X - Financial Regulation and Supervision

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Introduction

10.1 The Reserve Bank is entrusted with the supervision of the banking system in India under the provisions of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. The Reserve Bank regulates select financial institutions (FIs) and non-banking financial companies (NBFCs) under Chapter IIIB of the Reserve Bank of India Act. Consequent upon amendments to Chapters IIIB, IIIC and V, through the Reserve Bank of India (Amendment) Act in 1997, the Reserve Bank introduced a comprehensive regulatory framework in respect of NBFCs, including compulsory registration in terms of the amended Section 45-IA.

10.2 Structural and organisational changes in the financial system since the early 1990s under the impact of financial sector reforms and globalisation have fundamentally transformed the regulatory function. The large macroeconomic and social costs of recent financial crises have lent urgency to the worldwide quest for institutional arrangements and processes which enable efficient and appropriate oversight of financial systems. Drawing from the recommendations of the Committee on the Financial System (Chairman: Shri M. Narasimham), 1991, and the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham), 1998, financial sector reforms have consisted of reduction of statutory preemptions by way of changes in the policy environment, institutional strengthening, infusion of competition and establishment of a pro-active and comprehensive regulatory and supervisory framework.

10.3 Developments during 2000-01 cover the activities of the Board for Financial Supervision (BFS) and institutional performance - spanning commercial and co-operative banks, financial institutions and NBFCs - in terms of various parameters of supervision, *i.e.*, capital adequacy, provisioning, asset classification and income recognition, restructuring / rescheduling/ renegotiations of loans, non-performing assets, disclosure and exposure norms and entry norms for new private sector banks as well as for banks and NBFCs entering insurance business. Co-ordination issues between banks and financial institutions, issues in the supervision of co-operative banks and off-site supervision are also discussed. The subsection on institutional measures, which are directed towards strengthening and broadening the ambit of regulation and supervision over the medium-term and which apply across institutions in the financial sector, cover developments relating to macro-prudential indicators, risk-based supervision, universal banking, consolidated supervision and the initiatives undertaken in assessing the applicability of international standards to the Indian financial system.

DEVELOPMENTS DURING 2000-01

10.4 The BFS, set up in November 1994 under the Reserve Bank of India (Board for Financial Supervision) Regulations, is entrusted with the supervision of commercial banks, select FIs and NBFCs. The directions of the BFS are implemented by the Reserve Bank's Department of Banking Supervision (DBS), which supervises scheduled commercial banks (except regional rural banks), the Financial Institutions Division (FID) of DBS, which supervises select FIs and the Department of Non-Banking Supervision (DNBS), which supervises the NBFCs. The BFS has approved a new strategy of supervision comprising, *inter alia*, (i) the setting up of an off-site surveillance system for in-house monitoring of banks and other credit institutions, building a 'Memory' on all supervised institutions and setting up of a Market Intelligence and Surveillance Unit (MISU); (ii) restructuring of the system of bank inspections in terms of focus, process, reporting and follow-up; (iii) strengthening the statutory audit of banks and enlarging the role of auditors in the supervisory process; and (iv) strengthening the internal defence of the supervised institutions as an extension of the task of supervision. While on-site inspections in the case of domestic banks are based on the CAMELS model (capital adequacy, asset quality, management, earnings, liquidity and systems and controls), foreign banks are inspected on the basis of the CACS model (capital adequacy, asset quality, compliance and systems). The off-site monitoring system for surveillance over banks, introduced in 1995, has since been extended to select FIs and NBFCs as well. In the case of NBFCs, the supervisory framework consists of a four-pronged mechanism comprising (i) on-site inspection on the CAMELS pattern, *viz.*, capital adequacy, assets, management, earnings, liquidity, systems and procedures; (ii) off-site monitoring through periodic control returns from NBFCs using state-of-the-art information technology; (iii) an effective market intelligence network; and (iv) a system of submission of exception reports by statutory auditors of NBFCs.

10.5 During 2000-01 (July-June), the BFS reviewed the annual financial inspection in respect of 27 public sector banks, a consolidated report of the local head offices of the State Bank of India, 26 private sector banks, 50 foreign banks and 6 all-India FIs. During the year, 877 urban co-operative banks were inspected as against 828 banks during 1999-2000. In case of NBFCs, out of the 36,683 applications for the certificate of registration (CoR), 13,618 applications were approved and only 771 were permitted to accept public deposits as at end-June 2001. Besides, 270 regular inspections (and 1,193 scrutinies) were completed during the year. The Board also reviewed the monitoring with regard to bank frauds and house-keeping in public sector banks including reconciliation of entries in inter-branch accounts, inter-bank accounts (including *nostro* accounts) and balancing of the books of accounts of select FIs and NBFCs. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the BFS also provided guidance on several regulatory and supervisory concerns.

Scheduled Commercial Banks

Capital Adequacy

10.6 Scheduled commercial banks are required to maintain a minimum capital to risk-weighted assets ratio (CRAR) of 9 per cent since the year ended March 2000 and to assign a risk-weight of 2.5 per cent to cover market risk in respect of all securities including securities outside the SLR from the year ended March 2001 (in addition to the risk-weight prescribed for covering credit risk). Besides, some capital cushion was required to be provided for market risk. In April

2000, banks were advised to assign a risk-weight of 100 per cent for State Government guaranteed securities issued by defaulting entities and not on all the securities issued or guaranteed by the concerned State Government. Furthermore, banks were required to assign a 20 per cent risk-weight on all loans and advances granted to their staff which are fully covered by superannuation benefits and mortgage of house/flat. This stipulation was extended to FIs as well.

10.7 Deposits placed with the National Bank for Agriculture and Rural Development (NABARD)/Small Industries Development Bank of India (SIDBI) in *lieu* of the shortfall in banks' advances to the priority sector *vis-a-vis* the prescribed target were assigned a 100 per cent risk-weight as these deposits are in *lieu* of assets that carry a similar risk-weight.

Risk-Weighting and Provisioning Norms: Credit Guarantee Trust for Small Industries

10.8 The concessions in risk-weighting and provisioning norms applicable to DICGC/ECGC guaranteed advances were extended, *mutatis mutandis*, to advances covered by the guarantee scheme of the Credit Guarantee Trust for Small Industries.

Provisioning

10.9 It was clarified that the provision of 0.25 per cent on the standard assets of scheduled commercial banks would be applicable on a global portfolio basis and not on domestic advances alone. From October 2000, the general provision on standard assets was included in Tier II capital, together with other "general provisions and loss reserves", up to a maximum of 1.25 per cent of the total risk-weighted assets. Banks have also been advised to make, on prudential considerations, provisions in excess of the minimum prescribed by the Reserve Bank, based on their own perceptions of risks in respective accounts. As a further prudential measure, banks were required to transfer not less than 25 per cent of their net profit (before appropriations but after adjustment/provision for staff bonus) to the reserve fund as against the statutory minimum of 20 per cent.

Asset Classification

10.10 The existing norms relating to restructuring/rescheduling/renegotiation of terms of the standard and sub-standard loan assets in respect of banks and FIs were reviewed in the light of the international best practices and the Basel Committee guidelines, and norms were prescribed for asset classification immediately after restructuring/ renegotiation/rescheduling in respect of standard and sub-standard assets. Norms were also prescribed for the treatment of provisions against upgradation of restructured/ renegotiated/rescheduled assets. It was decided that a rescheduling of the instalments of principal alone, in the case of a standard asset, would not cause such assets to be classified in the sub-standard category provided the loan/credit facility is fully secured. Further, a rescheduling of the interest element would not cause an asset to be downgraded to the substandard category subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved. Under similar conditions, a sub-standard asset could continue to be classified as sub-standard even after restructuring, if the asset is either written off or fully secured and the sacrifice, if any in interest, is either written off or fully

provided for. The guidelines do not apply to doubtful assets.

Classification and Valuation of Investments

10.11 In order to make the valuation of the banks' investment portfolio reflective of the purpose for which such investments were made, commercial banks were required to classify their entire investment portfolio, with effect from September 30, 2000 (as on March 31, 2001, in the case of select FIs) under three categories, *viz.*, "held to maturity", "available for sale" and "held for trading". Investments under "available for sale" are to be marked to market at the year-end or at more frequent intervals. Investments under "held for trading" category are to be marked to market monthly or at more frequent intervals. Guidelines were also issued for the classification of investments, shifting of investments among the three categories, valuation of the investments, methodology for booking profit/ loss on sale of investments and providing for depreciation. The holdings under the "held to maturity" category are not to exceed 25 per cent of the total investments. In case of RRBs, the existing categorisation of their investments into SLR and non-SLR securities would continue, as they do not trade in securities. The RRBs would be exempted from marking to market norms in respect of SLR/approved securities up to March 2002, although non-SLR securities would have to be marked to market scrip-wise at the year-end or at more frequent intervals.

Investments in Privately Placed Unrated Debentures, etc.

10.12 Banks were advised to put in place appropriate systems to ensure that investment in privately placed unrated instruments is made in accordance with the systems and procedures prescribed under the respective bank's investment policy approved by the board. Banks were also advised to introduce a suitable format of disclosure requirements in respect of private placement issues, on the lines of the model format recommended by the Technical Group on Non-SLR Investments, with the approval of the board. The bank boards should lay down the policy and prudential limits on investments in bonds and debentures including a cap on unrated issues and on private placement basis, sub-limits for PSU bonds, corporate bonds, guaranteed bonds, issuer ceiling, *etc.* The policy laid down by banks should prescribe stringent appraisal of issues, especially by non-borrower customers, provide for an internal system of rating for non-borrower customers, stipulate entry-level minimum ratings/quality standards, lay down proper risk management systems, *etc.*

Voluntary Retirement Scheme

10.13 In case of expenditure under the Voluntary Retirement Scheme (VRS), the Reserve Bank, in consultation with the Institute of Chartered Accountants of India (ICAI), advised banks that: (i) the liability in case of *ex-gratia* payment should be recognised in the accounting year in which the decision to accept the voluntary retirement of the employee is taken and communicated to the concerned person and unless expended in the same period, should be treated as deferred revenue expenditure; (ii) the excess of terminal benefits over the actuarial provisions should be treated as deferred revenue expenditure unless expensed in the same year; (iii) leave encashment expenditure should be treated as current expenditure, unless the same is actuarialised for all employees, in which case, the excess over provisions may be treated as deferred revenue

expenditure and amortised over a period not exceeding five years; (iv) the period of deferment should be restricted to a maximum of five years including the year of acceptance of the VRS application by the bank; and (v) bonds issued in relation to VRS payments, net of unamortised deferred revenue expenditure, could be treated as Tier-II capital.

