11

Supervision of the Financial System

Introduction

While regulations provide the policy framework to ensure solvency and liquidity of banks and financial institutions (FIs), supervision refers to the instruments used to ensure compliance to this framework.[1] Internationally, different models are followed in the performance of these two functions. In some countries, the two functions are entrusted to different agencies. In the Reserve Bank, the two functions were kept apart in respect of commercial banks, and these were handled by two different departments. However, in respect of non-banking financial companies (NBFCs), FIs and urban cooperative banks (UCBs), there was one department/division each responsible for both regulation and supervision during the reference period. The National Bank for Agriculture and Rural Development (NABARD) exercised supervisory powers over regional rural banks (RRBs) and banks in the rural cooperative structure.

As the previous chapters have shown, major changes happened in the Indian financial sector during the period covered in this volume. These changes offered consumers a broader range of products, complex and new business processes, and a reformed financial system. The changes also led to a blurring of the distinction between banking and non-banking businesses. Supervision, as this chapter shows, needed to adapt to these changes.

The chapter discusses the supervisory role of the Bank in four segments: commercial banks, NBFCs, UCBs and FIs. It also discusses how important episodes involving individual banks and institutions under stress led to changes in supervisory practices and policies.

Supervision of Commercial Banks

The Framework of Supervision

While conventionally the Reserve Bank relied on periodic on-site inspection of banks as the main instrument of supervision, the system was modified from time to time.[2] In December 1993, the Bank bifurcated the regulatory and supervisory functions by entrusting the supervisory function to a newly created Department of Supervision. The setting up of the Board for Financial Supervision (BFS) in November 1994 was a milestone. The jurisdiction of the BFS, which originally covered commercial banks, was extended to FIs, NBFCs, UCBs, local area banks and primary dealers (PDs). The BFS laid down broad policies for on-site supervision and off-site monitoring, modalities for follow-up of inspection reports, and correction strategies for weaknesses observed in the functioning of banks and FIs.

An Advisory Group on Banking Supervision (2001) laid the future roadmap for the Bank in banking supervision.[3] Its recommendations covered corporate governance in banks, Basel core principles, internal controls, credit risk, transparency and disclosures, financial conglomerates, supervision of cross-border banking, and internal rating practices adopted by banks. The proposed actions were classified under three categories – actions that already existed or could be implemented within one year, recommendations that required a longer time frame for implementation, and recommendations not possible to implement or which would require action by the government.

As one of the supervisory agencies consulted by the Basel Committee on Banking Supervision (BCBS) in the drafting of the twenty-five core principles of effective banking supervision, the Bank had carried out an exhaustive review of the existing supervisory framework in the country, and found that most of the principles were already enshrined in statutes and regulations. The Bank had constituted seven working groups within the Bank to suggest measures for bridging the gaps observed in the areas of risk management practices, consolidated supervision, and cooperation with domestic and international regulators. The groups' recommendations (1998) were implemented, reinforcing the risk management guidelines. Formal systems of cooperation and coordination with other regulators were also gradually put in place.

On-site Inspection

On-site inspection continued to be the primary supervisory tool for the Bank during the reference period, but it underwent several changes. The BFS adopted a new approach to on-site inspection of banks from July 1997.[4] On-site inspections began to focus on statutorily mandated aspects of solvency, liquidity, and financial and operational health, based on a modified version of the CAMEL model. The five letters of the acronym CAMEL stand for capital adequacy, asset quality, management, earnings and liquidity. The new model was named CAMELS in 1998, where the added letter 'S' stood for systems and controls. The new rating model combined the quantitative as well as qualitative aspects of soundness to arrive at a composite rating under the six components.[5]

In the wake of irregularities in the loan portfolio of Indian Bank in 1995, the Reserve Bank introduced a system of conducting checks through periodic visits to head offices of banks and verifying discretionary lending by senior executives. However, as the first round of scrutiny did not bring out any serious transgressions by bank officials and as such examination was covered in the annual inspection of banks, the practice was discontinued in April 1997. An internal communication reached the media. *The Statesman* ran a piece on 16 April 1997 titled, 'RBI to Do Away with On-Site Inspection System.' The *Economic Times* (12 April 1997) commented, 'RBI Not to Vet Lendings by Bank Top Brass' and 'Decision Fuels Apprehensions over Free Flow of Funds to Political World'. When the government sought the Bank's clarification, the Bank restored the practice of half-yearly visits to head offices. The matter was reviewed again in December 2002 when regional offices were advised to conduct such scrutiny only if considered necessary by the central office on the basis of off-site analyses and market intelligence.

As part of moving away from transaction-based inspection, the Bank attached more importance to auditing the systems, including risk management in banks, at the corporate level. Consequently, inspection of bank branches was kept at the bare minimum. Until 1997, the Reserve Bank took up branches of banks for on-site scrutiny during the annual inspection of the banks concerned, as branches were treated as independent units for surveillance. This approach was gradually discarded in favour of CAMELS rating. The Bank decided that branch inspection reports need not be sent to banks and followed up. Reports of scrutiny of branches, if any, were to serve only as inputs for the Principal Inspecting Officer of the Reserve Bank at the head office.

The decision to reduce the number of branch inspections also reduced demands on scarce supervisory resources. The Bank, however, undertook quarterly monitoring on-site visits to newly licensed private sector banks in their first year of operation. Such visits continued in respect of new and old private sector banks that had weaknesses. The annual financial inspection findings and observations were categorised as 'major' or 'minor'. The major findings concerning the health of banks, such as solvency, capital adequacy, asset quality, management, systems and controls, including frauds, were followed up with the banks concerned for rectification. The Reserve Bank decided not to pursue the 'minor' findings, which were procedural deficiencies, in the follow-up process.

One of the issues that came up during inspections was the substantial divergence between the assessment of non-performing assets (NPAs) and provisioning estimated by banks' auditors and the Reserve Bank inspectors. The assessment made by the latter was usually more than the estimates of banks' auditors. A working group,[6] set up in January 1997 to examine the reasons for divergence, concluded that the divergence was largely due to the different interpretations of the Bank's guidelines on asset classification and provisioning. The group's recommendations were accepted and the necessary circular to banks and guidelines for inspecting officers were issued in July 2001.

A working group was constituted to review the existing on-site rating model in April 2000. The new model was tried first on four public sector banks with past data. The model was also tested in parallel with the existing model and the difference in ratings awarded to the banks examined. Then, changes were made to the model before it was put into operation in 2002. The four categories of rating styled as A, B, C and D were retained. Later, Reserve Bank officers and a representative from Fitch Ratings recommended a revised supervisory rating model and had it back-tested on three banks. The Reserve Bank implemented the new model from March 2006. The new major parameters included in the model were the effectiveness of risk management systems and quality of assessment. The broad parameters were advised to banks for their information.

The rating assigned by the Bank was conveyed to the top management. The rating was shared with other departments in the Bank, other regulators in case of financial conglomerates and home/host country regulators.[7]

Off-site Surveillance

The objective of off-site monitoring was to assess the financial condition of banks in between on-site examination of banks and to optimally use scarce supervisory resources. A comprehensive Off-site Monitoring and Surveillance (OSMOS) system based on prudential supervisory reporting framework was introduced in 1996. Quarterly returns were received from all banks in electronic format and stored in a database. The data were analysed and supervisory concerns arising out of the analysis were taken up with the banks. Depending upon the seriousness of the concerns, top executives, including the chief executive officers (CEOs) of the banks concerned, were called to the Reserve Bank for one-to-one personal discussions with the Deputy Governor or the Executive Director.

The exercise covered capital adequacy, risk-weighted assets and exposures, asset quality, loan concentration, operational results, connected lending, profile of ownership, control, management, liquidity, and interest rate risks. The format used for OSMOS returns was revised in December 1998. In July 1999, the second tranche of returns covering liquidity risk, interest rate risk and foreign exchange risk was introduced. Banks were required to prepare and forward the statement of structural liquidity, statement of interest rate sensitivity, statement of maturity, and position of foreign currencies to the Bank. There were provisions for penalties and reprimands for late filing of returns and for poor data quality. However, the Bank had not imposed a penalty on any bank during the reference period.

In 2002, a Joint Parliamentary Committee (JPC) on a stock market scam observed that neither the regulators (the Reserve Bank and the Securities and Exchange Board of India, or SEBI) nor the Ministry of Finance took steps to carefully monitor and effectively regulate the flow of foreign as well as domestic funds into the stock market. In compliance to this observation of the JPC, the Bank introduced from May 2003 weekly monitoring of purchases, sales and the outstanding balance of equity shares from select major banks to track the flow of funds to the capital market. Several other significant steps taken between 2003 and 2008 improved the effectiveness of off-site monitoring.[8]

The Bank was monitoring growth in loans to the real estate sector because the long-term nature of mortgage loans and short-term nature of banks' liabilities posed a potential asset–liability mismatch. An analysis of interest rate sensitivity of investments held by banks in HTM (held to maturity) and

AFS (available for sale) categories was carried out in September 2007. Five outlier banks, four foreign and one old private sector, were made aware of their vulnerability to rise in yields.

To monitor and regulate banks' activities in the call and money markets, the Governor directed the designing of a surveillance framework. An interdepartmental group formed in 2007 identified banks with a high level of net fortnightly borrowings in the call, repo, collateralised borrowing and lending obligation (CBLO), liquidity adjustment facility (LAF) and term money markets. Concerns, if any, were taken up with the identified banks.

Risk management was one area where major changes were introduced during the reference period.

Interest Rate Risk and Liquidity Risk Management

The Supervisory Department conducted a quarterly review of interest rate sensitivity of banks' investment portfolio and monthly reviews of banks' exposure to sensitive sectors. The reviews were carried out to determine the interest rate risk using 'duration gap method' prescribed by the Basel Committee. Banks were advised of the results of the study along with a guidance note for their use.

Since September 2003, under instructions from the Reserve Bank, banks carried out quarterly 'impact analyses' of an interest rate rise on banks' capital. The interest rate sensitivity analysis was done applying the modified duration approach, assuming an interest rate shock of 100 basis points (bps). It was observed in 2003 that the banking industry could withstand the impact of 72-bps increase in interest rates without having any erosion on their capital (thanks to the buffer of investment-fluctuation reserves and provisions).

In October 2003, the Governor directed the preparation of a technical paper to examine the impact of 100 per cent marking to market of all investments on the financial position of banks. It was found that the impact would not be significant; the combined impact was estimated at 0.11 per cent of the total investments. At the aggregate level, the impact would be about 0.75 per cent of the regulatory capital of the banking system. An IMF paper on interest rate risk of Indian banks also concluded that there was no threat to the core capital of banks because of the existence of sufficient cushion in the form of unrealised gains, together with the accumulated provision for depreciation and investment-fluctuation reserves.[9]

The frequency of the 'statement of structural liquidity' was revised from monthly to fortnightly in terms of instructions issued under Asset Liability Management Guidelines in October 2007. Banks were to estimate the required liquidity under market crisis scenarios, prepare contingency plans and fix the tolerance levels for various maturities. Banks were advised to undertake dynamic liquidity management and prepare the statement of structural liquidity on a daily basis and adhere to prudential limits as per Reserve Bank guidelines.

