.

v) The risk mapping for the banks covered under the pilot study under RBS was largely in alignment with the assessment made under CAMELS suggesting that CAMELS and RBS are compatible supervisory approaches.

2.5.3 Based on the pilot studies, it was concluded during 2006-07, that the banks in India were not ready for a full-scale roll out of RBS as they needed some more time for putting in place appropriate risk management systems and operationalising risk based internal audit. This Committee is mandated to examine various options and recommends implementable approach and processes of banking supervision to ensure effectiveness of bank supervision in a globalized environment.

2.6 Views of the Committee

General

2.6.1 The supervisory approach adopted by RBI for commercial banks has served it reasonably well and instances of bank failures have been minimal and the depositors' interests have been well protected in the midst of occasional challenges. However, in view of the changed ground realities reflected in growing size, complexity and new risks inherent in bank's balance sheets, increasing conglomeration and growing internationalisation of the Indian banking system, RBI's supervisory approach needs to be revamped. Even while the supervisory turf has become increasingly complex, over the same period, a commensurate development in the quantity and quality of the supervisory resources has not happened.

2.6.2 Against this backdrop, there is a need to make diligent, accurate and judicious judgment about the risks facing the supervised entities so as to initiate an appropriate and immediate supervisory action. To fulfill the above objectives, RBI in its role as the bank supervisor, needs to fully understand the risk profiles of the banks on an on-going basis and focus on areas of potential risks facing each institution so that a forward-looking supervisory action plans may be prepared and implemented. In this context, while the need to persist with a baseline supervisory oversight for all the entities need hardly be overemphasized, it is imperative for the supervisor to be risk-focused and judiciously employ the available resources so that the key risks are identified and managed. This would entail benchmarking the supervisory process/approach to the global best practices and make a move towards a forward looking risk-based approach to supervision from the comparatively more resource-hungry, transaction-testing and compliance-oriented approach in vouge at present.

Objectives of Supervision

2.6.3 Principle 1 of the Basel Core Principle for Effective Supervision sets out the promotion of safety and soundness of banks and the banking system as the primary objective for banking supervision. Some jurisdictions additionally assign other responsibilities like depositor protection, consumer protection, financial stability, financial inclusion, etc for their banking supervisors, provided these are not in conflict with the primary objective.

2.6.4 The various statutory provisions, which empower RBI to conduct supervision of banks, require RBI to prescribe standards and monitor liquidity, solvency and soundness of banks, so as to ensure that depositors' interests are protected at all times. RBI, in its role as a banking supervisor is also responsible for promotion of financial stability and protection of consumers. However, RBI's success in effectively discharging these additional responsibilities are closely intertwined with the safety and soundness of the banking system and therefore do not result in any conflict with its primary objective of depositors' protection and promoting safety and soundness of the banks/ banking system.

2.6.5 RBI has issued guidelines directing the banks to ensure quality service to their customers through setting up of Customer Service Committees and instituting customer grievance redressal mechanism. Further, RBI has also institutionalised a Banking Ombudsman Scheme which provides a system of expeditious and inexpensive resolution of customer complaints on account of deficiency in banking services. Ensuring fairness to customers, transparency in banks' pricing and positioning of products/ services etc. has, however lacked adequate supervisory focus over the years which is reflected in growing number of complaints at the offices of the Banking Ombudsman. In this context, the Committee firmly believes that customer protection should also be one of the core objectives of supervision.

2.6.6 The Committee is aware that the objectives of RBI's supervisory processes enshrined in the regulatory framework set out for the banks, are not explicitly articulated at present. The committee believes that an explicit articulation of supervisory objectives would render the supervisory planning process, including an assessment of the need for supervisory resources, tools and methods, more effective and purposeful. Such articulation would also facilitate fair evaluation of supervisory effectiveness against stated supervisory objectives. The Committee, thus, recommends that

protection of depositors' interests, promotion of financial health of banks/FIs and consequently promotion of financial stability and customers' protection should be articulated as overarching objectives of RBI's supervision.

Degree of intrusiveness of supervision

2.6.7 Presently, RBI conducts annual on-site examination at banks apart from taking up targeted scrutinies /appraisals for examining specific issues. Formal meetings with the CEO and the senior management of the banks after the Annual Financial Inspections and at quarterly intervals constitute other structured interface with the banks. For the banking groups identified as Financial Conglomerates, a half-yearly meeting with the CEOs of the major group entities is held. Such formal interactions with the supervised entities make the presence of the supervisor felt on an ongoing basis.

2.6.8 The Committee is of the view that the supervisor should not only be proactive in ensuring compliance but also be more intrusive if the risk management in a particular bank is perceived to be ineffective. In this context, the Committee observes that the banks' business plans, the planning process and the strategies to achieve the planned targets do not receive adequate supervisory focus at present.

2.6.9 While concurring that the level of intrusiveness in the affairs of a bank should be risk based, the Committee recommends that the supervisory assessment should begin with an appraisal of a bank's business plans (covering targets, strategy & efforts), planning process and the attendant strategies so as to capture the banks' strategic risk and also use this assessment as a yardstick for measuring the efficacy of the management. The supervisory assessment should also factor in deviations in a bank's business plan and strategy from the industry standards/averages and reasons attributed by the management for such deviations. The objective of the supervisor's review would not, however, be to question the business strategies adopted by a bank, but to evaluate the extent to which the bank management is involved in formulation of the strategy and measures contemplated to mitigate the attendant risks.

Reliance on external auditors

2.6.10 In some supervisory jurisdictions, external auditors are commissioned to undertake a full on-site examination or to review specific areas of operations within a bank. The external auditors also independently conduct annual statutory audits of the accounts of the bank as well as its compliance with accounting procedures and best practices. These provide an additional assurance to the supervisor about the bank's financial position. Several bank examiners use these audit reports and the compliance by the banks to the recommendations made by their external auditors as an important supervisory input.

2.6.11 The Committee is of the view that for improving the effectiveness of the supervisory processes, it is essential to eliminate the duplicity of efforts by various stakeholders. It noted that while banks were subject to transaction-level internal and external audits, the supervisors also conduct detailed transaction testing leading to duplication. In this context, the Committee suggests that the inputs from reports of the internal and external auditors should be utilised by the supervisors for off-site assessment and also form a basis for onsite examination.

2.6.12 With the stabilisation of Core banking solution in all banks, the committee opines that the branch audit of public sector banks may be dispensed with or drastically curtailed in the future. Wherever focused attention is required, the supervisor could commission special audits in the banks to probe into specific areas of concern.

2.6.13 On the extent of reliance to be placed on the work of the statutory auditors of the banks, the Committee noted that the quality of bank audit needed improvement and stringent qualifying requirements should be imposed on audit firms that are assigned external audit functions at banks. The committee recommends that the peer review of auditors should be made mandatory for quality assurance purpose. The Committee considers it necessary to make a realistic assessment of the "Role & Effectiveness of the Auditors" and the extent of reliance that the supervisor could place on such information. Accordingly, it recommends that RBI and the statutory auditors should jointly work

towards a formal code to enlist the mutual expectations, documentation requirements, information sharing requirements etc.

2.6.14 On the issue of whether the same audit firm should be engaged for auditing the operations of the entire banking group, the Committee is of the opinion that in view of the need for a fair and consistent approach and for ensuring accountability, it is desirable to the extent possible that group audit should be carried out by a single audit firm/ group of audit firms that are tasked to audit the bank. The Committee also notes that in view of the fragmented nature of audit firms in India, this may not be feasible at present, but if the supervisor has to place substantial reliance on auditors' work, this could be a necessary pre-condition that need be ordained for future.

Comprehensiveness of supervision

2.6.15 RBI's Consolidated Supervision of banks is limited to off-site assessment of the compliance with some prudential requirements (capital adequacy, single/ group exposures, capital market exposure on a group-wide basis) for consolidated banks. Intra-group /related party transactions are also assessed for compliance with arms length requirements during on-site inspections. In view of the growing trend towards conglomeration by the Indian banks & its gradual integration with the global financial markets, the Committee is of the view that it is necessary for the banks to focus on the risks that emanate from their domestic non-banking subsidiaries and the overseas banking subsidiaries/ branches. Accordingly, the supervisory efforts should also be comprehensive and be geared towards assessing risks for the parent banks from all its constituents. In this context, the Committee recommends that the supervisory focus should shift towards Consolidated Supervision of banking groups.

2.6.16 The effectiveness of Consolidated Supervision is incumbent upon sound understanding of the financial position and risks, solvency, management and control mechanisms for the banking group as a whole. For banks having cross-border presence, it can be achieved through sustained co-operation from other host supervisors. While RBI has signed MoUs with some of the overseas supervisory authorities for information sharing purposes, the Committee considers that for an effective Consolidated Supervision of Indian banking groups with sizeable overseas presence, it would be worthwhile to establish and host supervisory colleges.

2.6.17 Similarly for improving the information flow on the non-bank subsidiaries of the banks, the Committee is of the view that it is important for RBI to have an effective co-operation and information sharing mechanism with the other sectoral supervisors.

2.6.18 The Committee also takes note of the fragmented set up within the RBI for supervising different entities belonging to the same banking group. In this context, the Committee recommends that in order to facilitate effective Consolidated Supervision, the supervisory processes for various entities forming part of a banking group should be brought together within a single supervisory department. The Committee also recommends that a single point contact in the form of a 'Supervisory Relationship Manager' (SRM) should be created within the Department of Banking Supervision to ensure efficient and effective communication between the supervisor and the supervised entities.

2.6.19 While debating on the level at which the regulatory and supervisory departments within RBI should converge the Committee is of the view that it is an operational decision. However, the Committee suggests that the domains of regulation and supervision should be firmly demarcated and any entity specific decisions should be the sole preserve of the supervisory department. The Committee also noted that regulation is generic in nature and is applicable to all entities within the sector. To elaborate, prudential regulation covers the sector as a whole and regulatory prescriptions applicable as such to the sector are disseminated in public space. Therefore, the transactional regulation and regulatory approvals at the entity level are best avoided by regulatory department. This is essential both for clarity of jurisdiction for the supervised entity and for making the relationship /dealing desk an effective single point of contact in the Department of Banking Supervision. The Committee further recommends that the communication between the supervisor and the supervised entity is absolutely confidential and should not be subject to any public scrutiny.

Proposed Approach to Supervision

2.6.20 The growing complexities within the banking sector in India are manifest in significantly expanded balance sheets, complex products, processes and practices, and increased integration with the global financial system. Consequently, the supervisor has to be fully conversant with the risks inherent in the banks and the incipient risks building up in the banking system at all times leading to a need for monitoring the banks closely and continuously. To achieve the above objective, the Committee recommends that RBI's supervisory methods should be realigned to enable a realistic assessment of the potential risks which the banks may face. In other words, the supervisory tools should be geared towards assessing on a forward looking mode, the business and strategic risks facing the institution and its ability and preparedness to mitigate these risks.

2.6.21 The philosophy of risk-based supervision is built around evaluation of risks and identification of incipient problems for ensuring that the individual banks initiate corrective action much before the problems could undermine their safety and soundness. Under a compliance based approach, supervisory activities focus on the financial position of the supervised entities at a given point in time (stock). Risk-Based Supervision (RBS) on the other hand is a dynamic process (flow) where the emphasis is more on understanding and anticipating the possible risks the supervised entity will be facing when executing its business plan going beyond its current financial situation. For example, under the RBS approach, the supervisor while considering the bank's plan to introduce new products would focus more on the effects on the bank's capital if the initiatives were unsuccessful or, even, too successful! Compliance focuses more on whether the bank currently has sufficient capital and follows the rules that, it is assumed, are sufficient to ensure the objectives of supervision are met. In that sense, RBS can be said to be more preventive and forward looking as well.

2.6.22 Globally, RBS has gained recognition as the preferred approach to the traditional approach which focuses largely on determining the current financial condition of a bank, based on historical financial data and on quantifying a bank's current problems through the use of audit-like examination procedures. By contrast, RBS focuses on qualifying problems by identifying poor risk management practices and emphasizing the need for understanding and assessing the quality of risk management systems put in place by the banks for identifying, measuring, monitoring and controlling risks in an appropriate manner. RBS, thus benefits not only the bank supervisors, but also the regulated banks by way of improved risk management systems and oversight. It must, however, be acknowledged that it is impossible to eliminate all risks in a bank and consequently, the supervision is not aimed at eliminating risks but seeking to mitigate them. While practicing a risk based approach to supervision, the supervisors also undertake a certain measure of risk by focusing more on the banks which pose biggest risks to the supervisory objectives.

2.6.23 The bank supervisors favour an approach that would help them focus and dedicate supervisory resources to identify higher risk banks and areas of greater risk within the banks. Once those high risk areas and the banks exposed to such risks are identified, supervisory focus would turn towards assessing those risks and looking for ways to mitigate them. The key to effective RBS is to identify primary risks affecting a bank and to evaluate the significance of those risks for the bank. Once this is done, supervisory resources can be deployed more efficiently to address those identified risks. RBS, thus, meets the supervisor's need to rationalize the use of scarce supervisory resources.

2.6.24 The RBS approach is also consistent with the international best practice standards such as Basel II and the Basel Core Principles. For instance, Basel II requires banks to design and implement effective risk management systems. The Committee has noted following benefits of a risk focused approach for supervision of banks:

- Improved understanding of the risk profiles of banks, their business and of the quality of management;

- Early identification of emerging risks at individual banks and on a sectoral basis i.e. the risk contagion;
- Enable to indicate the direction of risks, possible to anticipate future scenarios and hence a forward-looking capability to initiate supervisory measures where needed;
- Optimum utilisation of the supervisory resources with a greater focus on material risks and risk management processes at banks.

2.6.25 The Committee believes that migration to risk based approach to supervision would facilitate improving the culture of risk management and oversight in the banks' management and therefore, RBI's supervisory programme should be drawn up by focusing on the risks posed by individual banks/ banking groups and supervisory resources should be allocated in line with their risk profiles.

2.6.26 The Committee notes that a minimum level of acceptable risk management systems (RMS) in the banks is an essential prerequisite for migration to a risk based approach to supervision. It also took note of the prevailing inadequacies of the IT systems, Management Information System and the risk management systems in majority of the Indian banks and apparent lack of incentives for the management of the public sector banks to improve the risk management systems (RMS) in their banks. The Committee is firmly of the opinion that addressing such inadequacies is central to the success of a risk-based supervision and in order to exhort the bank management to improve their RMS introducing regulatory disincentives like cap on further expansion of branches, balance sheet etc., could be a probable approach.

2.6.27 The committee recommends a Risk Based Supervisory framework for the Indian banks and has indicated ingredients of a baseline risk management system that should be in place at each bank before the Risk Based Supervision could be rolled out. The Committee also suggestes that full-scale RBS could be implemented across the banking industry from the supervisory cycle of 2013.

Supervisory Methods /Tools

2.6.28 In a risk-based supervisory framework, both onsite examination and off-site surveillance feed into one another as they are mutually interdependent. RBS is, therefore, designed and implemented as a process encompassing both on-site examination and off-site surveillance of banks.

Off-site Supervision

2.6.29 The ability of the supervisors to conduct a meaningful supervision on a 'close and continuous' basis with a risk-focus is dependent upon capturing and analysing detailed information about the banks, their profile, culture, risk tolerance, operations and environment on a dynamic basis. The Committee recommends that under the proposed risk-based framework, the off-site supervision should be substantially strengthened to provide inputs for the onsite visits. It also notes the quality and integrity of the data submitted by the banks to the supervisors is not reliable/ inconsistent and as such there is a need to eliminate any manual intervention involved in the flow of data from the banks to RBI. The Committee also recognises a pressing need for instilling some discipline in the banks to ensure data integrity.

2.6.30 The offsite supervisory process includes preliminary risk assessment of the banks based on captured data flows pertaining to their business plan/ strategies, group structure, financial statements, compliance and internal audit/plans and reports, observations of external auditors etc. This together with macro-economic factors and market intelligence inputs (received from rating agencies, industry groups, consultants etc.) are key inputs to decide on the scope, focus, resources and time for the onsite supervisory visits. The offsite supervisory process, thus, envisages that considerable time should be spent to analyse off-site data gainfully before embarking on an on-site examination exercise. To enable the banks to be sufficiently prepared for the onsite supervisory visit and facilitate an efficient on-site examination, the supervisors may share the scope and focus of the supervisory visit to the banks in advance.

On-site Examination

2.6.31 With the preliminary risk assessment of the banks being done off-site, under the RBS regime, the focus and orientation of the on-site visits would undergo a significant change from the present supervisory practice. Under the RBS approach, the onsite visits should focus more on filling gaps in information gathered during off-site analysis, conducting validation checks onsite of the risk aggregates to understand the extent of specific risks and also sectoral risks with a potential for contagion, conducting follow-up on issues identified from previous assessments and undertaking a limited review through interaction with the top management. Onsite inspection could also be used to verify the accuracy of the information submitted by the banks as part of regulatory reporting and compliance with banking regulations and accounting standards. The Committee is of the view that the level of risk rather than the volume of business should be the determinant of the periodicity of on-site examination and accordingly recommends that while the periodicity of the onsite supervisory examination /reviews for all large and risky banks could be annual, the on-site inspection of the smaller banks with a lower risk profile should be conducted only once in a 2 to 3 year cycle.

Thematic Reviews

2.6.32 Apart from the regular monitoring of banks, it is also necessary that supervisor undertakes thematic review of a particular product, market or practice using a specialised team to assess whether any risks are brewing within the sector or at system levels. Such thematic reviews help in discerning the quantum and nature of risks over a cross-section of banks and enable taking prompt actions to address them. Some indicative areas for such focused reviews may include observance of KYC compliance, management of money laundering risks, approaches for management of interest rate, exposure to sensitive sectors, investment and liquidity risk, NPA, pension liability, compensation practices etc.

Interactions with the Top Management of banks

2.6.33 Under the continuous supervision mode, the need to interact with the management will depend on the aggregate risks posed by an institution to the supervisory objectives at a given point in time. In this context, the present system of holding quarterly discussions with the Top Management of all banks as a matter of routine may be replaced with formal interactions, the periodicity of which is determined by the supervisor based on its risk assessment for a particular bank /banking group.

In this context, a mechanism for periodic interaction of the supervisor with the Top Management of the banks at a common platform, for deliberating on issues affecting the banking sector as a whole, would mutually benefit the supervisor and the supervised entities.

CHAPTER 3

SUPERVISORY PROCESSES

3.1 Introduction

Legal Basis

3.1.1 The Banking Regulation Act, 1949 (BR Act) provides the legal framework for regulation and supervision of banks. This statute, together with some provisions in the Reserve Bank of India Act, 1934, State Bank of India Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959 and Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 & 1980, empower the Reserve Bank of India (RBI) to prescribe standards and monitor liquidity, solvency and soundness of banks, so as to ensure that depositors' interests are protected at all times. An off-site monitoring of banks through various regulatory returns (prescribed under Section 27 of the BR Act) and periodic on-site inspection of banks constitute the main supervisory activities of the RBI to ascertain that the banks are in compliance with the licensing regulation laid down in section 22 of the BR Act.

3.1.2 Certain other provisions of the BR Act also mandate RBI to carry out inspection of banks for specific purposes viz. for determining a bank's eligibility for a license {Section 22(3)}, for winding up {Sections 38(4) and 44(1)}, for amalgamation {Sections 44A and 44 B} etc. Apart from above, Section 35 (1) (a) of BR Act empowers the RBI to cause a scrutiny of any banking company and its books of accounts. While section 35 of the BR Act confers upon RBI the general authority to conduct inspection of books and accounts of banks, the Act does not mandate on-site inspection of banks on an annual basis.

3.2 Evolution of Supervision of Commercial Banks

3.2.1 An Annual Financial Review (AFR) of public sector banks was introduced following the recommendation of the Pendharkar Committee in the mid 1980s. These AFRs were based on reports submitted by the banks themselves. The Padmanabhan Committee recommended merging the AFRs with the financial inspection paving the way for Annual Financial Inspections for all banks beginning from the year 1991. The Narasimham Committee (1991) recommended separating regulation and supervision. Partly in compliance with the recommendations of Narasimham Committee and also based on the recommendations of the Joint Parliamentary Committee, a Board for Financial Supervision (BFS) as a Committee of the Central Board of RBI was set up in 1993. At the same time, supervision was also separated from regulation by creating Department of Supervision (DoS) (later, Department of Banking Supervision 'DBS' in 1997) as a separate department carved out of the Department of Banking Operations and Development (DBOD).

3.2.2 The second Padmanabhan Committee (1995) recommended a system of ongoing supervision of the banking system. To this end, an Off-site Monitoring and Surveillance System (OSMOS) was introduced in 1996 to complement the on-site inspection. The new strategy of supervision was based on the CAMELS model focusing on Capital, Assets, Management, Earnings, Liquidity and Systems and Controls. The role of auditors was enhanced and broadened to include concurrent audits and certification of the quality of banks' compliance with various regulatory prescriptions. Over the years Prompt Corrective Action (PCA) framework, Consolidated Supervision, Supervision of Large and Complex banks/Financial Conglomerates etc. were inducted to augment and strengthen the supervisory processes. Risk-Based Supervision was introduced in 2003 on a pilot basis but the same was never formally launched.

Present Regime of RBI Inspection

3.2.3 The main objective of banking supervision by the RBI under various statutory provisions is to ensure that depositors' interests are protected at all times. RBI also has the implicit role of ensuring financial stability and consumer protection. RBI has adopted CAMELS framework (i.e. Capital adequacy, Asset quality,

Management, Earnings, Liquidity, Systems and controls) for supervision of commercial banks in India. RBI's supervisory processes include evaluation of banks' performance by way of an on-site Annual Financial Inspection broadly with reference to the following:

- Banks' financial condition and performance highlighting Asset Quality, Solvency and Capital Adequacy, Earnings Performance and Liquidity;
- Management and operating conditions focusing on Management (board and senior management), Systems and Internal controls, including risk management strategies;
- Compliance to Regulations including integrity of reporting and compliance to guidelines.

Based on the above evaluation, a Summary assessment is made which mainly highlights the supervisory concerns and identifies areas for corrective action. The AFI findings are recorded under CAMELS framework and a supervisory rating of the public/ private sector banks is done on the basis of scores obtained by them under relevant parameters of CAMELS. The foreign banks operating in India are rated under the CALCS (i.e. Capital adequacy, Asset quality, Liquidity, Compliance and Systems & Controls) model.

3.3 Supervisory Process

3.3.1 The current supervisory processes broadly involve *three stages viz. inspection planning for the banks, conduct of AFIs (onsite) and follow-–up and monitoring.* Off-site supervision through Offsite Monitoring and Surveillance System (OSMOS), Prompt Corrective Action (PCA) (i.e. based on pre-determined trigger points on CRAR, Net NPA and RoA), Risk Profile Templates, supervisory discussions supplement the AFI process. Supervisory Review and Evaluation Process (SREP) has been recently introduced as supervisory tool. The same supervisory processes are applied uniformly across all the supervised entities.