Non-Performing Assets

10.14 The performance of Indian banks in respect of their non-performing assets has shown an improvement in recent years (Table 10.1). With a view to further tightening prudential norms, the concept of "past due" in respect of the identification of non-performing assets (NPAs), which allowed a grace period of 30 days beyond the due date, was dispensed with effective March 31, 2001. In order to move towards international best practices and to ensure greater transparency, it was announced in the April 2001 monetary and credit policy statement that from the year ending March 31, 2004, the 90-day default norm, as against the existing norm of 180 days, would be adopted in the classification of advances as NPAs. As a facilitating measure, banks were advised to move over to the charging of interest at monthly rests by April 1, 2002. Banks would have to upgrade their Management Information Systems (MIS) for collecting data on loans where the default has occurred for more than 90 days and commence making additional provisions for such loans from the year ending March 31, 2002, with a view to strengthening their balance sheets and ensuring smooth transition to the 90-day norm. In this regard, banks' action plans would be monitored by the Reserve Bank on a half-yearly basis.

Table 10.1 : Frequency Distribution of Net NPAs to Net Advances - Scheduled Commercial Banks

Year	Public Sector Banks		Private Sector Banks		Foreign Banks
	SBI Group	Nationalised	Old	New	
1	2	3	4	5	6
1996-97					
Up to 10 %	5	12	22	9	36
Above 10 % and up to 20 %	3	6	3	Nil	1
Above 20 %	Nil	1	Nil	Nil	2
1997-98					
Up to 10 %	4	13	21	9	33
Above 10 % and up to 20 %	4	5	4	Nil	6
Above 20 %	Nil	1	Nil	Nil	3
1998-99					
Up to 10 %	4	14	16	9	27
Above 10 % and up to 20 %	4	4	4	Nil	10
Above 20 %	Nil	1	3	Nil	3
1999-2000					
Up to 10 %	7	15	17	8	32
Above 10 % and up to 20 %	1	4	6	Nil	6
Above 20 %	Nil	Nil	1	Nil	4
2000-01 P					

Up to to 10%	8	14	17	8	31
Above 10% and up to 20%	Nil	5	3	Nil	6
Above 20%	Nil	Nil	3	Nil	5

P Provisional.

Notes:
1. The Bareilly Corporation Bank Ltd. was amalgamated with Bank of Baroda with effect from June 3, 1999.
2. The Sikkim Bank Ltd. was amalgamated with Union Bank of India with effect from December 22, 1999.
3. The Times Bank Ltd. was merged with HDFC Bank Ltd. with effect from February 26, 2000.
4. The branches of the British Bank of the Middle East in India were amalgamated with HSBC with effect from September 25, 1999.
5. The Bank of Madura Limited was amalgamated with ICICI Bank Limited with effect from March 10,2001

Divergence in NPAs - Clarifications

10.15 Divergences have persisted in the assessment of NPAs by banks, statutory auditors and the Reserve Bank inspectors. Based on the recommendations of a Working Group, as per the directions of the BFS, user-friendly guidelines in a question-answer format were issued in June 2001.

Debt Recovery

10.16 Guidelines in respect of the Settlement Advisory Committee (SAC), issued in May 1999, ere revised in July 2000 for the compromise settlement of chronic NPAs of all sectors including the small sector. The guidelines provide a simplified, non-discretionary and non-discriminatory mechanism for recovery of NPAs. The revised guidelines cover accounts which have become doubtful assets or loss assets as on March 31, 1997 and also sub-standard accounts as on March 31, 1997 which became doubtful or loss assets subsequently, with an outstanding balance of Rs.5 crore and below. The time-frame for the revised guidelines, operative till March 31, 2001, was extended up to June 30, 2001 and banks have been given time up to September 30, 2001 for processing these applications/cases. All public sector banks have been directed to uniformly follow these guidelines, so that they maximise recovery of NPAs within the stipulated time. In order to make increased use of the forum of *Lok Adalats* to settle disputes involving smaller amounts, banks and FIs were also provided the following guidelines for implementation: (i) ceiling of amount for coverage under *Lok Adalats* would be up to Rs.5 lakh; (ii) the scheme may include all NPA accounts, both suit-filed and non-suit filed accounts, which are in the doubtful and loss category; (iii) the settlement formula has to be flexible and left to the boards of directors of banks and FIs, keeping in view certain essential parameters; and (iv) the banks and FIs should get in touch with State/district/*taluk* level authorities for organising *Lok Adalats*.

Disclosure Norms

10.17 With effect from March 31, 2000, banks are required to disclose in their balance sheets

the following information: (i) the maturity pattern of deposits, borrowings, investments, loans and advances and foreign currency assets and liabilities; (ii) movements in NPAs; and (iii) lending to sensitive sectors (*e.g.*, capital market, real estate and commodities). This is in addition to the extant disclosure stipulations regarding the capital adequacy ratio, Tier-I and Tier-II capital, percentage of shareholding of the Government of India, percentage of net NPAs to net advances, amount of provision made towards NPAs, depreciation in the value of investments and income tax during the year, amount of subordinated debt raised as Tier-II capital, the gross value of investments in India and outside India, the aggregate provisions for depreciation separately on investments in India and outside India and the net value of investments in India and outside India, interest income as a percentage of average working funds, non-interest income as a percentage of average working funds, operating profits as percentage of working funds, return on assets, business (deposits plus credit) per employee and profit per employee. The total exposure to sensitive sectors as on March 31, 2000 by scheduled commercial banks stood at Rs.19,669 crore, comprising 4.4 per cent of total advances. As a move towards greater transparency, banks are required to disclose the following additional information in respect of restructured loan assets in their published annual accounts under the 'Notes on Accounts', effective March 31, 2001: amount of (i) loan assets subjected to restructuring; (ii) standard assets subjected to restructuring; and (iii) sub-standard assets subjected to restructuring, respectively.

Exposure Norms

10.18 The exposure ceiling in respect of an individual borrower was reduced from 25 per cent to 20 per cent of the bank's capital funds, effective April 1, 2000. Where the existing level of exposure, as on October 31, 1999, was more than 20 per cent, banks are expected to reduce the exposure to the 20 per cent limit over a two-year period, *i.e.*, by end-October 2001. In consultation with banks, the Reserve Bank announced fresh guidelines in respect of the concept of "capital funds", measurement of credit exposure and the level of the exposure limit. The exposure ceiling is to be computed in relation to total capital in India as defined under capital adequacy standards (Tier I and Tier II), effective March 31, 2002. Non-fund based exposures are to be reckoned at hundred per cent and in addition, banks should include forward contracts in foreign exchange and other derivative products like currency swaps and options at their replacement cost value in determining the individual/group borrowers exposure ceiling, effective April 1, 2003. The exposure ceiling for a single borrower was further revised downwards from the existing 20 per cent of a bank's capital funds to 15 per cent, effective March 31, 2002. Group exposure limits were also revised downwards from the existing 50 per cent of a bank's capital funds to 40 per cent with effect from March 31, 2002. Only in the case of financing of infrastructure projects, the group exposure limit is extendable by an additional 10 per cent, *i.e.*, up to 50 per cent.

10.19 The guidelines for banks' exposure to capital markets were reviewed based on the recommendations of the Standing Technical Committee of Reserve Bank-SEBI officials on banks' financing of equities and investments in shares and guidelines were issued on November 10, 2000. Banks were advised that within the overall exposure to sensitive sectors, a bank's exposure to the capital market by way of investments in shares, convertible debentures and units of equity-oriented mutual funds should not exceed 5 per cent of outstanding domestic credit (excluding inter-bank lending and advances outside India) as on March 31 of the previous year.

On a further review and in line with the recommendations of the Reserve Bank-SEBI Technical Committee, revised guidelines were issued on

May 11, 2001. Banks could acquire shares, debentures and units of mutual funds, *etc.*, for direct investment in shares/debentures, *etc.*, at their own risk and for issuing loans and advances to individuals and share-broking entities for investment in capital markets on their own account. Shares/debentures may be assigned to banks by individuals and corporates as collateral and additional security for certain approved purposes which do not involve stockbroking or investment in the capital market. In terms of these guidelines, banks' exposure to capital markets in all forms was restricted to 5 per cent of total advances (including Commercial Paper) outstanding as on March 31 of the previous year. The ceiling of 5 per cent would cover : (i) direct investments in equity shares and convertible bonds and debentures; (ii) advances against shares to individuals for investment in equity shares (including IPOs), bonds and debentures, units of equity-oriented mutual funds; and (iii) secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers. A uniform margin of 40 per cent was prescribed on all advances/financing of IPOs/guarantees. A minimum cash margin of 20 per cent (within the margin of 40 per cent) was prescribed in respect of guarantees issued by banks.

10.20 Norms in respect of risk management and internal control systems for banks were specified. Banks making investments in equity shares/debentures, financing of equities and issue of guarantees within the 5 per cent ceiling were encouraged to build up adequate expertise in equity research as warranted by their scale of operations and formulate a transparent policy and procedure for investment in shares, *etc.*, with the approval of their boards. The investment and the audit committees, set up by their boards, primarily responsible for taking the investment decision as also for the surveillance and monitoring of such investments. As regards the valuation and disclosure requirements, equity shares in the banks' portfolios, whether held as primary security or as collateral for advances or guarantees, or as investment, should be marked to market, preferably on a daily basis, but at least on a weekly basis. Banks are required to disclose the total investments made in equity shares, convertible bonds and debentures, units of equity-oriented mutual funds and aggregate advances against shares in the 'Notes on Accounts' to their balance sheets. The guidelines are subject to review by the Reserve Bank-SEBI Technical Committee after six months.

Repatriation of GDRs/ADRs Proceeds

10.21 Considering the fact that banks which are raising capital abroad for improving their capital base have largely rupee-denominated assets and that most of the risk limits are linked to their capital, banks and FIs are required to repatriate the entire proceeds of GDRs/ADRs soon after the issue process is completed. The provision is applicable to direct investments in banks made by NRIs/OCBs, foreign banking companies or finance companies, including multilateral institutions.

Guidelines for Entry Norms for New Private Sector Banks

10.22 The banking industry has been experiencing the rigours of intensifying competition, on the one hand, and a tightening of prudential regulations, on the other. In view of these emerging

trends, the Reserve Bank revised the entry norms for new banks in January 2001. The minimum capital for eligible entities was set at Rs.200 crore to be raised to Rs.300 crore in three years. A minimum contribution of promotors was set at 40 per cent of the paid-up capital, with a lock-in period of five years, with the NRI participation restricted to 40 per cent of paid-up capital. Eligible entities were required to achieve an initial CRAR of not less than 10 per cent and priority sector lending of not less than 40 per cent of total net bank credit. Guidelines were also set out to ensure an arm's-length relationship between investing companies and promoter groups to prevent connected lending. Guidelines were also issued for the conversion of NBFCs to scheduled banks.