The framework for intervention by the Bank based on inspection findings and other parameters is discussed in the next section.

Prompt Corrective Action

The BFS desired in May 1999 that the Bank should draw up an intervention prescription schedule which should set trigger points for different types of concerns. A study group, which was set up to move towards risk-based supervision, prepared a schedule. This system of prompt corrective action (PCA) was to be based on three parameters, capital to risk-weighted assets ratio (CRAR), net NPAs and return on assets, with pre-determined trigger points. The scheme was placed before the BFS in 2000. After consultations with the government, the PCA framework was introduced on an experimental basis for one year. Foreign banks were not covered by the framework. The scheme was reviewed in 2004 and continued without change.

Six banks had hit the trigger points based on their financial results of March 2002. Of these six, three banks were under restructuring. The other three were not formally placed under the PCA framework but they were put on advance notice. By December 2002, more private banks had hit the trigger points. When informed of this, the banks represented informally that if placed under the formal PCA framework, they would be constrained to advise SEBI and stock exchanges, which could scare prospective investors. In that case, they would not be able to raise capital. Considering this point, the banks were put on alert but not formally placed under PCA. The Reserve Bank recognised that publicising the matter could have wider and adverse implications. It was, therefore, decided that when a bank hit any of the trigger points, 'structured and discretionary actions' would be taken against it.[10] In 2004 and 2005, one bank each (GTB and United Western Bank) had triggered structured/discretionary action against them by the Reserve Bank.

Both banks got merged with other banks subsequently. During the remaining years of the reference period, no bank had triggered such action on the part of the Reserve Bank.

Banks differed in their risk profile, which required supervision to be risk-based, as we see next.

Risk-Based Supervision

The risk-based supervision (RBS) approach was based on the principle of adapting supervision to the risk profile of the supervised entity. RBS involved continuous monitoring through off-site analysis of critical data impacting the risk profiles of the entities. On-site inspections looked into compliance with the BR Act, and the systems and procedures in place to deal with the risks. RBS was a step towards the transition to Basel II. The cornerstone of the supervisory process under Pillar II was 'risk-based capital assessment'.

In 1999, the Deputy Governor in charge of supervision set up an informal study group on international best practices in this field, to prepare an approach paper on RBS. The BFS approved the proposal to engage international consultants to develop the framework and suggest the sequencing of implementation. In 2000, the Bank used the services of the Department for International Development, United Kingdom (UK), to facilitate a move towards RBS. The organisation funded the international consultancy effort involved, and awarded the project to PricewaterhouseCoopers (PwC), London. PwC submitted its report in three instalments: a review of the existing supervisory approach, actions required for adopting RBS, and the synopsis of the Supervision Manual to be used in the RBS approach. The Project Implementation Group set up for the RBS project prepared a discussion paper titled 'Strategy and Road Map for Implementation of Risk-Based Supervision Project'.[11] The paper, prepared with inputs from PwC reports, was released to the banks in August 2001, and consultations with the banks took place thereafter.

The RBS process was rolled out in 2002–03. Banks were advised to set up a comprehensive risk management system, adopt a risk-based audit system and upgrade management information technology systems. A set of pilot studies led to further fine-tuning of the system. It was found that mapping of risks under RBS was generally in agreement with CAMELS rating. Implementation of risk-based internal audit was crucial to the success of RBS. In November 2000, the Bank set up a working group to suggest modalities for introducing risk-based internal inspection/audit system in banks.[12] The group found that a risk-based audit had not commenced or stabilised. In February 2005, banks were advised to fine-tune their audit process accordingly. However, in view of the various constraints faced by banks, the progress towards full-fledged inspection under RBS was slower than anticipated.

While the pilot run of the RBS continued parallel with the CAMELS model of supervision, studies were undertaken to evolve an appropriate model for the Indian banking system based on the experience gained from the RBS pilot runs. Efforts were made to align CAMELS and RBS into a single supervisory approach, incorporating the best features of both.

One of the key principles of Pillar II in the New Basel Capital Accord was the supervisory review process, which is considered next.

Supervisory Review Process

The principle, in the words of the Consultative Document (January 2001) of the BCBS, was that the '[s]upervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process'.

The Governor announced the introduction of the supervisory review process (SRP) for banks in the Annual Policy Statement for 2005–06. A framework to initiate SRP was evolved in February 2006 with twelve systemically important banks. In the first review, banks with significant exposure to sensitive sectors like real estate, highly leveraged NBFCs, venture capital funds and capital market were taken up. A special feature of the framework was to carry out 'stress testing' to assess how vulnerable the financials of a bank were under certain assumptions.

The framework attempted to capture in a nutshell the overall risk profile of a bank having a bearing on its liquidity and solvency position. A pilot study of a new private sector bank was completed in March 2006. The findings of the study were presented in the Regulated Institutions Group (RIG) meeting and, after some refinements, the pilot study served as a template for tracking other identified banks.[13]

The second review of SRP in January 2007 was split into two phases. Ten outlier banks were identified as having the largest capital market exposure and real estate exposure both in absolute terms and in relation to their net worth. In Phase I, besides data available from off-site returns, information on exposure to sensitive sectors was collected, analysed and discussed with bank officials. Phase II focused on on-site examination to assess the risk exposure of individual banks. The analyses suggested prima facie that the banks under review had proper risk management policies, systems and controls in place. However, certain minor deficiencies were observed, which were circulated among all banks advising them to initiate the corrective processes.

In June 2005, the definition of real estate exposure of banks was modified to include individual housing loans. This, together with a sharp increase in lending by banks to this sector, raised the exposure to real estate as a percentage to banks' total advances from 12.9 per cent in March 2005 to 19.4 per cent in September 2006. After a study of the emerging trends, banks were advised to lay down internal limits to ensure rating for builders, a minimum share of promoters' contribution, requisite security cover, guarantee from the originator, and have a panel of approved valuers. The exposure being long term in nature with interest rate risk, liquidity risk and credit risk, the Bank issued instructions and guidance notes for banks.

Banks with high capital market exposure were advised to bring it down by December 2007 to 40 per cent of their net worth. In December 2007, only two banks had capital market exposure greater than 40 per cent. They were given time up to March 2008 to bring it below the stipulated limit and the two banks later reported having done so as instructed.

It was proposed in March 2008 that SRP might from then on be conducted once a year on a regular basis. Also in March 2008, guidelines were issued to banks for implementing the Internal Capital Adequacy Assessment Process (ICAAP), which was part of Pillar II of Basel II accord.

A further area of discussion and improvement during the reference period was consolidated supervision.

Consolidated Supervision

Consolidated supervision refers to a supervision system that encompasses subsidiaries. Its absence creates incentives for banks to divert problem loans and losses to subsidiaries that are under weak supervision.

From March 2001, banks were required to voluntarily build in risk-weighted components of their subsidiaries into their own balance sheets on a notional basis, and earmark additional capital in stages. As a further step, public sector banks were asked to annex the accounts and reports on each of their subsidiaries to their balance sheets. State Bank of India (SBI) and a few other banks said that a large number of subsidiaries under them would make the annual reports unwieldy and that the overseas subsidiaries, which had different accounting years, would pose further problems. They were then asked to attach only the latest available balance sheets of overseas subsidiaries.

In November 2000, a working group identified three components of consolidated supervision: consolidated financial statements for public disclosure (CFS), consolidated prudential reports for supervisory assessment of risks (CPR) and application of prudential regulations on a group basis.[14] The group recommended that initially consolidated supervision could be targeted only for groups where the parent was a supervised institution. All banks under the purview of the Reserve Bank's consolidated supervision, whether listed or unlisted, were required to prepare and disclose consolidated financial statements from the financial year 2002–03 in addition to solo financial statements.

Effective supervision entails sharing information among stakeholders and regulators, which is discussed next.

Coordination and Information Sharing

An internal study group set up in 1998 recommended that a shared database should be created to serve the regulators and enforcement agencies. As suggested by the BFS, the Bank wrote to the Ministry of Finance to form a technical group to look into data sharing between regulators. These issues were considered in different discussions held with the government on the setting up of a Serious Frauds Office and a credit information bureau, and the introduction of suspicious transactions reporting.

In 1999, a High-Level Coordination Committee on Financial and Capital Markets (HLCCFCM) was set up, with the Governor as Chairman, the chiefs of SEBI and the Insurance Regulatory and Development Authority of India (IRDAI) and the Secretary in the Ministry of Finance as members, to iron out the regulatory gaps and overlaps. The HLCCFCM constituted three standing technical committees in respect of entities regulated by the Bank, SEBI and IRDAI. These technical committees discussed issues relating to capital market exposure and developments in the financial markets relevant to the task.

The HLCCFCM decided in 2004 that the three technical subcommittees set up to monitor banks, capital market and insurance companies would work as Crisis Management Groups in case of any unusual developments concerning their areas.

Financial conglomerates posed a specific set of supervisory issues.

Financial Conglomerates

The entry of some of the bigger banks into merchant banking and insurance made them into financial 'conglomerates'. The monitoring mechanism in India had three components: off-site surveillance; the standing technical committee with members from the Bank, SEBI and IRDAI on concerns arising out of the analysis of data from surveillance and exchange of information; and half-yearly discussion with the CEO of the conglomerate, in association with other regulators, to address supervisory concerns.[15]

The Mid-Term Review of Monetary and Credit Policy for 2003–04 announced the establishment of a special monitoring system for 'systemically important financial intermediaries'. An inter-regulatory working group[16] was constituted to identify such intermediaries and advise on a monitoring and reporting system for them covering intra-group transactions. In May 2004, based on the recommendations of this group, a financial conglomerate cell was set up in the Bank. Twelve conglomerates were identified, of which, the Bank, IRDAI and SEBI would supervise eight, three and one, respectively, from March 2007. The number subsequently increased to twenty-two, with the Bank as the principal regulator for seventeen, IRDAI for four and SEBI for one financial conglomerate.

From 2004, the technical committee on Reserve Bank–regulated entities monitored an integrated system of alerts, which was put in place jointly by the Bank and SEBI. The system provided for furnishing of information by SEBI received from stock exchanges and depositories to the Bank on transactions of large sales and purchases of stocks and securities for further investigation. However, the Bank could not establish a direct link between these transactions and flow of bank funds to the capital market in most of the cases. The technical committee also had oversight on the joint study of books of accounts and other operations of major entities in a financial conglomerate. Trusts and special purpose vehicles (SPVs) of the group (including mutual funds and venture capital funds) were brought under the financial conglomerate reporting framework. In fact, the definition of the financial conglomerate was debated at length and was left open-ended to allow for some flexibility.

The financial conglomerate return format was revised and implemented from the quarter ending in March 2007. In addition to the intra-group transactions and exposures, it also captured critical information such as gross and net NPAs, provision held against impaired assets, frauds and 'other assets' and information on regulatory violations noted by other regulators.[17] To facilitate smooth cooperation between the Bank, IRDAI, SEBI and NHB, a memorandum of understanding (MoU) was drawn up in 2007–08.[18]

Considerable efforts were made to improve corporate governance and transparency of banks' operations during the reference period, with supervision in view, as discussed in the next section.