Inspection Planning

3.3.2 The inspection cycle begins with drawing of the Annual Perspective Plan (APP) for the Annual Financial Inspections (AFIs) of the banks in the Central Office of the Department of Banking Supervision in consultation with the Regional Offices. The APP is prepared based on considerations of asset size, availability of supervisory resources etc.

3.3.3 To complement the Head Office inspection a representative cross-section of branches and controlling offices are also covered under AFI. Criteria for selection of branch/ controlling offices include, inter alia, asset size and off-balance-sheet exposure of the branches in such a manner to ensure coverage of 30% gross advances in respect of public and private sector banks and 60% in respect of foreign banks. Further, 1% of the rural branches and OBU of each bank are also generally covered every year. The Principal Inspecting Officers select the branches / controlling offices / LHOs of SBI for inclusion in the inspection. For few foreign banks and new private sector banks, branches are not inspected if information regarding loan appraisal, monitoring etc. are centralized and not held at the branches. The APP relies on information and inputs from various sources including inspection reports of branches /controlling offices / Local Head Offices, previous AFI reports /compliance, OSMOS returns, minutes of Quarterly Discussions (QDs), RBI's Nominee Directors, etc. to arrive at the strengths, weaknesses and other areas of concern regarding the functioning of the bank.

On-site Inspection

3.3.4 The CAMELS / CALCS based on-site inspection (AFI) is normally conducted with reference to the last audited balance sheet date. The onsite inspection is transaction- based, compliance-focused and involves review of systems and procedures prevailing in the bank. The on-site AFI is conducted by a team of RBI Inspecting Officers led by a Principal Inspecting Officer (PIO).

Inspection Report, Supervisory Rating and Follow up

3.3.5 The findings of the AFI are formally discussed by the AFI team with the CMD / CEO of the bank. Areas of divergence remaining unresolved are indicated separately in the draft Inspection Report. At the respective Bank Monitoring Division of Central Office, the Report is further processed. This involves final resolution of significant divergences, identification of Monitorable Action Plan (MAP), issue of supervisory letter to the bank, conduct of AFI discussion with top management of the bank, preparation of BFS memorandum on the findings of the AFI, finalization of rating and approval by BFS. The BFS approved supervisory rating is then communicated to the bank.

3.4 Supplements to Current Supervisory Process

Off-site Supervision

3.4 1 With the introduction of off-site returns (submitted by the banks online on Off-site Monitoring and Surveillance System – OSMOS) in March 1997, the supervisory system changed to a judicious mix of both on-site inspection and off-site surveillance and monitoring.

3.4.2 Analysis of off-site returns are carried out individual bank wise, bank group wise, peer group wise, industry wide, sectoral level etc. along with sensitivity to fluctuation in interest rates. The basic framework for analyses of off-site returns is on the CAMELS pattern. However, data on management / systems & control are not collected except for a number /aging of unreconciled entries in inter-branch adjustment account and accounts with banks in India / overseas.

3.4.3 On the basis of the off-site returns, macro level analysis including Aggregated Micro-Prudential Indicators (AMPIs) of the health of individual financial institutions and Macro-Economic Indicators (MEIs) associated with financial system soundness, are also carried out. These reviews are broadly based on - Macroeconomic Indicators, Capital Market, Interest Rate Scenario, CRR/SLR, Forex Market and Market Movements, Corporate Profitability, etc. Some of these Macro analyses are published in various journals of the RBI, while others are solely for the consideration of Top Management and BFS.

Discussions with the Banks' Management

3.4.4 In addition to AFI discussion, a system of Quarterly Informal discussions (QIDs) with the executives of the banks on issues emanating from analysis of off-site returns, position of compliance of the findings of AFI, new products introduced by banks, etc was introduced in 1999. As these discussions become an important supervisory tool over the years, the same was made a formal forum for interaction between banks and DBS in 2009. Further, for the banking groups identified as Financial Conglomerates, there is a system of half-yearly meeting with the CEOs of the major group entities.

Risk Profile Templates (RPT)

3.4.5 As part of pilot RBS, a Risk Profile Templates (RPTs) was developed by RBI to assist the banks in assessing their business and control risks in a structured and comprehensive manner. In 2006 the RPTs were revised and presently cover assessment of five business risk areas (viz., Credit risk, Market risk, Liquidity risk, Operational risk and Group risk); two control risk areas (viz. Management risk and Compliance risk) and Capital and Earnings. These RPTs are being updated by the banks on a quarterly basis.

Prompt Corrective Action (PCA)

3.4.6 To guard against regulatory forbearance and to ensure that regulatory intervention is consistent across institutions and in keeping with the extent of the problem, a framework for PCA was developed. The PCA framework links the regulatory action to quantitative measures of performance, compliance and solvency such as CRAR, NPA levels and profitability. The PCA framework based on identified trigger points including serious deterioration in CRAR, Net NPA and RoA beyond the tolerable limits could trigger supervisory action resulting in placement of banks under supervisory regime for closer monitoring and handholding.

3.5 Deficiencies / Gaps in the current supervisory processes

3.5.1 The changes in the financial landscape coupled with development in IT and financial engineering has increased the complexity of the product offered by the

banks. Liberalization and globalization has significantly enhanced the scope and domain of the banking activities in India. Against this backdrop, it becomes pertinent for the bank supervisors to keep themselves abreast of the changing ground realities and equip themselves for the emerging challenges. The Committee notes that, while the present approach to the supervision of banks has served the system rather well over the last two decades, it has its own share of deficiencies, some of which have increased in relevance owing to the changed environment. Some of the shortcomings identified by the Committee relating to the present inspection processes are as under:

(i) Inspection process follows a 'One size fits all' / uniform approach for all banks without due regard to either their risk profiles or the impact of their failure may have on Indian financial system.

(ii) Although OSMOS has been in place for more than a decade, the desired integration with the AFIs is yet to be achieved. This is perceived to be a weak link for ongoing / continuous supervision of the banks.

(iii) Deficiencies connected with end use of OSMOS include data gaps (i.e. OSMOS presently does not capture the risk parameters / limits), reliability and integrity of the off-site data etc. Further, many data duplications and manual interventions are observed in the off-site returns. Since these returns are compiled manually without sufficient cross validations before actual submission, a large degree of data inconsistency is observed vis-à-vis the data available in the Core Banking Platform of the banks.

(iv) The scope and coverage of on-site inspection is virtually identical for all the banks. Since the supervision lacks a risk focus, it results in inefficient allocation of supervisory resources. Presently, the Man hours consumed and time spent for conducting on-site supervision of banks in India is very high when compared to similar assessments in other peer jurisdictions.

(v) Quarterly discussion held with the top management of the bank by RBI is observed to be a very rigid formal structure and is not an event- driven exercise.

(vi) The present AFI process does not use thematic study or trend analysis in respect of asset quality assessment, earnings appraisal etc and hence is not adequately geared for capturing proxies to risks.

(vii) Although ICAAP is a key element of the bank's governance framework in matters of capital adequacy assessment, bank's risk profile, quality of risk management process, etc. assessment of ICAAP are not factored in adequately before commencement of on-site inspection.

(viii) SREP has not stabilized on account of several reasons including lack of skill / technical expertise.

(ix) Presently, the RPTs submitted by the banks, though comprehensive, are very voluminous and lack focus. This makes comprehensive analysis of RPTs an onerous exercise for the supervisors. Data from various off-site sources are not adequately leveraged to prepare for on-site inspection processes.

(x) Selection of bank branches for inspection is done on *ad hoc* basis and not as per risk assessment or findings of auditors under the Risk Based Internal Audits (RBIAs). Frequency of present AFI is also dependent on availability or otherwise of supervisory resources and not on risk perception of the banks and hence not risk-based.

(xi) Adequate attention has not been paid to the overseas inspection of branches and subsidiaries, in spite of rapid growth in the cross-border assets of Indian banks.

(xii) Outsourcing of data centres of banks to both on-shore and off-shore providers have enhanced the risk perceptions from such arrangements which are not adequately assessed under present inspection.

(xiii) The outcomes of on-site inspections, though shared with the concerned banks as supervisory reports, do not result in effective and monitorable risk mitigation plans.

(xiv) Due to lack of legal framework / bilateral MoUs as well as coordination among domestic regulators and overseas regulators /supervisors, the consolidated supervision of the banking groups are not done to the extent it is required.

(xv) Current supervisory rating does not capture the potential risks to which an institution may be exposed.

3.6 Views of the Committee

3.6.1 With a view to addressing these deficiencies, the Committee has recommended migration to Risk Based approach to Supervision (RBS). The committee is of the view that under the risk based supervisory framework, the on-site inspection process would benefit from the feedback loop through the offsite RPT and MIS, as also by drawing upon inputs from the banks' auditors. The on-site inspection process would also be integrated with thematic reviews and periodic supervisory meetings with top management of banks. The Committee is cognizant of the fact that the banks in India possess varying degrees of advancements in Risk Management Frameworks and therefore, it is of the opinion that in banks with rudimentary risk management structures, it would not be possible to conduct RBS with immediate effect. In this context, the committee recommends that a full-scale RBS may be implemented across all commercial banks without exception from the supervisory cycle of 2013.

Off-site Surveillance

3.6.2 The effectiveness of a risk based supervisory process is fundamentally incumbent upon a robust off-site surveillance mechanism. The essential attributes of a strong Off-site supervisory process would include being extensive, proactive and dynamic. 'Extensiveness' in respect of off-site supervision means that the off-site supervisory returns encompass all operations /activities of the bank/bank group including risk elements as well as its mitigants. 'Proactive' off-site supervision means being forward looking and ensuring generation of early warning signals on incipient risks, material to the activities of the bank and enable the supervisor to initiate necessary corrective supervisory actions promptly. A 'Dynamic' off-site supervision implies collection of comprehensive data /returns as frequently as possible and performing analysis of the same in between the supervisory cycles. To enhance the effectiveness of the offsite supervision over banks, the Committee recommends the following:

3.6.3 In order for the off-site surveillance system to be effective and efficient, the monitoring should be focussed on detecting and identifying risk elements in areas not covered by present regulations. The system should also facilitate collection/analysis of data for conduct of thematic reviews. The peer-grouping for thematic reviews should be based on functional aspects and not on the ownership and size of the bank.

Data Integrity

3.6.4 The Committee acknowledges that accuracy and integrity of data is central to the success of RBS and therefore a differentiation between genuine data errors and fabrication of data in the off-site returns should be made and defaults should be considered for appropriate penal action under the B.R. Act, 1949, and the RBI Act, 1934. In case of any serious and deliberate offences, disciplinary action should be considered.

3.6.5 A comprehensive and integrated application IT tool facilitating the collection of financial data (balance sheet, exposures, risk limits etc) as well as

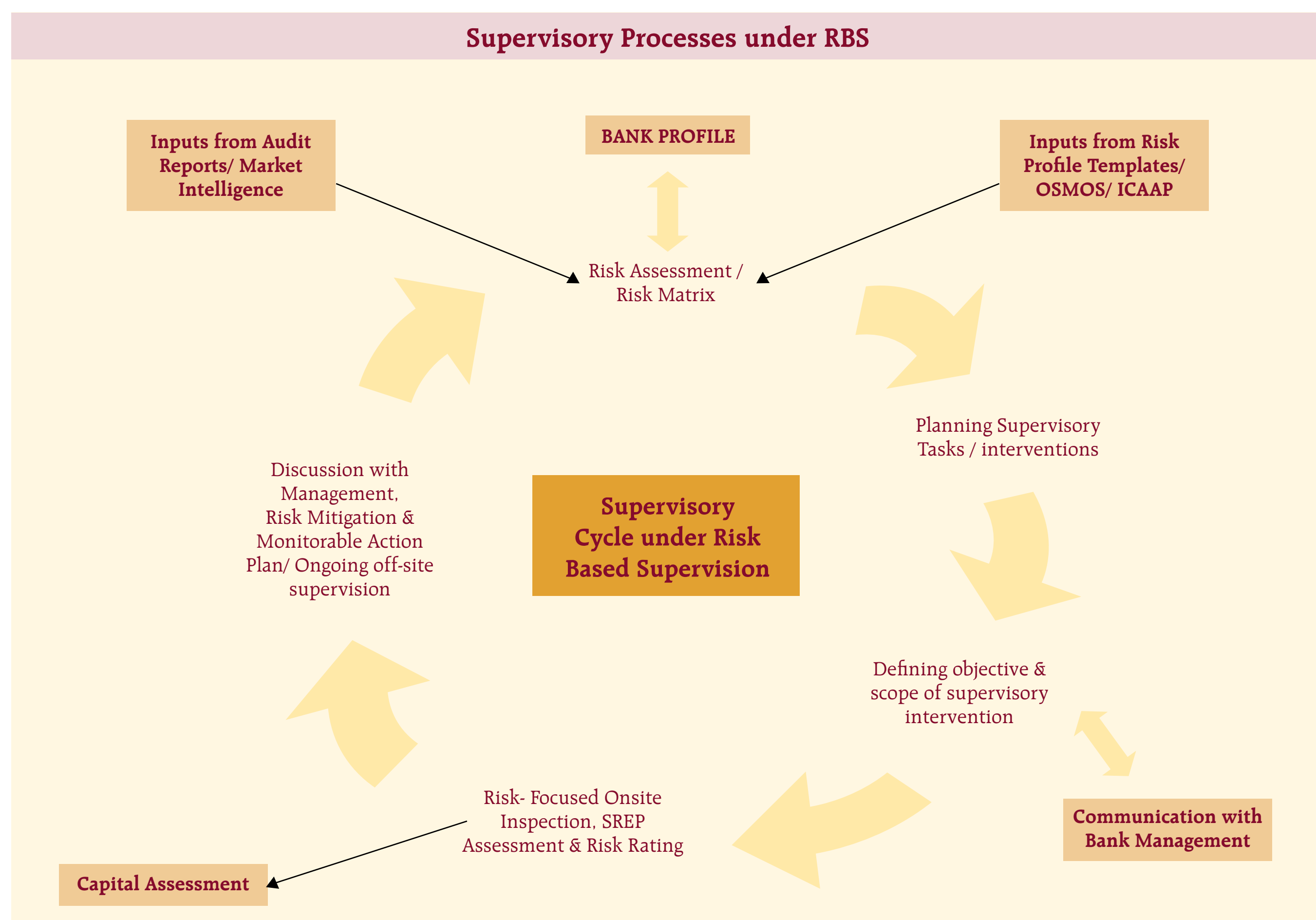
non financial information (policies, internal /external audit reports etc) should be put in place for effective off-site supervision under RBS. In this context, the Committee recommends that the Extensible Business Reporting Language (XBRL) based reporting system presently under implementation within RBI, may be leveraged upon.

3.7 RISK BASED SUPERVISION (RBS)

Supervisory Processes under RBS

3.7.1 RBS is an ongoing process wherein risks of a bank are assessed and appropriate supervisory plans designed and implemented by the supervisor. The frame-work consists of six key steps:

	Steps	Risk Based Tools
1	Understanding the bank	Bank Profile
2	Assessing risks faced by the bank for supervisory purpose	Risk Assessment / Matrix
3	Scheduling and Planning Supervisory Activities	Planning for supervisory actions / interventions
4	Defining Examination Activities, on-site reviews and on-going monitoring	Onsite Inspection – objective, scope, etc
5	Inspection Procedure	Onsite Inspection, conduct of SREP, offsite continuous supervision.
6	Reporting findings and recommendations and follow-up	Inspection Reports, Updating of the bank Profile.



Bank Profile

3.7.2 A profile containing comprehensive yet concise information about the bank should be prepared and the same should be updated on an ongoing basis using inputs from various sources including reports of previous inspections /risk assessments, off-site surveillance, management reports to board committees, internal and external audits findings, periodic discussions with bank's management etc. Broadly, such a profile should contain information on banks' corporate structure, most recent financials including capital structure material business lines and their contributions, key risks/risk mitigants, key management personnel, major findings of the most recent supervisory assessment of the bank. The Supervisory Relationship Manager, who is responsible to build and review bank's profile has to ensure that the same reflects current risk profile of the bank at any given time.

Risk Assessment

3.7.3 In keeping with the philosophy of risk based supervision, it is imperative that the supervisory focus is firmly on the key areas of risks within a bank. The risk assessment process involves updating bank related information collected from various sources including onsite supervision and comprehensively analyzing the material risk and other concerns arising out of banks' operations. The risks that are relevant from the supervisor's viewpoint need to be mitigated on a sustaining basis through adequate procedural and institutional mechanism. The objective of risk assessment encompasses the following:

- Determining the activities of a bank that may create potential hazards to the detriment of the supervisory objectives and goals;
- Determining the severity and impact of the risks and the effectiveness of risk management which would need supervisory action;
- Proposing corrective action, including risk management system, capital and reserves for mitigating the severity of risk and their impact;
- Devising supervisory programs of the bank and monitor the implementation of measures.

3.7.4 The committee is of the firm view that risk assessment is the key to entire Risk Based Supervisory Framework as the major supervisory actions including resource allocation, coverage and intensity of the actual on-site examination, supervisory intervention and the capital adequacy determination are to be a function of the risk profile of the bank which would be updated based on the risk assessment.

3.7.5 Accordingly, it is essential that the Supervisory Relationship Manager (SRM) undertakes an extensive and holistic assessment of various material risks (mainly credit, market, operational, liquidity and other pillar 2 risks) that the bank faces as part of his/her risk assessment of the bank. In order to ensure that the risk assessment has been made in a comprehensive, structured and comparable manner it is necessary to have a common risk assessment template across banks. In this context, while the major inputs for the risk assessment would need to be drawn from the Risk Profile Templates (RPTs), certain other inputs viz. regulatory reports submitted under OSMOS, banks' ICAAPs, deliberations with Management of the bank, statutory/internal audit findings and market intelligence, etc should also be factored in by the SRM. Reports from previous year's on-site inspections, targeted appraisals, thematic reviews, supervisor conducted stress tests and other information like macro-economic environment should also inform the risk assessment process. In view of the need for extensive supervisory judgement, the risk assessment produced by the SRM should be mandatorily subjected to internal validation by a committee of senior supervisors for quality assurance/ consistency purposes.

3.7.6 The supervisory stance under the risk based approach is determined from a matrix arising from the probability of failure of the bank and the impact such a failure may have on the financial system. Thus, risk to twin supervisory objectives (preventing failure of banks and stability of the banking system) may be determined as follows:

Risk to Supervisory Objective = Probability of Failure x Impact of Failure

Assessment of Probability of Failure

3.7.7 The risk assessment of the various risks embedded in the banks' business would be determined based on the inherent prudential risks and prudential risk control in place in the bank for each risk group. The net risk for all the component risk groups would be rated (using a scorecard template) on a continuous scale (**0 – 4**) and would be aggregated into a single score by assigning appropriate weights to each component as under:

Risk Assessment Matrix					
		Weights	Risk $_{Net}$		
			(85%)		Risk $_{OG}$ (15%)
			Risk $_{Inherent}$	Risk $_{Control}$	Oversight & Governance
Risk Group	Credit Risk	30%	70%	**30%**	
	Market Risk	20%	70%	**30%**	
	Operational Risk	20%	70%	**30%**	
	Liquidity Risk	20%	70%	**30%**	
	Pillar 2 Risk	10%	70%	**30%**	

Illustratively,

$$\textbf{Risk}_{\text{Net (Credit)}} = 70\%\ \textbf{Risk}_{\text{Inherent(credit)}} + 30\%\ \textbf{Risk}_{\text{Control (credit)}}$$

The aggregate net risk of the bank would be given by the following equation:

$$\textbf{Risk}_{\text{Net}} = \textbf{0.85}\ (0.3\ \text{Risk}_{\text{Net (Credit)}} + 0.2\ \text{Risk}_{\text{Net (Market)}} + 0.2\ \text{Risk}_{\text{Net (Operational)}} + 0.2\ \text{Risk}_{\text{Net (Liquidity)}} + 0.1\ \text{Risk}_{\text{Net (Pillar 2)}}) + \textbf{0.15}\ (\text{Risk}_{\text{OG}})$$

The **Risk** $_{Net}$ would be adjusted against the available capital (refer to Para 4.22 for detail) to imply about the risk of failure of the bank as per the following equation:

$$\textbf{Risk}_{\text{Failure(0-4)}} = \textbf{0.2}\ \{(\textbf{Risk}_{\text{Net(0-4)}})^2 + (\textbf{Capital}_{\text{Available(4-0)}})\}$$

The composite Risk Score which is a determinant of the probability of failure of the bank would be used to produce a Risk Index which together with the Impact Index described below would be used to determine the supervisory stance/approach.

Assessment of Impact of Failure

3.7.8 The impact of failure would need to be appropriately determined on the basis of size (on and off balance sheet) of the bank, its interconnectedness with the other market players, lack of substitutability (eg. level of dominance in the payment system) / financial institution infrastructure, complexity etc.

IMPACT RATING			
Impact Parameter	**Indicators**	**Rating Scale**	**Significant Weight (Indicative)**
Cross-jurisdictional Activity	Cross-jurisdictional claims	**(0-4)**	**10%**
	Cross-jurisdictional liabilities		
Size	Total exposures as defined for use in the Basel III leverage ratio	**(0-4)**	**20%**
Interconnectedness	Intra-financial system assets	**(0-4)**	**25%**
	Intra-financial system liabilities		
	Wholesale Funding Ratio		
Lack of Substitutability/ Financial Institution Infrastructure	Payments cleared and settled through payment systems	**(0-4)**	**25%**
Complexity	OTC derivatives notional value	**(0-4)**	**20%**
	Securities held for trade and available for sale		
Impact Rating		**(0-4)**	**100%**

3.7.9 In this context, it needs to be highlighted that both risk and impact behave non-linearly and therefore the risk and the impact scores derived from the templating exercise need to be appropriately scaled to amplify the significance of a higher score . Generally, all the supervisory jurisdictions which practice risk based supervision, raise the risk and impact scores to their 4th power to suitably discriminate between a low risk/impact and a relatively higher risk/impact bank. A graphical representation of the steps involved in the determining the supervisory stance/approach is as under:

	Risk –Impact Index Matrix			
	$Risk_{Failure}$ →			
Impact Rating ↑	16	64	144	256
	9	36	81	144
	4	16	36	64*
	1	4	9	16*

Baseline Monitoring; Close Monitoring; Active Oversight; Corrective Action

* Supervisory stance in respect of banks with the highest risk of failure would be the same irrespective of the Risk-Impact Index score

$$\text{Risk-Impact Index} = \text{Geometric Mean}\ \{(Risk_{Failure})^4, (\text{Impact Rating})^4\}$$

$$\text{i.e., Risk-Impact Index} = \{(Risk_{Failure\ (0\text{-}4)}) \times (\text{Impact Rating}_{(0\text{-}4)})\}^2$$

3.7.10 Based on the supervisory approach /stance for a bank determined by its position in the matrix, the areas of supervisory focus for each bank during the annual supervisory cycle would have to be worked out by the SRM. He/she would determine the areas of specific concerns requiring focused monitoring during the supervisory cycle, nature, intensity and coverage of the onsite examination, targeted appraisals, supervisory resource/ expertise requirement etc. The SRM would also need to periodically update the risk profile of the bank in the light of new business activities and modifications to products, processes and systems carried out by the bank.