10.23 The guidelines for entry of new private sector banks were revised to make the issue of licences selective and restricted to the applicants who can meet stringent prudential requirements and provide efficient customer service. As per the guidelines, the applications received by the Reserve Bank for setting up of new banks till March 31, 2001, will be screened by a High-Level Advisory Committee, headed by Dr. I.G. Patel, former Governor, Reserve Bank, before granting in-principle approval by the Reserve Bank. The Committee has submitted its report.

Norms for Banks/NBFCs Entering Insurance

10.24 Under the Insurance Regulatory and Development Authority (IRDA) Act, 1999, banks and registered NBFCs have been permitted to enter the insurance business. Insurance has been notified by the Central Government as a permissible form of business that could be undertaken by banks under Section 6 (1) (o) of the Banking Regulation Act, 1949. The norms are intended to ensure that risks involved in the insurance business do not get transferred to the bank/NBFC and that the banking/NBFC business does not get contaminated. The maximum equity contribution that a bank/NBFC could hold in a joint venture company on risk participation basis will normally be 50 per cent of the paid-up capital of the insurance company subject to compliance with any rules and regulations laid down by the IRDA/Central Government. On a selective basis, the Reserve Bank could permit a higher equity contribution by a promoter bank/NBFC, subject to divestment within a prescribed period. In proposals with a foreign partner contributing 26 per cent of equity, more than one public sector bank or private sector bank or NBFC could be allowed to participate in the equity of the insurance joint venture with the approval of IRDA/FIPB. Banks are required to meet specific criteria of entry on the basis of the latest available audited balance sheet. Banks/NBFCs which are not eligible as joint venture participants can make investments up to 10 per cent of the net worth of the bank or 10 per cent of owned fund of the NBFC or Rs.50 crore, whichever is lower, in the insurance company, for providing infrastructure/services support, and without any contingent liability for the bank. The banks/NBFCs, as also their subsidiaries, are allowed to undertake distribution of insurance products on agency basis without any risk participation.

Off-site Supervision

10.25 Under the Off-site Monitoring and Surveillance System (OSMOS), introduced in 1995, banks are required to submit DSB returns to the Reserve Bank. These returns, collected on a quarterly basis, are used for the purpose of prudential supervision of banks in between on-site inspections. The first *tranche* covers data on assets and liabilities, capital adequacy, operating

results, asset quality, large exposures, connected lending and the ownership pattern of banks. The second *tranche* covers data on exposure of banks to interest rate and liquidity risks (both in domestic and foreign currencies). A new return to capture key data on operations of domestic subsidiaries of banks has been introduced in September 2000 under the second *tranche*. Apart from these returns, banks are required to submit the balance sheet analysis and bank profile statements annually. The OSMOS database forms the main input for the half-yearly reviews on macro-prudential indicators. In future, this database is expected to constitute the core of the risk-based supervision framework.

Other Supervisory Initiatives

10.26 The State Bank of India (SBI) has incorporated a Credit Information Bureau (CIB) in collaboration with HDFC Limited and foreign technology partners to develop an institutional mechanism for sharing of information on borrowers/ potential borrowers among banks and FIs, within the confines of the existing legislation. In order to strengthen the legal mechanism for making the functioning of CIB effective, a draft master legislation covering its responsibilities, rights and obligations of the member credit institutions and safeguarding of the privacy rights, was forwarded to the Central Government.

10.27 With a view to developing an 'informal monitoring mechanism' along with the formal channels of supervision, the Reserve Bank activated the Market Intelligence Cell, which seeks to gather discrete information on banks, normally outside the structured reporting system.

10.28 A scheme of Prompt Corrective Action (PCA) based on certain triggers is being developed as a supervisory tool. The scheme is aimed at taking prompt action at an early stage for banks showing incipient signs of weakness and is in addition to the existing supervisory tools.

10.29 The Reserve Bank had set up a Working Group, in consultation with the Central Government, to examine the contents of the calendar of reviews for public sector banks and suggest changes as it was felt that the scope and content of some of the prescribed reviews were not meeting the intended objectives and required suitable changes in the light of the recent developments in the banking sector. Based on the Group’s recommendations, a revised calendar of reviews, effective August 1, 2000, was prescribed for public sector banks. This contains three parts, *viz.*, the reviews to be put up to (i) the board of directors; (ii) the management committee; and (iii) the audit committee of the board. The reviews prescribed cover all the functional areas of the banks in an exhaustive manner.

Co-operative Banking

Provisioning

10.30 Provisions towards standard assets for urban co-operative banks (UCBs) are not required to be netted from gross advances, as earlier, but to be shown separately as "Contingent Provisions against Standard Assets" under Other Funds and Reserves in the balance sheet. In case, banks are already maintaining excess provisions, under the Bad and Doubtful Debt

Reserve, the additional provision required for standard assets could be segregated from that reserve and parked under the head "Contingent Provisions against Standard Assets" with the approval of their boards.

Non-performing Assets

10.31 Advances granted to units placed under rehabilitation packages approved by the Board for Industrial and Financial Reconstruction (BIFR) and/or term-lending institutions, in the case of UCBs, are treated as NPAs. For additional credit facilities to them, provisioning norms apply only after a period of one year from the date of disbursement. This relaxation has been made applicable to SSI units, which have been marked as sick by banks themselves.

Exposure Norms

10.32 The credit exposure ceiling in respect of an individual borrower was reduced to 20.0 per cent (from 25.0 per cent) of the capital funds of an UCB, effective April 1, 2000. In case, the existing exposure level as on March 31, 2000 was in excess of 20.0 per cent, it would have to be reduced to 20.0 per cent by end-March 2002. The definition of capital fund has been broadened to include balances held under the building fund in addition to the share capital and statutory reserves.

Registration and Licensing Policy of New Urban Co-operative Banks (UCBs)

10.33 In order to ensure better financial health and improved corporate governance, the Reserve Bank revised the entry point norms (EPNs) for new UCBs upwards in line with the recommendations of the High Power Committee on Urban Co-operative Banks (Chairman: Shri K. Madhava Rao). It was stipulated that, at all times, there should at least be two directors with suitable banking experience or relevant professional qualifications. The promoters should not be defaulters to any financial institution or bank. No criminal proceedings should have been instituted against the promoters and promoters should not be associated as directors with any chit fund/ NBFC/co-operative bank.

Conversion of Co-operative Credit Societies into Urban Co-operative Banks

10.34 In line with the guidelines issued under recommendations of the High Power Committee, a co-operative credit society, as defined under provisions of the Section 5(ccii) of the Banking Regulations Act, 1949 (as applicable to cooperative societies), may apply for conversion into an UCB if it possesses net owned funds and total membership not less than the Entry Point Capital and membership norms, respectively, prescribed for setting up new UCBs as indicated above. It should have (i) been making profits in each of the previous three consecutive years; (ii) secured 'A' class audit rating for the last three years successively; and (iii) a CRAR that should not be less than the ratio prescribed by the Reserve Bank.

10.35 The periodicity of inspection of UCBs was revised. All weak urban co-operative banks and scheduled urban co-operative banks would be inspected annually (including weak scheduled banks). Well-managed non-scheduled banks would be inspected once in three years. All other

non-scheduled banks would be inspected once in two years. In case of newly licensed banks, supervisory efforts would be stringent from the initial period itself with a view to avoiding financial difficulties in the nascent stage.

Issues in Supervision

10.36 The asymmetry in the application of prudential norms and regulatory systems for UCBs *vis-a-vis* commercial banks has been the subject of attention in the recent period. The involvement of two authorities (Central Government/State Governments and the Reserve Bank) in the regulation of UCBs has resulted in overlapping jurisdiction and difficulties in carrying out administrative/ prudential measures with the required speed and stringency. In order to strengthen the efficacy of the Reserve Bank's regulation/ supervision over UCBs, important measures were announced in the monetary and credit policy for 2001-02 (Box X.1). Further, the recommendations of the High Power Committee for amending the provisions in the Banking Regulation Act for strengthening the Reserve Bank's regulations over UCBs are under consideration of the Reserve Bank and the Central Government.

Box X.1
Strengthening Supervision of Urban Co-operative Banks

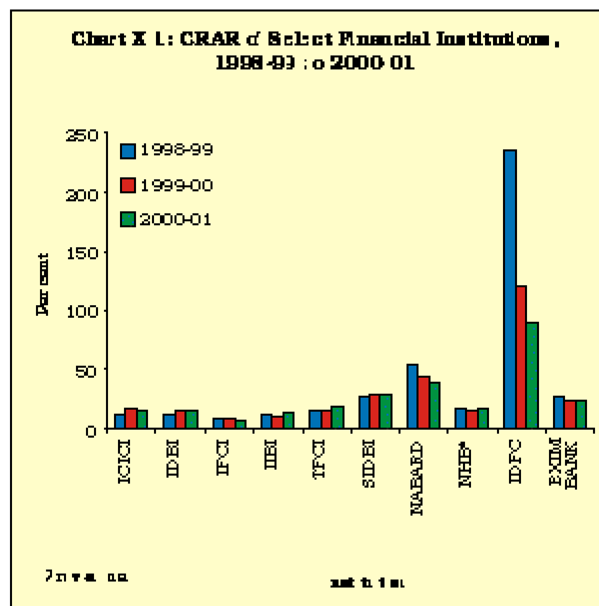
- No fresh proposals for lending directly or indirectly against security of shares either to individuals or any other entity (with effect from April 19, 2001).
- Borrowings in the call/notice money market on a daily basis not to exceed 2.0 per cent of their aggregate deposits as at end-March of the previous financial year.
- No increase in term deposits with other UCBs. Present term deposits to be unwound before end-June 2002.
- The SLR component to be maintained in the form of Government and other approved securities for non-scheduled UCBs with NDTL of Rs.25 crore and above raised from 10.0 per cent to 15.0 per cent, and from nil to 10.0 per cent for UCBs with NDTL less than Rs.25 crore. For scheduled UCBs, the same increased from 15.0 per cent to 20.0 per cent (increased levels to be achieved by end-March 2002).
- With effect from April 1, 2003, scheduled UCBs to maintain their entire SLR assets of 25.0 per cent of NDTL only in Government and other approved securities.

10.37 In the light of the recent experience, an option meriting consideration is the setting up of a new apex supervisory body, which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs. At present there are 2,084 UCBs, of which 51 are scheduled. This apex body could be under the control of a separate high-level supervisory board consisting of representatives of the Central Government, State Governments, the Reserve Bank as well as experts and may be given the responsibility of inspection and supervision of UCBs and ensure their conformity with prudential, capital adequacy and risk-management norms as laid down by the Reserve Bank. The Reserve Bank is in consultation with the Central Government regarding this proposal.