Corporate Governance, Disclosure and Housekeeping

A committee report of 2001 pointed out that the government performed multiple functions as 'owner, manager, quasi-regulator, and sometimes even as the super-regulator of public sector banks', which was not conducive to good governance.[19] A Consultative Group of Directors of Banks and Financial Institutions reviewed the supervisory role of boards of banks and FIs in 2002.[20] In June of the same year, banks were asked to adopt and implement the recommendations of the group. In May 2007, private banks were advised that their memoranda and articles of association should conform to the BR Act provisions and the recommendations of the group.

The Reserve Bank's supervisory strategy included strengthening the internal control system of banks, the introduction of risk-based internal audit, and increased use of statutory auditors for verification and certification of certain aspects. Banks were to constitute an audit committee of the board of directors, with such members who had prior experience in management, finance, accountancy or auditing. Banks were also required to have a committee of executives for overseeing the internal audit function. In July 1997, banks were instructed to appoint Compliance Officers to monitor compliance with all instructions, directives and guidelines issued by regulatory bodies. Guidelines on compliance functions were issued to banks in November 2006.

A committee set up in 1997 to review the formats of final accounts of banks led to fresh guidelines on disclosure.[21] Based on the committee's note on disclosure and transparency in final accounts, banks were advised to make additional disclosures, such as the percentage of shareholding of the government in nationalised banks, capital adequacy ratios, the percentage of net NPAs, provision made towards NPAs, and the gross and net value of investments. Further directives were issued in January 1998 and February 1999 for additional disclosure.

The BFS monitored fraud-prone areas like inter-branch reconciliation, clearing differences, reconciliation of Nostro account, and long-pending entries for adjustment and balancing of books. The reporting system under OSMOS included data on housekeeping position in banks. A technical assistance group in 1998 recommended changes in housekeeping.[22] To ensure that banks paid close attention to inter-branch accounts, they were asked to make 100 per cent provision for the net debit position in the inter-branch accounts, arising out of unreconciled entries (credit and debit) outstanding for more than three years as of 31 March every year.[23] The Reserve Bank would impose penalties on the banks with unsatisfactory performance in inter-branch accounting. Subsequently, the period was reduced to one year and further to six months. To ascertain the reasons for clearing differences, an in-house study group was set up in August 2002 that discussed the issue with banks and service branches. The recommendations of the group were sent to banks for necessary action. Guidelines were issued in July 2003 for netting off old and small value entries of less than ₹500 outstanding for more than three years.[24]

The entire system of appointment of auditors for public sector banks was reviewed in 1998 and the procedure was streamlined. The Reserve Bank recommended a list of audit firms and auditors to the public sector banks for their appointment as statutory auditors by the Government of India. The selection was made out of a panel of firms received from the Office of the Comptroller and Auditor General of India. Private sector and foreign banks were required to take prior approval of the Reserve Bank for appointing their statutory auditors. For this purpose, a panel of three audit firms was submitted by each of these banks. The Reserve Bank recognised that the eligibility norms for the statutory central auditors were lax and formed a working group in 2003 to review the list. Based on the recommendations, the empanelment norms were revised and implemented from 2004–05.

In 1999, a Committee on Technology Upgradation in the Banking Sector recommended development of in-house capabilities (instead of outsourcing) by banks for auditing their information technology departments.[25] In June the same year, banks were advised to create electronic data process audit cells in their inspection departments.[26]

The Reserve Bank had to step in on occasions as the lender of last resort, which role is discussed below.

Lender of Last Resort (LOLR)

The Reserve Bank is empowered to act as the lender of last resort (LOLR) to rescue banks and FIs in temporary distress. For example, in the case of Global Trust Bank Ltd (GTB), there were two episodes when the Bank extended LOLR support facility.[27] In 2001, in the wake of a liquidity crisis faced by cooperative banks in Gujarat following the failure of Madhavpura Mercantile Cooperative Bank (discussed later), the Reserve Bank issued a press release announcing a special collateralised liquidity facility to cooperative banks in the state as a temporary measure to protect well-managed cooperative banks. The support under LOLR was always extended at interest rates much higher than market rates.

Among non-banks, the Reserve Bank had extended LOLR support to UTI Asset Management Company during 1996–2000 and to the Deposit Insurance and Credit Guarantee Corporation (DICGC) in 1999. Support was extended to Canara Bank in 1998 when it had to rescue its mutual fund arm by buying up the units called Canstar issued with a high fixed rate of return. The Gujarat State Cooperative Bank was helped with a special liquidity facility in 2001.

The need for extending LOLR support did not arise in subsequent years during the reference period because banks maintained securities in excess of their SLR requirement and insurance companies and mutual funds stayed active as lenders in collateralised financial markets. The Reserve Bank, however, did need to take confidence-building measures on certain other occasions. For example, in 2003, certain automated teller machines (ATMs) of ICICI Bank in Gujarat went cash-dry in a period of consecutive holidays, prompted by rumours that the bank was going bust. In addition to providing liquidity support on a holiday, the Reserve Bank's regional office in Ahmedabad issued a formal statement to assure the public of the viability of the bank, which stopped panic withdrawals.

On another occasion, a branch of UTI Bank in Vadodara, Gujarat, was closed down on 11 August 2004 because the municipal commissioner had authorised the demolition of the third floor of the building, which was constructed without proper approval. Since the branch functioned in the ground floor of the same building, it was asked to vacate the premises immediately, giving rise to the rumour that the bank had been ordered to close down, and led to panic withdrawals by depositors from ATMs. The Regional Director of the Reserve Bank at Ahmedabad opened the vaults early in the morning next day to make cash available to the bank. The Reserve Bank spared no efforts in mobilising the required currency notes, including accessing the nearby chest of a nationalised bank when there was a shortage of ₹500 notes. The Reserve Bank deputed its officers to the ATMs and branches of the bank where large crowds had gathered for withdrawals to clarify the position and reassure them. The Regional Director also took up the matter with the Chief Secretary to arrange for the lifting of the closure order. The panic withdrawals subsided the next day.

Effective supervision requires an effective penalty system for non-compliance, a discussion on which follows.

Penal Measures

The BR Act was amended in 1994, in terms of which the penalty that could be levied on banks in respect of a contravention of the provisions of the Act was enhanced from a maximum of ₹2,000 to ₹500,000. The Reserve Bank issued 'letters of displeasure' for capital market exposure beyond the prudential limit and non-compliance to know-your-customer, or KYC, norms.

In 1997, the Reserve Bank imposed a penalty on fifteen banks of ₹500,000 each for short-selling of securities, excess utilisation of export credit refinance and violation of KYC norms. The banks needed to obtain approval of their board of directors for payment of the fine to the Reserve Bank, which acted as a deterrent.

An in-house group was set up in 1999 to recommend the criteria for levying penalties under the BR Act, keeping in view gaps between the existing systems and the 'core principles for effective banking supervision'. The idea was to avoid arbitrariness involved in the imposition of different penalties for similar violations. The group held that penal action on banks should not be publicised or circulated among other banks. This was agreed to by the BFS. The group suggested denial of branch expansion, denial of access to refinancing, raising CRR and denial of access to the money market as penal measures. While the Bank resorted to denial of licenses for new branches for temporary periods against certain banks, measures such as raising of CRR were not used.

In 2002, the Enforcement Directorate informed the Bank of certain high-value and suspicious cash transactions undertaken by one C. Surendran and his fourteen associates with banks in Kerala and Mumbai. The large cash deposited in Mumbai branches was immediately transferred to branches in Kerala and Coimbatore and was again withdrawn mostly in cash. Reserve Bank investigations revealed that ten banks (four public sector, five private sector and one foreign bank) were involved, which had not exercised diligence in undertaking the transactions. Show-cause notices were issued to three public sector and four private sector banks for imposing a monetary penalty and they were advised to take appropriate disciplinary action against delinquent officials, file criminal complaints where their involvement was established, and freeze the bank accounts concerned. A penalty of ₹500,000 each was imposed on all seven banks for not adhering to the Reserve Bank's instructions on KYC in the handling of high-value cash transactions. One private sector bank was issued a letter of displeasure and the foreign bank a cautionary letter. No action was taken against the fourth public sector bank because the amount involved was very small.

The Standing Technical Advisory Committee on Financial Regulation (STACFR) discussed whether or not penalties should be publicised. Recognising the role of market discipline under Basel II, and in the interest of enhancing transparency, from October 2004 the Bank imposed penalties and would place the information in the public domain. It was also proposed to advise banks to incorporate a paragraph in the *Annual Report*, indicating the findings of the latest Reserve Bank inspection regarding divergence in provisioning requirement and CRAR. However, a notice would be sent to the bank giving an opportunity for a hearing before taking a decision to place the information in the public domain.

The impact that suspected frauds had on supervisory practices is discussed next.

Initial Public Offering Scam and Bank Frauds

In December 2005, SEBI informed the Bank that certain bogus or *benami* (fictitious name) demat accounts had been opened in the banks, and requested the latter to investigate the role of banks in opening accounts in favour of such entities. SEBI was concerned because these accounts were used to fund initial public offering (IPO) applications. The Reserve Bank found that some brokers, with the help of depositories, had approached banks for opening multiple accounts in the names of purported applicants and requested banks to fund IPOs in fictitious names. Banks granted loans without KYC and anti-money-laundering (AML) safeguards, and to multiple accounts with the same name. The IPO refund amounts were parked in mutual funds for brief periods. Banks were advised to credit the proceeds of individual 'account payee' refund orders into accounts of brokers. Brokers had made use of bank funds by devious methods for cornering the retail portion of primary issues.

Reviewing this case, Deputy Governor V. Leeladhar reflected that 'what was disturbing was that our inspection carried out some six months back of the same bank branches which were involved in the IPO related irregularities had not brought out anything in this regard though the transactions had already taken place'.[28] The Reserve Bank fixed accountability and took action against those inspecting officers under Staff Regulations. Show-cause notices were issued to banks, and their replies and oral submissions were not found acceptable. Several banks were subjected to penalties.

Banks were required to report all actual or suspected frauds involving ₹100,000 and above to the Reserve Bank. All individual cases of fraud involving amounts of ₹10 million and above were monitored at the Fraud Monitoring Cell in the central office, while frauds of less than that value were monitored by the Bank's regional offices. The cell facilitated an integrated approach to monitoring of frauds in the financial sector and to coordinate with other agencies (such as the Central Bureau of Investigation, or CBI).

When frauds were reported by banks, the Reserve Bank issued caution advice to all banks giving details of delinquent borrowers and their associates, so that other banks were put on guard. A study group set up in 1998 analysed 107 bank frauds reported during the previous three years. The group's report was sent to banks for their information and guidance. In September 2000, N. L. Mitra, retired director of the National Law School, Bangalore, was appointed by the Bank as a consultant to advise on banking law reforms.[29] He also chaired an expert committee which recommended a separate Act to deal with financial frauds. In May 2002, banks were asked to report compliance with those recommendations of the committee that could be implemented without any legislative changes. The second part of the report, relating to legislative amendments to the Indian Penal Code, Indian Evidence Act and

Criminal Procedure Code and enactment of the proposed Financial Frauds Act, was forwarded to the government for necessary action.