3.7.11 The supervisory stance/intervention of RBI based on the position of the bank in the risk matrix could be one of the four: "Baseline Monitoring", "Close Monitoring" "Active Oversight", "Corrective Action". Each supervisory stance would be associated with specific supervisory actions to be initiated by the supervisor. The objective of the intervention process is to enable the Supervisor to identify areas of concern at an early stage and intervene effectively so as to minimize losses. Indicatively, these intervention stages and supervisory actions associated with each stage of intervention could be on the following lines:

Planned Supervisory Activities

a) **Baseline Monitoring:** The banks falling within this zone in the risk matrix are perceived to be posing little risk to the supervisory objectives as also their failures would have limited impact on the financial system. The banks falling under this zone are likely to be characterized by stable financial condition and strong internal controls and governance systems. Therefore, the supervisor may not need to be overly concerned in respect of these banks and limit its supervisory work to a baseline offsite monitoring. Such banks should be taken up for onsite supervision only **once in three** years. However, as part of the annual supervisory cycle for such banks, short-duration visits may be made by one/two officers for verification of the accuracy of the regulatory returns and to study specific issues in one or more risk areas/controls.

b) **Close Monitoring:** Banks falling under this zone would be posing relatively higher risk to RBI's supervisory objectives and their failures would have greater implication for financial stability. These institutions are likely to be characterized with modest financial condition and risk management systems and controls and would therefore need greater supervisory focus as compared to baseline monitoring. The supervisory actions in such banks should comprise enhanced off-site monitoring of the bank with increased frequency/granularity of reporting requirements. The periodicity of on-site inspections in the banks falling under this zone could be **once in two years.** The management, Board of directors and external auditor of the bank may be apprised by the supervisor about the potential risks that the bank faces and the action required to correct these deficiencies. Further, the Supervisory Relationship Manager could programme one or more short duration on-site visits to look at specific risk areas/ control and also hold interactions with the bank management on these issues.

c) **Active Oversight:** Banks falling under this zone would be considered as posing significant risk to RBI's supervisory objectives and their failures would have significantly higher impact on the financial stability. As these banks are likely to be vulnerable to adverse business and economic conditions and may have 'material' safety and soundness concerns, the supervisor would need to have active oversight on these banks. The supervisory actions in such banks should comprise

yearly on-site inspections covering the risk areas judged as high/medium in the risk assessment exercise. The bank's external auditor may also be given a mandate to enlarge the scope of the review of the financial statements and/or to perform other procedures and prepare a report thereon. RBI's examinations should also have extensive transaction testing. The risk mitigation plan prepared by the inspection team should be closely monitored by the SRM for compliance by the bank. The onsite visits could also be supplemented with short-duration targeted appraisals/scrutinies for assessing progress and interactions with management.

d) **Corrective Actions:** Banks falling under this zone would be considered as posing grave risks to RBI's supervisory objectives and their failures would have severe impact on the financial stability. In view of the large scale threat of potential failure of these banks, the supervisor would need to put these banks under continuous watch. This would include commissioning external specialists or professionals to thoroughly assess the quality of loan portfolio, security, asset values, sufficiency of reserves, etc. as also requiring the management and the board of directors of the bank to consider resolution options such as restructuring the bank or seeking a prospective partner for merger, amalgamation or takeover. RBI's on-site inspections in such banks would be on an **annual** basis with wide coverage of the material risk areas coupled with elaborate transaction testing. The reports from external specialists could be used to direct the management to consider corrective actions which would be continuously monitored for compliance.

3.7.12 Irrespective of the supervisory stance/approach determined in respect of a particular bank, a comprehensive report highlighting the financials, level/ direction of material risks, risk mitigants and a risk mitigation plan, wherever applicable, would have to be prepared and put up to the Board of Financial Supervision on an annual basis.

3.7.13 While observing that the Risk Assessment was critical for framing an appropriate supervisory response, the Committee also acknowledges that the exercise involved both quantitative and qualitative assessments by the concerned supervisors. In order to ensure consistency/standardization of supervisory judgment across the banking system, the Committee underscores the need for developing an objective risk assessment template. It also acknowledges that the risk assessment process requires a high degree of competence and skill on the part of the supervisor to produce an optimum Risk Matrix. Towards this end, the committee desires that if needed, technical inputs from professionals or specialists could be used to ensure that the risk assessment process is robust, consistent and conforms to the global standards. The Committee also recommends that the process of Risk Assessment must be documented in a supervisory manual and a gist of the risk assessment process may also be shared with the supervised entities.

Scheduling and Planning Supervisory Activities

3.7.14 Based on the risk assessment of the bank, the SRM would be required to prepare a comprehensive supervisory action plan for the bank. The supervisory actions on the bank based on the perceived risk about the bank, would range from an on-site inspection (full scale or targeted) to only a continuous off-site monitoring supervision during a particular year. *In this regard, the Committee is of the view that all banks, irrespective of their risk profile/outcome of the risk assessment exercise, should be subjected to an on-site inspection at least once in three years.* It is important to ensure that the proposed supervisory action plan for the bank is adequate and appropriate to its assessed risk profile and would be able to address the assessed deficiencies /concerns in a demonstrable manner. The Committee is of the view that the supervisory action plan should be shared /discussed with the bank's senior management. The supervisory planning and scheduling for supervisory actions must facilitate optimum allocation of supervisory resources to ensure timely and effective conduct of supervision.

On-Site Inspection Objectives & Scope

3.7.15 Based on the supervisory plan of a bank, the Supervisory Relationship Manager would prepare a

detailed note listing the key objectives and scope of the on-site inspection process. Thus, the on-site inspection would focus on specific areas of concern in a bank and would include a thorough review of the bank's internal risk management systems, governance in that area and an appropriate level of transaction testing commensurate with the severity of assessed risk. Allocation of supervisory resources including composition of the inspection team, requirement of risk specialists, duration of the inspection etc. would be decided based on the objectives of the onsite inspection. It would be imperative that the designated inspection team duly completes all pre-inspection preparations including thorough study of observations of the SRM in the risk assessment document and analysis of relevant data/ information relating to the bank before commencing the on-site inspection for an efficient, focused and qualitative exercise. The Committee is of the view that the supervisor may share the scope and focus of the supervisory visit with the banks in advance so as to ensure that the bank is aware of the data/information requirement of the inspection team well in advance and the process is conducted within a disciplined timeline.

Inspection Procedure

3.7.16 In performing on-site examination, supervisors would be guided by procedures as laid down in the Supervisory Manual, which may be revised from time to time. The procedure adopted should be tailored based on the supervisory action plan. The focus of the supervisors should be on adequately assessing management's ability to identify, measure, monitor, and mitigate risks. The inspecting officers may use advance business intelligence tools, vulnerability and configuration assessment software etc. to achieve the supervisory objectives. The outcome of the on-site inspection should be a report indicating supervisory issues or concerns related to the bank and should include appropriate comments regarding deficiencies noted in the institution's risk management systems and recommend concise, specific, time bound and monitorable risk mitigation measures. The Committee is aware that the coverage of Inspection report under RBS would not be uniform, as presently obtaining under CAMELS, on account of variance in the risk profile and the risk category of the banks.

Supervisory Review and Evaluation Process (SREP)

3.7.17 Inadequate supervisory assessment can expose the banking system to vulnerabilities and potential loss of depositors' confidence. The lessons from the recent Global Financial Crisis have shown that certain institutions failed due to certain risks embedded in their products and processes even though they were assessed by their supervisors as being adequately capitalised and highly liquid. This underscores the deficiencies in the supervisory capabilities to accurately determine adequacy of capital as part of the supervisory assessment. The underlying objective of the Pillar 2 process of the Basel II Framework is to ensure that the a) Banks have a process (ICAAP) for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital level; and b) Supervisors have to review and evaluate the banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratio and take appropriate supervisory action. SREP follows the principle of comprehensiveness (i.e. the capital assessment should be driven by the supervisor's understanding of the legal, operating, and corporate governance structure of the organization and its primary strategies, business lines, risk management and internal control functions).

3.7.18 Basel II framework has been made applicable to all the banks in India since April 2009. As required under the Pillar 2, the banks are submitting their Board approved ICAAP documents, both at solo (global position) and consolidated level, on an annual basis and the supervisory authorities are required to subject all banks to a SREP exercise and initiate supervisory measures deemed necessary. So far, two rounds of SREP exercise have been carried out by the supervisor (RBI) on a pilot basis and it is observed that the ICAAP at the banks and the SREP by the supervisor, have yet to fully mature and stabilise.

3.7.19 The risk based supervisory framework for the commercial banks in India being recommended by the Committee is consistent with the objectives of the Pillar 2 requirements as the framework seeks to achieve early identification of problems in banks and intervene where appropriate. The Basel II Framework also

acknowledges that the bank's capital assessment process has to be appropriate to the nature, scope and complexity of its activities which is also consistent with the risk sensitive approach being recommended by the Committee.

3.7.20 Under the proposed risk based supervision process, the Committee recommends that the risk assessment process mentioned above should be leveraged upon in determining the level of supervisory capital for each bank. Further, as part of the overall supervisory activities, a holistic review of the ICAAP involving a quantitative review of the inherent Pillar 1 risks (Credit, Market, Operational) and a quantitative / qualitative review (to the extent possible) of Pillar 2 risks (all other risks that a bank is exposed to) should be conducted. As part of the review, an overall assessment of adequacy of bank's capital targets, its strategy and capacity for achieving and maintaining these targets should be made.

Inspection Reports, Discussion with Bank and Follow-up

3.7.21 The inspection process would entail supervisory meetings with the CEO/Senior Management of the bank on the issues and concerns arising out of the inspections. Along with the inspection report, a time bound Risk Mitigation/ Monitorable Action Plan (MAP) should also be prepared and closely monitored for ensuring speedy compliance. The compliance should be monitored by the Supervisory Relationship Manager on an on-going basis. The Committee recommends that the extant quarterly discussion with the banks needs to be replaced with structured meetings with bank management, the frequency of which may be determined in accordance with the assessed risk profile of the concerned bank.

3.8 Continuing off-site Supervision

3.8.1 One basic tenet of the risk based approach is to have a greater focus on institutions that are assessed more risky/vulnerable by the supervisors. The supervisory program in respect of more 'risky' banks includes a mix of on-site supervision as well as off-site surveillance comprising monitoring of vulnerabilities, compliance to risk mitigation plan etc. However, the judgment of a bank /institution as less risky does not relieve/ absolve the supervisor from its supervisory duties. Those banks which are considered potentially less risky /vulnerable as per the supervisory risk assessment, are to be subjected to an ongoing off-site supervision commensurate with the level of assessed risk.

3.9 Supervisory Rating

As part of the annual supervisory process for each bank under RBS, a supervisory risk rating exercise capturing the supervisory risk in a bank shall be undertaken. It is envisaged that the proposed supervisory rating would measure the 'net risk' in a bank. This rating would convey a sense about the 'riskiness' of the bank as perceived by the supervisor. The details of the proposed supervisory rating are indicated separately under Chapter 4.

IMPORTANT SUPERVISORY TOOLS / PRACTICES

3.10 Stress Testing & Reverse Stress Testing

Stress Testing

3.10.1 Stress tests are forward-looking and dynamic methods for determining the Capital requirement and detecting weakness in the risk management process of the bank. Therefore, under the risk based supervisory approach, stress testing method should be given a higher weight amongst the analytical toolset. Within RBI, a macro level (top-down) stress testing of the banking system is undertaken to identify the threats and potential risks that may arise from environmental or other financial markets. At present, single factor sensitivity tests for assessing the impact of a range of stress scenarios on the credit, interest rate, foreign exchange rate, equity price and liquidity risks are conducted on quarterly basis. Similarly, to assess the resilience of the system to adverse macroeconomic scenarios, stress testing analysis is carried out by the supervisor. Two major groups of macro testing exercises are conducted: one based on a multivariate regression, and the other based on a vector autoregressive (VAR) model. While the former allows evaluating the impact of a particular macroeconomic variable on the banking system's NPA and capital ratios, the latter reflects the impact of the overall economic stress situation on the

NPA ratio and bank capital through a feed-back effect. The macro stress tests are also conducted on a quarterly basis.

3.10.2 The Committee notices that though micro level (bank specific) stress testing guidelines have been operative for quite some time, they are not being used as supervisory tools to the desirable extent. In this context, the Committee desired that stress testing should be an integral part of the supervisory processes and used extensively for deciding on the supervisory stance. The Committee also recognized wide variations in the way the banks conduct stress tests for their portfolio and acknowledges that the assumptions and severity of scenarios considered by the banks in this regard have major repercussion on the management actions that would be necessary in the wake of these stress tests.

Since each bank has a different portfolio of risk on account of varying business activities that it undertakes, there is bound to be a fair degree of variety in the stress scenarios that they consider. In this context, the Committee is of the view that in order to bring in an element of uniformity, consistency and comparability in the stress tests across the banking sector, supervisory estimates of few common scenarios/ macroeconomic environment variables based on domestic/global financial market developments, eg. GDP Growth, Sectoral Growth, Fiscal Situation, inflation, External Sector, Capital Flows etc. as well as interest rate movements, may be communicated to the banks in advance for conducting the stress testing of their individual portfolios. Further, the banks should also be advised to internally upgrade their stress testing framework (including back-testing) using plausible stress scenarios in light of their portfolio and risk appetite so that meaningful management actions are possible.

Reverse Stress Test

3.10.3 Stress tests, when combined with carefully constructed scenario analyses, can be helpful, but even under the best of circumstances, stress tests have limitations in anticipating potential events that would result in bank failure. To overcome such limitations, the method of "reverse stress tests" compliments stress testing.

3.10.4 Reverse stress tests, starts from a known stress test outcome (like breaching of regulatory capital ratios, illiquidity or insolvency) and anticipating events that would lead to such an outcome for the bank (Refer: *"Principles for sound stress testing practices and supervision"* by the Basel Committee on Banking Supervision in May 2009,). To have uniformity across banks, the Committee recommends that reverse testing could be carried using parameters like large operational risk events, large litigations, large net redemptions, credit rating downgrade, collapse of wholesale/retail funding markets, *loss equal to say 10-20% of Tier-1 capital (or may be CET-1) within 2-3 quarters* etc. Also, the reverse stress testing should be undertaken by the banks with active involvement of Senior Management.

3.10.5 The Committee is of the opinion that for smaller and simpler banks, reverse stress-testing may be restricted as a qualitative exercise, involving scenario selection by senior management. However, for large and complex banks, a more sophisticated approach to reverse stress-testing involving quantitative modeling may be developed by the bank.

3.11 Thematic Review

3.11.1 Thematic supervision is a way of risk-based supervision, where thematic methods are applied to perform risk identification, detection, assessment and management that occur at several banks and have a material impact on banking sector. In combination with other information, the repeated, frequent and similar problems indicate areas where thematic reviews are needed. Thematic review may be conducted in any area where inherent risk may be perceived to have potential for contagion. Such areas may include, for example, Liquidity risk management, Asset quality, trade financing activities, mortgage lending, treasury activities, Risk disclosures (Pillar 3), management of money laundering risks, KYC compliance, etc. Under RBS regime the areas for conduct of thematic study would be guided by the process of risk identification. Risks to be identified for thematic study may come from several different sources, including the following:

- Supervisory findings of individual banks;
- Nature and trend of customer complaints;

- Trends observed from Consumer protection angle which may include new products being offered, feedback from consumer protection organizations etc
- Market data and market intelligence;
- Emerging trends from macroeconomic and banking sector analysis;
- Information gathered from meetings with banks management especially with those having below average rating;
- Information received from law enforcement agencies, peer international and domestic supervisors; etc.

3.11.2 Thematic approach to supervision is not intended to assess and handle risk at individual banks. However, if prominent risks and problems are noticed during thematic inspection at one or more banks, such risks would have to be considered under bank specific procedure which may lead to targeted inspection at the bank.

3.11.3 The thematic work should be planned in a way that would harmonize the work with bank specific supervision. Also, the sample of banks to be considered for thematic review should have a fair distribution across banks with high risk to identified thematic risk. Thematic Review can be carried out either through a short on-site inspection, data request through templates, theme discussions with banks etc. Thematic reviews are consistent with the risk based supervisory framework as such reviews help the supervisors in being proactive in assessing specific issues across the banking sector thereby ensuring optimum utilization of available supervisory resources and revisions to regulatory prescriptions, where necessary. The Committee, therefore, recommends that thematic review may be integrated into the proposed risk based supervisory framework for enhancing efficiency and effectiveness of supervision of commercial banks in India.

3.12 Role of Auditors

Role of Internal and External Audit

3.12.1 Banks select their statutory auditors based on the criteria approved by the Sub-Committee (Audit) of the BFS which defines the appropriateness and suitability for the selection and appointment of statutory auditors, both for auditing of the whole bank as well as for the branch auditing. As per the extant guidelines, statutory auditors are not permitted to do any other internal auditing work simultaneously for the same bank. In addition to their normal functions, as of now, the statutory auditors are required to furnish certificates /validations for certain items, like verification of SLR requirements, asset classification, income recognition, provisioning, treasury functioning etc. The statutory auditors furnish their findings / concerns in the Long Form Audit Report (LFAR) to the bank and a copy of which is forwarded to RBI by the bank. RBI had initiated risk based audit regime for commercial banks and the Risk Based Internal Audit (RBIA) framework guidelines issued by DBS, RBI in 2002 mandating selective transaction testing along with an evaluation of the risk management systems and control procedures prevailing in various areas of a bank's operations. However, most of the banks are yet to fully implement the RBIA framework.

Views of the Committee

3.12.2 Effective audit function in banks should ensure compliance with regulatory and prudential guidelines by the concerned banks. The Committee has noted that, the AFI of banks continue to throw up significant divergences in classification of assets, shortfall in provisioning, instances of delayed detection and reporting of frauds etc. Such recurring divergences highlight general inefficiency and inadequacy of the audit function (both internal and external auditing) at banks. With banks migrating to core banking platform and even centralized risk management, audit of the branches of banks has become mostly redundant. Besides, the scope of branch audits hardly covers aspects of Credit Risk Management and internal control as part of operational risk.

3.12.3 As the efficacy of Risk Based Supervision would be largely dependent on the accuracy and integrity of the audited data /information provided by the banks as part of off-site supervision, banks' auditors would need to play a crucial and effective role. The recent consultative paper on "internal audit function in the banks" put up for comments by the Basel Committee

on Banking Supervision states the function of Internal Audit in the banks as:

> "*An effective internal audit function should evaluate, independently and objectively, the quality and effectiveness of a bank's internal control, risk management and governance processes, which would assist senior management and the Board of Directors in protecting their organisation and its reputation.*" Further, the paper states that the Supervisors should have regular communication with the bank's internal auditors to discuss (i) the risk areas identified by both parties, (ii) understand the risk mitigation measures taken by the bank, and (iii) monitor the bank's response to weaknesses identified.

3.12.4 Bank supervisor and external auditors perform different economic and statutory roles, and are responsible to different parties – supervisors to their governments and taxpayers, and auditors to bank shareholders. However, their focus areas and concerns show a remarkable degree of commonality. The Basel Committee on Banking Supervision has recognised this commonality in the Core Principles for Effective Banking Supervision and stated that supervisors may use external auditors to supplement the work of the Supervisor. In this context, the Committee is in agreement that the role of external auditors needs to be enhanced. Also, bilateral meetings between the supervisors and external auditors on specific issues of supervisory concerns can yield fruitful results. Such bilateral meetings should identify the exclusive areas to be allocated to the auditors and the modalities for ensuring accountability for the supervisor's complete dependence on the auditors. Indicatively, such areas can include transaction testing, asset classification and income recognition as per the prudential norms, etc.

3.13 Pre-requisites at banks for roll out of Risk Based Supervision

3.13.1 The Committee considered it absolutely essential that a minimum baseline risk management framework should be in place at banks before RBS can be rolled out. To this end, the Committee recommends that RBI should ensure that an effective baseline risk management framework is in place at the banks. Alongside adherence to the risk management guidelines in place for the banks, they should also have systems in place to ensure the following:

- Robust Management Information System – This can be ensured if the bank has a robust IT system that supports reliable and quality data for effective decision making. This may include implementation of Enterprise Data Warehouse Project (EDWP) at banks and provisions for improving data availability /quality to RBI by way of automated data flow from the bank;
- Integrity of data submitted by banks to the supervisory authorities;
- Efficiency/transparency in internal transfer pricing mechanism; and
- Risk-return trade off and *transparency* in pricing of loans and other products, especially of *Annual Equivalent Rates (AER)* and *Annual Percentage Rates (APR)* of return on both sides of the balance sheet; and

Indicatively, the risk management framework at the banks should have the following elements:

- Independence of Risk Management Structure and Board level oversight on RMS and Internal Audit function,
- Risk Management system should be an integral part of business processes,
- Risk Based Internal Audit function should be effective,
- Strong ICAAP processes for determination of Pillar II risks.

The Committee recommends that RBS should be rolled out at the earliest instead of being rolled out in a phased manner preferably from the next supervisory cycle (2013).

CHAPTER 4

SUPERVISORY RATING

Introduction

4.1 Bank supervisors have legal powers to collect extensive off-site information about bank's financial health, business plan and strategies etc. which are normally not available to other stakeholders. Additionally, onsite inspections are also undertaken by the supervisors to verify the accuracy of off-site data and observe the business processes, governance systems & control from close quarters for gathering further supervisory information. The information gathered by the supervisor is used to identify current and potential problems that the bank faces/may face, for appropriate supervisory attention and effective resource allocation. Generally, supervisors in most jurisdictions use the information gathered by them through various sources to arrive at a composite measure of overall health of the bank. This composite score is often termed as 'Supervisory Rating' and is exclusively used for supervisory purposes including intervention. The 'CAMEL' system of supervisory rating is one such internationally recognized and popular supervisory rating system which is in vogue in many jurisdictions including India.