Financial Institutions

Capital Adequacy

10.38 Analogous to the regulations for scheduled commercial banks, select all-India FIs are required to maintain a minimum capital to risk-weighted assets ratio of 9 per cent since the year ended March 2000 and to assign a risk-weight of 2.5 per cent to cover market risk in respect of the entire investment portfolio from the year ended March 31, 2001 over and above the 20 per cent/100 per cent risk-weight already assigned for credit risk in non-Government/non-approved securities (Chart X.1). FIs are also required to assign a risk-weight of 100 per cent for State Government guaranteed securities issued by defaulting entities. A risk weight of 20 per cent should be assigned to all such loans and advances granted by the FIs to their own employees as are covered by superannuation benefits and mortgage of flats/houses. All other loans and advances to own employees should, however, be subject to a 100 per cent risk weight.



Provisioning

10.39 In May 2000, the netting of provision against standard assets from gross advances was discontinued in respect of select all-India FIs. These provisions are to be shown separately as "Contingent Provision against Standard Assets" under "Other Liabilities and Provisions" in the balance sheets. This provision is not eligible for inclusion in Tier II capital or reckoned for arriving at net NPAs. In October 2000, this stipulation was amended in the light of international best practices to allow FIs to include the "General Provisions on Standard Assets" in their supplementary (Tier-II) capital. However, the provisions on standard assets along with other “General Provisions and Loss Reserves” should not exceed 1.25 per cent of the total risk-weighted assets. Effective May 30, 2000, the excess provision towards depreciation on equity investments should be appropriated to the “Investment Fluctuation Reserve Account” (IFRA) instead of the “Capital Reserve Account” (CRA) and is eligible for inclusion in Tier II capital. The existing amount of excess provision towards depreciation on investment held in the CRA is also to be transferred to the IFRA. The amount held in the IFRA could be utilised in future to meet the depreciation requirement on investments. The extra provision needed in the event of

depreciation in the value of investments is to be debited to the profit and loss account and if required, an equivalent amount may be transferred from the IFRA as a 'below-the-line' item after determining the profit for the year.

Classification and Valuation of Investments

10.40 In April 2000, FIs were required to value the investments in mutual fund units at market rates, as per stock exchange quotations, if available. Otherwise, the latest net asset value (NAV) declared by the mutual fund in respect of each particular scheme should be used for valuation. Pursuant to the recommendations of an informal group set up by the Reserve Bank, the guidelines for classification and valuation of investments by FIs were revised with effect from March 31, 2001, so as to bring the norms in consonance with the international best practices. The guidelines, *inter alia*, required FIs to classify their entire investment portfolio as on March 31, 2001 as 'held to maturity', 'available for sale' and 'held for trading'.

Asset Classification and Income Recognition

10.41 In order to bring parity in the NPA norms for banks and FIs, an asset of an FI would be treated as non-performing if interest and/ or instalment of principal remain overdue for more than 180 days with effect from the year ended March 31, 2002, as against the present norm of an overdue period of 365 days or more in respect of principal and more than 180 days in respect of interest. Guidelines issued to public sector banks for recovery of dues relating to NPAs were extended to all the central public financial institutions (*viz.*, IDBI, IFCI Ltd., IDFC Ltd., IIBI Ltd., TFCI Ltd., Exim Bank, NABARD, SIDBI and NHB) FIs were required to issue notices by August 31, 2000, to eligible defaulting borrowers to avail of the opportunity for a one-time settlement of their outstanding dues. Subsequently, the period for giving notice was extended up to September 30, 2000. The guidelines for settlement of the outstanding dues, which were to be operational up to March 31, 2001, were later extended up to June 30, 2001. FIs have also been given time up to September 30, 2001 for processing applications and cases in this regard.

Exposure Norms

10.42 In line with the best international practices, the Reserve Bank has decided to adopt the concept of “capital fund” as defined under capital adequacy standards for determining the exposure ceiling for the FIs, effective March 31, 2002. Effective from March 31, 2002, the exposure ceiling for ‘single borrower’ would be brought down from 20.0 per cent to 15.0 per cent of capital funds. Similarly, in case of group borrowers, the ceiling would be brought down from 50.0 per cent to 40.0 per cent and this ceiling is extended by an additional 10.0 per cent in the case of infrastructure projects, *i.e.*, up to 50.0 per cent. At present, in respect of non-fund based credit limits, only 50.0 per cent of such limits or outstandings, whichever is higher, is required to be taken into account for computing the extent of exposure. However, effective April 1, 2003, it should be reckoned at 100 per cent value. At present, derivative products, such as, forward rate agreements (FRAs) and interest rate swaps (IRS), *etc.*, are also captured for computing the exposure by applying the credit conversion factors to the notional principal amounts as per the ‘original exposure method’. Effective April 1, 2003, FIs should also include forward contracts in foreign exchange and other derivative products such as currency swaps,

options, *etc.*, at their “replacement costs”.

Disclosure Norms

10.43 Effective 2000-01, FIs are required to disclose as part of their 'Notes on Accounts', the following details, *viz.*, CRAR, core CRAR and supplementary CRAR, amount of subordinated debt raised and outstanding as Tier-II capital, risk-weighted assets, shareholding pattern, asset quality and credit concentration, maturity pattern of domestic and foreign currency assets and liabilities and details on operating results. Besides, they have to disclose details relating to loan assets and substandard assets which have been subjected to restructuring separately.

Advances against Shares and Debentures

10.44 In September 2000, FIs were required to ensure that whenever the limits of advances granted to a borrower against the security of shares/debenture exceeded Rs.10 lakh, the shares/debentures are transferred in the name of the FI concerned. With amendments to the SEBI (Depositories and Participants) Regulations, 1996 to facilitate pledge of dematerialised securities, the FIs could invoke the pledge in case of default by the borrower, subject to the provisions of the pledge documents and the depository would register the FI as beneficial owner.

Resource Mobilisation by Financial Institutions

10.45 Under the guidelines as modified on June 21, 2000, FIs are not required to seek the Reserve Bank's prior approval/registration for raising of resources by way of issue of bonds (both public issue and private placement) subject to the fulfilment of certain conditions, *viz.*, (i) a minimum maturity of 3 years; (ii) call/ put or both options, if any, not to be exercisable before the expiry of one year from the date of issue of bonds; (iii) the YTM offered, at the time of issue of bonds, including those with call/put options, not exceeding 200 basis points above YTM on the Government of India securities of equal residual maturities; and (iv) the 'exit' option on the bonds not to be offered before the end of one year from the date of issue.

10.46 The outstanding total resources mobilised at any point of time by an individual FI, including funds mobilised under the 'umbrella limit' prescribed by the Reserve Bank should not exceed 10 times its net owned funds (NoF) as per the latest audited balance sheet. The limit fixed for raising resources by FIs would be only an enabling provision. It was clarified that the resource requirements along with the maturity structure and the interest rate offered thereon would need to be arrived on a realistic basis and derived, *inter alia*, from a sound system of ALM/risk management.

10.47 In case of floating rate bonds, FIs are required to seek prior approval from the Reserve Bank, with regard to the 'reference rate' selected and the methods of floating rate determination. Prudential requirements set by other regulatory authorities such as the SEBI, *etc.,* also apply.

10.48 A format of consolidated returns in respect of raising of resources by all India FIs through money market instruments and bonds was introduced and the same was revised on December 5, 2000, to facilitate inclusion of additional information on short-term borrowings and

data on commercial paper, which has been included under the one-time 'umbrella limit'.

Rating for Public Deposits of FIs

10.49 The rating for term deposits accepted by all India FIs was made mandatory, effective November 1, 2000, in order to improve the functional efficiency of the market.

Co-ordination Issues Between Banks and FIs

10.50 Pursuant to the recommendations of the Working Group on Harmonising the Role and Operations of Development Financial Institutions and Banks (Chairman: Shri S.H. Khan), a Standing Co-ordination Committee was constituted in August 1999 under the *aegis* of the IDBI with representatives from select FIs and banks. Projects jointly financed by banks and FIs give rise to certain operational issues which, it was felt, could be better addressed through a more effective and closer co-ordination between the two sets of lenders, *viz.*, banks and FIs. Therefore, attention was focused on large projects jointly financed by banks and FIs in order to avoid delays and facilitate better solutions to the common problems. With these ends in view, select banks and FIs evolved ground rules in certain areas for consideration and adoption by banks and FIs, comprising, *inter alia*, a time-frame for sanction of facilities, asset classification across consortium members, disciplining borrowers through changes in their management, adoption of a group approach to borrowers, levy of charges in problem accounts and sharing of securities and cash flows.

Supervisory System for FIs

10.51 As a part of the integrated supervisory strategy, a Prudential Supervisory Reporting System (PSRS) for an on-going off-site surveillance was introduced in July 1999 to periodically obtain the essential data pertaining to prudential concerns of the Reserve Bank and to help the build-up of the MIS on prudential parameters within the FIs. The PSRS, patterned broadly on the lines of the off-site surveillance system initially prescribed for the banks, comprises seven returns - three quarterly, two half yearly and two annual -covering assets and liabilities of the FIs, capital adequacy, operational results, asset quality, ownership and control, large credit and the list of subsidiaries/associates.

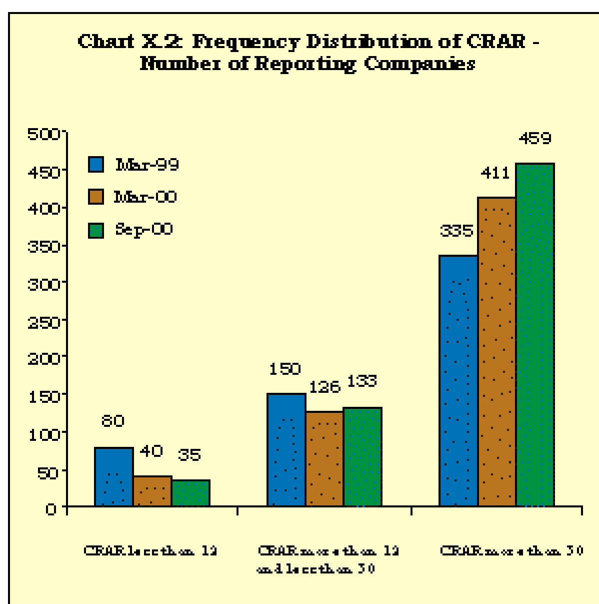
10.52 Changes in the practices/procedures followed in conducting the financial inspection of FIs were effected from January 24, 2001. Information requirements of the inspection team would be advised to the FIs at least a month before the commencement of inspection to ensure better time management and efficiency of the examination process. Before the commencement of inspection, the management of the FIs would be requested to make a presentation to the inspection team on their perspective of risk exposures and the manner in which these risks were addressed in the past and the future strategy in this regard. With a view to strengthening the on-site inspection mechanism, inspections would be conducted annually instead of once in two years. The inspection of all ten FIs would be taken up during the inspection cycle 2001-2002 with reference to the date of balance sheet of the FIs for the accounting year 2000-2001.