The Reserve Bank sought to align the supervisory oversight on frauds with the Supervisory Review and Evaluation Process (SREP) under Pillar 2 of Basel II by factoring in the increase in frauds while profiling the operational risks faced by the banks. An Advisory Board on Bank Frauds was set up by the Reserve Bank in March 1997 to advise on cases referred to by the CBI (more details in Chapter 15).

The collapse and merger of GTB was one of the major episodes in the Indian financial sector during the period covered by this volume as discussed below.

Global Trust Bank Ltd

This new private sector bank was set up in 1994 and its founders included Ramesh Gelli, who was its first chairman. In August 1997, in the 30th meeting of the BFS, Governor Rangarajan stated that 'in view of the adventurous style of functioning of the present chairman (Ramesh Gelli) and various irregularities ... the bank might be kept under close watch'. Next year, inspecting officers observed that 'there was concentration of power at the level of chairman (who was also the CEO)'. In January 1999, critical supervisory concerns were noticed by the Department of Banking Supervision relating to credit appraisal, NPAs, CRAR and the internal control systems. In the same year, the regional offices were advised not to issue fresh branch licenses to GTB. However, in October 2000, the order was reversed in view of the bank's satisfactory performance.

Another crisis developed in 2001. There were reports that 'certain overseas corporate bodies' were lending support to a prominent stockbroker who was cornering the shares of GTB. The bank did not seek the Reserve Bank's acknowledgment for transfer of its shares in excess of 5 per cent. In view of SEBI investigations into the scandal, the bank's application for a merger with a new private sector bank was kept on hold. Before the Reserve Bank could take a decision, the proposed merger was called off by the parties concerned. In the same year, the bank's capital market exposure was 31 per cent of its total advances as against the prescribed limit of 5 per cent. The bank's reliance on interbank deposit was high. It was also found that GTB had lent heavily to a particular stockbroker and affiliated entities. Some of these investments became problem assets. When the bank came to the Reserve Bank for LOLR facility in April 2001 without having approved securities to offer as collateral, the Reserve Bank provided funds against public sector undertaking bonds as a special case but on condition that the chairman and the CEO submit his resignation. It was also made clear that he should not be on the board of the bank as a director. As directed, he did not seek re-election in the next General Body meeting.

GTB attracted the proposed PCA, or 'prompt corrective action', on all the three counts: CRAR, NPA and return on assets. The Reserve Bank took the view that supervisory action had to be balanced when public deposits were involved because supervisory intervention itself could precipitate a run. It avoided such an outcome by extending liquidity support and also ensured the appointment of a new chairman in April 2001, who had earlier served in a public sector bank. In December 2001, the BFS members recommended the merger of GTB with another bank.

In March 2002, the bank's gross NPAs stood at 58 per cent, as assessed by Reserve Bank inspectors. If full provisioning were to be made as required, it would have led to the declaration of loss and negative net worth, which could have shaken the confidence of depositors and caused a possible run on the bank.

The publication of GTB's financial results for the year ending in March 2003, after much delay in September 2003, revealed a net loss of ₹2.72 billion with CRAR at 0.02 per cent and net NPA at 20 per cent. Since this disclosure was expected to create panic among depositors, the Bank took the unusual step of issuing a press release on 30 September 2003 stating that

> the [bank's] present management had made special efforts in the recovery of non-performing assets relating to the previous years…. The Reserve Bank of India welcomes the decision of the Global Trust Bank Ltd., and its Board of Directors to clean up the balance sheet … for sound functioning of the bank and for the good health of the financial system.

Besides, there was a large divergence between Reserve Bank inspection and audited accounts for the year ending in March 2003 as well. While the bank and its auditors had estimated the gross NPAs at ₹9.16 billion, the Reserve Bank inspecting team estimated it at ₹16.89 billion. Actions were taken against the two statutory auditors of GTB, who had certified the accounts for March 2002 and March 2003, in view of the grave discrepancies which neither the bank nor the auditors were able to explain. The explanation furnished by one of the auditing firms was seen as unsatisfactory. Hence, the matter was referred to the Institute of Chartered Accountants of India (ICAI) in August 2004 for necessary action. Pending the outcome of the enquiry taken up by the ICAI, the Reserve Bank advised banks in October 2004 that they might consider awaiting further advice from it before engaging the auditing firm. Four cases were filed against the Reserve Bank at four different High Courts by the firm, challenging the Reserve Bank's advice. The Calcutta High Court passed an interim injunction against the Bank in May 2005. The stay order, however, did not have any bearing on the Bank as it had not 'banned' the audit firm from being engaged by banks. Eventually, the case filed against the Bank was dismissed and the Bank withdrew its advice to banks in April 2008.[30] The ICAI probe against the audit firm remained inconclusive.[31]

In February 2004, Gelli was re-inducted onto the board via co-option (taking the number of his family directors to three in a total of eight). The Reserve Bank expressed serious discomfort, and he resigned again in March 2004. The bank was then planning to come out with a rights issue; it was advised to report its true financial position in the offer document for the information of potential investors.

In May 2004, GTB informed the Reserve Bank that a foreign private equity fund, Newbridge Capital Ltd, United States (US), had expressed interest in taking up a stake by investing US$200 million in the bank, subject to the Reserve Bank's approval. But the proposal did not find favour as the Reserve Bank was not comfortable with investment by a private equity firm whose antecedents were not known and, therefore, could not be said to be in compliance with the 'fit and proper' criteria.

On an application made by the Reserve Bank, the government notified the moratorium on GTB on 24 July 2004. For the first time, the moratorium order covered the ATMs as the bank had a good network of ATMs across the country. Despite the Reserve Bank disabling the ATM switch as per the moratorium order, there were queues of bank customers seen at the ATMs and the Reserve Bank had to despatch its officers to the branches, especially in Andhra Pradesh, to assure them. The next day, despite it being a Sunday, the Reserve Bank issued a press release reassuring the depositors of GTB about the safety of their funds and the arrangement being made to bring back normalcy. The draft scheme of amalgamation between GTB and the public sector Oriental Bank of Commerce (OBC), which had expressed its interest in the matter, was put in the public domain by the Reserve Bank through a press release on the very next day, 26 July 2004. The merger came into effect on 14 August 2004, making the entire transition smooth and swift.

OBC filed complaints with the CBI in respect of fifty borrower accounts involving ₹13.09 billion. Former chairman Gelli was implicated in fourteen cases. The Deputy Governor wrote to the Ministry of Finance in July 2004 pleading for an income tax benefit to OBC to set off the GTB losses as it was technically a compulsory merger under Section 45 of the BR Act, 1949. The Reserve Bank pointed out that it was incongruous to extend tax benefits to voluntary mergers but to deny it for compulsory mergers. The government agreed and extended income tax benefit to OBC.

When analysing the GTB affair, the BFS cited criticisms in the media based on the impression that the Reserve Bank had acted late. For example, Sucheta Dalal published an article titled 'RBI's Shoddy Role in the GTB Saga' in *Financial Express* on 2 August 2004. Another commentator, Dilip Dasgupta, was more moderate in his assessment: 'While most people accepted the efficacy, swiftness and fairness of RBI action, … it could have come much earlier' (*Treasury Management*, December 2004). The Reserve Bank was criticised because the shareholders of GTB lost their entire invested capital. The Reserve Bank, however, was concerned only with the interests of depositors as mandated in the BR Act. From the Reserve Bank's viewpoint, any hasty intervention could have pushed GTB into bankruptcy, jeopardising depositors' interest, but with the nature of action taken by the Reserve Bank, all the depositors were fully protected.

Wilful defaulters posed a particular challenge to supervision and this issue is taken up next.

Wilful Defaulters and Credit Information Bureau

In 1999, the Chief Vigilance Commission advised the Reserve Bank to publicise the names of *all* wilful defaulters. However, under the provisions of banking laws, such disclosure was permissible only in suit-filed accounts. The Bank was circulating the list of suit-filed accounts of ₹10 million and above and the list of suit-filed accounts of wilful defaulters with outstanding advances of ₹2.5 million and above every year among banks, and the information was also placed on the Reserve Bank's website.

In June 1999, an internal working group recommended that a Credit Information Bureau be set up under the Companies Act, 1956, with equity participation from commercial banks, FIs and NBFCs. SBI, in association with other institutions, set up the Credit Information Bureau (India) Ltd (CIBIL) in January 2001. Another working group[32] examined the role of credit information bureaus in collecting data on wilful defaulters. Based on its report (January 2002), further instructions were issued to banks for data collection on wilful defaulters.

When the names of the directors on the boards of defaulting companies were reported and shared, the professional and independent directors protested that they should not be treated on a par with promoter directors. Therefore, banks and FIs were advised (in April 2000 and December 2001) that while reporting the names of directors of borrowing companies, banks must identify and mark the nominee, independent and professional directors so as to distinguish them from promoter directors.[33]

In April 2004, the Bank advised the Indian Banks' Association (IBA) that progress in data collection and sharing through CIBIL had not been satisfactory. Some banks pointed out that there was no data protection guarantee from CIBIL, and suggested that in the agreement between CIBIL and banks, a data protection clause could be incorporated. The Bank advised the IBA to arrange for inclusion of such a clause.

The Parliamentary Standing Committee on Finance in its eighth report expressed concerns over the persistence of wilful defaults. A working group in November 2001 and an in-house group in January 2002 considered the definition of wilful defaulters.[34] Six indicators were identified: deliberate non-payment of dues despite having adequate cash flow and net worth, siphoning off funds, assets sold/not purchased, falsification of records, disposal of securities, and fraudulent transactions. Banks and FIs were advised to consider initiating criminal action against wilful defaulters in fit cases under the provisions of the Indian Penal Code. In response to observations made in the JPC report (2002) regarding diversion of funds by borrowers with mala fide intention, the Bank wanted STACFR to examine the issue. The committee opined that banks should advise the borrower of their intention to classify him as a wilful defaulter and provide a reasonable time for making an appeal before actually declaring him as such. Accordingly, the process was clarified to banks in June 2004.

In May 2005, the Credit Information Companies (Regulation) Act, 2005, was passed. The rules and regulations for the implementation of the Act were framed by the Reserve Bank based on the recommendations of an internal working group. In April 2007, applications were invited for the issue of certificate of registration from companies wishing to start the business of credit information. The applications received in response were kept pending until the government issued a notification on foreign direct investment (FDI) in this business. In 2007, the government permitted 49 per cent FDI in credit information companies, following which, in 2008–09, the Bank granted in-principle approval to four credit information companies, including CIBIL.

As Indian banks operated branches abroad, and foreign banks did the same in India, overseas operations and compatibility of regulation became a concern, as we see next.

Overseas Operations and Cross Border Supervision

A monthly reporting system for host country regulatory violations was prescribed for Indian banks with an overseas presence, for submission to their board of directors and to the Reserve Bank. In 1999 and 2000, there were bilateral discussions between the Financial Services Authority (FSA) of the UK and the Reserve Bank about Indian banks in the UK. The FSA identified certain concerns relating to UK subsidiaries of four public sector banks, such as inadequate provision for outstanding settlements, failure of assessment of risk on a group basis, and lack of common operating or information technology standards across the group. The FSA also expressed concerns about the rationale and viability of two public sector banks' branches operating in London. In respect of foreign banks operating in India, a group set up in 2002 recommended that specific supervisory concerns such as penalty imposed by the Reserve Bank, letter of displeasure issued, and any other serious supervisory concern should be conveyed to the home country supervisors with a copy to the head office of the foreign bank.