CAMELS Rating Framework

4.2 CAMEL model of rating was first developed in the 1970s by the three federal banking supervisors of the U.S (the Federal Reserve, the FDIC and the OCC) as part of the regulators' "Uniform Financial Institutions Rating System", to provide a convenient summary of bank condition at the time of its on-site examination. The banks were judged on five different components under the acronym C-A-M-E-L: Capital adequacy, Asset quality, Management, Earnings and Liquidity. The banks received a score of '1' through '5' for each component of CAMEL and a final CAMEL rating representing the composite total of the component CAMEL scores as a measure of the bank's overall condition. The system of CAMEL was revised in 1996, when agencies added an additional parameter 'S' for assessing "sensitivity to market risk", thus making it 'CAMELS' that is in vogue today.

Approach for Supervisory Rating in India

4.3 Prior to 1998, the department of supervision (DoS) had been rating the banks in India on the basis of assessed 'solvency' relative to the impairment of the components of reported owned funds. The Padmanabhan Committee (1996) had observed that this form of rating was inadequate since it did not evaluate the banks based on financials such as capital adequacy, liquidity and earnings and was misleading because even if the bank was solvent, it might have had serious management, operational and compliance problems which did not get adequately reflected. The Committee had, thus, recommended a need for substituting the rating with a realistic rating framework modelled on the rating methodology employed by the supervisory authorities of USA. The Committee had also recommended two separate models for Indian and foreign based banks based on a differential mix of rating factors: CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems & Control) for Indian banks and CACS (Capital adequacy, Asset quality, Compliance, and Systems & control) for foreign based banks in India. Each of the components in either CAMELS or CACS was to be assigned a rating on a scale of 1-5 in order of performance. A composite rating on a scale of A-E was to be assigned as a summary rating. The Committee had also recommended that unlike the US system where the banks are rated after the on-site examination process, the supervisory rating in RBI should be done at the Central Office taking into consideration the findings of the on-site examination process and also other supervisory information available at Central Office. The Committee was of the opinion that such an exercise would be more realistic and comprehensive as it would not be limited solely to the findings of the on-site examination process.

4.4 Based on the recommendations of the Padmanbhan Committee, the commercial banks incorporated in India are presently rated on the 'CAMELS' model (Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Systems & control), while foreign banks' branches operating in India are rated under the 'CALCS' model (Capital adequacy, Asset quality, Liquidity, Compliance, and Systems & control). As mentioned above, the Committee had originally recommended a CACS model, which was subsequently modified to also include Liquidity (L) as an additional parameter. Further modifications, in the form comprising additional granularities in the rating scale of parameters under CAMELS have since been introduced by RBI. Presently, each of the components of CAMELS is rated on a scale of 1-100 in ascending order of performance. The score of each CAMELS element is arrived by aggregating (by assigning proportionate weights) the scores of various sub-parameters that constitute the individual CAMELS parameter. Each parameter is awarded a rating A-D (A-Good, B – Satisfactory, C -unsatisfactory, and D-poor). Further, to bring granularity in rating, there are modifiers by way of (+) and (-) under each of A, B and C making a total of ten scales A+ through to D. The composite "CAMELS rating" is arrived by aggregating each of the component weights as indicated in the table below. Further the overall composite score is adjusted downwards for poor performance in one or more components.

Weights of various parameters under the CAMELS/ CALCS Model

	CAMELS	CALCS
Capital Adequacy	18	18
Asset Quality	18	18
Management	18	–
Earnings	10	–
Liquidity	18	18
Compliance	–	26
System & Control	18	20

Principles of Supervisory Rating

4.5 Bank Supervisory ratings are supervisory opinions about the 'soundness' of a bank. Soundness may be commonly understood in terms of risk of bank failure. The supervisory ratings reflect both quantitative assessment of risks to bank failure and expert supervisory judgment on relative and absolute strength of the bank. Thus, rating cannot unequivocally be explained by a particular set of data and criteria. From a supervisory standpoint, depositor protection is the primary objective of bank supervision and a bank failure may be construed as a situation wherein the concerned bank becomes/ is likely to become insolvent and is/would be unable to repay its depositors. The capital buffer maintained by the bank for absorbing unexpected losses is the single largest determinant of the solvency of a bank. The unexpected losses in a bank could arise due to crystallisation of single or multiple risks which the bank faces in its business. Normally banks also have access to additional capital from various sources, including shareholders and lenders, which would cushion the impact of capital erosion in stress scenarios. Since banks' retained earnings along with ability to raise fresh capital is key to building up a buffer for absorbing unexpected loss, supervisors generally perceive such banks to be comparatively more sound. It must be emphasised that while the failure of a bank is primarily dependent on the financial strength of that bank, potential support available to the bank during distress by other shareholders and national authorities/ Central Bank in the form of capital injections, asset purchase, liquidity provisions etc. due to a bank's systemic importance bring additional dimension in assessing bank failure by the supervisor. In this context, it may also be noted that the earnings of a bank could, however, be quite volatile partly on account of their higher leverage which is also reflected in consistently higher volatility in returns on banking stocks over the non-financial stocks over past several decades.

Statistical model for predicting deterioration of banks' financial conditions (leading to failure of the bank) involves searching of explanatory variables that provide a reliable forecast for the financial failure. Academicians have tried to develop models to predict possible financial failures in different industries. Altman (1968) applied the discriminant analysis to corporate failures using financial ratios calculated from balance sheet and income statement data. Logistic regression and Probit models have been widely used

in the prediction of bank failure (Martin, 1977; Thomson, 1991, Espahdobi, 1991). These methods are preferable to discriminant analysis because of superior statistical properties and have found acceptance with a growing number of researchers. Financial ratios measuring liquidity, solvency, asset quality and earnings are the main explanatory variables used to estimate the probability of failure of the bank. However, due to the development of risk analysis, the causes of bank failure can now be more closely identified as arising from such risk as credit risk, market risk, operational risk, liquidity risk, interest rate risk etc.

Deliberations in the HLSC

4.6 The changing nature of banking evident in a shift from offering traditional products and services to engaging in more complex banking activities has necessitated that the supervisor periodically refines the contours and methods employed for an accurate and reliable estimate of banks' health. In this context, the Committee has expressed its preference for a risk-based approach to supervision of commercial banks, wherein the supervisory focus would be on the major risk drivers in the bank. Against this backdrop, the Committee deliberated upon whether a modified form of CAMELS rating with enhanced risk focus could be adopted for India under the RBS regime. It observed that the supervisory authorities in Hong Kong and Spain had successfully adopted a CAMELS based rating system even though their supervision was conducted under the risk based approach.

4.7 The Committee had elaborate deliberations on the existing rating framework under the CAMELS pattern. To supplement the work of the HLSC, a Technical Committee (TC) was constituted to study the supervisory rating framework in detail and make recommendations for consideration of the HLSC.

4.8 The Committee observes that while the rating system had served the needs of the supervisors to a reasonable extant, it needed to be revamped in the light of some limitations observed in the supervisory journey of RBI and also apprehensions and reservations expressed by commercial banks. Some of the notable limitations of the CAMELS framework observed by the Committee include the following:

- The rating system was largely focused on a "point in time" assessment of the performance of the bank while the risk elements were not receiving adequate focus. The rating was, therefore, neither forward looking nor dynamic in nature. Also various risk mitigants as part of System and Control were not being adequately factored.
- There was considerable subjectivity in analysing parameters like Management and Systems & Control as part of the CAMELS based rating framework due to which there was lack of consistency both within and across the banks.
- The rating was primarily based on the comprehensive on-site assessment of the bank as part of the AFI and was not adequately leveraging upon inputs from off-site surveillance of banks including other monitoring tools like ICAAP, RPTs, internal and external audits of the banks.
- The rating scale was too granular (10 point scale) and therefore, it was difficult for RBI to assign appropriate supervisory responses commensurate with each rating.
- Banks having been mandated to maintain minimum capital as per licensing and prudential norms, were receiving a better rating due to high weightage given to level of their capital adequacy. (Most banks were maintaining adequate regulatory capital and thus obtaining higher scores on this count). Earning of the bank was also being accorded higher marks in CAMELS even though higher earnings could be both a source of strength (due to retained earnings) and also a source of risk (higher earnings due to risky activities).

4.9 While deliberating on the adequacy of the present CAMELS rating framework, the committee observed that more often than not the rating score assigned to a bank, did not accurately reflect the

supervisory assessments. Some of the limitations of the rating framework which lead to erroneous supervisory assessment have already been highlighted above. The Committee is concerned that the process of arriving at a composite rating by considering various parameters and assigning appropriate weights to various parameters is a very complicated exercise and requires a lot of fine tuning based on supervisory experience and judgement.

Views of the Committee: Shift in focus

4.10 For a new supervisory rating system under the proposed risk based approach to supervision, the Committee decides to focus only on the risk elements and delink the exercise from performance evaluation. In this context, it is also agreed that the major risk elements (including pillar 2) would be identified and their net risk would be derived by adequately adjusting the respective risk mitigants against the inherent risk. Further, the foreseeable risks which result in expected loss could be covered by the bank in their pricing and therefore, the focus of the risk assessment exercise should predominantly be on those risks which could translate into unexpected losses.

4.11 The Committee is also concerned that although the existing CAMELS based rating framework captured a few risk elements, it was primarily geared towards assessing the banks' performance. It is of the view that the purpose of supervisory rating should be to reflect the risks which may cause a bank to fail rather than representing banks' performance alone. The Committee concludes that the CAMELS based rating system would not be appropriate under the risk based approach that is being contemplated in the Indian context and, therefore, is of the view that the existing supervisory rating framework needed to be realigned in a manner so as to capture the 'riskiness' of the bank.

4.12 The Committee is of the view that the risk of bank failure should ideally be captured using the parameters which are sources of risks in the bank. Some of the key risk areas which have already been identified and internationally accepted are credit, market, operational, liquidity, strategic/business, group risk etc. While a quantitative measure of key risks like Credit, Market and Operational risk are possible and enumerated under pillar I of Basel II Framework, there are limitations in quantitative measurement of other key risks which must be assessed qualitatively. Thus, while all the risks which a bank is exposed to are captured under pillar 1 or pillar 2 the exact measurement and their quantification, is an arduous task considering the need for qualitative interpretation. Also, a lack of clear understanding of the correlations (if any) between various risk areas and a very limited availability of past data on bank failures makes it extremely difficult to objectively and accurately assess the probability of failure of a bank. Supervisors have been cognizant of these limitations and tried to indirectly measure and assess some of the non-quantifiable risks through expert supervisory judgement.

4.13 The committee notes that supervisory judgement is not an exact science. While a lot of researches have gone into the methods of quantification of various risks, these are invariably based on a few basic supervisory assumptions. Additionally, the Pillar 2 risks and the control elements like Management, Systems and Control, strategy etc. can only be assessed qualitatively. Also, the nature of the banking industry and local environment can be factored into assessment of banks only in a qualitative way. The Committee is aware of these limitations and is of the opinion that elements which predominantly require a qualitative assessment should be judged taking into account the prevailing industry practices and should be rated on a relative benchmark vis a vis the practices followed in other banks.

Proposed Supervisory Risk Rating

4.14 Explanatory parameters contributing to risk can either be measured statistically or by expert judgement. Due to the range of information and their diversity, many explanatory parameters can only be estimated through qualitative expert judgement, however, wherever possible, such expert judgement should be based on statistical estimates and other quantitative indicators.

4.15 To measure various risks in a bank, the Committee recommends adopting a Scorecard approach wherein respective explanatory parameter would be assessed by adding up a set of component scores of key factors. In devising a scorecard based supervisory model, it is important that factors and respective

weights to be assigned are determined using statistical tools and also supervisory judgment. In the context of application of weights to risk rating, it is pertinent to note the observations made under the CEBS guidelines on SREP under Pillar 2:

- Higher risk to get a higher weight than smaller risks
- A risk should get a higher weight than its control
- Weaker controls should get higher weight than stronger ones

4.16 Based on the recommendation of the Technical Committee, the HLSC has identified five Inherent risk groups to be considered for determining the risk of unexpected losses that may crystallise in any bank:

- Credit Risk
- Market Risk
- Operational Risk
- Liquidity Risk
- Pillar 2 Risk (other than those covered above)

4.17 The net risk arising from each of the respective risk groups is computed by netting/adjusting the respective Risk control against the inherent risks. The net risk in the bank may be represented by the following equation:

$$\textbf{Risk}_{Net} = \textbf{Risk}_{Inherent} + \textbf{Risk}_{Control}$$

where,

Risk $_{Net}$ = *Net Risk* is the residual risk remaining after taking into account the mitigating effect of Risk Control measures for the corresponding risk group. This is also a measure of the probability of unexpected losses materializing in a bank

Risk $_{Inherent}$ = Measure *of* uncertainty in business operations of the bank which has the potential to translate into unexpected loss.

Risk $_{Control}$ = Measure of system and Control put in place for mitigating the Inherent risk for respective risk group component. Governance and Oversight by the management which are high level controls and cannot be attributed to any single identified risk groups and are sought to be captured using a separate template (Governance and Oversight). A *lower* **Risk** $_{Control}$ *score corresponds to a better control and governance framework for the respective risk groups.*

4.18 For the purpose, a list of factors considered for determining Inherent Risk and efficacy of Risk Control elements (using templates- indicative templates for few risk groups are enclosed as Annex) for the respective risk groups that could be used in the scorecard after applying suitable weights (The factors and weights would have to be calibrated by back testing and statistical analysis) have been identified as under:

RISK ASSESSMENT MATRIX

			Risk $_{Net}$ (85%)		**Risk** $_{OG}$ (15%)
		Weights	**Risk** $_{Inherent}$	**Risk** $_{Control}$	
Risk Group	Credit Risk	30%	70%	**30%**	**Oversight & Governance**
	Market Risk	20%	70%	**30%**	
	Operational Risk	20%	70%	**30%**	
	Liquidity Risk	20%	70%	**30%**	
	Pillar 2 Risk	10%	70%	**30%**	

Illustratively, Risk $_{Net\ (Credit)}$ = 70% **Risk** $_{Inherent(credit)}$ + 30% **Risk** $_{Control\ (credit)}$

The aggregate net risk of the bank would, therefore, be given by the following equation:

$$\textbf{Risk}_{Net(0\text{-}4)} = \textbf{0.85}\,(0.3\ \text{Risk}_{Net\ (Credit)} + 0.2\ \text{Risk}_{Net\ (market)} + 0.2\ \text{Risk}_{Net\ (Operational)} + 0.2\ \text{Risk}_{Net\ (Liquidity)} + 0.1\ \text{Risk}_{Net\ (Pillar\ 2)}) + \textbf{0.15}\,(\text{Risk}_{OG})$$

The **Risk** $_{Net}$ is determined on an ascending linear scale (from 0 to 4) from the scorecard with a minimum value of '1' for the lowest perceived risk.

Probability of failure of bank

4.19 While the overriding objective of the supervisors is to ensure that the bank is financially solvent, under the risk-based approach to supervision, it is imperative that the supervisor has some measure of the absolute/ relative probability of failure of bank in order to be able to exercise differentiated supervision. While it is theoretically possible to model and estimate the

probability of failure of banks using statistical method like Logistic regression model, in practice, it is impossible to achieve an exact estimation of default probability as the default event, in the form of bank failure suffers from lack of adequate historical data. Actual defaults of banks in the Indian context are extremely rare and poor financials have generally served as indicators to determine if the banks are financially viable or not. The supervisory actions like forced mergers /amalgamation have more often than not precluded the possible failure of banks in India.

Since the supervisor is more interested in identifying problem banks rather than in accurately measuring the exact default probability, it would suffice if the supervisor using a reasonable model is able to obtain a rough estimate of likelihood of the bank failure. Supervisor should be able to identify key explanatory parameters that are responsible for bank failure and the approximate weights that need to be assigned to these in the scorecard based model. The supervisor should also be able to construct a relative scale of default probability to be able to judge and rank the banks on the relative scale. In this context, it must be emphasised that the supervisory rating assigned to banks is essentially a measure of relative probability of failure in comparison to other banks.

4.20 The Committee is of the opinion that the key elements of the supervisory action/intervention should be based on the outcome of the risk assessment and supervisory rating exercise. The objective of the supervisory action/intervention would be to reduce the probability of failure of bank to a tolerance level as determined on the basis of supervisory comfort. In this context, it is important that under the Risk Based Approach to Supervision, the supervisor sets its risk tolerance level and also sets the supervisory benchmarks for net risk in banks, supervisory Capital (over and above the minimum regulatory capital) and also an acceptable level for probability of bank failure.

Role of Capital/ Capital Support (Available Capital)

4.21 Capital Support is the buffer available with the bank to absorb unexpected losses that may materialize in the banking books. All banks in India are required to maintain a minimum level of regulatory capital, However the supervisor, in his assessment under Pillar 2 of SREP may determine the adequacy/inadequacy of the capital held by the bank vis-à-vis the risks inherent in its business and could require the bank to hold additional capital if he determines that the risk to unexpected losses cannot be adequately covered by the available capital. Since all the risk in the bank including the Pillar 2 Risk are to be assessed using a scorecard approach, the consequent supervisory rating exercise should be able to assess the adequacy/inadequacy of the available capital and also compute additional capital (supervisory capital), if required. Thus, the Committee recommends that determination of adequacy of available capital as part of the SREP exercise could be integrated with the supervisory rating and the requirement of additional capital, if any, could be on the basis of the supervisory rating of the bank.

Supervisory Rating (indicating the probability of failure)

4.22 The risk to failure of a bank can be ascertained by adjusting the net Risk of the bank against its available capital. Though, the capital support may also be inferred in terms of available capital, sustainability of earnings and past ability to raise capital as explanatory variables, in times of distress, there is a possibility that the bank would neither be having any retained earning not be able to generate enough earnings nor would it be in a position to raise additional capital from shareholders. Further, the banks build up their capital either through retained earnings or equity capital infusion from the shareholders which are reflected in the quality/quantity of the available capital. Under these circumstances, the capital available may be considered as sole buffer available to the bank. Accordingly, the Capital Adequacy Ratio of the bank (CRAR) is to be used as a measure of the capital available(**Capital** $_{\textbf{Available}}$) and is measured on a descending linear scale (from 4 to 0) with the bank having available capital beyond a supervisor determined level of CRAR assigned a score of 0.

The interplay between the **Risk** $_{\textbf{Net}}$ and **Capital** $_{\textbf{Available}}$ for ascertaining a measure of risk of bank failure

is not well established. However, based on an empirical analysis, the relationship can be approximated by the following equation:

$$\textbf{Risk}_{\text{Failure(0-4)}} = 0.2\ \{(\textbf{Risk}_{\text{Net(0-4)}})^2 + (\textbf{Capital}_{\text{Available(4-0)}})\}$$

Using the above equation, the **Risk** $_{\text{Failure}}$ is determined on an ascending linear scale (from 0 to 4). An estimate of the probability of bank failure (this gives a relative probability) can be estimated as per single factor Logit model from the logistic distribution function by using the **Risk** $_{\text{Failure}}$ as under:

$$\textbf{RelativeProbability}_{\text{Failure}} = 1/(1+\exp\text{-}(\beta_0+\beta_1 \textbf{xRisk}_{\text{Failure(0-4)}}))$$

An indicative logit curve (Fig. 1), for estimating the relative probability of failure of the bank based on a simple model with various hypothetical scenarios (failure/survival) constructed with different values of **Risk** $_{\text{Net (0-4)}}$ and **Capital** $_{\text{Available(4-0)}}$ is as under:

The values of β_0 and β_1 [1]are – 5.832 and 3.339 respectively. The relative probabilities of failure would need to be rescaled to estimate actual default probability based on actual observations/instances of bank failure/ financial distress.

Supervisory Intervention /Monitorable action plan

4.23 The purpose of the supervisory rating exercise would be to apprise the bank about the key risk areas identified by the supervisor amongst various risk groups including their respective inherent and control parameters plus the direction/trend of the risk in each group and also overall risk. From the supervisory perspective of reducing risk in key risk groups and also bringing down the probability of failure (if falling outside the comfort level of the supervisor) of bank, the supervisor would seek to bring down the risk of failure (**Risk** $_{\text{Failure}}$) by suggesting measures aimed at either addressing specific parameters under identified risk groups (Risk $_{\text{Control}}$ and/ or Risk $_{\text{Inherent}}$) or/and mandating holding of additional supervisory capital.

$$\text{i.e . } \Delta \text{ Probability of Failure} = f(\Delta \text{ Risk}_{\text{Net(0-4)}}, \Delta \text{ Capital}_{\text{Available(4-0)}})$$

Graphically, this can be depicted as follows (Fig. 2):

Fig. 1: Estimation of Relative Probability of Failure

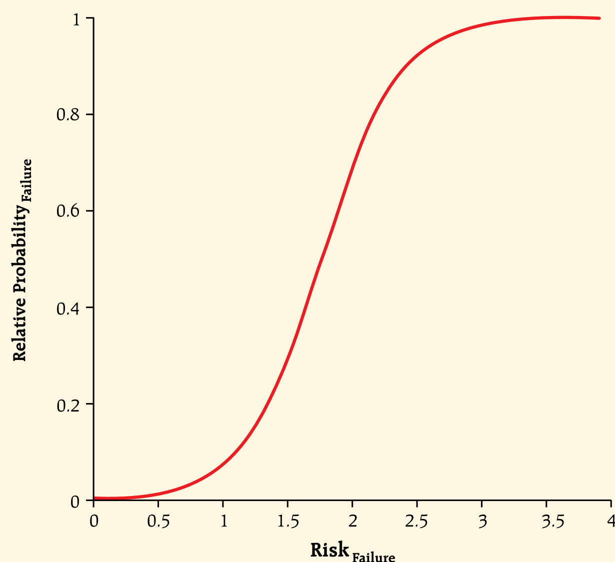
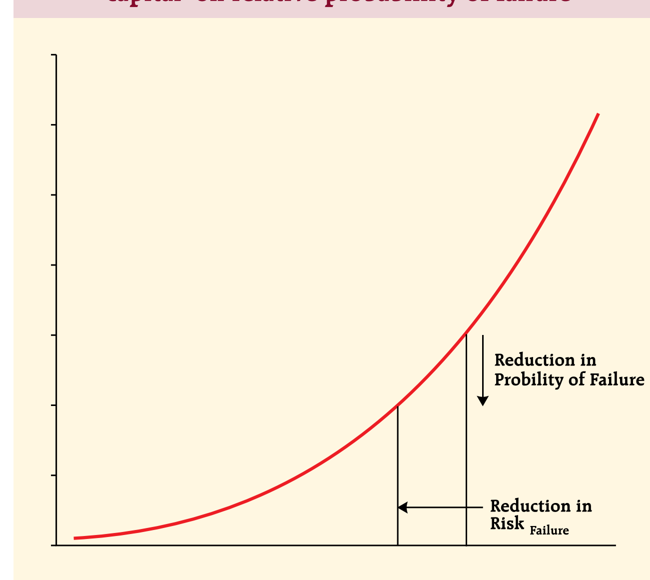


Fig. 2: Impact of Reduction in Net Risk/Increase in capital on relative probablility of failure



[1] The values of β_0 and β_1 are a function of the risk scores determined from the risk templates and the model supervisory scenarios representing a state of failure/survival built using the **Risk** $_{\text{Net (0-4)}}$ and **Capital** $_{\text{Available(4-0)}}$. β_0 and β_1 would change if the risk templates are re-calibrated.