Non-Banking Financial Companies

Capital Adequacy

10.53 The norms relating to CRAR have been made applicable to NBFCs accepting/holding public deposits with effect from end-March 1998. These stipulate that every such NBFC shall maintain a minimum CRAR consisting of Tier-I and Tier-II capital which should not be less than 10 per cent on or before March 31, 1998 and 12 per cent on or before March 31, 1999, of its aggregate risk-weighted assets and of risk-adjusted value of off-balance sheet items. Further, the equipment-leasing and hire-purchase finance companies without minimum investment grade credit rating were allowed to take public deposits only if they had a CRAR of 15 per cent and above. Moreover, the requirement of CRAR for loan and investment companies accepting public deposits was also raised to 15 per cent. The total of Tier-II capital will be limited to a maximum of hundred per cent of Tier I capital for the purpose of compliance with norms.

10.54 As regards the frequency distribution of CRAR for NBFCs, as many as 537 out of 577 companies (93.1 per cent) had a CRAR of 12 per cent and above, as at end-March 2000, with as many as 411 companies (71.2 per cent) registering a CRAR in excess of 30 per cent. As at the end of September 2000, as many as 592 out of 627 reporting companies (94.4 per cent) reported a CRAR equal to or in excess of the stipulated minimum with as many as 459 companies (73.2 per cent) having a CRAR above 30 per cent (Chart X.2).



Asset Liability Management

10.55 The Reserve Bank introduced an ALM system for NBFCs for effective risk management in their various portfolios. Initially, the ALM system has been made applicable to NBFCs which have an asset size of Rs.100 crore or more or public deposits of Rs.20 crore or more as per their balance sheet as on March 31, 2001. The guidelines would be fully operational by the year ending March 31, 2002. The NBFCs not qualifying at present have also been advised to put in place an ALM system so that these guidelines apply to all NBFCs.

10.56 Residuary Non-Banking Companies (RNBCs) are required to invest not less than 80 per cent of their deposits in a prescribed manner. They have been permitted to invest up to two per cent of the aggregate deposit liabilities in the schemes of mutual funds approved by the SEBI along with the schemes of the Unit Trust of India (UTI), subject to an overall ceiling of ten per cent of investment in the various mutual fund schemes taken together. The two per cent sub-ceiling would not be applicable to schemes of the UTI.

Public Deposits by Non-Banking Financial Companies

10.57 Public deposits of NBFCs comprise all deposits except those by way of borrowing from (i) the Central/State governments; (ii) FIs, (iii) international bodies; (iv) inter-corporate deposits; (v) banks; (vi) mutual funds; and (vi) secured debentures, *etc.* Receipt of money from persons who fall in the category of relatives of directors of the NBFC as specified in the Companies Act, 1956 was exempted from the definition of 'public deposit' as defined in the NBFC Acceptance of Public Deposits' (Reserve Bank) Direction 1998. Money received by NBFCs by issue of CP is exempted from the purview of public deposits. The maximum rate of interest that the NBFCs, miscellaneous non-banking companies (chit fund companies) and Nidhi companies can pay on their public deposits was reduced, effective April 1, 2001, from 16 per cent to 14 per cent per annum. In respect of the RNBCs, on and from July 1, 2000, the floor interest rates payable was lowered by two percentage points to 6 per cent per annum, to be compounded annually, on amounts deposited in lump sum or at monthly or at longer intervals and 4 per cent per annum (to be compounded annually) on the amounts deposited under daily deposit schemes.

10.58 The Supreme Court upheld the constitutional validity and reasonableness of the provisions of Section 45-S of the Reserve Bank of India Act, 1934 that prohibits unincorporated bodies engaged in the business of financial institution from accepting public deposits except from certain specified relatives. By virtue of this judgement, about 3,000 writ petitions pending before various high courts all over India challenging the constitutional validity of Section 45-S of the Act were dismissed.

Rationalisation of Returns submitted by NBFCs

10.59 The formats of all the returns to be submitted by the NBFCs, RNBCs and chit fund companies at quarterly, half-yearly and annual intervals were rationalised with a view to improving the reporting of supervisory information and facilitating electronic processing of these returns. A monthly return on the repayment of deposits was prescribed for NBFCs holding public deposits but whose applications for CoRs under Section 45-IA of Reserve Bank of India Act, 1934 were rejected or cancelled, if granted. The returns on the asset-liability position of the NBFCs holding public deposits of Rs.20 crore and above for the purpose of monetary and liquidity aggregates were expanded to include items of supervisory information and also for picking up early warning signals of deterioration in their financial health.

Other Supervisory Initiatives

10.60 The Reserve Bank has taken an active role in educating the general public and the NBFC

personnel in order to familiarise them with the need for having better systems and procedures for improving compliance with the regulatory framework. The campaign comprises a three-pronged strategy consisting of advertisements in print media, spots on electronic media and informal publicity through seminars, press meets, *etc.* At the same time, police officials and officials of the State Governments were trained to equip them with the skills of pro-actively dealing with unscrupulous elements in the NBFC sector. The Reserve Bank continues to follow up with various State Governments and the Union Territories for enacting legislation for protection of depositors' interest. Five States have enacted the Protection of Interest of Depositors (in Financial Establishments) Acts, while three State Governments have taken necessary steps for enactment.

Miscellaneous Issues in Regulation and Supervision

10.61 The Reserve Bank undertook several initiatives in recent years to amend the relevant laws with a view to developing the legal infrastructure for financial sector reforms. The major legal reforms initiated in the banking sector in the recent months encompass areas such as security laws, the Negotiable Instruments Act, fraud on banks and the regulatory framework of banking. The Reserve Bank also forwarded its recommendations to the Central Government for comprehensive amendments to the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. The Financial Companies Regulation Bill, 2000 incorporating provisions contained in the Chapters IIIB and IIIC of the Reserve Bank of India Act, 1934, with certain modifications and certain new safeguards to protect the interests of the depositors and regulate the financial institutions in a more effective manner, has been referred to the Standing Committee on Finance.

Institutional Measures

10.62 Contemporaneous with the operational dispensation of the regulatory and supervisory functions, the Reserve Bank has been undertaking structural measures to strengthen the financial system and improve the efficiency of financial intermediation. In general, measures for institutional reform have emerged out of a consultative approach involving policy authorities, market participants, technical committees and advisory groups, as well as experts within the country and abroad. These structural measures have focused on improving the institutional infrastructure for a sound and resilient financial system, strengthening prudential and supervisory norms consistent with the organisational changes occurring in financial institutions, and developing the appropriate technological architecture. During 2000-01, emphasis was placed on developing financial markets, improvement in risk management and internal control mechanisms, debt recovery and upgradation of the payment and settlement system.

Macro-Prudential Indicators (MPIs)

10.63 The association of financial sector crises with problems in the real sector and the increasing severity of financial crises have prompted central banks all over the world to move to a system of preventive supervision. This consists of identifying early warning indicators to anticipate crises and undertake prompt corrective action to prevent crises before they occur. Under the new approach, early warning indicators combine the use of micro-prudential indicators of the supervised institutions (*i.e.*, banks, FIs and NBFCs), with macro-economic

indicators to constitute macro-prudential indicators. In this regard, an inter-departmental group was constituted and a pilot review of MPIs for the half-year ended March 2000 was finalised, followed by a review for September 2000. Over time, these reviews are expected to act as the foundation of an early warning system (Box X.2).

Risk-Based Supervision

10.64 In India, the simultaneous dismantling of controls and strengthening of the financial sector has posed challenges to regulation. In line with international best practices, the Reserve Bank has been gradually developing a risk-based supervision methodology, while simultaneously refining on-site inspection procedures.

10.65 The services of reputed international consultants were engaged to develop an overall plan for moving towards risk-based supervision (RBS) in India incorporating international supervisory best practices. Pricewaterhouse Coopers (PwC), London was appointed as consultant for the project with the assistance of the Department for International Development (DFID) of the UK. The consultant submitted a report to the Reserve Bank in May 2001. The RBS project is slated to enter the implementation stage.

Universal Banking

10.66 The FIs are expected to continue to have a special role in the Indian financial system pending the development of the debt market in terms of liquidity and depth. They also have the option to transform into a bank provided the prudential norms as applicable to banks are satisfied. In recognition of the need for a transition path towards universal banking, several operational and regulatory issues would need to be addressed. These, *inter alia*, relate to reserve requirements, permissible activities, disposal of non-banking assets, composition of the board, prohibition on floating charge of assets, nature of subsidiaries, restrictions on investments, connected lending, licensing, branch network, assets in India, formats of annual reports, managerial remuneration of chief executives, deposit insurance, authorised dealers' licence, priority sector lending and prudential norms. In April 2001, FIs were advised to work out the transition paths for their evolution towards universal banks and submit the same to the Reserve Bank.

Box X.2
Macro-Prudential Indicators: The Indian Initiatives

The micro-prudential intensive supervisory framework in India has exhibited a certain degree of macro-prudential orientation in the recent years. Unlike the micro-prudential intensive framework that emphasises institution-specific idiosyncratic risks, macro-prudential analysis intends to identify and contain systemic risks. The financial stability assessment framework is strengthened and becomes more effective when macro-prudential dimension of surveillance supplements the micro-prudential analysis.The micro-prudential perspective is essentially a bottom-up approach in which soundness of each institution can ensure a sound financial system. The macro-prudential perspective that uses aggregated prudential indicators of soundness follows a top-down approach. As a result, when risks to the system as a whole are identified on the basis of the signals received from a core set of macro-prudential indicators (MPIs), specific institutions that could be vulnerable are identified using the information reported regularly to the supervisor.

In the literature on banking/financial crises, several common indicators of vulnerabilities have been identified based on the experience of different episodes of crises in different countries. Macro-economic indicators typically display a distinctive pattern before the on set of a crisis as also during the period when the crisis unfolds. Macroeconomic indicators (MEIs) therefore, form a critical sub-set of the MPIs. Aggregated micro-prudential indicators (AMPIs) - representing aggregation of supervisory micro-prudential indicators across all institutions in a financial system - constitute the other important subset of the MPIs. Given the limited research on AMPIs, the recent initiatives focus only on developing a core set of AMPIs which appear to be relevant when seen in the context of the recent episodes of financial crises. Important AMPIs include indicators such as capital ratios, sectoral credit concentration, non-performing loans and provisions, connected lending, leverage ratios, return on assets, expense ratios, maturity structure of assets and liabilities, liquid asset ratios, sensitivity to market risk, foreign-currency denominated lending, *etc.* Besides AMPIs and MEIs, MPIs also include market-based indicators like credit ratings, sovereign yield spreads and market prices of financial instruments.