A working group was constituted in late 2007 to prepare a roadmap for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators. The report recommended the signing of a bilateral MoU with overseas regulators and supervisors and introducing a regular system of on-site inspection of overseas offices of Indian banks. However, the signing of the MoU by the Reserve Bank, which required sharing the findings of on-site inspections with overseas supervisors, was not feasible. The Prevention of Money Laundering Act, 2002, had certain provisions that prevented the sharing of information on financial crimes.

The Office of the Comptroller of Currency of the US Government, as the home country supervisor, wanted access to the books and records of the Indian branches of the US banks which were under the Comptroller's supervision in 2005. The officials had a meeting at the Reserve Bank headquarters in May 2006 where they informed the Bank that they would prefer informal arrangements relating to supervisory cooperation and sharing of information. The Bank agreed to deal with them on a reciprocal basis. In November 2006, the Comptroller stated that they would coordinate with the other US banking regulatory agencies for an information exchange agreement. The consent for such an agreement was received from the Comptroller in April 2008.

Two other incidents were noteworthy. A public sector bank had to pay a fine of US$7.5 million in November 2001 to US authorities for the reported failure of their branch in New York to maintain correct and accurate records of customers. Prompt action taken by the Reserve Bank avoided undue publicity, but the bank had to pay the penalty. In the second case, after one of the branches of an Indian private sector bank was penalised by the Hong Kong Securities and Futures Commission in 2007 for allegedly carrying on private banking business without a licence, the BFS directed that commercial banks having overseas operations should report such incidents to the board of directors and the Reserve Bank on a monthly basis.

Miscellaneous Matters

Governor Jalan convened a meeting of the CEOs of nine banks in October 1999 to get feedback on the existing supervisory system. One of the action points to follow was a system of 'quarterly informal discussion' by officials of the Reserve Bank's regional offices with the executives of banks whose head offices were located in their jurisdiction on issues emerging from on-site inspections and off-site data.[35]

A fragile banking sector and weak supervision were seen to have precipitated the Asian crisis. In 2000, the Governor directed that an interdepartmental group be set up for compilation and review of micro-prudential indicators. The Bank began to analyse macroeconomic indicators together with micro-prudential indicators of the health of the individual financial institutions to arrive at macro-prudential indicators, which reflected the health and stability of the financial system. Macro-prudential indicators were being compiled since March 2003 as part of the Bank's initiatives in adopting best international practices for monitoring the stability of the financial system.[36] The exercise showed the potential vulnerabilities in the financial system.

A review was done in September 2007 to study the impact of the developments in global financial markets to assess the exposure of the Indian financial system to the US subprime mortgage market. In the same month, the Bank convened meetings with senior officials of select banks to sensitise banks to the weaknesses in the domestic financial sector. In the case of public sector banks, no unusual movement in delinquency trends was reported. As for the new private sector banks, the feedback was of an increasing trend in delinquencies and an increase in credit cost to borrowers. This was taken up with four banks individually for a review of their credit portfolio, given the sharp rise in their retail NPAs. Reserve Bank officials met with the senior representatives of the four domestic rating agencies in late 2007 to elicit their views on the crisis and its domestic implications. As per their feedback, the subprime crisis in the US was unlikely to be replicated in India due to more stringent and prudent underwriting standards followed by Indian banks.[37]

The Bank's guidelines on derivatives focused on 'suitability' and 'appropriateness' of derivative products. There were media reports since November 2007 about some corporate clients of banks suffering significant mark-to-market losses on account of their derivative transactions as well as reports of bank clients complaining of mis-selling of derivative products to them. The Reserve Bank, therefore, carried out a scrutiny of select banks. It came to light that banks had not followed 'suitability and appropriateness' requirements. A series of meetings followed to discuss and sort out the issue.[38]

Non-Banking Financial Companies

Until the mid-1990s, the supervision of NBFCs was restricted to finding out whether the companies were complying with the directions issued on deposits and related activities. In 1996, an expert group had made certain recommendations for upgrading the existing supervisory system over NBFCs.[39] Thereafter, the supervisory framework for NBFCs included, apart from on-site inspection and off-site surveillance, scrutiny of market intelligence and auditor's reports. In 1997, the Department of Supervision in the central office was bifurcated into two entities, the Department of Banking Supervision and Department of Non-Banking Supervision.

The number, diversity and geographical spread of NBFCs made on-site inspection a challenge. It was, therefore, decided that supervision would mainly focus on deposit holding or accepting companies. Chapter III of the RBI Act was amended in January 1997, which vested considerable powers with the Reserve Bank for effective supervision over NBFCs. The Reserve Bank also brought the companies' asset side of the balance sheet to scrutiny during on-site inspections. It involved the assessment and evaluation of the financial health of a company on CAMELS pattern, which was almost on the lines of examination of commercial banks.[40]

In 2001 and 2002, a system of supervisory rating was introduced on the basis of the recommendations of the expert group,[41] and a manual for on-site inspection of NBFCs was made available to the Bank's inspecting officers. The regional offices were advised in October 2007 to take up scrutiny of systemically important non-deposit-taking NBFCs (excluding government companies) to verify compliance with prudential norms and directions. On off-site surveillance, the Bank created a website to be exclusively used by NBFCs for filing regulatory returns directly from their offices. In 2000, the Bank introduced the Computerised Off-site Surveillance and Monitoring System (COSMOS) for the NBFC sector.

In March 1999, NBFCs were instructed to submit a return on liquid assets. The Bank issued advertisements in major newspapers cautioning these companies. The reaction to these instructions was intriguing. Some companies requested the Bank to allow them to withdraw their applications for issue of certificate of registration, while many others decided not to file applications for grant of the certificate. Some non-deposit-taking companies filed 'nil' returns. Altogether, 15,000 NBFCs filed liquid asset returns with the Bank. The Bank issued show-cause notices to the NBFCs that did not submit these returns. For example, the Bank's Hyderabad office had advised 1,477 companies to submit the return, of which 657 companies did not respond, 362 letters were returned undelivered and 458 companies submitted the return.

In 2005, a separate format was devised for closer monitoring of top fifty deposit-taking NBFCs. A core group of officers was formed for monitoring their functioning. The supervision of non-deposit taking financial companies (other than the 'systemically important' ones with assets above ₹1 billion) was essentially done through market intelligence and auditors' reports, as they were not submitting regulatory returns. The system was strengthened by designating suitable officers at the Bank's central office and at each of its sixteen regional offices as Market Intelligence Officers. A close rapport was established with credit rating agencies, and they informed the Bank the credit ratings assigned by them to investment instruments of NBFCs.

In view of the shortage of inspecting staff with the Bank, inspection of all deposit-taking NBFCs with public deposits between ₹5 million and ₹50 million, regardless of their net-owned funds, was entrusted to chartered accountant firms whose names appeared in the Comptroller and Auditor General panel or in the Reserve Bank–approved list of branch auditors. Around 2,560 NBFCs were thus covered. The audit fees were borne by the Bank. A set of reports on the lines of the long form audit report in vogue for banks was introduced, wherein the auditors gave their opinion on the compliance of the company with regulatory and prudential norms. The statutory auditors of NBFCs were directed to furnish to the Bank 'exception reports', containing violations of statutory provisions and directions. Not many such reports, however, were received by the Bank.[42]

In January 1999, regional offices were asked to closely interact with state governments and other agencies concerned for coordinated oversight over NBFCs. This was in addition to the formal body, the State Level Coordination Committee, functioning in every state under the chairmanship of the Regional Director.[43] The Bank also filed complaints with the Economic Intelligence Wings of state police authorities against unincorporated bodies that accepted public deposits. Several states had taken steps to put in place legislation, as suggested by the Bank, for effectively dealing with unauthorised acceptance of public deposits by NBFCs and unincorporated bodies engaged in financial business.

A Special Cell with a Joint Legal Adviser was constituted in the Bank for taking legal action against defaulting NBFCs. It was imperative to prevent the flight of depositors' money from companies that had been issued prohibitory orders and, therefore, the Bank posted observers or special officers to act as 'watchdogs'. It appointed special officers on contract basis for one to three years to oversee the affairs of five problem NBFCs in 1999–2000. These officers were required to furnish periodic reports to the Bank.[44]

The BFS regularly reviewed and individually monitored the position in respect of problem NBFCs and weak NBFCs, those NBFCs whose certificates of registration had been cancelled or rejected, and holding public deposits of ₹0.10 billion and above. There were thirteen such companies in 2006. The problem companies were those that had been defaulting in repayment of deposits, while the weak companies were those that had liquidity or other problems but were not defaulting in repayment. By March 2008, there were eight such companies.

There was yet another category called vanishing companies, which referred to companies that had become untraceable at the addresses available with the Bank. Though some had applied for certificates of registration, the communications from the Bank were returned undelivered. In 2000, the Bank furnished the lists of such companies to the relevant departments of state governments for taking legal action against the promoters and directors, and to protect the interests of depositors. SEBI had sent a list of eighty defaulting companies to the Bank. Of the eighty companies, twenty-seven were found to be NBFCs. Offices of these companies were found locked and promoters were not available. The information was shared with regional offices to add to their database so that the promoters concerned and directors were not allowed to start new NBFCs. State governments were asked to take penal action against these companies.

In November 2005, the regional offices were advised to ascertain the activities of non-deposit-taking companies, to monitor their overall functioning and to hold meetings at quarterly intervals or at reasonable intervals with them to stay informed. In February 2006, it was advised that these meetings would help validate the judgement regarding 'fit and proper' character of the management of the companies.

The deposit-taking NBFCs with deposits above ₹0.20 billion and systemically important non-deposit-taking companies were advised to frame their internal guidelines on corporate governance. There were around thirty residuary non-banking financial companies (RNBCs), of which only two were large, and the Bank had stopped registration of new RNBCs. During the reference period, the Bank stepped up supervision of these two companies (Peerless and Sahara). These two cases, therefore, deserve a longer description.

Residuary Non-Banking Financial Companies

In March 1997, the net worth of Peerless General Finance and Investment Ltd (Peerless) was negative at ₹12.32 billion. The Bank advised the company to fully comply with the statutory provisions and directions. Though the company earned operating profit, the net worth was negative (until 2001) and, in the normal course, such NBFCs would be debarred from accepting public deposits. However, deposits continued to increase. Following a meeting between the Bank and the company representatives, an extension of one year was granted up to January 2002 for attainment of minimum net-owned funds for grant of certificate of registration, subject to investment of entire fresh deposits in eligible securities, recovery of dues from the group and connected companies, and reduction in NPAs. The company was given another extension of time up to January 2003 to fulfil these conditions. The company in October 2002 reported that it had since achieved the minimum net-owned funds, albeit with several qualifications in the auditor's report.

The cost of regularising discontinued and lapsed accounts for the depositors was prohibitive; it involved making arrears payments with 8–10 per cent interest compounded yearly, against the 5 per cent interest paid by the company on recurring deposits and 3.5 per cent on daily deposits. No KYC was done by the company for two-thirds of the deposit accounts.