In this context, the Committee proposes to use a matrix approach (Box 4) for determining the nature of supervisory action as under:

Box 4: Supervisory Intervention Matrix

Supervisory Rating	Δ Probability of Failure			Remarks
	Δ $Risk_{Net}$		Δ $Capital_{Available}$	
	Δ $Risk_{Control}$	Δ $Risk_{Inherent}$		
A				
B	Yes			
C	Yes		Yes	
D	Yes	Yes	Yes	PCA Framework
E				Recovery and Resolution , Merger & Amalgamation

Based on the supervisory rating, a comprehensive supervisory intervention plan for the bank would be prepared. It is important to ensure that the proposed supervisory action plan for the bank is adequate and appropriate to its assessed risks across all risk groups and would be able to address the assessed deficiencies /concerns in a demonstrable manner. The Committee is of the view that the supervisory intervention should be shared /discussed with the bank's senior management.

4.24 Supervisory Ratings

Indicatively supervisory rating of the bank determined in terms of its relative and approximate probability of failure vis-a-vis its risk of failure can be represented as under Fig 3 & 4 respectively:

Good (A): Probability of failure is well below the supervisory risk appetite. The banks which are rated as good are perceived to be healthy and would require very limited supervisory intervention.

Satisfactory (B): Probability of failure is within the acceptable supervisory risk appetite. These banks have a few risks which are of concern that could possibly be addressed by improving the risk controls. In such banks, the management, Board of directors and external auditor would be apprised by the supervisor about the potential risks that the bank faces and the specific actions required to correct these deficiencies.

Unsatisfactory (C): The bank would have a probability of failure marginally higher than the supervisory comfort. Along with improving /tightening risk management and controls, the banks would also need additional capital to bring down the probability of failure within the supervisory comfort zone. The risk mitigation plan prepared by the supervisory team would need to be closely monitored for compliance by the bank.

Poor (D): The bank has a high probability of failure and would need to not only raise additional capital but also restructure its business to bring down the inherent risks in the business. The banks with a 'D' rating would be placed under the PCA framework and their compliance with the mandated supervisory action plan

Fig. 3: Rating of banks based on Relative Probability of Failure

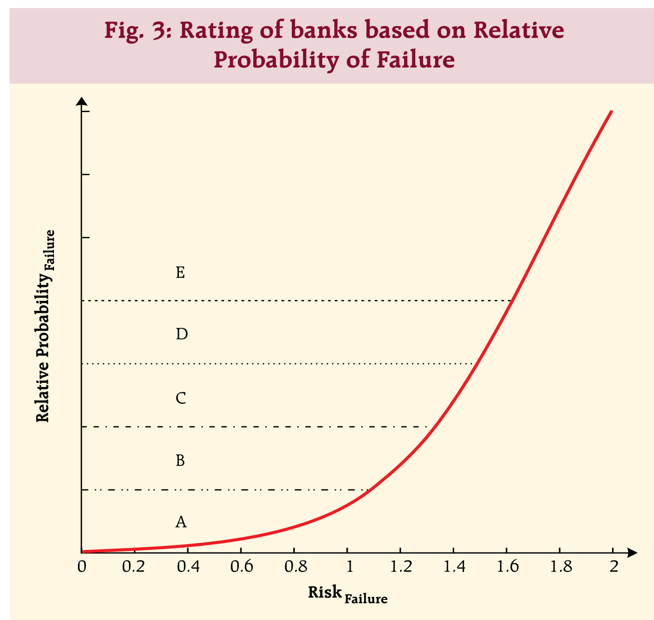
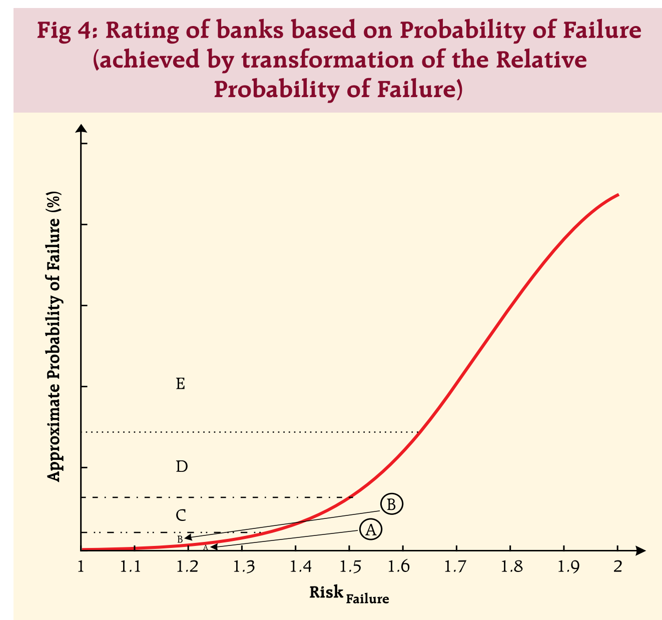


Fig 4: Rating of banks based on Probability of Failure (achieved by transformation of the Relative Probability of Failure)



would need to be monitored on a monthly basis. The intervention could be in the form of instructions / directions to the management and the board of directors to consider options such as restructuring the bank or seeking a prospective partner for merger, amalgamation or takeover. The risk mitigation plans in such banks would need to be continuously monitored for compliance.

Very Poor (E): The bank with this rating is no longer a viable entity and would need to be wound up or merged/amalgamated with another bank. The supervisory action would entail taking over management control of the bank and also finding a suitable merger proposal or putting the bank under an orderly resolution process.

Disclosure of Rating

4.25 All supervisory information including the supervisory rating is highly confidential. A bank's supervisory rating is to be known only to the bank's senior management and the concerned supervisory officials. While the supervisory rating is confidential and not disclosed to public even on a lagged basis, the public may infer the nature of supervisory information on bank's health based on subsequent actions or disclosures by banks.

4.26 Deliberating on the need to publicly disclose the findings of the rating exercise, the members are unanimous that such information about banks with poor rating would have a direct bearing on the public perception and could lead to a run on them. The Committee observed that in line with its depositor protection objective, if the supervisor is convinced that the bank is not capable of meeting its depositor liability, he would place the bank under moratorium which would anyway be public information. In view of the above, the Committee is of a considered opinion that supervisory rating should not be made public. This recommendation is in line with the extant international supervisory practices.

CHAPTER 5

CONSOLIDATED & CROSS-BORDER SUPERVISION

5.1 Introduction

5.1.1 In India, banks can undertake certain eligible financial services or para-banking activities either departmentally or by setting up subsidiaries. Under the provisions of Section 19(1) of the Banking Regulation Act, 1949, banks may, with the prior approval of RBI form subsidiary companies for undertaking various types of banking business which they are otherwise permitted to undertake[2], for carrying on the business of banking exclusively outside India and for such other business purposes as may be approved by the Central Government. During the last two decades, a host of non-banking activities like Mutual Fund, Insurance, Pension Fund, Housing Finance, Depositories, Merchant Banking, Primary Dealer, Payment Services etc. are being undertaken by banks in India. While some of these activities can be undertaken departmentally by the bank, the extant regulations necessitate floating of separate subsidiaries by banks to undertake Insurance, Securities and Pension Fund activities.

5.1.2 While the group entities are generally a source of strength since they enable diversification of revenue and income streams they may also prove to be a source of weakness adversely affecting the financial condition, reputation and overall safety and soundness of the bank as witnessed during the recent financial crisis. One of the lessons for supervisors globally has been on laying renewed focus on Consolidated Supervision of bank groups. The consultative document of Core Principles, BCBS[3] has significantly enhanced the role of supervisors for effective supervision of the banking group on a consolidated basis. The group-wide approach to supervision of "banking group" has been expanded to include non-bank (including non-financial) entities, if relevant, along with holding company, bank and its offices, subsidiaries, affiliates and joint ventures, both domestic and foreign.

Present Approach to Consolidated Supervision

5.1.3 Consolidated Supervision is defined as "an overall evaluation (qualitative as well as quantitative) of the strength of a group to which the bank belongs." The supervisor's purpose in consolidated supervision is not to supervise all the companies in a group containing a bank but to supervise the bank (or supervised institution) as part of the group and assess the potential impact of other group companies on the bank. Thus, it is a group-wide approach to supervision where all the risks run by a banking group are taken into account. The approach to consolidated supervision has two components: *Quantitative and Qualitative*.

5.2 Consolidated Supervision in India

5.2.1 Based on the recommendations of the Multi-disciplinary Working Group[4], the Consolidated Supervision framework has been in place in India with three key components:

- Consolidated Financial Statements (CFS): All banks coming under the purview of Consolidated Supervision of RBI are required to prepare and disclose Consolidated Financial Statements in addition to solo financial statements.
- Consolidated Prudential Reports (CPR) for supervisory assessment of risks which may be transmitted to banks (or other supervised entities) by other group members and
- Prudential limits relating to capital adequacy, large exposures/risk concentration and liquidity risk management on a consolidated bank basis.

[2] Under clauses (a) to (o) of sub-section 1 of Section 6 of the Banking Regulation Act, 1949

[3] Core Principles of Effective Banking Supervision (Principle 12: Consolidated supervision) , Basel Committee of Banking Supervision (BCBS), March 2012

[4] Working Group on Consolidated Accounting and Other Quantitative Methods to Facilitate Consolidated Supervision(Chairman: Shri Vipin Malik), December 2001

Quantitative Supervision

5.2.2 **Consolidated Reporting:** As per the RBI guidelines, Consolidated Financial Statements is 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). The CFS normally includes consolidated balance sheet, consolidated statement of profit and loss, Principal Accounting Policies, Notes on Accounts, etc. and is publicly disclosed. The Consolidated Prudential Reports (CPR) comprise of Consolidated Balance Sheet, Consolidated Profit & Loss Account, and select data on financial/ risk profile of the consolidated bank. For the purpose of preparation of CPR, the consolidation excludes group companies which are engaged in: (a) insurance business and (b) businesses not pertaining to financial services. The bank also discloses maturity wise distribution/ analysis of assets and liabilities on a consolidated basis in the CPR. Additionally, certain prudential limits on Capital Adequacy, large exposures and liquidity are also prescribed.

Qualitative Supervision

5.2.3 In addition to the above quantitative norms, as part of RBI's guidelines to the banks on para-banking activities, certain qualitative norms have also been mandated for the parent bank. These include evolving appropriate strategies on:

- Maintaining an "arms length" relationship with the subsidiary /mutual fund sponsored by the bank in regard to business parameters
- Periodic review of the working of subsidiaries by the Board of Directors of the parent/sponsor bank and
- Periodic inspection/audit of the books and accounts of the subsidiaries

Supervision of Large and Complex Banks

5.2.4 The Consolidated Supervision framework for bank groups in India at present can be broadly classified into two categories:

(i) The framework for all banks having subsidiaries;

(ii) The framework for select Large and Complex Banks (LCB) which are systemically important.

While the quantitative supervision framework is applicable to all the banking groups (both i and ii) some of the qualitative aspects of supervision have been specifically mandated for only (ii). Incidentally, some of these LCB are also classified as Financial Conglomerates (FC). Further, based on criterion of size, interconnectedness, substitutability and extant of overseas operation and also owing to their importance from the perspective of systemic stability, some banks have been identified for close and continuous monitoring. The offsite and onsite supervision of these banks is conducted at the the central office level of the Department of Banking Supervision.

Supplementary Qualitative supervision for LCB/FC

5.2.5 In addition to CPR, the banks considered as large and complex are also mandated to submit a quarterly offsite Return. The Return, presently received outside the OSMOS system is designed to identify and track the following aspects within a banking group:

- Large intra-group transactions and risk concentrations in major financial markets
- Adherence to arms length principles
- Build-up of any disproportionate intra-group exposure (both fund based as well as non- fund based) amongst group entities
- Group-level concentration of exposure to various financial market segments and counterparties outside the group
- Group entities with deteriorating financials and large risk concentrations and
- Information on adverse events such as fraud, penalty/ strictures etc levied/ passed by regulators/ courts/ administrative agencies etc.

5.3 Views of the Steering Committee

General

5.3.1 Over the last two decades, the banks have increasingly looked to diversify their revenue streams by venturing into non-banking activities exposing themselves to new risks. Against this back drop, it is imperative for RBI, as the lead supervisor of the banking groups, to supervise such a bank not only as a solo entity, but also on a consolidated basis. The Committee has deliberated on the adequacy of the supervisory approach to consolidated supervision of banks in India and is of the view that though adequate regulations and policy are in place, the process of consolidated supervision needs enhanced focus. The committee is of the view that the consolidated data and reports being gathered as part of CPR needs to be effectively utilized and recommends that along with the data for solo banks, the consolidated data should be adequately used for offsite analysis of banking groups.

5.3.2 The committee also notes that though many of the banks have more than one subsidiary /associate, their group structure is fairly simple. Further, many banks have sponsored one or more Regional Rural Banks (RRB) which are their only group entities. In this regard, the Committee is of the view that for smaller bank groups having limited intra-group transactions, wherein the parent bank has either only RRBs as subsidiaries or the combined assets of subsidiaries is less than 10% of the groups consolidated assets, the Consolidated Supervision may be limited to monitoring adherence to quantitative regulatory norms and monitoring of contagion or concentration risk. However for other larger banking groups with significant non-banking activities and important from systemic viewpoint, the extant framework for Consolidated Supervision needs to be strengthened. Thus, the Committee recommends a differentiated approach to Consolidated Supervision with more focused attention to large and complex banking groups.

5.3.3 The Committee notes that as per the extant guidelines the banks are required to prepare their annual ICAAP documents on a group-wide basis. Thus, the supervisor while conducting SREP exercise as part of Pillar 2 Supervisory Review would be in a position to assess the strength of the bank not only on a stand-alone, but also on a group-wide basis. In conformity with the overall objective of preparing the supervisory framework for bank towards risk based supervision, the Committee recommends having a risk focused approach to consolidated supervision. To begin with, large and complex bank groups may be considered under this approach.

5.3.4 As the lead supervisor of banking groups, in addition to supervision of the parent bank on a solo basis, RBI is also interested in prudential supervision of the group as a whole. In this regard, the Committee considers it appropriate that the RPT for the bank, in addition to capturing the risks from the parent bank, should also adequately capture the risks arising out of non-banking entities in the group. Further, during the supervisory assessment of the Group risks and formulation of appropriate supervisory response as part of consolidated supervision, impact analysis of potential risk arising from the material entities of the group should be conducted.

Specific views on:

Group Capital Adequacy

5.3.5 A key area of concern for the supervisors in Consolidated Supervision is capital adequacy. A regulatory inconsistency/difference could lead to 'double gearing', where the same capital, issued by the parent, may be counted twice. Another consequence could be in the form of 'excessive leveraging', whereby the debt issued by the parent could be down-streamed as equity to other subsidiaries. The supervisor should be able to assess the minimum capital (prudential capital) that a group should hold and also the eligible capital that the supervisor would recognize for capital adequacy purpose. Further, the banking group would be expected to hold a surplus capital over the eligible capital to ensure that the eligible capital does not fall below the required capital. This capital should also be able to cover the unexpected losses that may arise due to risks which have not been factored for capital adequacy purpose. The materiality of any group entity may be determined by considering the significance on group's capital and financial position including the

potential risks for significant loss. Further, while determining materiality of the entity, the above principles may be subjected to the following quantitative cut-off test:

- Individually the entity constitute more than 5% of the consolidated group; and
- The aggregate of the material entities constitute not less than 90% of the consolidated group.

The RRBs, however, need not be subjected to this materiality test.

5.3.6 The group should prepare and have in place a capital management plan with appropriate systems and processes to identify, measure and manage risks arising from activities of the group entities (including non-regulated) under both normal and also stressed conditions. Often the surplus capital available within the group may not be freely transferable, due to extant legal and regulatory norms. Thus, while assessing the capital adequacy of the banking group the supervisor would also need to assess the level of freely available 'surplus' capital.

Understanding Group structure and business

5.3.7 The structure of a banking group can be fairly simple wherein the bank is the parent or very complex wherein the bank is itself a part of another larger group. While most of the domestic banks in India have a fairly simple structure with the bank being the parent, some of the banking groups have resorted to cross-holding amongst group entities making their structure fairly complex and opaque. The presence of step-down subsidiaries, if any, further complicates the group structure. A thorough understanding of the group's governance, operation and legal structure including the business lines, risk management and control is, thus, essential for any supervisor. While some information may be publicly available the Committee is of the opinion that the supervisor should develop clear understanding of the group structure and share holding pattern along with major lines of accountability within the group.

Governance

5.3.8 A banking group is not a legal entity but a business enterprise in which the legal entities operate as a group under the parent bank to execute a business strategy. The business model envisages certain common and consolidated business initiatives through joint and/ or concerted resource mobilisation for the group and for each legal entity within the group. The objectives of establishing 'fit and proper' norms for groups is to ensure that the supervisors are able to determine whether the entities are soundly and prudently managed and directed and whether key shareholders are a source of weakness to those entities. Some key parameters on which the supervisor may assess the effectiveness of Governance include: (i) Competence of senior management; (ii) Strategies and policies; (iii) Internal control and audit including group wide oversight; (iv) Internal risk management structure; (v) Policy on Conflict of interest; (vi) Transparency and Public Disclosures.

Group Risk Management

5.3.9 Theoretically, the benefits of conglomeration include potential risk-reducing gains from geographic and product diversification and gains from potential cost synergies[5]. The group, by transferring risks from one corporate entity to another in which that risk may either be managed more efficiently or through geographic and product diversification tries to achieve risk-reducing gains. However, a poor group-wide risk management structure could easily offset the gains of risk-reducing through diversification. In this context, group risk management plays a key role. While assessing the group-wide risk, the supervisors should primarily focus on the following:

- Board and Management oversight of group-wide risk management;
- Risk identification and measurement process;

[5] Consolidated Supervision: Managing the Risks in a diversified Financial Services Industry, June 2001, IMF

- Groups internal control mechanism and effectiveness thereof; and
- Integration of risk management with management objectives.

Intra-group Transactions

5.3.10 Supervisory concerns may arise when intra-group transactions and exposures (ITEs) have potential for negatively impacting the parent bank. Another source of concern is that ITEs provide avenues for "contagion", the danger of which increases when the group uses multiple gearing and excessive leveraging. The supervisor must, thus, assess the appropriateness of the significant ITEs on the following parameters:

- Capital or income being inappropriately transferred from the bank;
- Whether the ITEs are at arm's length and not disadvantageous to the bank;
- Impact on solvency, the liquidity and the profitability of individual entities within a group;
- Scope for supervisory arbitrage.

Liquidity Management

5.3.11 Banking groups could adopt a variety of structures for managing liquidity risk that range from highly centralised to highly decentralised. The decision on an appropriate structure for liquidity management could be based on considerations of efficiency, minimisation of funding costs, diversification of funding sources, technology systems in place for ALM , feasibility of moving funds and collateral and also taking into consideration regulatory and legal aspects impacting cross-border /sectoral flows of funds.

5.3.12 The liquidity risks which a group entity may be potentially exposed to, can be broadly categorized under following three types: (i) Funding mismatch risk; (ii) Market liquidity risk; (iii) Contingent liquidity risk. For appropriate management of liquidity risk at a group-level, the group should formulate a liquidity management framework covering significant group entities from liquidity perspective. In this context, it would be desirable if a uniform approach towards liquidity management principles across the entire group is adopted. Also, material entities of the group from liquidity perspective should conduct a stress test at periodic intervals, factoring in the entities' business models and environmental risks. The results of such liquidity stress test should be reviewed by an appropriate committee at entity level and also reviewed by the parent on an annual basis.

5.4 Cross - Sector Supervision (Domestic)

Legal Challenges in supervision of non-bank group entities

5.4.1 A fundamental problem facing supervisors in Consolidated Supervision is their limited rights in accessing prudential information on those parts of the group which they do not supervise. There is no legal basis for undertaking a supervision /regulation of a banking group. In essence this means that within a banking group, the RBI cannot seek information from the Insurance /Securities entities either directly or through their sectoral supervisors (IRDA/SEBI) in the event of undesirable developments in the group. This limitation is more pronounced in Consolidated Supervision of large banking groups which have significant presence in non-banking activities wherein the parent bank is exposed to risks arising out of material group entities. The regulators have tried to work around this handicap by instituting high level forums for exchange of supervisory information. Some form of group wide monitoring is also being undertaken by calling for financial information about the subsidiary through the parent bank. However, these arrangements are only informal and do not have any legal sanctity. In this context, the Working Group on Introduction of Financial Holding Company (FHC) Structure in India (Chairperson: Shyamala Gopinath, May, 2011) has recommended FHC model under RBI's regulation as a preferred model for the financial sector in India. Since, the success of Consolidated Supervision framework is incumbent upon gathering/analysis of financial information of the group entities, there is thus a need to formalize the information sharing arrangements between the RBI on one hand and the bank on the other; and amongst the regulators. In this connection, it may be mentioned that the proposed amendment to

the Section 29 of the BR Act, 1949, seeks to empower RBI to gather information on the subsidiaries of the banking companies.

Supervisory Co-operation & Information Sharing Mechanism

5.4.2 As part of inter-regulatory cooperation, an informal arrangement amongst the financial sectors regulator existed in the form of a High Level Coordination Committee on Financial Markets (HLCCFM). The functions of the HLCCFM have since been subsumed by a formal body of Financial Stability Development Council (FSDC), with representatives of Government, RBI, SEBI, IRDA and PFRDA as members. Along with systemic stability and financial inclusion, monitoring of large FCs is one of the mandates of FSDC. A broad framework and modalities for FC monitoring is presently under consideration by the sub-Committee of FSDC.

5.4.3 The Joint Forum[6], BCBS has spelt out the norms for identification of Group-level supervisor (Lead Supervisor) with clearly delineated responsibility for ensuring effective and comprehensive group-level supervision, including a coordination process. Further, effective implementation of FC supervision, the role of the supervisors has been spelt out as under:

- Clarity in objectives and responsibilities of each supervisor for effectiveness of FC supervision
- Arrangements for information flows and coordination
- Measures to enhance coordination to enable effective group-wide supervision, including sharing of information
- Establish appropriate coordination mechanisms to exchange possible cross-sectoral and cross-border exposures to each other
- Develop, implement and maintain coordination arrangements for normal and stress situations
- Have confidentiality arrangement for information received from other supervisors keeping in view the extant legal provisions and
- Arrangements for resolving differences between supervisors.