One commonly used framework for analysing the financial health of an individual institution is the CAMELS indicator set. In India, the micro-prudential framework for regulation and supervision of individual institutions uses a set of indicators facilitating: (i) peer group analysis based on critical financial ratios, and (ii) development of supervisory bank rating systems involving assignment of ratings based on the behaviour of certain indicators in relation to pre-specified norms/benchmarks. Both these approaches primarily use CAMELS based indicators. A Prompt Corrective Action framework based on some of these micro-prudential indicators (particularly CRAR, net NPAs and Return on Assets) is also expected to be operationalised so as to trigger corrective action at the earliest possible sign of weakness and to prevent any major deterioration in a bank's performance. To strengthen the effectiveness of the micro-prudential framework, efforts are under way to develop a core set of MPIs for India. In the March and September 2000 reviews, the objective was essentially to generate time-series information on AMPIs for the major financial institutions being supervised by the Reserve Bank and to identify major areas of systemic vulnerability as per the signals received from these AMPIs. Given the Reserve Bank's jurisdictions over supervision, AMPIs at present relate to scheduled commercial banks, NBFCs, select all-India FIs and PDs. In the absence of any established theoretical/empirical framework to explain the causal interactions between AMPIs and MEIs, an attempt was made in the first two reviews to identify certain linkages that could facilitate specifying a model of early warning for India in subsequent reviews.

Like the MPI based models trying to link MEIs and AMPIs, there are certain other statistical models which estimate rating changes for individual banks based on the behaviour of certain financial and non-financial variables (helping in triggering rating downgrades before complete information on CAMELS become available). Certain bank/institution specific models - known generally as "failure or survival prediction models" - also try to identify the probability of failure using certain economic and financial indicators based on their respective empirical importance in explaining a bank failure. Such models either rank the risk-based on certain probabilities assigned to each determinant of bank failure or use a bivariate probit technique. To simplify the use of indicators, there have been attempts to capture all the critical indicators of vulnerability in a few major composite indicators (*i.e.*, index of exchange market pressure, index of banking system vulnerability, and index of external vulnerability) by applying some arbitrary risk scoring (*i.e.*, different risk scoring for different values of each variable) and arbitrary weights (for generating composite indicators through aggregation across a set of select core indicators of vulnerability).

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Issues in Ownership

10.67 At present, the Reserve Bank holds a substantial stake in the State Bank of India (SBI), National Housing Bank (NHB), Infrastructure Development Finance Company (IDFC), Deposit

Insurance and Credit Guarantee Corporation (DICGC), National Bank for Agriculture and Rural Development (NABARD), Bharatiya Reserve Bank Note Mudran Limited (BRBNML), Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI). The Narasimham Committee on Banking Sector Reforms was of the view that ideally, theReserve Bank should not own the institutions it regulates in view of the conflict of interest that may arise between the ownership and supervisory roles of the Reserve Bank. In the Discussion Paper prepared by the Reserve Bank on Harmonising the Role and Operations of Development Financial Institutions and Banks (January 1999), it was suggested that in order to enable the Reserve Bank to concentrate on its regulatory and supervisory functions, the ownership of financing institutions could ideally be delinked from the Reserve Bank through transfer of such ownership to the Government. The Reserve Bank accepted the recommendation for transfer of ownership of its shares in the SBI, NHB and NABARD to the Central Government. The Reserve Bank also plans to initiate the process in respect of IDFC at an appropriate time.

International Standards

10.68 The Reserve Bank has been making efforts to ensure the convergence of its supervisory norms and practices to international best practices with the long-term vision of aligning the Indian banking system with global standards. As a member of the Core Principles Liaison Group (CPLG) since August 1998, the Reserve Bank was nominated by the CPLG to the Working Group on Capital set up by them to provide the perspectives of the non G-10 countries in the drafting of the new capital adequacy framework.

10.69 The Reserve Bank released its views on the new capital adequacy framework in April 2000 with a view to generating a national debate. It was pointed out that where banks are of a simple structure and have subsidiaries, the Accord could be adopted on stand-alone basis with the full deduction of equity contribution made to subsidiaries from the total capital. Secondly, for assigning preferential risk -weights for banking book assets (excluding claims on the sovereign)- preference has been expressed for assessments made by the domestic rating agencies as opposed to external rating agencies. The scepticism about the role of external rating agencies is based on the premise that different external rating agencies not only employ different sets of parameters, but also the mix and weightage of objective and subjective factors vary across agencies. Thirdly, the Reserve Bank is of the opinion that the risk-weighting of banks should be de-linked from that of the sovereign in which they are incorporated and instead, preferential risk-weights in the range of 20-50 per cent on a graded scale could be assigned on the basis of risk assessments by domestic agencies.

10.70 The Basel Committee on Banking Supervision (BCBS) released its New Capital Accord in January 2001 (Box X.3). The feedback received from a few banks indicates the need for substantial upgradation of the existing MIS, risk management practices and procedures and technical skills of the staff. Banks would, therefore, need to initiate necessary steps to ensure that they are equipped to adopt the New Accord.

10.71 The Reserve Bank has forwarded its comments on the New Accord to the Basel Committee. First, as the complexity and sophistication of the proposals restrict their universal

application in emerging markets, the spirit of flexibility, universal applicability and discretion to national supervisors, consistent with the macroeconomic conditions specific to emerging markets, need to be preserved, while finalising the New Accord. Secondly, the New Accord should initially be applied to all internationally active banks. Further, a simplified standardised approach may be evolved for other banks and the national supervisors should have discretion to implement the New Accord in a phased manner. Thirdly, to ensure uniform application across all jurisdictions, the Basel Committee should define internationally active and significant banks. In this regard, the Reserve Bank is of the view that all banks with cross-border business exceeding 15 per cent of their total business may be classified as internationally active. Significant banks may be defined as those banks with complex structures and whose market share in the total assets of the domestic banking system exceeds one per cent. Fourthly, to moderate the cross-holdings of capital, the Basel Committee may consider prescribing a material limit (10 per cent of total capital) up to which cross-holdings of capital and other regulatory investments could be permitted and any excess investments above the limit would be deducted from total capital. Finally, External Credit Assessment Institutions (ECAIs) should not be assigned the direct responsibility for risk assessment of banking book assets. Ratings of organisations such as Export Credit Agencies (ECAs), which publicly disclose their risk scores, rating process and procedures, subscribe to the publicly disclosed OECD methodology and qualify for use by national supervisors, may be used for assigning preferential risk - weights.

Box X.3
The New Basel Capital Accord

The 1988 Basel capital adequacy norms, which set down the agreement among G-10 central banks to apply common minimum capital standards to their banking industries, almost entirely addressed credit risk. The business of banking, risk management practices, supervisory approaches and financial markets each have undergone significant changes since then. The Basel Committee on Banking Supervision (BCBS) brought out their Consultative Paper on New Capital Adequacy Framework in June 1999 and a second revision in January 2001 after an informed public debate with a view to tuning the capital adequacy framework to fast paced changes in the institutional structure and to address the dissatisfaction with the 'one-size-fits-all' tenet of the capital adequacy ratio requirements. A final round of consultations will end in 2002 and the final Accord will take effect by 2005.

The Accord rests on the three pillars of (i) minimum capital requirement; (ii) supervisory review process; and (iii) market discipline. While the current definition of capital and the minimum requirement of 8 per cent of capital to risk-weighted assets has been retained, the revised Accord will be extended on a consolidated basis to holding companies of banking groups and will refine the measurement of risks. While retaining the measurement of market risk, the Accord emphasises the measurement of operational risk and credit risk (either by the standardised or the internal rating-based (IRB) approaches). In case of the standardised approach, although the risk measurement would be the same, there would be four categories for claims on corporates - 20 per cent, 50 per cent, 100 per cent and 150 per cent - of risk weightage as against the present single uniform risk weight of 100 per cent. The IRB approach, on the other hand, will be allowed to use its internal estimates of the borrower's creditworthiness to assess credit risk in the portfolio subject to strict methodological and disclosure standards. The supervisory review emphasises the need for banks to develop sound internal processes to assess the adequacy of capital based on a thorough evaluation of its risks, which in turn could be evaluated by supervisors. With a view to bolstering market discipline through enhanced disclosure by banks, the New Accord sets out disclosure requirements in several areas, including the way in which banks calculate their capital adequacy and their risk assessment methods.

The New Accord is expected to foster a healthy market-based banking system. The advanced risk management techniques could prove a challenge to the emerging economies, especially given the lack of adequate supervisory skills and the need to shift scarce supervisory resources away from direct supervision towards implementation of these specific proposals.

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International Standards and Codes: Indian Initiatives

10.72 The Reserve Bank appointed a Standing Committee on International Financial Standards and Codes (Chairman: Dr.Y.V. Reddy) in December 1999, in consultation with the Government, in order to (i) identify and monitor developments in global standards and codes being evolved in the context of international developments; (ii) consider the applicability of these standards and codes to the Indian financial system; and (iii) chalk out a road map for aligning India's standards and practices to the evolving international standards. The Financial Stability Forum (FSF), established in April 1999 in order to promote international financial stability by improving the functioning of markets and reducing systemic risk through information exchange and international cooperation in supervision and surveillance of financial markets, identified a dozen areas grouped into three areas, *viz.,* macroeconomic policy and data transparency (covering monetary and financial policy transparency, fiscal policy transparency, data dissemination and data compilation), institutional and market infrastructure (covering insolvency, corporate governance, accounting, auditing, payment and settlement and market integrity) and financial regulation and supervision (covering banking supervision, securities regulation and insurance supervision) for priority implementation. The Standing Committee has constituted ten advisory groups comprising of non-official experts, in the areas of banking supervision, bankruptcy laws, corporate governance, data dissemination, fiscal transparency, insurance regulation, international accounting and auditing, monetary and financial transparency, payment and settlement system and securities market regulation to examine the feasibility and time frame of compliance with international best practices (Box X.4).

10.73 The Indian approach follows an internationally acclaimed systematic three-step process of (i) identification of standards and codes in relevant areas; followed by (ii) an in-depth assessment of the issues pertaining to the present status of applicability, relevance and the existing degree of compliance, the feasibility of compliance and the earmarking of the possible time frame for transition given the prevailing legal and institutional practices by experts; and thereafter, (iii) mapping a comprehensive course of possible actions for achieving the best practices, with due prioritisation of some of the more important codes and standards. The reports of all the advisory groups have already been placed in the public domain. This would be buttressed by efforts for the widest possible dissemination including by means of seminars and workshops to foster a national debate and generate a consensus towards the necessity of change and sensitise the regulatory authorities, agencies and institutions about the priority areas of action.