In 1998, the Bank inspection and special audit of Sahara India Financial Corporation Ltd (Sahara) revealed holding of huge public deposits and asset–liability mismatch. Its credit rating had been downgraded and liquidity affected, leading to default and failure in repayment of deposits. Orders of the Company Law Board were not honoured, and several complaints were received from depositors. The Bank's inspection in 1999–2000 revealed contravention of several provisions of RNBC directions and NBFC prudential norms. The company was advised to desist from investment in real estate and withdraw the investment made in Amby Valley Lake City Project. The Bank's inspection in 2000–01 assessed Sahara's net loss at ₹1.32 billion as against net profit of ₹0.16 billion reported by the company.

In May 2003, there were concerns arising out of deposit funds held in transit for a longer period than necessary with a group company acting as an intermediary. The Bank directed the company in January 2004 that the deposit funds should not remain with the agent for more than one day. Sahara sought more time to submit an action plan. By March 2004, the income tax claims made on the company amounted to ₹11.12 billion and if they devolved, its entire net worth and a substantial portion of deposit could get eroded. The annual inspections of the company revealed adverse features such as unjustified forfeiture of deposits, interest unpaid on lapsed deposit accounts, unpaid or unclaimed deposits not disclosed, agent (a group company) enjoying float funds in 1,439 bank accounts, and so on.

The public deposits with the company continued to rise, however, and stood at ₹135.55 billion in September 2005, rising further to ₹184.55 billion by June 2007. It defaulted in maintaining 'directed investments' from April 2006 to March 2007. It was found that the company had included income tax refund claims as 'directed investments'. Defaulted deposit accounts constituted 77 per cent of the total deposit accounts. The KYC done on agents and field workers were deficient.

As the Bank was not sure of the truthfulness of the company's records, it engaged one of the audit firms to carry out a forensic audit of Sahara, which had not been done by the Bank before. The firm verified the authenticity of the records in 2007 and assisted the Bank officers in carrying out an inspection of the RNBC. Following this, the Bank took steps to familiarise its supervisory staff with the basics of forensic audit, which was also built into the Bank's inspection exercise.

The Bank called the executives of the company for a meeting in January 2008. The company wrote to the Bank after the meeting that it would comply with the Bank's directive of limiting the deposits at ₹168 billion by April 2009, and not by April 2008 as asked for. The company also wanted permission to accept public deposits for another seven years. The Bank directed the company to scale down its deposit acceptance activity and to map an orderly exit from the RNBC business model. As the company failed to comply with the Bank's directions on freezing the deposit level and other directions, the company was issued a show-cause notice on 9 May 2008, as to why the company should not be prohibited from accepting fresh deposits. Later, an order was served (4 June 2008) prohibiting the company from accepting further deposits from the public. The company filed a writ petition before the Lucknow Bench of the Allahabad High Court on the next day, and obtained a stay order. The Bank moved the Supreme Court through a special leave petition for setting aside the order of the High Court. The Supreme Court passed an order holding that the Bank had complied with the rules of natural justice but added that an opportunity of personal hearing would be appropriate. The Court directed the company to appear before the Bank on 12 June 2008. Based on submissions made by the company, the earlier order was modified by the Bank and the company was directed not to accept any deposit maturing beyond June 2011.[45]

Primary (Urban) Cooperative Banks

The guidelines for inspection of UCBs were thoroughly revised in 1999 on the pattern of annual financial inspection of commercial banks. In the new system, the assessment was on the CAMELS pattern. Revised guidelines were issued to regional offices in August 2001 for on-site inspection of UCBs.

In 2001, certain stockbrokers used cooperative bank funds to speculate in the capital market. The brokers were operating through a network of 'overseas corporate bodies', foreign institutional investors, banks and mutual funds. The presence of various layers in the transactions made it difficult to trace the source of funds. When the stock market crashed in 2001, the financial losses had to be borne largely by certain UCBs.

After this episode, the JPC (2002) suggested that the Bank should improve the quality of both on-site and off-site supervision of UCBs by making it more bank-specific. An internal working group (2003) recommended that all scheduled UCBs in 'weak' and 'sick' categories should be inspected annually, and other well-managed banks once in two years. The recommendation was accepted.

A rating mechanism for UCBs was necessary. A working group was set up in October 2001 to develop such a rating model, especially for UCBs.[46] The group suggested a framework of rating based on the CAMELS model. In the process, it was revealed that the UCBs had to do a lot to improve their internal systems before they could be subjected to the proposed rating model and that they needed assistance for improving their management information systems and technology.

Due to an increase in the number of UCBs, the system of on-site periodic inspection came under stress. A system of off-site surveillance was, therefore, introduced for scheduled UCBs in April 2001. Initially, there were ten quarterly returns.[47] These were replaced by a set of one annual and seven quarterly returns for the scheduled UCBs from March 2004.[48] A database was built with inputs from on-site inspections too. Suitable software was developed to facilitate the preparation and submission of returns by UCBs electronically. This was followed by the installation of the application software in banks during 2004 for preparing and forwarding the returns.

Weak banks posed a persistent problem. The policy was to segregate those banks whose net worth was negative and whose deposits had been eroded to the extent of 5 to 10 per cent. As per the new norms for classification of UCBs introduced from March 2002, banks were categorised as Grades I, II, III and IV based on their financial position. While Grade I and II banks had no major supervisory concerns, the other two grades indicated the presence of supervisory concerns of varying degrees. So far, supervisory actions were being taken on a case-to-case basis and there was no prescribed policy regarding quantitative signposts or trigger points. The classification rationalised such actions to focus on certain grades. The graded supervisory action in respect of scheduled and non-scheduled UCBs in Grades III and IV was implemented from April 2003 and April 2005, respectively. The Bank was to apply the course of action with some flexibility in respect of UCBs in states that had signed the MoU (see the previous chapter). It was later decided not to implement the graded supervisory action in states that had signed the MoU, but to make decisions based on the recommendations of the Task Force on Cooperative Urban Banks (TAFCUB).

By the end of the reference period, MoUs had been signed with fourteen state governments and with the central government for multi-state UCBs. This had effectively covered 83 per cent of the UCBs and 92 per cent of the deposits of the sector. The TAFCUB mechanism had a positive impact on the functioning of UCBs, as mentioned in Chapter 10. In March 2005, 725 out of 1,872 UCBs were either weak or sick. The number was down to 496 by March 2008.[49]

UCBs were generally not permitted to invest their resources outside the cooperative sector. They were not allowed to have direct capital market exposure except in the bonds of public sector units, bonds and equity of all-India FIs, and Tier II bonds of public sector banks. On becoming aware of irregularities in securities transactions, the Reserve Bank conducted scrutiny of twenty-five major UCBs in 2001–02. Some of the banks had not adhered to the prudential norm of 5 per cent limit fixed for individual brokers. There were buying and selling of securities at off-market rates. Instead of accessing the interbank market either directly or through brokers, transactions were undertaken with brokers as counterparties (principal), at rates unfavourable to banks. There were buying and selling of government securities, with broker firms virtually acting as a front office (dealing room), and brokers using cooperative banks for funding or offloading their proprietary positions. Some transactions were fictitious. A total of thirteen UCBs, eight in Gujarat, four in Maharashtra and one in West Bengal, had incurred financial losses from transactions in securities.

In view of these findings, the Bank advised the UCBs (April 2002) that the role of the broker should be limited to bringing two banks together.

All future transactions (from July 2002) had to be done through subsidiary general ledger or dematerialised accounts. The Bank advised the Government of Gujarat to supersede the boards of nine UCBs for irregularities in securities transactions, which resulted in financial losses. Seven of the nine UCBs filed writ petitions in the High Court of Gujarat against the action. The Minister of Cooperation wrote to the Governor not to insist on the supersession of the boards, which might undermine public confidence in the urban bank sector and sought a year's time to correct things. But there was no recovery from the broking entities, and the financial position of the nine banks deteriorated further. The Gujarat government proposed reconstruction schemes for these banks but the Reserve Bank was not in favour after the unsatisfactory experience of implementing reconstruction schemes in other cases. At least in the case of three of the nine banks, the Bank wanted the government to take them to liquidation to enable at least the small depositors to receive some money. The financial strength of the five other banks gradually improved and the ninth bank was merged with a strong bank.

By April 2002, thirteen UCBs were issued show-cause notices for their exposure to the capital market by way of advances to stockbrokers and related irregularities.[50] Seven banks were issued letters of displeasure. In June 2002, a penalty of ₹500,000 (maximum as per statute) was imposed on five UCBs for sanctioning credit facilities to share brokers. These UCBs were also denied the issue of branch licences for one year. The banks represented against the imposition of penalty and brought pressure on the Reserve Bank through the Government of India. But the Bank advised the government that there was no case for going back on the decision. The banks, after a long delay, paid the fine.

A working group (1996) recommended that state governments should give autonomy to UCBs on audit, including selection and appointment of auditors.[51] However, implementation was slow and uneven. Matters relating to the audit of the UCBs, including the appointment of auditors, were outside the purview of the Bank because the relevant Section 30 of the BR Act was not applicable to UCBs. The Reserve Bank's inspecting officers, therefore, were required to comment on the quality of audit and the rating accorded by the state government auditors. The MoUs signed with states provided for a statutory audit of UCBs with deposits of over ₹250 million by chartered accountants in place of officers of the state cooperation departments and application of 'fit and proper' criteria for CEOs of UCBs based on the guidelines of the Bank.[52]

A key episode in the process of improving supervision of UCBs was the case of the Madhavpura Mercantile Cooperative Bank (MMCB), Ahmedabad. The MMCB was set up in 1968, granted a license by the Reserve Bank in 1994, included in the second schedule in 1996, and registered under the Multi-State Cooperative Societies Act in 1998. It had twenty-eight branches, including two in Maharashtra, and had been one of the popular and the biggest UCBs in Gujarat. Chairman R. N. Parikh and CEO and managing director D. B. Pandya continued at the helm almost since inception, until it was placed under the administrator in 2001. Its financial reports indicated a steady and healthy growth until then.

Early in 2001, the bank got involved in financing stockbroking firms belonging to Ketan Parekh and his associates in a big way, in contravention of the Reserve Bank guidelines. As the share market fell in February–March 2001, the brokers could not mobilise funds to pay for deliveries in March 2001. In April 2001, against sanctioned limits of ₹2.05 billion, the outstanding balances amounted to ₹8.88 billion. The stockbrokers and their associates owed the bank ₹10.80 billion without adequate collaterals. The figure represented 68 per cent of total advances.

On 9 March 2001, there was a sudden rush of depositors at the bank's Ahmedabad branches, which increased steadily until the 12th (the 10th and 11th being bank holidays), on the rumour of the bank's exposure to the Ketan Parekh group. The bank continued to meet the heavy demand of depositors by extending its working hours until the morning of 13 March. At that point, it had to close down all its branches without notice, as it was no longer able to cope with the demand for withdrawal of funds. This also triggered a run on the deposits of several other banks in Gujarat. The board of the bank was superseded on the very next day, 14 March, at the Bank's instance and an administrator was appointed on the same day.