5.5 Views of the Committee

5.5.1 Due to the presence of multiple regulators in the financial sector, supervisory cooperation amongst the sectoral regulators has been necessitated from the perspective of preventing "supervisory arbitrage", undertaking effective Consolidated Supervision and maintaining systemic stability. It, therefore, becomes imperative for the sectoral supervisors to appreciate their specific roles and responsibilities in supervision of a material part of a bigger financial group. The Consultative document of the BCBS has included "Cooperation and collaboration"[7] as a separate Core Principle with emphasis on cooperation, including analysis and sharing of information, and undertaking joint work, with all domestic supervisors. To facilitate flow of information and have a coordinated approach towards issues of concern, the Committee suggests that a mechanism of structured exchange of information and cooperation be developed amongst the sectoral supervisors. An arrangement through a formal MoU is desirable.

5.5.2 Presently, the Consolidated Supervision of FCs is being undertaken through a mechanism of "lead regulator", wherein the respective sectoral regulator of the "parent entity" of the group is also responsible for the consolidation supervision of the group. The Committee if of the opinion that such an institutional arrangement with FSDC at the apex level for coordination amongst regulators and periodic meetings with FCs is adequate in the Indian context. However the level of coordination amongst regulators for effective FC supervision would need to be enhanced under the aegis of FSDC. Further, to address the issues of systemic stability due to the operations of FCs, an integrated approach to collection of supervisory data of systemic

[6] Principles for the supervision of financial conglomerates, Consultative document, December 2011, Joint Forum, BCBS

[7] Principle 3: Cooperation and collaboration, Core Principles for Effective Banking Supervision, Consultative Document, December 2011, BCBS

importance (like intergroup financial transactions amongst FC) would be desirable.

Recovery and resolution mechanism

5.5.3 The objective of an effective recovery and resolution regime for banks is to make feasible the resolution of banks without severe systemic disruption and resorting to taxpayer support of banks. While, a recovery plan is prepared by the bank identifying options to restore financial strength and viability when the bank comes under severe stress /financial loss, the resolution plan is intended to facilitate the effective use of resolution powers entrusted in the supervisor to determine a detailed roadmap to resolve a failed financial institution without severe disruption and resorting to government bailouts.

5.5.4 The Committee while deliberating on the issue has taken note of the importance of an effective Recovery and Resolution Plan (RRP) in India. After the Financial Crisis in 2008, the RRP have received increased international attention. The FSB has also placed a discussion paper for future implementation amongst its members. Against this backdrop, the Committee has noted that in future, India too will be obligated to initiate necessary changes in the legislation and regulations for Indian banks and also internationally active foreign banks in India and resolution plan of their parent to align them with FSB recommendations. The Committee notes that resolution planning has major connotation on financial stability considerations and thus the FSDC could be the appropriate forum. However, as the initial point of contact with bank, it is incumbent on the part of the supervisor to be sensitive to the need of having and ensuring the operational capability and effectiveness of any RRP as per the extant legal /regulatory provisions. In view of the importance of RRP, the Committee is of the view that a separate group may study the aspects in depth.

5.6 Cross- Border (Overseas)

5.6.1 An essential criterion for the host country in permitting cross-border banking operations is the efficacy of the home supervisor practices on global consolidated supervision. To be able to undertake effective cross-border supervision, it becomes imperative that the home supervisor develops an agreed communication strategy and put in place information sharing arrangement on reciprocal basis with host supervisor. Underlining the importance of Home-host relationship in cross-border supervision, the consultative document of Core Principles, March 2012 (Principle 13: Home-host relationships) of Effective Banking Supervision issued by the Basel Committee of Banking Supervision (BCBS) has stated: "Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks."

Operations of Foreign banks in India

5.6.2 Foreign banks in India have been operating as branches of international bank /banking group and are thus not required to prepare CFS under Accounting Standard 21 (AS 21). However, they submit CPR consolidating the NBFCs with the bank's Indian operations. Further, prudential norms as prescribed under CPR are also applicable to foreign banks. While accounting consolidation of foreign bank's associates/ affiliates and sister concerns are not feasible due to their corporate structure, supplementary Consolidated Supervision for three large and complex foreign banks is being done.

5.6.3 Although a large number of foreign banks have presence in India, a vast majority of them have less than two branches. Some of these banks however have substantial off-balance assets which make them significant from a supervisory standpoint. Few of these banks are considered large and complex and are subject to close and continuous supervision. RBI has been giving 'no objection' on reciprocal basis to overseas supervisors to inspect branches of home country banks operating in India. RBI supervisors have also been attending the supervisory colleges of some of the big global banks /banking groups on invitation from the home country supervisors.

Overseas operations of Indian banks

5.6.4 Over the years, a large number of Indian banks have established sizeable overseas presence through branches, subsidiaries, joint ventures and representative offices network. United Kingdom, Hong Kong, Singapore, United States of America, UAE and Bahrain in Middle East account for a sizeable share (83.81%) in the total assets of Indian banks deployed in overseas centers. While the average percentage of overseas assets to total Global assets of these Indian banks is around 10%, for a couple of banks this ratio is higher than 20% indicating significant international presence.

5.6.5 The system of off-site supervision of the overseas branches of Indian banks by RBI is broadly on a pattern similar to those applicable to bank's domestic operations. The banks are required to furnish information on exposures to borrowers, for liquidity and for country risk management in addition to financial information on overseas operations of the bank under OSMOS. In addition to these structured returns, information on overseas frauds, defaults, regulatory observations, business environment, audit, credit and control areas are reported in unstructured form (outside OSMOS system).

5.6.6 While the overseas operations of Indian banks operating abroad are guided by the host country's regulations, RBI intermittently undertakes onsite inspection of overseas branch/ subsidiaries subject to permission from the host regulator. The cross border operations of Indian banks have expanded significantly during the last few years. RBI has recently started entering into MoUs with overseas banking supervisors for facilitating effective cross-border supervision.

Supervisory Colleges for Indian Banks

5.6.7 In India, at present no supervisory colleges have been set up for any bank/ banking group. However, RBI has been attending the supervisory colleges of some of the major foreign banks operating in India whenever invited by overseas Supervisors/ Central Banks.

5.6.8 Supervisory Colleges as a form of supervisory tool for information sharing are operational in many jurisdictions. The primary objective of a supervisory college is to assess and develop an understanding of the risk profile of an international banking group of which the home supervisor is also the lead supervisor. As the consolidating supervisor, the home supervisor has the largest stake in effective functioning of the supervisory college. Over time, the supervisory colleges have also developed as a forum for broader issues such as discussions and planning of supervisory assessments and sharing information about the overall risk assessment of banking entities as well as the banking group. The BCBS[8] stated that the objective of Supervisory Colleges should be to "enhance information exchange and cooperation between supervisors to support the effective supervision of international banking groups. Colleges should enhance the mutual trust and appreciation of needs and responsibilities on which supervisory relationships are built".

5.7 Views of the Committee

5.7.1 The overseas operations of Indian banks are supervised by the respective national supervisors. While there has been a conscious and ongoing effort on part of supervisors of major economic jurisdictions to align their supervisory practices with the global best practices, some of the overseas jurisdictions where the Indian banks are operational may are 'perceived' to have less stringent supervisory framework than existing in India. As the home regulator, it thus becomes incumbent upon RBI to keenly assess the extant supervisory regimes in such jurisdictions and require the Indian banks to establish comprehensive risk management guidelines for their overseas operations and meticulously observe them so as to guard against greater supervisory and economic risks.

5.7.2 Notwithstanding the supervision by the host country, RBI as the home supervisor will not be able to have a comprehensive view of the bank's operation without an on-site examination of some of the branches and subsidiaries whose operations pose a higher risk

[8] Good practice principles on supervisory colleges, October 2010, BCBS

to the overall soundness of the parent bank in India. The Committee also notes that in respect of some of the Indian banks, the capability and expertise of the Boards of Directors and Top Managements for assessing the international operation of banks is limited. In this context, the findings of onsite supervision of bank's operations would provide valuable insight and inputs for the board of the bank and improving their risk management. Also, the supervisor would be able to have a better assessment of the overseas risk on the parent bank. Such exercise also exposes the supervisory staff to the extant supervisory environment in other jurisdictions.

5.7.3 In accordance with the BCBS Principles (October 1996), a formal arrangement for supervisory cooperation with overseas supervisors through a Memorandum of Understanding (MoU) is considered essential. The terms and conditions of the MoUs entered into by RBI with host country supervisors would determine the supervisory approach and the focus on overseas operations of globally active Indian banks. In this context, the Committee notes that the current process of RBI entering into MoUs with overseas bank supervisors is desirable and needs to be pursued further.

5.7.4 The growing global activities of some of the large Indian banks have necessitated putting in place a formal mechanism of supervisory cooperation and information exchange with host supervisors for effective cross-border Consolidated Supervision. The Committee thus recommends setting up of supervisory colleges in respect of large globally active Indian banks having significant (Say 15%) share of assets from foreign operations as a percentage of total assets.

CHAPTER 6

INSTITUTIONAL STRUCTURE AND HUMAN RESOURCES

Corporate Governance in Banks

6.1 Introduction

6.1.1 According to Organization for Economic Co-operation and Development (OECD), the Corporate Governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as the board, managers, shareholders and other stakeholders as well as spells out the rules and procedures for making decisions on corporate affairs. Advisory Group on Corporate Governance under the chairmanship of Mr. R. H. Patil defined corporate governance as the system by which business entities are monitored, managed, and controlled.

6.1.2 The Board and Top Management of a bank are the first line of defense for the material risks that face a bank. World over, there has been a growing recognition that the risk management framework and processes alone may not be sufficient to control the risks in a bank unless there is an effective corporate governance system in place. While the Board and Management of a bank are responsible for good governance and performance of the bank, it is the supervisor's role to assess and ensure that banks follow good corporate governance practices. Recognizing the importance of corporate governance as a key to effective supervision, the Basel Committee on Banking Supervision (BCBS) in its guidance note of October 2010 recommended: *"Supervisors should regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles."*

6.1.3 The BCBS has identified six key areas of corporate governance in banks indicating the best practices standards for banks on these parameters for greatest supervisory focus and attention. The six key areas include: (i) Board practices; (ii) Senior management's accountability; (iii) Risk management and internal controls; (iv) Compensation; (v) Complex or opaque corporate structures and (vi) Disclosure and transparency.

6.2 Evolution of Corporate Governance of Banks in India

6.2.1 In the pre-reform era wherein the public sector banks were dominant with relatively few private banks, there were very few regulatory guidelines covering corporate governance of banks. However, in the post reform era, the government shareholding in public sector banks was diluted and a larger number of private sector banks entered the banking arena. Due to competition faced from private sector banks, the public sector banks were accorded larger autonomy with bigger responsibility. With the Board being given the flexibility to draw up their own business plans, it became imperative for the board members to be more knowledgeable and be professionally aware of policy choices.

6.2.2 A general overarching corporate governance structure is stipulated particularly in respect of the listed companies. Clause 49 of the Listing Agreement put out by SEBI, deals with the corporate governance aspect for the listed companies and cuts across all sectors in India. In addition, extensive sectoral guidelines are in place for the banking companies in the form of statutory provisions under the Banking Regulation Act, 1949. The recommendations of Dr. Ganguly Committee on corporate governance also served as regulatory framework on corporate governance for banks.

6.2.3 Some of the other measures initiated by the Reserve Bank to strengthen the corporate governance in the Indian banking sector include:

- Distancing the regulator from the functioning of the Boards (Reserve Bank has withdrawn its nominee directors from almost all the private sector banks);

- Legislative amendments in regard to the public sector banks to remove the provisions for mandatory nomination of RBI officers on their boards;
- Sensitized the Government to keep in view the policy framework for governance in private sector banks while deciding on the appointment of the directors on the Boards of public sector banks and constitution of various committees of the Board;
- Established a uniform regulatory framework for public and private sector banks by reviewing existing instructions specifically applicable to the public sector banks; and
- Enhanced RBI's capacity to ensure sound governance especially relevant to the banks, consistent with global best practices by several amendments to the Banking Regulation Act, 1949.

6.3 Supervisory Concerns on Corporate Governance

Fit and Proper Criteria for Nominee Directors, CEOs

6.3.1 Though the extant criteria stipulated specific areas of background (such as accountancy, banking, economics, finance, agriculture, etc) that a Board of director should be drawn from, it does not specify the extent or degree of professionalism or expertise required in regard to that area. There is no legal provision as of now for the Reserve Bank to insist on the 'fit and proper' for the directors nominated by the government or elected by the shareholders to the Boards of the public sector banks. The appointment of the CEOs in the public sector banks, as well as their removal, is solely under the discretion of the Government.

Splitting the Posts of Chairman and CEO of Banks

6.3.2 With a view to bringing about transparency and efficiency in the working of the Board and Senior Management of banks, Ganguly Committee had recommended bifurcation of the posts of the Chairman of the Board and the CEO of the bank. Since 2007, the Reserve Bank has implemented this recommendation in all the private sector banks. Ganguly Committee recommendations to this effect have also been echoed by the aforesaid BCBS paper titled, 'Principles for Enhancing Corporate Governance' put out in October 2010.

Compensation

6.3.3 It is generally accepted that the flawed and perverse compensation structures for banks' top management in the advanced economies were one of the significant drivers for the 2008-09 economic crisis. The prevalent compensation structures rewarded bank management which was able to generate greater profits at the expense of overlooking hidden risks. The Financial Stability Board (FSB) has since evolved a set of principles to govern compensation practices and the Basel Committee has developed a methodology for assessing compliance with these principles. The proposed framework involves increasing the proportion of variable pay, aligning it with long-term value creation and instituting deferral and claw-back clauses to offset future losses caused by the executive. The Reserve Bank has the power, in terms of the Banking Regulation Act, 1949 to regulate board compensation, including the pay and perquisites of the CEOs of private sector banks. In evaluating compensation proposals for whole-time directors and CEOs of private sector banks, the Reserve Bank is guided by relevant factors such as the performance of the bank, compensation structures in the peer group, industry practices and regulatory concerns, if any. As regards bonus, the Reserve Bank from time to time, has issued guidelines restricting levels of bonus to be paid to them and to other employees of the bank in respect of whole-time directors and CEOs. Post-crisis, responding to a public voice on the need for reform the Reserve Bank in January 2012 issued guidelines on 'Compensation of Whole-Time Directors /Chief Executive Officers /Risk-Takers and Control Staff', which proposed that banks should have a compensation policy in place to align compensation structures with prudent risk taking and institute a claw-back mechanism. These guidelines are for implementation by private sector and foreign banks from the financial year 2012-13.

Conflicts of interest

6.3.4 Conflicts of interest may arise as a result of the various activities and roles of the bank or between the interests of the bank, its customers, board members or senior managers. Conflicts of interest may also arise when a bank is part of a broader banking group. It thus becomes imperative that the board ensures that policies are in place to identify and mitigate potential conflicts of interest. To achieve transparency in this process, the Committee is of the view that the board should have a formal written **conflicts of interest policy** and an objective compliance process for implementing the policy.

Succession Planning

6.3.5 Succession planning is key to business continuity for any organization, especially for commercial and corporate entities such as a bank. Grooming future leaders is a process which often needs time and investments by the organization. At some point in the future a successor will be required to continue the management of the organization. Plans for succession should consider a variety of scenarios, such as a CEO's retirement at an appropriate age, a CEO's decision to leave and give notice, medical or other emergency (illness or temporary absence of CEO) or untimely death. The board should develop a pool of prospective replacements by identifying, talents and leadership potentials at an early stage and groom them. In this context, the Board and top management can play an important role in ensuring smooth transitioning and succession. Nepotism, favouritism and biases are detrimental to professional bodies particularly in banks which are not only reposed with shareholders' but also depositors' trust. While orderly succession can be planned well in advance, often the Boards of banks are not prepared to handle crisis situations wherein most of the Top Management functionaries resigned /leave enmass. The new incumbent is often clueless to most of the ills which the previous management would have perpetrated and thus is disadvantaged in taking remedial measures. Such situations have come to fore during the 2008-09 Crisis in some jurisdictions. A case of mismanaged succession also happens when supercession of some of the senior management causes their exodus due to dissatisfaction with the succession change.

6.4 Views of the Committee

6.4.1 On the role of a bank's board, members of the Committee are unanimous in their view on the predominant role that the Board of directors of the banks should play in the risk management of the bank. The Committee is of the view that a bank's board is the first line of defense against any threat of material risk and irrespective of risk management framework and risk control structures that may be in place, it is the willingness of the board and senior management to act and their effectiveness which can efficiently remedy the adverse situations.

6.4.2 On the issue of separating the posts of Chairman of the board and CEO the Committee is of the view that given the positive experience in India as well as the global endorsement for this position, the natural course of future actions would be to see if similar separation of the posts of chairman of the board and the CEO could be extended to public sector banks. An important criterion for enforcing the same would be the extent to which strict eligibility criteria for the position of the chairman of the board of a public sector bank can be laid down and enforced.

6.4.3 On succession planning, the Committee recommends that the supervisory assessment of banks' governance on this aspect should be proactive, intermittent and specific with realistic suggestions.

6.4.4 Unlike corporates, the failure of a bank has ramifications not only amongst the shareholders, but also the depositors. The scourge of contagion and its ramifications for the entire financial system and the economy further compounds the impact of its failure. Considering the inter-linkages with the financial system, the responsibility for depositor protection through sound and effective corporate governance becomes paramount in efficient functioning of the banking system.

6.4.5 In emerging economies like India, banks are more than mere agents of financial intermediation as they carry the additional responsibility of leading

financial sector development and of driving the government's social agenda. Besides, the institutional structures that define the boundaries between the regulators and the regulated and across regulators are still evolving in emerging economies. Managing the tensions that arise out of these factors makes corporate governance of banks in emerging economies even more challenging. In the light of the foregoing, the Committee is of the view that corporate governance can be considered effective only if board and senior management in banks pass the fitness, suitability and appropriateness tests and are further supported by robust and active risk management and internal control functions. The safety and soundness of a bank is thus driven by the triad – corporate governance supported by effective risk management and internal control system. Hence the Committee recommends the following agenda for the supervisor to ensure that the above-mentioned triad is strengthened in the banks:

(i) Supervisor must assess bank's Corporate Management structures and practices together with its Risk Management as integral parts and not in isolation to establish that risk management functions are in alignment with business processes of the bank and not in silos.

(ii) Supervisor must assess the role of the Board in providing guidance on bank's strategic objectives, risk strategy, corporate governance and corporate values as well as its effectiveness in providing oversight to the Senior Management. In this context, the supervisor may also assess the competence of the Board members vis- a-vis their qualification, experience and understanding of key affairs of the bank;

(iii) The Supervisor must sensitize the Board about the need for sustained efforts to build leaders and groom potential leaders early in their career. Supervisor must also comment on the deficiencies in succession plan and practices of the bank;

(iv) In case of banking group, the supervisor should asses and establish whether the board of the parent entity has the overall responsibility for adequate corporate governance across the group and whether the board was ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities;

(v) Supervisor should focus on bank's compliance to the best practices on corporate governance, which include:-

a. Adherence to the Fit and Proper criteria for board members, ensuring the right mix of specialists on the board, especially at least one Risk Management specialist on the board;

b. Risk management structure, internal control system and functions - a separate and independent Risk Department headed by the Chief Risk Officer. The board and senior management should know and understand the bank's operational structure and the risks that it poses ("know-your-structure" as per BCBS Principle No. 12 on Corporate Governance, October 2010);

c. Independent board Committees like Risk Committee, Audit Committee, Compensation Committee, HR or Governance Committee, Ethics / Compliance Committee - ensuring that these committees have an optimal mix of skills and experiences that, in combination, allow the committees to fully understand and objectively evaluate and bring fresh thinking to the relevant issues. In order to achieve the needed objectivity, membership should be composed of non-executives and to the extent possible, a majority of independent members;

d. Of the specialized Board Committees, supervisors should ensure that the Risk Committee and the Audit Committee report directly to the board;

e. Supervisors should have direct interaction with the specialist committees like audit, risk management, etc. to better understand

the bank's functioning in these key areas which are of concern to the supervisors;

f. Supervisors must focus on the transparency or otherwise of the corporate governance structure and function in the bank; and

g. Supervisors to check bank's adherence to arms length principle and conflict of interest policy.

Accountability of the Board /Top Management of the bank

6.4.6 While the actions or inaction of the Top management of a bank has a direct bearing on the depositor's interest, their accountability and responsibility to their depositor is limited. The Board of the bank and its management are primarily accountable to the shareholders. The Committee is of the view that the accountability of the board and top management needs to be enhanced and put to greater scrutiny by the supervisor. Some of the supervisory measures that could improve the accountability of the bank's Board/Top management include the following:

a) Presently, the deliberations/discussions of the proceedings of the meetings of the Board and its committees are primarily written as minutes. Often the observations and reservations, if any expressed by Board members are not adequately captured through these minutes. The Committee recommends that the proceedings of the Board and its important committees may be either written in detail as "Talking Minutes" or audio/video recorded and preserved. Preservation and Access Policy may be framed to maintain secrecy and accessibility for evaluation of the performance of Board members by Regulator/ GOI. This will also be helpful in ascertaining the 'fit and proper criteria' in assessment of future appointments;

b) The supervisor may explicitly outline the responsibilities of the Board, which among others should include the role of the Board in formulating strategies and preparation of Business Plan, review the progress and business performance against board approved plans and strategy; and

c) The AFI report on management of banks should sufficiently focus on the control function of management on articulating clear business plans, risk drivers and risk mitigation plans.

Institutional Structure and Human Resources

6.5 Introduction

6.5.1 The growing complexity of banking operations across the globe has posed a question about an optimal structure for bank supervisors. Organizational structures of the supervisory setup are designed to be effective in their respective economic environments, jurisdiction and given cultures. Certain attributes which provide basic criteria for the supervisors to be effective have normally been understood and broadly identified. For instance, the IMF Internal Staff Note indicates the attributes that enable the supervisors to act include Legal authority, Adequate Resources, Clear Strategy, Robust internal organization and Effective working relationships with other agencies. Thus, adequacy of resources and robustness of the internal organization are central to building a strong, effective and efficient supervisory setup in any jurisdiction.

6.6 Present Supervisory Setup in the RBI

6.6.1 Structure of BFS

Board for Financial Supervision (BFS) with Governor, RBI as the Chairman, Deputy Governor In-Charge of the Department of Banking Supervision as the Vice Chairman is at the apex of the supervisory structure in RBI. BFS oversees the functioning of Department of Banking Supervision (DBS), Department of Non-Banking Supervision (DNBS), Financial Institutions Division (FID) and Urban Banks Department (UBD) and gives directions on the regulatory and supervisory issues. BFS from time to time also gives directions on system of bank inspections, off-site surveillance, strengthening of the role of statutory auditors and strengthening of the internal defences of supervised institutions. The Audit Sub-committee of BFS oversees the system of concurrent audit, norms of empanelment and appointment of statutory auditors,

the quality and coverage of statutory audit reports, and the important issue of greater transparency and disclosure in the published accounts of supervised institutions. The BFS approves policies and issues general guidance /instructions in the matters of banking supervision. It also issues directions/ orders for specific supervisory actions in respect of individual banks. BFS awards the rating to individual banks based on the AFI findings. The Central Office of the DBS provides Secretariat to the BFS, processing information for and executing decisions of the BFS.