Box X.4
International Financial Standards and Codes: Recommendations of Advisory Groups

The Advisory Group on Banking Supervision (Chairman: Shri M.S. Verma) assessed the position of the Indian banking system and its regulation and supervision *vis-à-vis* the principles laid down in 16 different papers brought out by the Basel Committee on Banking Supervision. These have been grouped under seven major areas, *viz.,* core principles, corporate governance, internal control, credit risk, loan accounting, transparency and disclosures, financial conglomerates and cross-border banking. The Group concluded that, given the level of complexity and development of the Indian banking sector, the level of compliance with the standards and codes is of a high order. Wherever there are significant gaps, these can be remedied within a reasonable time-frame and, as such, are not cause for immediate concern provided that necessary amendments to laws, wherever required, are put in place without delay. The Group has stressed the need for making directors on bank boards conversant with issues such as risk management and for setting accountability standards for boards and greater transparency and disclosures in respect of their constitution and functioning. A recurring theme in the Group's report is the need to put in place scientific risk management systems in banks. In the opinion of the Group, banks are handicapped in implementing a reliable credit rating and other risk management systems due to (i) lack of qualified personnel; (ii) absence of reliable high frequency historical data; and (iii) lack of proper appreciation of risk management concepts at the middle and senior management levels. The Group has called for introducing the concept of materiality in the matter of disclosures and also greater disclosures in respect of, *inter alia,* significant concentrations of credit risk, movement in provisions, cumulative provisions and transactions with affiliated and related parties and large shareholders. While the overall compliance in respect of internal control principles is high, the Group has stressed the need for action in areas such as performance-related compensation, quality of management information systems and in increasing the awareness about risks involved in and the controls required in working in a computerised environment. To better supervise financial conglomerates, the Group has recommended that the Reserve Bank consider introducing formalised coordination between different regulators. It has also recommended designation of one of the regulators involved as a primary regulator and co-ordinator with clearly assigned roles and responsibilities. The Group has also called for greater co-ordination and sharing of information between supervisors across borders. In the future, the methods of supervision would have to become increasingly risk-based with greater reliance on the boards of banks themselves and the external auditors.

The Advisory Group on Bankruptcy Laws (Chairman: Dr. N.L. Mitra) recommended a comprehensive bankruptcy code incorporating the provisions relating to reorganisation, winding up and liquidation of a corporate entity, and settlement of all other related issues including cross-border insolvency. The Group suggested the repeal of Sick Industrial Companies (Special Provisions) Act and abolition of Board for Industrial and Financial Reconstruction (BIFR). The Group also favoured the institution of a dedicated high court bench as bankruptcy court and the replacement of the office of the Official Liquidator with a professional bankruptcy institution known as the "Trustee". The Group also recommended the evolution of an effective trigger point for bankruptcy, time-bound bankruptcy proceedings, prioritisation of claims and orderly and effective insolvency procedures. The Group further recommended a special procedure for banks and financial institutions and for the institutions in the businesses like insurance, non-bank financing, telecommunications, *etc.* For public sector undertakings and Government companies, the Group recommended the same procedure as applicable to other corporate entities.

The Advisory Group on Corporate Governance (Chairman: Dr R.H. Patil) made recommendations regarding the Group's areas of responsibilities of the board to stake holders/shareholders, selection procedures for the appointment of directors of the board, size and the composition of the board, committees to oversee the practice of corporate governance, disclosure and transparency standards, role of shareholders, role of auditors, *etc.* spanning the institutional categories of the private corporate sector, banks and the development financial institutions and Central and State public sector enterprises set up under the Companies Act. The Report has observed that since most of the Indian companies belong to the East Asian "insider" model, where the promoters dominate governance, it is essential to bring reforms quickly so as to make boards of corporates/banks/financial institutions/public sector enterprises more professional and truly autonomous. As the statutory framework for corporate governance has already been enshrined in the Companies Act, the Group has felt that it is desirable to amend the Companies Act suitably for enforcing good governance practices in India. To improve governance mechanism in public sector units, the Group has recommended transferring of the actual governance functions to the boards from the concerned administrative ministries and strengthening the boards by streamlining the appointment process of directors. Further, the Group has underlined the need for public sector banks to maintain a high degree of transparency in regard to disclosure of information.

The Advisory Group on Data Dissemination (Chairman: Dr. Vaidyanathan, *vice* the late Dr. Pravin M. Visaria) pointed out that there were a large number of data categories under which India had been disseminating information more frequently and with a shorter time-lag than those prescribed by the IMF's Special Data Dissemination Standard (SDDS). The Group concurred with the position taken by the official agencies in this respect that India should opt for "flexibility" option pertaining to the data on labour market as it would be difficult to generate quarterly data on employment, unemployment and wages/earnings using the ILO's sophisticated concepts, definitions and classifications because of the large agricultural sector and also of sizeable unorganised segments in the non-farm sector. Regarding the standard on international investment position (IIP) required in the SDDS, the Group noted that if the data on IIP could be made available before September 30, 2002, India would be fully compliant in this category. So far as the data template on international reserves and foreign currency liquidity is concerned, the Group observed that the data put up by India compares favourably with those of many other countries and that a view has to be taken for disclosing such information based on the disclosure of information as practiced by many other developing countries. The Group proposed compilation of forward-looking indicators, *viz.,* the surveys of business expectations and greater co-ordination between various agencies with a view to refine data dissemination in respect of general government operations (or total public sector operations) including the data for these two sub-sectors.

The Advisory Group on Fiscal Transparency (Chairman: Dr. Montek Singh Ahluwalia) was of the view that current fiscal practices at the central government level satisfy the minimum requirements of the IMF's Code of Good Practices on Fiscal Transparency in many areas. Though there are deficiencies in some important areas, many of these will be substantially addressed once the Fiscal Responsibility and Budget Management Bill (FRBMB) is enacted. The Group has recommended amplifying the scope of the FRBMB to include the essential elements of a budget law, list macro-economic assumptions regarding GDP growth, inflation, export and import growth, the current account deficit, savings and investment rates, and project major categories of expenditure and revenue for two years ahead. The Group also recommends the implementation of the FRBMB proposal, requiring that the Reserve Bank end the practice of providing direct support to government securities at the primary issue stage, by the end of three years. The other important recommendations relate to increased reporting on contingent liabilities, major tax expenditures and *quasi* fiscal activities; quantification of fiscal risks, fuller discussion of the consolidated position of central and state governments especially regarding basic fiscal balance measures; availability of information on the overall public sector balance, government equity and outstanding loans to public sector enterprises and the Oil Pool Account deficit. The simplification of the tax structure, with greater use of information technology, especially electronic filing, is also recommended. Fiscal practices at the state level were felt to be generally behind the standards achieved at the central government level. The Group recommended that the Finance Secretaries Forum could review the report and determine a set of minimum standards on transparency, which all state governments should achieve within a three-year period.

The Advisory Group on Insurance Regulation (Chairman: Shri R. Ramakrishnan) was of the view that the Indian position of allowing foreign companies to operate through joint venture arrangements with an Indian company with a share holding not exceeding 26 per cent in the paid-up capital of the insurer, was broadly comparable with international practices. While the Indian requirements in respect of minimum capital requirements, deposit requirements, business plan and reinsurance were adequate, the Group recommended that minimum capital levels could be fixed for each class of business rather than on aggregate basis. The Group favored the "file and proceed" requirements in respect of new insurance products adopted in India, but recommended that the actuarial certification, premium rate tables and benefit design should be treated as public information in the interest of transparency. With regard to actuarial and solvency issues, the Group observed that the Indian standard is on par with the international norm in the matter of estimating the liability under life insurance polices, while that in relation to solvency margin requirements is actually more stringent. While there do exist certain gaps in evaluating general insurance technical reserves, the Group was of the view that these could be addressed in due course. The Group recommended that unit-linked life insurance business could be brought under the definition of life insurance business, with closer co-ordination between the regulators. While the Indian standard regarding the taxation of life insurance companies is at par with the international practice, the Group proposed that the transfer to the catastrophe reserve could be allowed in certain cases to be made out of pre-taxed profits.

The Advisory Group on International Accounting and Auditing (Chairman: Shri Y.H. Malegam) reviewed the availability of various accounting and auditing standards in India and compared them with the corresponding international standards. In case of the Indian accounting standards (AS), while the International Accounting Standards (IAS) served as a benchmark from the angle of statutory recognition, the US Generally Accepted

Accounting Principles (US GAAP) served as a yardstick from the practical perception of the investor. With regard to the Indian auditing standards, standards issued by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC) served as the reference point. The Group noted that the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) had, at the time of submission of the report, issued 19 standards, which were on par with those of international standards subject to differences owing to country-specific applicable laws, customs usages and trade practices. The Auditing Practices Committee (APC) of the ICAI had issued 20 statements on Standard Auditing Practices (SAPs) and four additional statements on auditing which were anchored on the international standards. The Group also discussed the agenda for the future and, in particular, addressed issues pertaining to bridging the gap between AS and IAS, restructuring of the ASB with a view to making it autonomous within the ICAI, the need for a single standard setting authority, the need for convergence of corporate and tax laws associated with various accounting standards and how to position an effective implementation procedure for the accounting standards in India.

The Advisory Group on Transparency in Monetary and Financial Policies (Chairman: Shri M. Narasimham) has recommended that the Government should set out objectives to the central bank, with parliamentary endorsement and accord it the necessary autonomy to fulfill its responsibilities, if necessary by amending the Reserve Bank of India Act. The Group was of the view that the Government should consider setting a medium-term objective for monetary policy, *viz.,* the inflation rate to the central bank. In the view of the Group, a reasonable degree of fiscal responsibility is also necessary to provide the central bank reasonable headroom to operate monetary policy. The Group also recommended the setting up of a monetary policy committee (MPC) comprising the Governor, Deputy Governors and three other members drawn from the Central Board who are knowledgeable in the areas of macroeconomics, monetary analysis, central banking policy and operations in banking and finance.

The Advisory Group on Payments and Settlement System (Chairman: Shri M.G. Bhide), recommended extensive legal reform especially empowering the Reserve Bank to supervise the payment and settlement system, institution of a framework for ensuring at least the Lamfalussy standards for the deferred net settlement (DNS) and such suitable framework for RTGS systems and spread of electronic-based transactions through appropriate price incentives *etc.* The Group was of the view that the Reserve Bank should eventually come out of the role of a payment systems provider except for funds settlement. The Group recommended, *inter alia,* the introduction of rolling settlement in the liquid segment of the equity market, allowing current account facility with the Reserve Bank to the clearing corporations for ensuring settlement facility on the books of the Reserve Bank as an interim measure pending the eventual grant of a limited purpose banking licence to them with appropriate prudential guidelines thereon, building up of an institutional mechanism for centralised collection of information, their dissemination to market participants and prudential guidelines for implementing cross-margining across markets in order to deal with problems arising from participants undertaking multiple exposures in various markets at any point in time and permitting securities borrowing and lending systems for institutions in both the debt and equity segments in India. The Group has also recommended the establishment of a clearing agent abroad by the Clearing Corporation of India (CCI), institution of a separate guarantee fund for the foreign exchange clearing, appropriate integration between the participating banks and the CCI and their interface with the real-time gross settlement (RTGS) system.