The media alleged laxity on the part of the Reserve Bank. The JPC observed (in response to Question No. 1157) that the Reserve Bank's inspection before this episode did reveal several major irregularities. 'RBI though enormously empowered under the BR Act to enforce strict discipline on the bank, ... stated to have taken recourse to simply writing to the bank seeking rectification.'[53] The Reserve Bank defended itself in its reply that as per inspection findings, the bank had the capacity to pay its depositors in full and hence cancelling the license was not an option, which would have had systemic effects impacting public confidence. The adverse developments in MMCB took place during the period between two Reserve Bank inspections, which was one of the reasons for the delay in taking action.

The government formed a group in April 2001 to work out a rehabilitation plan for MMCB. To prevent a run on a large number of UCBs that had kept deposits with MMCB, a bail-out plan was suggested. The Reserve Bank was not convinced about the viability of the scheme, which envisaged restructuring of MMCB over a period of ten years, mobilising deposits of ₹8 billion, with focus restricted to the liabilities side, but went along with it so that at least funds could be released to small depositors by the DICGC. The Gujarat government was advised to either extend its guarantee for repayment of deposits by MMCB or to issue subordinated debts to UCBs having deposits with MMCB. If there was no positive response from the state government, the UCBs would be required to make disclosure of their deposits with MMCB by way of 'notes on accounts' of their balance sheets.

The reconstruction scheme for MMCB was discussed in the first meeting of TAFCUB for multi-state banks in March 2007. Based on the recommendations of TAFCUB, the Reserve Bank conveyed its no-objection to the Central Registrar of Cooperative Societies (CRCS) to the issue of a notification modifying the scheme of reconstruction, so as to defer all payment by a year, pending revision of the scheme. Considering the difficulty in realisation of dues of MMCB if taken to liquidation, it was decided that the licence should not be cancelled, and the decision to liquidate should be taken later. But the scheme failed to take off as it could not effect significant recoveries in NPA accounts, especially from big brokers. Still, the contagion effect of the MMCB debacle had been largely contained by March 2008.

The DICGC filed a suit in 2007 against MMCB in the Bombay High Court for recovery of ₹4.01 billion plus interest at 6 per cent, being the amount released earlier by the DICGC. Left with no hope of reviving the bank, liquidation seemed to be the only option. But the decision came only in 2012, when the Bank had to revoke the licence and order the winding up of the bank and appoint a liquidator.

The fallout from the MMCB episode extended to a public sector bank. Three companies belonging to the Ketan Parekh group maintained current accounts with the bank's Stock Exchange Branch, Mumbai. Though the companies did not enjoy any credit limits, pay orders of other banks were regularly discounted in these accounts. From November 2000, it started discounting banker's cheques and pay orders issued by UCBs. The branch discounted as many as 1,504 of these for ₹65.50 billion, including 251 banker's cheques favouring the three Ketan Parekh group companies, involving ₹42.14 billion issued by MMCB, between January and March 2001. The proceeds of all the thirteen pay orders discounted were credited to the group companies. But the pay orders were returned unpaid to the bank as MMCB failed to meet its clearing liabilities. The Reserve Bank scrutiny carried out between 30 March and 3 April revealed the failure of internal control and risk management systems in the bank. Though the bank refused to admit any lapse on its part, a letter of displeasure was issued by the Reserve Bank.

Another landmark case was the Charminar Cooperative Urban Bank Ltd, Hyderabad (Charminar). Charminar was registered and licensed in 1985, had seventeen branches in the twin cities of Hyderabad and Secunderabad, and was profitable since inception. The bank had deposits of ₹1.29 billion in 1998 when it applied to the Reserve Bank for inclusion in the second schedule. The bank brought pressure on the Reserve Bank from various quarters for a favourable decision in this regard. The Reserve Bank carried out an inspection in December 1998. The inspection revealed that 42 per cent of the deposits held by the bank were from institutions. Guidelines on prudential norms had not been followed in many cases. It had violated the Reserve Bank directives on credit exposure norms and unsecured advances. Therefore, the Reserve Bank advised the government in January 2000 that the bank 'was not considered favourably for inclusion in the second schedule since its CRAR in March 1999 was low at 2.86 percent'.

The bank's published loss for 2000–01 was ₹19.2 million. Had it followed the extant provisioning norms, the loss would have been ₹79.7 million. The failure of another cooperative bank in Andhra Pradesh (Krushi Bank) had a contagion effect on Charminar. Besides, it faced liquidity problems since April 2001. The bank was placed under directions in February 2002. The state government came forward with a reconstruction scheme for the bank. There was a difference of opinion between the Reserve Bank and the state government in regard to the manner and the ratio in which the realisations made by the bank would be shared between the DICGC and the depositors. Discussions were held with the officials of the state government and these issues were sorted out and a consensus was reached that the recoveries would be shared on a pro-rata basis between DICGC and the bank. Thereafter, the Bank accorded approval for the scheme and the order of reconstruction became effective from March 2003.

In a meeting between the state government and Reserve Bank officials, the Chief Minister of Andhra Pradesh directed his officials to approach the two public sector banks based in Andhra Pradesh to explore the possibility of merging Charminar Bank with them. However, the legal opinion was that a cooperative bank could not be amalgamated with a nationalised bank. In August 2004, the Reserve Bank wrote to the Chief Secretary of the state expressing supervisory concern on the deteriorating financials of the bank. The response of the government was found inadequate. The bank was again prohibited from accepting fresh deposits. The TAFCUB for Andhra Pradesh reviewed the reconstruction scheme and a revision was deliberated and taken up. [54]

The Reserve Bank inspected another bank, the South Indian Cooperative Bank, Mumbai, in March 2002, and found its financial position satisfactory and assigned a Grade I rating (lowest risk). The statutory auditors appointed by the Registrar of Cooperative Societies (RCS) did not detect any wrongdoing in March 2003 and classified it 'A' (lowest risk). But the inspection carried out by the Reserve Bank in December 2003 revealed gross irregularities, which was contested by the bank. The financial results for 2003–04 brought out huge losses. In August 2004, the bank, which had public deposits of ₹2.30 billion, was placed under a moratorium, and as requested by the Reserve Bank, the RCS superseded the board of directors in the same month. By March 2005, there was an erosion of 43 per cent of its deposits. The CRAR was negative at 273 per cent, and gross NPAs amounted to 84 per cent of the total advances. The bank was issued a show-cause notice for cancellation of licence in October 2005. However, in view of the appointment of a retired professional banker as the new administrator by the RCS in March 2006, cancellation of licence was not pursued. In August 2008, the Reserve Bank approved a scheme of amalgamation with another UCB, which became effective from September 2008.

The Krushi Cooperative Urban Bank Limited, Secunderabad, was another bank, like MMCB, where the chairman had continued since inception and the bank was taken to liquidation in October 2001. The move had a contagion effect on other UCBs in Andhra Pradesh, including the Charminar Bank. In the case of City Cooperative Bank Limited, Lucknow, the bank faced a heavy rush for withdrawal of deposits on 20 March 2001 in all four branches, triggered by a news report in a local daily about defaults by a stockbroking firm. On 22 March 2002, directions were issued, and on 9 April 2002, the board was superseded, the bank's license cancelled, and an administrator appointed.

Financial Institutions

The Financial Institutions Division was created in June 1997 within the Department of Banking Supervision and was entrusted with both regulatory and supervisory functions over FIs.[55]

The first round of inspection of nine institutions (IDBI, ICICI, IFCI, EXIM Bank, IIBI, TFCI, NABARD, SIDBI and NHB) was completed in 1997–98. A draft inspection manual was prepared in the Reserve Bank in 2000 and made available to the Bank's inspecting officers. To introduce a rating system for FIs, an internal group of senior officers was formed in 2001 that evolved a rating model and it was tested with the past inspection reports. The new rating model was implemented with effect from March 2002.

An off-site surveillance system was introduced in 1998 and in the following year, the prudential supervisory reporting system was put in place. In 1999, disclosure norms were introduced. They were advised to disclose additional information by way of notes on accounts to financial statements. The Bank also looked into the guidelines for auditing.[56]

In 2004, a working group looked into the regulatory and supervisory issues relating to term lending and refinancing institutions and improvements in the flow of resources to the FIs.[57] On the basis of the group's recommendations, supervision of NABARD, SIDBI, NHB and EXIM Bank, which were deposit-taking FIs, would continue. But FIs not accepting public deposits and classified as NBFCs having an asset size of ₹5 billion and above would be subject to limited off-site supervision. Non-deposit-taking FIs were not subjected to annual inspection from 2004–05 onwards.[58]

Conclusion

The Reserve Bank enjoyed more autonomy in 'supervision' of commercial banks as compared to 'regulation', where the government had to be consulted before taking new initiatives and major decisions. The Bank had been proactive in exercising supervision. It sharpened its tools taking cues from global developments and best practices and adapting them to the Indian context. During the reference period, off-site surveillance of banks was broadened and made more focused, and the system handled and analysed more information than before. After the UCB crisis of 2001 and failure of GTB in 2004, the Reserve Bank strengthened its supervisory function. There were continuous innovations. The earlier total dependence on on-site inspections lessened, early warning systems were introduced, and the system became more efficient in processing information and taking timely action.

The Bank's supervision of NBFCs was less of a challenge as they moved away from public deposits; off-site monitoring became the primary instrument of supervision, supplemented by external audit. With UCBs, along with regulatory initiatives (see the previous chapter), TAFCUB proved to be an effective mechanism for coordinated supervision. As for the FIs, the supervisory role of the Reserve Bank continued to be limited and transitory.

Notes

1. The legal basis for both regulation and supervision is provided by the Banking Regulations Act (BR Act), 1949, in respect of commercial banks and cooperative banks, and the Reserve Bank of India (RBI) Act, 1934, for non-banking financial companies (NBFCs) and all-India FIs.
2. Based on the recommendations of expert groups, of which the Pendharkar Working Group (1985) and Padmanabhan Working Groups (1991 and 1995) were important.
3. Chairman: M. S. Verma. This was one of the ten groups and expert committees constituted by the Standing Committee on International Financial Standards and Codes.
4. In accordance with the recommendations of the Padmanabhan Working Group (1995).
5. The rating system is explained in Ranjana Sahajwala and Paul Van den Bergh, 'Supervisory Risk Assessment and Early Warning Systems', Basel Committee on Banking Supervision Working Papers, 2000.
6. Chairman: P. R. Khanna.
7. The issue of sharing the supervisory rating with external rating agencies was examined in 2007. But the rating and the methodology remained confidential, as it was observed that the world over, no regulator published or made public the supervisory ratings assigned by it to its regulated entities.
8. For example, in September 2003, an interdepartmental 'core group' was formed to help evolve an analytical framework to track certain critical financial parameters of systemically important banks. In 2005, Governor Reddy directed that an analysis be carried out of the movement of select balance sheet items of commercial banks between January and March that year. The analysis found that the incremental credit–deposit ratio overall stood at 157 per cent in that quarter. Certain outlier banks had recorded as high ratios as 935 per cent, 676 per cent and 300 per cent. The sources of funds were:

drawing down of excess statutory liquidity ratio (SLR) investments, accretion to owned funds and overseas borrowings.