6.7 Views of the Committee

General

6.7.1 Presently the bulk of off-site monitoring of banks is done at Central office of DBS, while the supervision of banks is undertaken primarily through the various Regional Offices of the department, except in case of twelve large and Complex banks for which both offsite and onsite supervision are integrated at the Central office level.

6.7.2 There is thus a need and scope for better coordination between the Regional Offices and the Central Office of DBS through exchange of information and coordination for leveraging the off-site supervision into the onsite inspection process. Further, for optimum utilization of the available supervisory resources, the combined pool of both Regional and Central Office needs to be taken into account.

6.7.3 Owing to the way the regulatory and supervisory departments are structured in RBI, presently, the commercial banks have to deal with different departments for seeking regulatory/supervisory clarifications. For example, for the primary dealership business, non bank financial activities, foreign exchange business etc. being conducted within the same banking group- either departmentally or through a subsidiary mode, a bank would have to approach different departments in RBI leading to uncoordinated supervisory responses and information gaps.

6.7.4 The multiple points of contact for the banks within RBI impedes the efficiency and effectiveness of the supervisory processes resulting in supervisory blind spots and undermining an effective Consolidated Supervision of the commercial banks. In this regard, the Committee is of the view that while there is a need to have clear separation between the regulatory and supervisory departments at operational levels, wherever feasible, all the supervisory functions within the RBI that have a bearing on the operations of a commercial bank need to be brought together for an improved Consolidated Supervision.

6.7.5 From a supervisory standpoint, it is essential that the DBS is aware of all interactions/exchanges that other regulatory /supervisory departments within RBI have with the bank. In this regard, the Committee recommends that for ensuring an effective supervisory mechanism, a single point of supervisory contact should be established for the banks within RBI (Department of Banking Supervision). The objective of establishing the single point of contact would be to ensure that supervisory department's views and recommendations are obtained on all references received from the banks and the supervisor is aware of all communications made with individual banks from within RBI. In this context, the Committee also recommends that this single point of contact should be in the form of a Supervisory Relationship Manager / Desk Officer for each individual bank. As the work assigned to the 'Supervisory Relationship Manager (SRM)' will be multifaceted in nature, it would be essential to mandate minimum qualification of expertise / experience, keeping in view the profile of the bank. The SRM of each bank being the focal point and common reference point for both the bank as well as other departments of RBI would be expected to undertake a wide range of activities pertaining to the specific bank. While for larger and more complex banks, more than one SRM may be necessary, one of which would act as the nodal officer for interacting with the bank.

Role of Supervisory Relationship Manager

6.7.6 Some of the important roles and responsibilities of the SRM as envisaged by the Committee are as under:

- Maintain a continuity of knowledge about the bank (building bank profile, Risk Templates and risk profile) within the supervisory department of RBI and shall be well versed with the history of the

bank's AFI observations, risk assessments and other supervisory issues;

- Shall be a reference point for all interactions, including correspondences between the bank and the RBI on all supervisory issues;
- Involve in offsite monitoring of banks as well as in the supervisory activities including onsite supervision, SREP, rating etc;
- Provide and respond to periodic information requests from other departments of RBI which can be extracted from the common central database under the umbrella supervisory department; and
- Assist the bank in entity-specific decisions /approvals by expeditiously liaising with other departments of the RBI internally.

6.7.7 To be effective in discharging the role of a SRM, it would be imperative that the SRM requires stability and continuity over a reasonably long tenure. The Committee thus recommends that the role of the SRM be institutionalized within the supervisory department by clearly identifying job description and accountability. A dedicated team of examiners may be identified and stationed at the Central Office of DBS to provide assistance to all the SRMs in conducting Thematic Reviews, Targeted Reviews of functional areas and product lines during a supervisory cycle.

6.8 Supervisory Skills

6.8.1 Of late, the degree of sophistication and complexity of banking activities has increased substantially. In this context, the report of the Internal Working Group on Human Resources in DBOD and DBS (2006) had made broad recommendations for (a) entry point norms for posting of staff to these Departments, (b) longer tenure for officers posted to these departments (a minimum of 7 years), (c) Optimal allocation of resources to the Regulatory and the Supervisory Departments etc. The Technical Note of the Financial Sector Assessment Program (FSAP) - India (October 2011) has also made incisive remarks regarding the need for training and specialization for bank supervisors.

6.8.2 At present, there is no accreditation program for bank inspectors. The Committee suggests introduction of an "inspector certification" program for all bank supervisors in the supervisory department. The certification program could include a well-defined training module along with on-the-job training to enable the bank examiners gain a requisite level of knowledge and experience before determining their readiness to receive the inspector certificate. The Committee is also of the view that the Rotational assignments in other departments should be a means of broadening an individual's knowledge and skills and not the end of a career as a bank supervisor. Some of the approaches that could achieve this objective include:

- Focus on rotation of supervisory personnel primarily with other departments / functions that are supervisory in nature (including regulatory departments), rather than moving supervisory personnel to non-supervisory Departments, or moving people from non-supervisory Departments into supervisory ones.
- Identify and limit the number of people for broad rotations across the RBI to a small percentage of overall staff. There is a clear value in having a cadre of people with broad experience across the central bank, but the absolute number of such true generalists can be quite small and still accomplish the objective of developing future generations of RBI leadership.

Training

6.8.3 Training and development are essential in building a pool of skilled, knowledgeable and competent staff. Ideally, training should combine formal instructions with case study, seminars and on-the-job experience. Also, opportunities to interact with supervisors from other jurisdictions help in keeping abreast with latest developments and cross-fertilization of ideas. Presently, the RBI has been drawing up the training and development programmes for its supervisory staff which include:

- In-house departmental training programmes by drawing resource persons from India and abroad;

- External training programmes at Reserve Bank Staff College, Chennai and College of Agriculture & Banking, Pune; and
- Foreign Training through tie-up arrangements with BIS, FSA, IMF etc including occasional deputation to various Central Banks or International Financial Institutions etc.

6.8.4 The Committee is of the view that while the current training programmes for supervisors within RBI provide adequate scope and opportunities for skill updation of officers, they do not focus on developing specialists within the supervisory department. Also, amongst the supervisory staff, the level of skill and experience has wide variance. The Committee therefore recommends that for undertaking key supervisory roles in specialized areas of risk management and modelling, treasury, credit, operational risk, and assuming the role of lead /principal inspecting officer, the supervisory staff should have an acceptable base level of knowledge /skill and experience especially those who are involved in supervision of banks having large and complex operations. Additionally, for undertaking general supervisory activities, accreditation with specific programs and training designed for AML /KYC, off-site supervision, customer service, accounting etc. is desirable. To be able to develop a pool of supervisory resources, the supervisory department would need to plan and identify areas of expertise and also identify officers going forward.

Specialization

6.8.5 The world over, supervisors have not only taken cognizance of the changing landscape of banking activities but also promptly responded to the compelling need to have supervisory inputs from specialists in various functional areas of the banks. In this context , RBI, in its Internal Working Group report on Human Resources in DBOD and DBS (2006) had identified certain areas of specialization which included Risk Analysis / Management (RAM), Basel II implementation, 'Policy Research, Analysis and Intelligence', Supervision / Regulation of Complex and Conglomerate Banks and Legal affairs. The role of specialists becomes more pronounced in Risk Based Supervision of banks, wherein in most jurisdictions, the existing supervisory resources are supplemented with specialists in areas of Risk Management, modeling etc. The Committee is of the view that the need to create a knowledge pool of specialists is rather urgent and pressing for the RBI. In this context, the Committee has noted the inherent limitations in updation of skill sets of the RBI's internal supervisory staff. The Committee therefore recommends specific shortfalls may be met by engaging the services of external agencies to train and adequately equip existing staff.

6.8.6 There is a need to upgrade the supervisory resources in some of the non-core supervision areas like IT audit, forensic audit etc. While external specialized agencies may be hired for undertaking such activities on need basis, the Committee is of the view that RBI should ensure that in the long run it is able to develop its own pool of resources in these non-core areas also. To this end, the Committee suggests that at the time of hiring any external agency for undertaking certain non-core supervisory activities, the in-house supervisors should also accompany and participate in such assignments in order to gain the required experience and expertise.

6.8.7 The Committee believes that there is an imperative need for specialist supervisors having adequate knowledge in the areas of risk assessment and measurement. As in other major supervisory jurisdictions, the supervisory resource pool needs to be strengthened with external experts. In this context, the Committee recommends that in order to create a pool of domain experts within RBI, a system of continuous movement of people from RBI to external organizations i.e. commercial banks (in areas like risk management, financial engineering, treasury operations, capital planning etc), accounting firms, academia, capital market, brokerages, legal firms etc. and vice versa should be instituted. This needs to be encouraged through well-defined career progression programme and made an integral part of HRM function within RBI. In this context, it is important that vertical movement within the department and the organization needs to be replaced by horizontal/vertical movement from other areas/functions etc. within and outside RBI.

CHAPTER 7

SUMMARY OF MAJOR RECOMMENDATIONS

A summary of major recommendations of HLSC indicating the relevant paragraph numbers in the Report is as under:

7.1 Supervisory Approach

Objectives of Supervision

7.1.1 While the protection of depositors' interests should be the primary objective of RBI's supervisory process, promotion of financial stability and customers' protection should also be articulated as overarching objective of RBI's supervision. (2.6.5 & 2.6.6)

Approach to Supervision

7.1.2 In view of the emerging challenges and ensuring optimization of supervisory resources, a risk-based approach for supervision for commercial banks in India is recommended. It is imperative that each bank has a certain basic risk management framework in place before the Risk Based Supervision can be rolled out. Accordingly, the Committee has outlined the ingredients of a baseline risk management framework and suggests that full-scale RBS should be implemented across the banking industry from 2013 Supervisory cycle. (2.6.27)

7.1.3 The Committee recommends that along with focus on supervision of banks on a solo basis, RBI should also focus on Consolidated Supervision of banking groups. In view of the fragmented set up within RBI for supervising different entities belonging to the same banking group, the Committee recommends that a single point contact in the form of a 'Supervisory Relationship Manager' should be created within the Department of Banking Supervision to ensure efficient and effective communication between the supervisor and the supervised entities and to aid the Consolidated Supervision process. (2.6.15 & 2.6.18)

Jurisdiction of Supervision

7.1.4 The domains of regulation and supervision should be firmly demarcated and any entity specific decision should only emanate from the supervisory department. This is necessary for clarity of jurisdiction for the supervised entity and for making the relationship manager an effective single point of contact in the Department of Banking Supervision (DBS). The communication between the supervisor and the supervised entity is confidential and should not be subject to any public scrutiny. (2.6.19)

7.2 Supervisory Methods/Tools under RBS

Off-site Supervision

7.2.1 In view of increased reliance on offsite supervision under RBS it is important to ensure quality and integrity of data. Accordingly, the Committee recommends that manual intervention in the flow of data to RBI from the supervised entities should be eliminated and penal provisions should be invoked for deliberate submission of wrong data/ supervisory information(2.6.29 & 3.6.4)

On-site Examination

7.2.2 The level of risk and the probable impact of a bank's failure rather than the volume of business should be the determinant of the periodicity/intensity of on-site examination in banks. In view of continuous off-site supervision under RBS, a differentiated approach based on the risk/impact assessment of individual banks for determining the periodicity of onsite supervisory examination /reviews (ranging between 1 to 3 years) is recommended. (2.6.31 & 3.7.16)

Reliance on External Auditors

7.2.3 RBI and the statutory auditors should jointly work towards a formal code to enlist the mutual expectations, documentation requirements, information sharing requirements etc with the objective of eliminating duplicity of supervisory efforts. (2.6.11 & 2.6.13)

7.2.4 As the branch audit of public sector banks could be dispensed with or drastically curtailed in future RBI could commission special audits to probe into specific areas of concern. (2.6.12)

Interactions with the Top Management of banks

7.2.5 The present system of holding quarterly discussions with the Top Management of all banks may be replaced with formal interactions, the periodicity of which may be determined by the supervisor based on its risk assessment for a particular bank /banking group.

7.2.6 A mechanism for periodic interaction of supervisor with the Top Management of the banks at a common platform for deliberating on issues affecting the banking sector as a whole, may be put in place as it would be beneficial for both the supervisor and the supervised entities. (2.6.33)

7.3 Supervisory Processes

Supervisory Processes under RBS

7.3.1 The proposed supervisory cycle under RBS would involve six key processes: (i) Understanding the bank (Bank Profile), (ii) Assessing risks faced by the bank for supervisory purpose (Risk Assessment / Matrix), (iii) Scheduling and Planning Supervisory Activities (Planning for supervisory actions / interventions), (iv) Defining Examination Activities, on-site reviews and on-going monitoring (Onsite Inspection – objective, scope), (v) Inspection Procedure (Onsite Inspection, conduct of SREP, offsite continuous supervision) and (vi) Reporting findings and recommendations and follow-up (Inspection Reports, Updating of the bank Profile). (3.7.1)

Bank Profile

7.3.2 A profile containing comprehensive yet concise information about the bank should be prepared and the same should be updated on an ongoing basis. (3.7.2)

Risk Assessment

7.3.3 The risk assessment process involving updating bank related information collected from various sources should be conducted by the supervisor on a continuous basis. (3.7.3)

7.3.4 Both the risk score and the impact scores derived from the template based exercise would determine the Risk –Impact Matrix indices. (3.7.9)

Supervisory Actions /Intervention

7.3.5 In order to ensure consistency/ standardization of supervisory judgment across the banking system an objective *risk assessment template for identified risk groups would be used* to produce an optimum Risk Matrix. Towards this end, the Committee desires that technical inputs from professionals or specialists could be used to ensure that the risk assessment process is robust, consistent and conforms to the global standards. The Committee also recommends that the process of Risk Assessment must be documented in a *Supervisory Manual* and a gist of the risk assessment process may also be shared with the supervised entities (3.7.13)

Scheduling and Planning Supervisory Activities

7.3.6 The supervisory actions on a bank based on the perceived risks about the bank, would range from an on-site inspection (full scale or targeted) to only a continuous off-site monitoring during a particular year. In this regard, the Committee is of the view that all banks, irrespective of their risk profile /outcome of the risk assessment exercise, should be subjected to an on-site inspection at least once in three years. The Committee is of the view that the supervisory action plan should be shared /discussed with the bank's senior management. (3.7.14)

Stress Tests

7.3.7 Stress testing should be an integral part of the supervisory process and used extensively for determining the soundness/capital adequacy of banks. In this regard, reverse stress testing should be undertaken by the banks with active involvement of Senior Management. (3.10.2 & 3.10.4)

Thematic Review

7.3.8 Thematic reviews should be increasingly used under the proposed risk based supervisory framework for supplementing and enhancing efficiency and effectiveness of the supervisory process. (3.11.3)

7.4 Supervisory Rating

7.4.1 The existing CAMELS based rating system would not be appropriate under the risk based approach. Under

the RBS, the focus of the rating framework should be to measure the riskiness of a bank and not to evaluate its performance. (4.11)

7.4.2 Under the risk focused rating framework, the riskiness of a bank would be computed using a risk template for identifying the inherent prudential risk and the risk control elements for various risk groups. The outcome of the SREP and the supervisory risk rating above would be used for determining the nature of supervisory intervention (for reduction of risk or prescription for additional capital over and above the regulatory capital, wherever necessary). (4.14 & 4.21)

Disclosure of rating

7.4.3 In line with the extant international supervisory practices, the supervisory rating should not be made public as it is confidential information and can only be shared with the concerned banks. (4.26)

7.5 Consolidated and Cross Border Supervision

7.5.1 A differentiated and risk focused approach to Consolidated Supervision with more focused attention on large and complex banking groups is necessary. (5.3.2 and 5.3.3)

Understanding Group structure and business

7.5.2 The supervisor should develop clear understanding of the group structure and share holding pattern along with major lines of accountability within the group. (5.3.7)

Governance

7.5.3 For assessing the effectiveness of Governance, the key parameters would include: (i) Competence (ii) Strategies and policies (iii) Internal control and audit including group wide oversight (iv) Internal risk management structure (v) Policy on Conflict of interest (vi) Transparency and Public Disclosures. (5.3.8)

Cross- Sector Supervision (Domestic)

7.5.4 To facilitate flow of information and have a coordinated approach towards issues of concern, a mechanism for structured exchange of information and cooperation amongst the sectoral supervisors should be developed. In this context, a formal MoU is also desirable. (5.5.1)

Recovery and Resolution Mechanism

7.5.5 In view of the importance of Recovery and Resolution Planning for banks, the Committee recommends that a separate group may study the issue in depth. (5.5.4)

Cross-Border (Overseas)

7.5.6 The Committee recommends setting up of supervisory colleges in respect of large globally active Indian banks having significant share of overseas assets as a percentage of total assets. (5.7.4)

7.6 Institutional Structure and Human Resources

7.6.1 The safety and soundness of a bank is driven by the triad of Corporate Governance, effective risk management and internal control systems. There is a need to strengthen the triad in banks. (6.4.5)

Conflicts of Interest

7.6.2 To achieve transparency in addressing conflicts of interest, the board should have a formal written conflicts of interest policy and an objective compliance process for implementing the policy. (6.3.4)

Segregation of the post of Chairman and CEO

7.6.3 Given the positive experience in India as well as internationally, separation of the posts of chairman of the board and the CEO could be extended to public sector banks. (6.4.2)

Single point of Supervisory Contact

7.6.4 There should be a single point of contact in DBS in the form of a Supervisory Relationship Manager / Desk Officer for each individual bank. As the work assigned to the 'Supervisory Relationship Manager' will be multifaceted in nature, minimum qualifications of expertise / experience may be mandated, keeping in view the profile of the bank. (6.7.5 & 6.7.6)

Developing Supervisory Skills

7.6.5 An "inspector certification" program may be introduced for all bank supervisors in DBS. (6.8.2)

7.6.6 In view of the inherent limitations in updation of skill sets of the RBI's internal supervisory staff, services of external agencies could be engaged to train and adequately equip existing staff. (6.8.6)

7.6.7 With a view to creating a pool of domain experts within RBI, a system of continuous movement of people from RBI to external organizations i.e. commercial banks (in areas like risk management, financial engineering, treasury operations, capital planning etc), accounting firms, academia, capital market, brokerages, legal firms etc. and vice versa should be instituted. This needs to be encouraged through well-defined career progression programme and made an integral part of HRM function within RBI (6.8.7)

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ACRONYMS

AER	Annual Equivalent Rates
AFI	Annual Financial Inspection
AFR	Annual Financial Review
ALE	Asset Liability & off-balance sheet Exposures
ALM	Asset Liability Management
ALO	Report on Asset Liability and Exposures
AML	Anti-Money Laundering
AMPI	Aggregated Micro-Prudential Indicator
APP	Annual Perspective Plan
APR	Annual Percentage Rates
AS	Accounting Standard
BCBS	Basel Committee on Banking Supervision
BFS	Board for Financial Supervision
BIS	Bank of International Settlements
BR Act	Banking Regulation Act
BSA	Balance Sheet Analysis
CACS	Capital adequacy, Asset quality, Compliance and Systems & controls
CAGR	Compound Annual Growth Rate
CALCS	Capital adequacy, Asset quality, Liquidity, Compliance, and Systems & controls
CAMELS	Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems & controls
CEBS	Committee of European Banking Supervisors
CEM	Report on Country exposures
CEO	Chief Executive Officer
CET-1	Common Equity Tier-1
CFS	Consolidated Financial Statements
CMD	Chairman & Managing Director
CPR	Consolidated Prudential Reports
CRAR	Capital to Risk-weighted Assets Ratio
CRR	Cash Reserve Ratio
DBOD	Department of Banking Operation and Development
DBS	Department of Banking Supervision
DNBS	Department of Non-Banking Supervision
DoS	Department of Supervision
EDWP	Enterprise Data Warehouse Project
FC	Financial Conglomerates
FED	Foreign Exchange Department Operations and Development
FHC	Financial Holding Company
FI	Financial Institution

FID	Financial Institutions Division
FMD	Financial Markets Department
FSA	Financial Services Authority
FSB	Financial Stability Board
FSDC	Financial Stability Development Council
GDP	Gross Domestic Product
HLCCFM	High Level Coordination Committee on Financial Markets
HLSC	High Level Steering Committee
HR	Human Resources
ICAAP	Internal Capital Adequacy Assessment Process
ICAI	Chartered Accountants of India
IDMD	Internal Debt Management Department
IMF	International Monetary Fund
IRDA	Insurance Regulatory and Development Authority
IRS	Statement of Interest Rate Sensitivity
IT	Information Technology
ITEs	Intra-group Transactions and Exposures
KYC	Know Your Customer
LCB	Large and Complex Bank
LFAR	Long Form Audit Report
LHO	Local Head Office
MAP	Monitorable Action Plan
MEI	Macro-Economic Indicator
MIS	Management Information System
MoU	Memorandum of Understanding
NBFC	Non-banking Financial Company
NPA	Non-Performing Asset
OECD	Organization for Economic Co-operation and Development
OSMOS	Offsite Surveillance and Monitoring System
PCA	Prompt Corrective Action
PFRDA	Pension Fund Regulatory and Development Authority
PIO	Principal Inspecting Officer
QD	Quarterly Discussion
QID	Quarterly Informal Discussion
RAM	Risk Analysis / Management
RAQ	Report on Asset Quality
RBI	Reserve Bank of India
RBIA	Risk Based Internal Audit
RBS	Risk Based Supervision

RCA	Report on Capital Adequacy – Basel I
RCL	Report on Connected Lending
RDBMS	Relational Database Management System
RLC	Report on Large Credits
RLE	Report on Large Exposures
RMS	Risk Management System
RoA	Return on Asset
ROC	Report on Ownership and Control
ROF	Report on Frauds
ROP	Report on Profitability
ROR	Report on Operating Results
RPCD	Rural Planning and Credit Department
RPT	Risk Profile Template
RRB	Regional Rural Bank
RRP	Recovery and Resolution Plan
SCB	Scheduled Commercial Banks
SCoB	Scheduled Co-operative banks
SEBI	Securities and Exchange Board of India
SIFI	Systemically Important Financial Institutions
SIR	Statement of Interest Rate Sensitivity – Forex
SLR	Statutory Liquidity Ratio
SREP	Supervisory Review and Evaluation Process
SRM	Supervisory Relationship Manager
TC	Technical Committee
UBD	Urban Banks Department
VAR	Vector Autoregressive
XBRL	Extensive Business Reporting Language