The Advisory Group on Securities Market Regulation (Chairman: Shri Deepak Parekh), which compared the Indian standards with the principles laid down by the International Organisation of Securities Market Regulation (IOSCO), emphasised the need to strengthen inter-regulator co-operation, preferably by bestowing legal status to the High Level Group on Capital Markets (HLGCM). The Group observed that regulatory co-operation would be more effective if designated functionaries (not necessarily only at the top level) are allowed to share specified market information on a routine and automatic basis. The Group favoured the demutualisation of stock exchanges as a necessary step for promotion of fairness and investor protection as the conflict of interest, inherent in the current ownership and governance structures of many stock exchanges, could render self-regulation ineffective. The Group recommended that SEBI's authority over enforcement of securities regulation needed to be enhanced, *inter alia,* by providing SEBI disgorgement powers that would effectively deter market players from regulatory violations. As regards legal issues, the Group highlighted the need for (i) inclusion of both regulatory responsibilities and the authority to carry them out in the same legislation; (ii) a shift from institutions-specific regulation to market-specific regulation; and (iii) simplification and streamlining of the legal framework. In respect of mutual funds, the Group underlined (i) the need for bringing UTI under the purview of SEBI; (ii) introduction and implementation of international accounting principles across the mutual fund industry; and (iii) reduction of discretion of the asset management company (AMC) in adopting valuation of thinly traded/non-traded securities.

10.74 The Reserve Bank also constituted Working Groups to devise revised strategies of on-site supervision over banks for continuous supervision. Some of the important steps taken on the basis of their recommendations include changes in the frequency of inspections, restructuring of reporting formats, introduction of the system of off-site monitoring and the introduction of the CAMELS rating system.

10.75 A multi-disciplinary Working Group (Chairman: Shri Vipin Mallik) was set up to examine the scope for the introduction of consolidated accounting and quantitative techniques for consolidated supervision, in line with the international best practices. A Working Group (Chairman: Shri G. Sitharaman) was set up to prepare a technical paper covering concerns about systemic risk in the banking system, particularly in view of its role in the payments and settlement system, depositor and *niche* interests. Another Working Group was constituted by the Government in July 2000 (Chairman: Shri M.R. Umarji), to examine the vesting of power with banks and financial institutions for taking possession and sale of securities without intervention of the courts and to draft a Bill for consideration of the Government. The Working Group has submitted its report to the Government along with the draft Bill titled “Creation and Enforcement of Security Interest by Banks and Financial Institutions Bill, 2001”. The Bill has been placed on the Reserve Bank’s website on August 3, 2001 for a period of one month, inviting views and comments of organisations and interested persons.

10.76 The Government of India constituted an Expert Committee under the chairmanship of Shri T. R. Andhyarujina for the purpose of formulating specific proposals to give effect to the suggestions made by Narasimham Committee II relating to changes needed in the legal framework. The Committee submitted its report in February 2000. As a follow-up, Government of India constituted a Working Group (Chairman: Shri S. H. Bhojani, with Shri M. R. Umarji, as a member from the Reserve Bank) on asset securitisation in July 2000 to examine the Expert Committee’s recommendations for implementation. This Working Group has drafted a Bill on asset securitisation for enactment and submitted to the Government.

10.77 In view of the increasing level and complexity of frauds in the banking industry, the Reserve Bank has constituted a Committee on Legal Aspects of Bank Frauds (Chairman: Dr. N.L. Mitra) to define financial frauds, lay down procedural laws, examine the process of investigation of bank frauds and prosecution of persons involved.

10.78 The Task Force, set up by the Central Government under the chairmanship of Shri Jagdish Capoor, to study the co-operative credit system, suggested several measures to strengthen the co-operative credit system. It has recommended that the societies should be run professionally on business principles through development of staff and local leadership, reducing Government control. Cooperative banks should have freedom to take investment decisions without the prior clearance from the Registrar of Co-operative Societies and the interest rate spread available to primary agricultral co-operative societies (PACS) should be adequate to meet costs, leaving some surplus. State governments could adopt the prescribed Model Co-operative Societies Act or dovetail the essential features of the same in their respective State Co-operative Societies Acts so as to ensure democratic functioning of cooperatives with least interference from State Government and leaving banking functions clearly under the governance of Banking

Regulation Act. There should be effective supervision of lower tiers of the co-operative credit system by visits by officials of the higher tiers and introduction of audit of co-operatives by chartered accountants. The Task Force has recommended several structural changes such as an exit route for unviable units and integration of long-term and short-term cooperative credit structures. In case such integration is not possible, both types of institutions are to be allowed to handle long-term as well as short-term credit. The Task Force recommended rehabilitation of potentially viable units through a package of measures which encompasses financial, operational, organisational and systemic aspects after studying its viability and possibility of turnaround in five to seven years.

The financial burden of rehabilitation will be shared by members contributing 20 per cent (10 per cent in case of long-term structure) of the requirement by mobilising additional share capital, with the balance amount provided by Central and State Governments by way of interest bearing bonds to be redeemed in a phased manner. A committee approach to write off what is clearly not recoverable and compromise settlements is suggested. It has also suggested that the provisions of the existing Debt Recovery Tribunals may be extended to co-operative banks where the loan size is more than Rs.1 lakh so as to expedite recovery of chronic overdues. Setting up a Co-operative Rehabilitation and Development Fund at NABARD by contribution from the Central Government and another Mutual Assistance Fund at the State level by contribution from co-operative institutions in the state concerned are other recommendations of the Task force.

10.79 A Committee set up under the chairmanship of Shri P. Sabanayagam for examining various aspects of the functioning of the Nidhi Companies to suggest an appropriate policy framework for overall improvement of the Nidhi Companies and for restoring the confidence of investing public, submitted its report to the Central Government in September 2000. The Department of Company Affairs (DCA), Government of India has issued notifications containing guidelines for Nidhis as on July 26, 2001 towards implementing some of the recommendations of the Sabanayagam Committee after deliberations with the Reserve Bank, representatives of the Chamber of Nidhis, Federation of Mutual Benefit Funds *etc.*

Consolidated Supervision

10.80 In recent times, there has been a renewed focus on empowering supervisors to undertake consolidated supervision of bank groups. The Core Principles for Effective Banking Supervision issued by the BCBS have underscored this requirement as an independent principle, which requires that bank supervisors have the ability to supervise banking groups on a consolidated basis. Consolidated supervision is defined as "an overall evaluation (qualitative as well as quantitative) of the strength of a group to which a large bank belongs, in order to assess the potential impact of other group companies on the bank". A major element of this approach is the production of financial reports on a consolidated basis which combine the assets and liabilities and off-balance sheet items of banks and their related companies, treating them in effect as if they were a single entity.

10.81 The Reserve Bank has taken several initiatives to move towards a system of consolidated supervision. In the second half of 2000-01, banks were advised to voluntarily build in the risk-weighted components of their subsidiaries into their own balance sheet on a notional basis, at par

with the risk-weights applicable to the bank's own assets. Banks were directed to earmark additional capital in their books over a period of time so as to obviate the possibility of impairment of their net worth when the switchover to a unified balance sheet for the group as a whole is adopted. The additional capital required was to be provided in the banks' books in phases, beginning from the year ended March 2001. To further the aim of consolidated supervision, the Reserve Bank advised banks to annexe the balance sheet, profit and loss account, report of the board of directors and the report of the auditors in respect of each of their subsidiaries to their own balance sheets beginning from the year ended March 2001.

10.82 Recent developments in the capital market and in the co-operative banking system have thrown up new challenges for the conduct of the regulatory functions. The multiplicity of regulatory authorities in several segments of the financial system has often hindered the containment of systemic risk arising out of imprudent behaviour of a few small entities. It is in this context that the Reserve Bank has been seeking a clearer definition of its regulatory role. For this purpose, it has been involving public opinion as well as expert assessment of the need for enabling changes in the legislative framework for financial regulation (Box X.5).

Box X.5
Unified Financial Supervision

The ambit of regulation could be determined either by institutions, functions, markets or products. The blurring of distinctions between the four implies that the regulatory jurisdictions would tend to overlap. While some countries have a single regulator, others have either a regulator for each sector or a combination of sectors, such as combined securities and insurance regulation, banking and securities and banking and insurance. A unified regulator was introduced in the UK in 1997 and subsequently Japan, South Korea, Chile, South Africa, Germany, France and Canada have followed suit. Practitioners of unified regulation are more common in developed countries as opposed to emerging/transition economies. The USA, on the contrary, represents a situation of multiple supervisory authorities (*e.g.,* the Federal Reserve, Federal Deposit Insurance Corporation and the Office of the Comptroller of Currency), although recent legislative changes have to some extent diluted the compartmentalisation of the regulatory framework (Table) .

Table : Select Regulatory Structures

Structure	No. of countries
1	2
Separate agencies for each of the three key sectors*	35
Securities and insurance regulations combined	3
Combined banking and securities regulation	9
Combined banking and insurance regulation	13
Unified supervision (in central bank)	3
Unified supervision (outside central bank)	10

* The three key sectors are banking, insurance and securities.
Source: Abrams and Taylor (2000), sample 73 countries.

While the revealed preference among countries is for a regulatory structure based on specialised agencies, the balance of argument tends to suggest that in less developed countries, banking supervision is best conducted under the authority of the central bank.

The case for unified supervision is based on a better assessment of creditworthiness, taking into account liquidity, solvency and prudential behaviour, economies of scale due to pooling of resources, minimisation of the costs incurred by supervised entities, avoidance of regulatory arbitrage, lowering of the potential for moral hazard

associated with the lender of last resort function and speed of regulatory response. Furthermore, unified supervision complements the monetary authority's market intelligence system. International co-operation is facilitated due to a single contact point for all regulatory issues.

On the other hand, the blurring of the distinction between banking, securities and insurance activities, the emergence of multi-functional conglomerates operating in a globalised environment are developments, which, *inter alia,* have been cited as arguments for a renewed focus on the structural aspect of financial regulation. Issues of moral hazard in unified regulation associated with lack of clarity in the face of multiple objectives set for a single authority and concentration of power in a single authority leading to excessive regulation have also been cited as arguments against unified financial supervision. Furthermore, there could be diseconomies of scale due to rigid and bureaucratic structure in the single authority. There are several arrangements whereby either single or multiple regulators can function while ensuring appropriate coordination, pooling of resources and clarity of roles and responsibilities. Under any system, issues of information exchange and co-ordination are critical. Regulatory objectives, coverage, skills, operational effectiveness and credibility are the elements which will determine the choice of regulatory regime. Irrespective of the choice, rationale, scope, and limits, the objectives and the instruments need to be clarified so as to place public expectations from regulators in the appropriate perspective. At a legislative level, changes to distinguish owners, regulators and market participants are essential. Designing and managing these changes requires a combination of political will and professional skill.

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