9. In March 2008, the net erosion in the value of securities held in the trading book for assumed rise in yields by 100 bps, 125 bps and 150 bps accounted for 2.22 per cent, 2.83 per cent and 3.44 per cent, respectively, of the total regulatory capital at the system level. This did not pose any concern as fifty-four banks of the seventy-eight scheduled commercial banks had capital to risk-weighted assets ratio, or CRAR, of 12 per cent and above, and the aggregate average CRAR of all seventy-eight banks was 13.01 per cent, with no bank having CRAR below the stipulated minimum of 9 per cent as of March 2008. Only one bank's CRAR would have dropped below 9 per cent level for an assumed rise in yields by 100 bps.
10. The proposed structured actions included placing restrictions on (*a*) expansion of risk weighted assets, (*b*) entry into new lines of business, (*c*) on declaration of dividends, and so on. Discretionary actions envisaged included ordering of recapitalisation of banks and disallowing banks from (*a*) increasing their stake in subsidiaries, (*b*) incurring capital expenditure, (*c*) expansion of staff and filling up of vacancies, and so on.
11. The group had as member the Executive Director and the Heads of Banking Regulatory and Supervisory Departments.
12. Chairman: President of the Institute of Chartered Accountants of India, or ICAI.
13. The RIG was set up in 2004 with members drawn from the regulatory and supervisory departments of the Bank. It was to periodically meet and discuss regulatory issues, keeping in view the financial products and services in the market, and the market intelligence reports available. Groups were set up in regional offices too and the proceedings of the meetings were sent to the central office, and issues which needed the attention of the RIG in the central office were put up to them. The group in the central office had seven meetings in 2007–08.
14. Chairman: Vipin Malik, Director, Central Board, RBI.
15. The framework was based on the principles set forth by the Joint Forum of BCBS, the International Organization of Securities Commissions and the International Association of Insurance Supervisors. It covered issues of capital adequacy (at solo as well as group level), conduct of intra-group transactions, exposures consistent with arm's length principles, implementation of 'fit and proper' and corporate governance principles, and risk management guidelines.
16. Chairperson: Shyamala Gopinath.
17. The thresholds for fund-based and non-fund-based transactions were increased for focused monitoring. The dominant/major entity in the group, called the 'designated entity', collected and collated financial conglomerate information and forwarded them to the principal regulator for analysis.

18. A team of Reserve Bank officials visited the United States, the United Kingdom and the De-Nederlandsche Bank, the central bank of the Netherlands, to study the financial conglomerate monitoring mechanism in these countries. The team prepared in December 2007 an approach paper on supervision of financial conglomerates in India with suggestions to further strengthen the supervisory framework.
19. An advisory group set up by the Standing Committee on International Financial Standards and Codes on corporate governance (Chairman: R. H. Patil, Chairman, UTI-AMC).
20. Chairman: A. S. Ganguly, Director, Central Board, RBI.
21. In line with BCBS guidelines, with representatives of ICAI, banks and the Reserve Bank.
22. Members were from the Reserve Bank, ICAI and select banks.
23. Starting from the accounting year ending in March 1999.
24. Banks had to ensure that at least 50 per cent of a bank's business operations (both advances and deposits separately) and 100 per cent of treasury transactions were covered under the concurrent audit system. A working group was set up to study the scope and effectiveness of the existing concurrent audit system in commercial banks, which recommended that the risk-based internal audit system should cover all 'high risk' areas of operation of banks.
25. Chairman: A. Vasudevan, Executive Director.
26. Another working group (Chairman: R. B. Barman, Executive Director) finalised the standards and procedures for information systems audit and security guidelines for banking and financial sector in 2001.
27. First, to the extent of ₹4.63 billion in 2001 against the collateral of public sector bonds as a special case because the bank did not have government securities in excess of SLR requirements and, thereafter, a special liquidity facility of ₹1.80 billion in July 2004 when it was placed under moratorium.
28. 12 April 2007, in-house 'Conference on Bank Supervision', Mumbai.
29. He also chaired the Advisory Group on Bankruptcy Laws (set up by the Standing Committee on Standards and Codes) and the Expert Committee on Legal Aspects of Bank Frauds constituted by the Reserve Bank.
30. Incidentally, it came to light in January 2009 that the said firm was also auditor to another company which crashed out due to an accounting fraud.
31. At the time of writing in 2018, the case was being heard by the Disciplinary Committee of the Institute of Chartered Accountants of India.
32. Chairman: S. R. Iyer, Chairman, CIBIL.
33. A few minor problems needed to be addressed in this regard. For example, banks had been asked (October 1999) to obtain the consent of the borrowers and their guarantors for disclosure of their names in case of default. ITC Ltd, and a few other big borrowers, expressed their dissatisfaction on this. The

Bank, therefore, made the requirement of consent clause in the agreement prospective, applicable only to those loan sanctions and renewals effected after the issue of circular.

34. The working group was set up under the chairmanship of the IBA chairman, S. S. Kohli.
35. These quarterly meetings, which served as an important supervisory tool, commenced from the January–March 2000 quarter in regional offices, and attended by the CEOs and executive directors of banks, which were presided over by Regional Directors. The system enabled a continuous assessment of a bank to provide, among other things, the needed background canvas for undertaking annual on-site inspection.
36. The analysis which was put up to the BFS covered macroeconomic aggregates and financials of commercial banks, NBFCs, UCBs, all-India FIs, PDs, RRBs and cooperative banks.
37. Bank credit, which logged significant growth during the three year period from 2004 to 2007, recorded a distinct deceleration in growth in 2007–08, one of the reasons being the regulatory interventionist measures taken by the Reserve Bank. There was periodic stress testing of credit risk and interest rate risk to assess the vulnerability embedded in bank balance sheets and strategies. Supervisory action was initiated with identified outliers.
38. A few other measures and action points bear a quick recap. A system of monthly monitoring was put into effect from 2001 onwards of banks that were financially weak. In 1998, banks were advised to monitor unhedged foreign currency exposure of their corporate clients. In 2001–02, banks were advised to put in place a system for monitoring such unhedged external exposures. Considerable discussion took place on 'principle-based supervision' during the reference period. Principle-based supervision is an approach that provides for regulation by the underlying principles, rather than target- and product-specific rules. The approach, however, places greater reliance on the discretion of the supervisors in interpreting the principles. During the reference period, some discussion occurred in the Reserve Bank on these alternatives. Subsidiaries of banks did not come under the purview of the BR Act but they were regulated by SEBI, NHB, the Reserve Bank and IRDAI. The Reserve Bank's guidelines suggested that the parent bank should inspect and audit the books and accounts of the subsidiaries at appropriate intervals. Finally, the Reserve Bank considered the introduction of generally accepted accounting principles (US GAAP) in Indian banks for loan loss provisioning. An internal working group set up to examine the effect of its implementation (December 2002) suggested a roadmap and a time frame. But the IBA and the ICAI were not in favour of its introduction, since the US GAAP required much higher provisioning compared with Indian norms, substantial documentation and the generation of historical data.

39. Chairman: P. R. Khanna, chartered accountant.
40. In 1999, on a sample basis, 20 per cent of non-deposit taking companies were inspected with particular attention paid to companies on which there were adverse market reports.
41. Chairman: P. R. Khanna.
42. Three audit firms were issued show-cause notices for deficiencies and inconsistencies in their reports of special audit of NBFCs. The matter was also taken up with the ICAI for appropriate action at their end. Further, the Bank decided not to consider these audit firms for any other assignments.
43. The committee met once in six months, and its members included the Registrar of Companies, Company Law Board, a representative from ICAI, state government officials and industry representatives.
44. The Bank wanted to ensure that such appointments were not seen as the Bank assuming a controlling or management role, as the special officer was posted basically to monitor the company's affairs. Therefore, the Governor instructed that the officers be recruited from outside the Bank.
45. These two RNBCs were advised by the Bank to shift to another viable business model and to stop accepting any new deposit maturing beyond 2011. Peerless reported having stopped accepting fresh deposit and renewal of deposits from 2011. Until the writing of this volume, Sahara had not submitted an alternative business plan and the Bank was receiving complaints that the company was accepting deposits from the public without authorisation.
46. Chairperson: V. S. Kaveri, Professor in the National Institute of Bank Management, Pune.
47. These included those designed to ascertain the banks' assets and liabilities position, profitability, NPAs, loans to directors, and large exposure.
48. The information covered in these returns pertained to balance sheet, off-balance sheet exposures, profit and profitability, asset quality, sector-wise concentration of advances, connected lending, and capital adequacy.
49. Among other measures taken, a system of quick scrutiny of the loan portfolio of UCBs was put in place. Observing the bullish trend in the stock market, regional offices were advised in January 2004 to conduct quick scrutiny and special inspection of the banks that had recorded unusual credit expansion. Further, to achieve regulatory convergence between commercial banks and cooperative banks and to comply with one of the core principles of BCBS, a PCA framework was proposed for UCBs with effect from March 2005, based on five parameters: CRAR, net NPA, return on assets, history of losses/profits, and non-compliance with CRR and SLR.
50. Some UCBs had issued guarantees to stockbrokers. One UCB alone had issued 278 guarantees to stockbrokers. When questioned, the banks replied that the Reserve Bank's instructions did not prohibit non-fund facilities like

guarantee, as the circular mentioned only 'credit facilities'. The banks were instructed to regularise the position by 'recalling such guarantees, if still outstanding'. The banks pointed out that existing/outstanding guarantees could not be cancelled unilaterally as they were irrevocable.

51. Chairman: V. M. Chitale, chartered accountant.
52. The Bank took a few other steps to tone up the quality of corporate governance in UCBs. For the purpose of licensing new UCBs, it was prescribed that their boards should have at least two directors with professional qualifications or adequate experience in banking. A few instances of problems with the urban cooperative banks are discussed later.
53. The Bank appointed a one-man committee in January 2003 under P. V. A. Rama Rao (former Managing Director, NABARD) to look into the involvement, if any, of Reserve Bank officers in the wrongdoings of MMCB and take action).
54. The scheme, however, failed to yield the desired results. Subsequent inspections revealed no improvement in its financial position. Its licence was cancelled by the Reserve Bank in 2011 and liquidation ordered.
55. The Informal Advisory Group (IAG) (Chairman: Y. H. Malegam) on Regulation and Supervision of Financial Institutions submitted its report in 2000. The IAG had suggested refinements in the existing system of on-site and off-site supervision. An internal group was set up to examine the recommendations of the IAG. The views of FIs were also obtained and suggestions accepted. The scope of the annual on-site inspection of FIs was widened to include risk management.
56. The Bank circulated to the FIs the standardised check-lists prepared by the Committee on Computer Audit (April 2002). The FIs were advised to set up an audit committee of the board. The draft guidelines on 'consolidated accounting and consolidated supervision' (on the lines issued to banks) were sent to FIs in September 2002 and, based on feedback, final guidelines were issued in August 2003.
57. Chairman: N. Sadasivan.
58. Even the off-site surveillance system for these FIs was dismantled and replaced with a simplified information system from December 2005. Half-yearly reviews of the performance of the FIs were done based on data collected from returns.