ANNEX

Indicative Risk Assessment Templates
Credit Risk
Inherent Risk Elements

Sr. No.	Elements	Norms	Score
1.	**Quality of Exposures**		
	(a) Corporate Advances		
	(i) Ratio of change in RWA for credit risk (on balance sheet items) to change in RWA for total assets (on balance sheet total assets)		
	(ii) Percentage of credit exposures (including investments in lieu of advances) in the top 50% of the rating grades above hurdle rate (including hurdle rate) to total rated exposures. At beginning of each supervisory cycle, the range may be reviewed to capture the change in the economic cycle.		
	(iii) Un-hedged forex exposure of customers to total forex exposure of the customers with the bank		
	(b) Retail Advances		
	Weighted average LTV of outstanding portfolio (i.e. for the outstanding loan book the weighted average LTV at the time of sanction)		
	(c) Investments		
	(i) Non-SLR investments in top three rating grades to total non-SLR investments		
	(d) Counterparty Bank/FI Risk		
	(i) Percentage of exposure in the top 50% of the internal rating grades above hurdle rate (including hurdle rate) to total counterparty exposure		
	(e) Off – Balance Sheet Exposures		
	(i) Growth in RWA of customer deals for past three years and quantum of change in impact on P&L for corresponding years		
	(ii) Amount and number of LCs/BGs devolvement/invocation and by the borrower/bank counterparty over previous year. (This parameter may have to be seen in percentage terms i.e. amount and number of LCs/ BGs devolved /invoked to total amount and number of LCs/BGs outstanding at the beginning of the year)		
	(iii) Non-payment of crystallised MTM by the borrower/bank counterparty during the year to total crystallised MTM during the year		
2.	**Credit Concentrations**		
	(a) Unsecured exposure (on and off balance sheet) to total exposures		
	(b) (i) Commercial Real Estate, (ii) Capital Market, (iii) NBFC and (iv) Commodity sector exposures (such as gold, food grain and metal exposures through exchanges)		

Sr. No.	Elements	Norms	Score
	(c) (i) Industry concentrations (ii) Herfindahal Hirschman Index (HHI) for industry wise concentration (d) Borrower concentrations exposure of top fifty exposures to total exposures and exposure of top 20 group exposures to total exposures (excluding exposure to quasi regulatory bodies such as NABARD/SIDBI) - Single borrower and group borrower concentrations (number and amount of excess over regulatory/internal norms)		
3.	**Country Risk** (a) Quantum of exposure to medium and high risk countries (as defined by ECGC) to total non-India exposures.		
4.	**Deterioration in Asset Quality** (a) Ratio of gross NPAs + write offs during the year + restructured standard advances during the year to the gross advances at the beginning of the year. (b) Ratio of fresh slippage to actual recoveries during the year Up-gradation should not be considered (c) Ratio of provision plus write offs during the year to total income from advances and investments (d) Three year weighted average of fresh slippage to outstanding standard advances at the beginning of the year. *(Weights in proportion to outstanding standard advances at the beginning of the year)* (e) Three year weighted average ratio of slippage of sub standard assets to doubtful to outstanding sub standard assets at the beginning of the year. (f) Net NPA to net advances ratio We may decide to keep one of the two parameters (PCR or net NPA) after back testing. (g) Quick Mortality to amount disbursed during the year – separate ratios for retail and corporate (Quick Mortality (a) retail - slippage within 12 months from date of first disbursement , and (b) corporate - slippage within 24 months from date of first disbursement (h) Trend of three year rolling average over the previous three years, of slippages in restructured accounts as a percentage to total standard restructured accounts during the respective years. (i) Under provisioning in nonperforming assets to total provision required for non performing assets (*Assets: Advances, Investments and Other Assets)*		

Credit Risk - Controls			
Sr. No.	**Elements**	**Norms**	**Score**
(a)	Adequacy of risk management architecture		
(b)	Adequacy of loan policy, restructuring policy, recovery policy, collateral management policy		
(c)	Adherence to laid down policies including adherence to suitability and appropriateness policy for derivatives – Extent of deviation (Quantum of loans originated in the retail segment with deviations from internal norms/ceilings. PIO to also keep watch on the quantum of NPAs emanating from loans sanctioned with such deviations). – Extent of deviation from policies and regulatory norms maybe considered in non retail pre sanction appraisals.		
(d)	Counterparty bank risk (i) System of review and monitoring of limits (ii) Basis / Rationale for setting up of limits and whether the same is documented in a transparent manner (iii) Breaches in limits fixed (PIO to check if limits have been increased during the year in the form of accommodative actions)		
(e)	Delegation of Powers (DoP) – whether the DoP is clearly laid out and communicated, whether DoP is used or not (i.e. whether all proposals are being pushed to the higher committees), whether reporting is being done at required periodicity.		
(f)	Post disbursement supervision – documentation review/renewal, verification of collaterals, adequacy of insurance cover, creation of charge, unit visits, monitoring of drawing power, End use of funds – processes in place to ensure end use of funds and adherence to the same, monitoring of problem credits, monitoring of large credit exposures, adequacy of loan review mechanism, review of off-balance sheet exposures, etc.		
(g)	Adequacy of risk rating framework and usage in bank including pricing		
(h)	Processes in place for minimising risk arising out of country exposures including securities taken, legal documentation, registration of charges in overseas territories, taking into account history of customers and experience with countries dealt with, controls in terms of tenure of exposures, etc.		
(i)	(i) NPA divergence by AFI, Statutory auditors and overseas regulators to gross NPA as per bank (ii) NPI divergence by AFI, Statutory auditors and overseas regulators to gross NPI as per bank		
(j)	Stress Testing – Whether events and scenarios as also their combinations have been taken in accordance with RBI guidelines on stress testing. Extent of deviation.		
(k)	Preparedness towards implementation of advanced approaches.		

Note - The impact of Credit Derivative Swaps (CDS) should be taken into account while determining the adherence to limits, efficacy of documentation, delegation of power (system and usage), formulation and adherence to policies, concentrations, etc.

ANNEX B

Market Risk
Inherent Risk

Sr. No.	Elements	Comments	Maximum Score
1.	Size, Nature and Complexity of Investment portfolio		
	(i) % of capital charge for market risk over the total capital		
	(ii) % increase in the capital charge for market risk in comparison with the previous year		
	(iii) Impairment in the value of AFS + HFT category for 200 basis point shock. (As a % of capital)		
	(iv) Depreciation in the value of investments held under trading book – AFS+HFT portfolio		
	(v) Investments out of restructured loans		
	(vi) Likely impact on the value of HTM portfolio for 2% shock- Potential		
	(vii) Derivatives as a % to total risk assets of the bank (credit equivalent) (Higher the %, higher is the risk)		
	(viii) No. of breaches of all trading (including derivative) risk limits		
	(ix) Likely impact of one percentage change in interest rate (100*PV01) only in trading portfolio - negative impact		
	(x) Information ratio of the portfolio		
2.	Forex risk		
	(i) NOOPL as a % of total assessed capital fund		
	(ii) % utilisation of NOOPL		
	(iii) % utilisation of AGL		

Market Risk - Controls

	Major Components and Elements for assessment		Maximum Score
a)	Adequacy of market risk management architecture (Equity Risk Management, process to identify/ measure/ manage Foreign Exchange Risk, control systems designed to provide timely, accurate and informative MIS, evaluation of Front Office, Mid Office and back Office functions etc. may also be seen)		
b)	System in place to monitor regulatory guidelines relating to Valuation, classification, sale and shifting from HTM category and necessary reporting thereof		
c)	Whether aggregate risk limits / position limits cover all major trading positions		
d)	Whether risk limits / trading limits have been validated through back testing and the validation periodically updated		
e)	Whether stop-loss / take profit targets on trading positions generally adhered to?		

	Major Components and Elements for assessment		Maximum Score
f)	Net PV01 of securities transferred to HTM as a % aggregate AFS PV01 [negative / small number means more interest rate sensitive securities have been transferred to AFS implying active PV01 reflecting higher proportion of aggregate interest rate risk and hence better risk control]		
g)	Is the management of ALM and proprietary trading completely segregated ? Is the management of AFS portfolio distinctly bifurcated between ALM and proprietary trading ?		
h)	Profit on sale of HTM securities as a % of aggregate trading profits [higher the ratio more the dependence on banking book for profit implying poorer profit planning]		
i)	Are inter-bank, customer and liability related cash and derivative transactions subjected to price-scan ?		
j)	Are intra day trading positions oversight by mid-office commensurate to the risk being run ?		
k)	Are trading position defeasance period / individual trades being independently overseen / analysed by mid office for unusual trading practices ?		
l)	Presence of scientific and market related TPM		

Interest Rate Risk in the Banking Book Inherent Risk		
	Inherent Risk- IRR indicators	**Maximum Score**
	Total Marks	
a)	Earnings perspective: % decline in the NII due to standardised shock of 200 bps over 12 month horizon	
b)	Economic value perspective - % of decline in the capital funds due to standardised shock of 200 bps	
c)	Contribution of profit on HTM asset sales as a % of aggregate profit before tax	
d)	% of change in the NII as compared to previous year	
	Interest Rate Risk in the Banking Book - Controls	
a)	Whether comprehensive policies including responsibilities, accountabilities, desired limits/ positions consistent with the strategic directions and risk tolerance levels/appetite are in place and properly communicated to all concerns?	
b)	Does the bank have an effective transfer pricing mechanism linking liability pricing to that of assets	
c)	Is the Base rate computation documented and the adherence to the laid down policy appropriate?	
d)	Are the base rate reviews co-terminus with review of pricing of liability term structure?	
e)	Adequacy of stress testing methodologies in risk analysis, risk management, limit setting and provision of capital and effectiveness thereof	
f)	Whether control systems are designed to provide timely, accurate and informative MIS.	

ANNEX C

Operational Risk
Inherent Risk Elements

	Components/ Elements	Norms	Risk scores
1.	**People Risk**		
	i) Competence of people in different levels, job rotation, availability of job cards/ delegation of power and second level control /validation points, extent of mis-selling of products.		
	ii) Movement in attrition levels particularly in critical areas like Treasury during last three years		
2.	**Process Risk**		
	A. House Keeping		
	i) Overall pendency, age of unreconciled items in inter-bank, transit, Nostro, Vostro accounts and clearing differences as well as implementation levels on adherence to extant instructions/strategies.		
	ii) Movement of unreconciled items during past three years		
	B. Fraud, vigilance and accountability		
	i) Incidence of frauds in the bank		
	ii) Trend in movement of frauds in the last three years in terms of number and quantum		
	iii) Staff related frauds – number, nature and whether fraud due to failure of people / processes		
	iv) Adherence to KYC/AML norms		
	v) Adherence to policy on staff accountability		
	C. Customer Service and Complaint Redressal mechanism		
	i) Trend in number and nature of complaints (including the outsourced areas) besides Banking Ombudsman awards during the last three years.		
	ii) Quality of information on bank's website, customer information about products offered, display of information at branches mandated by regulator as well as bank's own policy		
3.	**Technology risk**		
	i) Effectiveness of IT systems • extent of computerization / Core Banking Solutions. • compatibility of IT systems with business model of the bank and scalability to future strategies. • data warehousing capability (system for purged data) • ability to interface between different applications and generate MIS without manual intervention and appropriate validations • capability for NPA identification • Extent of cyber frauds, phising attacks) • History of operational break downs (Systems down time, ATM down time, Programming error, etc)		
	ii) Adherence to regulatory instructions/ bank's policy with regard to Business Continuity Plan (BCP)/Disaster Recovery System (DRS)		

	Components/ Elements	Norms	Risk scores
4.	**Compliance Risk**		
	A. Compliance to various reporting requirements		
	i) Accuracy, timeliness, integrity and reliability of Management Information System (MIS) with regard to Internal, Regulatory reporting and balance sheet disclosure.		
	ii) Quality of internal returns, their usage and follow-up		
	B. Timely and effective compliance to various regulatory guidelines/instructions, audit and inspection observations		
	i) Regulatory compliance (status of AFI compliance /show cause notices/ penalties)		
	ii) Compliance (Others) (SEBI, IT,other regulators, overseas Regulators)		
	iii) Compliance to various audits of the bank viz, LFAR, Internal Audit, IS audit		
5.	**Legal risk**		
	Level of compliance to accounting standards with regard to claims against the bank not acknowledged as debt (CND), decrees passed against the bank, incomplete/defective documentation, quality of SLAs on outsourcing etc.		
6.	**Outsourcing risk**		
	• Adherence to the extant regulatory guidelines and bank's internal policy		
	• Extent and criticality of the outsourced activities		

Operational Risk - Controls			
	Components/ Elements	**Norms**	**Risk scores**
1.	**People Risk**		
	Policy for training/orientation programmes, recruitment process/procedures etc. Adequacy of vigilance mechanism in place for taking corrective action including removal of systemic deficiencies, examination of staff accountability, appropriate leave policy and compensation structure especially for dealers to deter mis-selling, excessive risk taking tendencies etc.		
2.	**Controls for Process Risk**		
	A. House Keeping		
	i) Systems and procedures /policies in place for reconciliation of inter-branch, transit accounts, suspense/sundry, Nostro/Vostro accounts,		
	ii) Existence of maker-checker concept, strong exceptional reporting etc. as well as well defined accounting policy based on regulatory instructions and accounting standards		
	B. Fraud, vigilance and accountability		
	i) Systems / Procedures in place especially in sensitive areas/aspects for deterring fraud, prevention of recurrence , staff involvement etc.		
	ii) Robustness of KYC/AML policy, procedures etc. in place, system to enforce the same viz, in built checks and balances to freeze transactions /accounts in case of non-compliance the guidelines, periodical reviews, etc		

Operational Risk - Controls			
	C. Customer Service and Complaint Redressal		
	System in place for complaint/grievance redressal with well documented procedures and its dissemination among staff. System to include treatment of complaints by 'whistle blower'. Also proper systems to ensure customer confidentiality.		
3.	**General Controls for Technology Risk**		
	i) Systems/Procedures laid down for back up, BCP, Disaster recovery and validation process.		
	ii) Controls in place for preventing phishing attacks as well as hacking of net banking site including incidence of cyber frauds by frequent reviews, enhancement of security features, etc		
	iii) Controls in place to restrict and monitor the direct access/modification of data where manual intervention is required		
	iv) IT training and awareness of applications to all Support Groups, which is reviewed at prescribed intervals.		
4.	**Compliance Risk**		
	A. Controls for Management Information Systems		
	i) System in place for ensuring reporting requirements.		
	ii) Well documented/robust calendar of returns, in tune with extant instructions and appropriate systems in place for reporting lines in respect of Exceptional Statements		
	B. Controls for Inspection, Audit (Statutory, concurrent etc.) including RBIA besides system to ensure Quality of compliance and closure of inspection reports		
	i) System in place for ensuring quality of compliance to AFI and other audit observations including the active involvement of ACB in ensuring the same.		
	ii) System in place for ensuring full coverage, submission of LFAR, MOC, finalization of accounts etc. by Statutory Auditors.		
	iii) System in place for ensuring scope, quality and coverage of various internal audits viz, internal inspection, concurrent audit, special audit, etc.; and period review of the audit function of the bank.		
5.	**Legal risk covering claims, decree (against the bank)**		
	i) System in place for ensuring proper documentation, insurance, SLAs while outsourcing, handling of tax disputes/aspects by legal professionals, obtention of legal opinion in case of CNDs etc.		
6.	**Effectiveness of Operational Risk Management architecture and its oversight**		
	i) Independence and integrity of risk management function		
	ii) Effectiveness of identification of all significant risks		
	iii) Quality of assessment/ measurement of risks		
	iv) Effectiveness in monitoring the level of risks		
	v) Extent of use of the risk management systems for business strategy/ decisions		

ANNEX D

Liquidity Risk

Inherent Risk Elements

Sr. No	Components/ Elements	Norms	Risk scores
(A)	**LIQUIDITY RISK INDICATORS – STOCK APPROACH** **(CARE - FORTNIGHTLY/MONTHLY AVERAGES TO BE TAKEN FOR CALCULATION OF ALL RATIOS)** 1. (Volatile Liabilities - Temporary Assets) / (Earning Assets - Temporary Assets) Measures the extent to which hot money supports bank's basic earning assets. Since the numerator represents short-term, interest sensitive funds, a high and positive number implies some risk of illiquidity. 2. Core deposits / Total Assets Measures the extent to which assets are funded through stable deposit base 3. (Loans + mandatory SLR + mandatory CRR + Fixed Assets)/Total Assets Loans including mandatory cash reserves and statutory liquidity investments are least liquid and hence a high ratio signifies the degree of 'illiquidity' embedded in the balance sheet. 4. (Loans + mandatory SLR + mandatory CRR + Fixed Assets) / Core Deposits Measure the extent to which illiquid assets are financed out of core deposits. Greater than 1 (purchased liquidity). Less than 1 (stored liquidity) 5. Temporary Assets/Total Assets Measures the extent of available liquid assets. A higher ratio could impinge on the asset utilisation of banking system in terms of opportunity cost of holding liquidity 6. Temporary Assets/Volatile Liabilities Measures the cover of liquid investments relative to volatile liabilities. A ratio of less than 1 indicates the possibility of a liquidity problem. 7. Volatile liabilities / Total Assets Measures the extent to which volatile liabilities fund the balance sheet 8. Ratio of top depositors to total deposits • **20 top** depositors for deposit size up to 25000 crore • **50 top** depositors for deposit size up to 50000 crore • **100 top** depositors for deposit size up to 75000 crore • **200 top** depositors for deposit size up to 1 lakh crore or more 9. Net Stable Funding Ratio – {Available Stable Funding (ASF) / Required Stable Funding (RSF) } *100 > 100% 10. **Liquidity Coverage Ratio (LCR)** (Stock of high quality liquid assets / Total net cash outflows over the next 30 calendar days) *100 ≥ 100%		

Sr. No	Components/ Elements	Norms	Risk scores
B	**COMPLIANCE TO VARIOUS LIMITS FOR LIQUIDITY MANAGEMENT** 11. Trend of compliance with ALM Guidelines of RBI – adherence to RBI norms in regard to first four buckets under structural liquidity statement 12. Trend of compliance with Internal limits on maturity mismatches set by the management 13. Trend of compliance with CRR/ SLR requirements 14. Trend of compliance vis-à-vis bank's internal policy – including various ratios, liquidity/borrowing policies, targeted liquidity level, liquidity risk tolerance, deposit concentration, etc. 15. Trend to manage intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions 16. Foreign currency liquidity risk as monitored through MAP statements - compliance with AD (MA Series) Circulars		

Volatile Liabilities: (Deposits + borrowings and bills payable upto 1 year). Letters of credit – full outstanding Component-wise Credit Conversion Factor of other contingent credit and commitments Swap funds (buy/ sell) upto one year. Current deposits (CA) and Savings deposits (SA) i.e. (CASA) deposits reported by the banks as payable within one year (as reported in structural liquidity statement) are included under volatile liabilities. Borrowings include from RBI, call, other institutions and refinance.

Temporary assets =Cash + Excess CRR balances with RBI + Balances with banks + Bills purchased

discounted upto 1 year + Investments upto one year + Swap funds (sell/ buy) upto one year.

Earning Assets = Total assets – (Fixed assets + Balances in current accounts with other banks + Other assets excluding leasing + Intangible assets)

Core deposits = All deposits (including CASA) above 1 year + net worth

Assessment of Liquidity Risk Risk Control			
Sr. No	**Components/ Elements**		
1.	Adequacy of liquidity risk management policy including articulation of tolerance limit and Funding strategies - (Care – not to be linked to market liquidity risk i.e. liquidity risks due to market disruptions or inadequate market depth) – It should provide effective diversification in the source and tenor of funding. Over -dependence on specific funding sources, say a particular market segment, if it is followed as a business model, may also be examined.		
2.	Efficacy of short-term Dynamic Liquidity monitoring mechanism (including intra-day liquidity positions)		
3.	Quality of ALM MIS in terms of information availability, accuracy, adequacy and integrity		
4.	Level of Top Management's involvement in ALM		

Sr. No	Components/ Elements		
5.	Analysis of behavioral maturity profile of various components of on / off-balance sheet items on the basis of assumptions and trend analysis supported by time series analysis		
6.	Tracking the impact of embedded options and to realistically estimate the risk profiles in their balance sheet. Any strategy in place to manage the situation arising out of exercise of embedded options		
7.	Backtesting - Frequency of variance analysis for validating/ fine-tuning the assumptions		
8.	Frequency of simulated studies on liquidity risk management and its impact on balance sheet due to various possible changes in market conditions – Both institution specific and market wide stress scenarios.		
9.	Contingency funding plans (CFP) to overcome such situations and frequency of reviews on CFP - evaluation thereof – Whether CFPs were linked to stress test results, clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. Also, the liquidity line commitments available may be evaluated.		
10.	Use of sophisticated software / models used for liquidity management - Evaluation in terms of • assumptions in the model are made known to ALCO and ALM Support Groups. • assumptions are reviewed at least once a year. • model is able to capture all the on-balance sheet and off-balance sheet items.		
11.	ALM support groups (for analyzing, monitoring and reporting the risk profile of the bank and preparing simulated studies forecasting the effects of various possible changes in market conditions related to balance sheet and recommending action needed to adhere to bank's internal limits)		
12.	Oversight of Board/ MCB/ ALCO Quality of oversight on liquidity management function Frequency/ timeliness of review/ monitoring of liquidity management policies Understanding of liquidity risk management (policies/ risks/ limits) by the senior management		

ANNEX E

Governance and Oversight

Sr. No.	Elements	Norms	Risk Scores
1.	**Corporate Governance**		
	a) Compliance with regulatory guidelines on corporate governance		
	b) Professionalism in the Board (qualification and experience of directors, capacity to avoid dominance of one or two directors, system of forwarding agenda papers and recording of minutes, effective monitoring of implementation of board-directions)		
	c) Quality of deliberations Comprehensiveness and adequacy of reviews and quality of directions		
	d) Adequacy of the Board's role in the formulation of policies on (i) business strategy, (ii) HR strategy including succession planning, (iii) strategy for technology, (iv) long term strategic planning.		
	e) Adherence to above policies / strategies by the Board (delegation of powers may be looked into in detail).		
	f) Strategy for pricing of products and services - Both assets and liabilities		
	g) Review of audit and compliance function		
	h) Overall risk management function and its evaluation (including group risk)		
	i) Effectiveness of Board Committees		
2	**Oversight**		
	a) Ability and effectiveness of top management to implement Board's strategy		
	b) Leadership, integrity, accountability		
	c) Assessment of HO control over branches		
	d) Compliance culture		